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Foreign VC Investment In Canada:

A Profile of Foreign Investors and Domestic Investees

October 21, 2003

Prepared by PricewaterhouseCoopers LLP for Industry Canada

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Executive Summary

Industry Canada requested that PricewaterhouseCoopers LLP (PwC LLP), with the assistance of MacDonald & Associates, conduct a study of the foreign venture capital sector. The study was designed to provide a high-level profile of a small number of foreign VC investors, including both those that do and do not invest in Canada, and of Canadian firms financed by foreign and domestic VC funding, so as to contribute to the development of an understanding of the types of factors influencing foreign VC investment in Canada and the advantages and disadvantages associated with foreign, relative to domestic, VC financing. The study was not designed to afford a detailed investigation into these issues, but rather provide a profile of the types of issues surrounding foreign VC investment based on a high-level review of published data and a survey of about 35 individuals in the industry and provide an indication of some of the key issues to be further investigated. It is also important to note that the interview findings are based on the perceptions of the individuals interviewed.

Review of data on foreign VC investments and discussions with selected representatives of the VC industry suggest that foreign VCs serve a symbiotic role together with Canadian VCs in providing the resources for the growth of Canadian companies.

- The importance of foreign VC financing has grown dramatically over time, according to data supplied by MacDonald & Associates. Foreign VC financing has grown from 3% of VC financing in Canada in 1998 to over 26% in 2002.
- Domestic VCs are critical for supporting new and small ventures. Domestic VCs are the primary source of financing for smaller deals – they account for over 95% of investments of less than \$5 million. This is key to building a critical mass of companies and clusters of skilled talent that is a necessary pre-condition for the attraction of foreign VCs. They are also critical for making referrals to US VCs, and serving as the local player that can keep a close watch on an a company in a region where foreign VCs have limited experience. They serve as a bridge for developing the local cluster to the point where it attracts the foreign VC, and then as a local knowledge base in the early phases of foreign VC's investment in Canada.
- Foreign VCs are critical for providing an expanded pool of financing, and providing links to suppliers, customers and additional sources of talent. They are a key source of financing for larger deals; they account for about 35% of investments in companies of over \$5 million. Once they invest in one company in a particular region, they begin to develop a knowledge base about the region, and are then more likely to invest in other companies in the region.

Top-tier and Mid-tier VCs are important sources of financing for Canadian companies, according to a review of the Canadian and US VC investment data by MacDonald & Associates and PwC/Thomson Venture Economics/National Venture Capital Association MoneyTree survey, respectively.

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- Of the top 10 US VCs (those investing in 40 or more deals in the US in 2002), all but one invested in Canada over the last five years. However, among the nine VCs investing in Canada, the number of deals in Canada represented 1.7% of all of deals by top-tier players in 2002.
- While fewer mid-tier VCs (VCs investing in between 21 and 39 deals) invested in Canada (37%), these deals in Canada represented 2.2% of all of deals by mid-tier VCs in Canada in 2002. Consequently, the mid-tier players are at least as important as the top tier players.

VCs participating in the survey stated that the key factor drawing the interest of foreign VCs is the quality of the business opportunity.

- Foreign VCs are seeking companies that have developed leading-edge technology for a large and ready market, and can successfully and profitably grow the business. VCs are typically looking for a 30% to a 50% annual return on their investments. In general, it is the business opportunity that will drive this number.
- A key factor in driving an investment decision is the strength of the cluster within which the Canadian company operates. Foreign VCs want to be assured that as the Canadian company grows, there is a sufficient pool of local talent from which it can draw on.

Findings from the survey suggest that there are two major factors that currently limit the investment of foreign VCs in Canada.

- There are fewer entrepreneurs and marketing specialists that have experience in launching and growing successful companies in Canada than in the US; this is perceived as a major weakness amongst Canadian firms.
- The tax regime is seen to be a significant deterrent to investing in Canada. There is a significant amount of confusion around investment regulations and taxation policies. As a result, a number of US VCs have experienced significant adverse and unexpected impacts on the exit of their investment. This is serving to dissuade not only those VCs who invested and faced these adverse impacts, but many other VCs who might have considered investing, but are choosing to avoid it based on the negative experiences of their peers.

Participants in the survey provided numerous recommendations for Canadian firms

- **Build a strong management team.** All companies agree that building a strong management team is the central feature to success. Most companies advise that bringing in a senior person from the US can provide the company with more experienced entrepreneurial leadership and connections than is possible with most senior people from Canada. Companies should either build a strong management team or make it clear that the existing management team is willing to work with a more experienced senior team.
- **Have a presence in the US.** This is critical if the business strategy is focused on the US customer.
- **Leverage domestic VCs.** Not only are these an important source of financing, they have connections to foreign VCs.

- **Go directly to foreign VCs, but with a referral.** It is worthwhile to develop a strong referral to the US VC (e.g., through current investors), as “going in cold” can often produce a negative outcome. Many US VCs will look at all companies that present itself; however, the decision makers from the US VC will typically only spend time on those companies that were referred to them by someone they trust.
- **Be polished and strong on marketing.** Interview participants reported that they felt it was critical that Canadian companies be very polished and strong on marketing. Some participants even said that Canadian firms should look to emulate the behaviour

Participants in the survey provided numerous recommendations for Canadian governments

- **Reform taxation policy.** Reductions to personal, corporate and capital taxes are all expected to have a positive effect on entrepreneurial activity. However, the most significant barrier to foreign VC investment is the issues surrounding foreign property classification and capital gains taxes. Many US investors have experienced significant adverse, and unexpected, tax consequences upon their exit from Canadian investments that could have been addressed through proper planning (e.g. get a Section 116, use alternative structure to LLC for direct Canadian investment). As a result, the tax environment is creating significant problems that may reverse the trend of growing foreign VC investment. This is due both to problems associated with existing regulations that VCs have encountered on exiting their investments, and a lack of awareness about investment and taxation policies, and the consequences of adopting alternative structures. In summary, changes to the taxation system, as well as clear publication of the guidelines and the options, could significantly increase the amount of foreign VC investment in Canada.
- **Fund/coordinate university research.** The Canadian university system is highly regarded by US VCs. However, Canadian governments fund proportionately less R&D than many OECD countries. Moreover, what is funded is underfunded – grants are spread across too many projects and are too small in size to be effective. The average grant size in Canada is significantly smaller than the average grant size in the US. This puts a heavy burden on researchers to always be applying for grants. It also discourages large, risky projects relative to small, incremental, predictable research. In addition, potential young entrepreneurs become discouraged, which leads to “brain drain” across the border.
- **Market to foreign VCs:** Canadian governments, media and companies should promote past successes, and existing opportunities in high-profile areas. Many investor misconceptions (e.g., higher tax rates) of Canadian investments can be resolved through marketing programs that would provide clarity to foreign investors.
- **Facilitate the building of management capability.** Canadian firms are well known for developing good IT. However, they are perceived to suffer from a lack of experienced entrepreneurial management, which limits the growth of companies. Several suggestions were offered to overcome this problem.
 - Reward entrepreneurial activity through lower taxes/tax credits.
 - Increase immigration from countries with entrepreneurial background

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- **Invest strategically on a cluster basis:** The strength of the local cluster is a key factor in the investment decision. Survey participants recommended that when making decisions to establish research facilities, and launch and invest in companies, such investment should be done on a cluster basis.
- **Limit influence on investment decisions.** Some VCs reported that they believe that Government-regulated VC investments distort the market and damage the likelihood of firms attracting private financing, particularly from the US.
- **Buy from Canadian start-ups.** Several survey participants indicated that the US Government actively promotes innovation in start-ups by being among their first willing purchasers, and that Canadian Governments are seen to be risk averse.

1. Introduction

New high-growth technology-based businesses have long been recognized as having a central role in maintaining a growing, innovative economy. In particular, small businesses have been credited with serving three major roles in economic growth (OECD, 1998). Studies have repeatedly shown that small businesses are the driving force for job growth. They are also a critical source of innovation; they are inherently driven to introduce innovations and create new markets to enable their growth. Thirdly, small firms serve a symbiotic role with large firms, enabling them to transfer risk, manage operations efficiently, and serve as a source for the exploitation of innovation on a mass scale. In addition, an entrepreneurial climate provides the opportunities necessary to attract and maintain highly qualified individuals who are seeking a dynamic environment where they can effect real change.

Access to capital is a key limiting factor in the growth of new firms. Small and new firms, by the very nature of their size and newness, lack the financial assets and historical track record to secure traditional financing to exploit their innovations and achieve rapid growth. The venture capital industry has emerged to match risk-taking investors with promising new companies.

The venture capital industry has grown dramatically over the last eight years (the period of time for which data is available from the MacDonald & Associates Venture Capital Survey). Total VC investments in Canada grew from \$1 billion in 1996 to \$5.8 billion in 2000, a 54% compound average annual growth rate. Foreign venture capital investment was a major driver in this growth, outpacing growth in all other sources of financing, and growing by compound average annual growth rate of 164% over the six-year period. According to MacDonald & Associates, foreign venture capital financing in Canadian firms increased from \$31 million in 1996 to \$1.5 billion in 2000, a five-fold increase.

VC financing has plummeted since 2000. Total VC financing in Canada fell by 43% in 2002 of the total amount invested in 2000. Similarly, foreign VC financing has fallen dramatically to 45% of the 2000 figure. However, this drop is significantly less than the dive in VC financing in the US, where total investments plunged from a high of \$106 billion in 2000 to \$21 billion in 2002.

In summary, VC investments have grown significantly over the 1996 to 2002 period, despite the fact that they have fallen from their high in 2000. Foreign VC investments drove much of the growth over the 1996 to 2000 period, and while they dropped over the following two years, they still account for one quarter of all VC investments.

In recognition of this importance of foreign VC financing, Industry Canada requested that PricewaterhouseCoopers LLP, with the assistance of MacDonald & Associates, conduct a study of the foreign venture capital sector. The study was designed to provide a high-level profile of a small number of foreign VC investors, including both those that do and do not invest in Canada, and of Canadian firms financed by foreign and domestic VC funding, so as to contribute to the development of an understanding of the types

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of factors influencing foreign VC investment in Canada and the advantages and disadvantages associated with foreign, relative to domestic, VC financing. The study was not designed to afford a detailed investigation into these issues, but rather provide a profile of the types of issues surrounding foreign VC investment based on a high-level review of published data and a survey of about 35 individuals in the industry and provide an indication of some of the key issues to be further investigated. It is also important to note that the interview findings are based on the perceptions of the individuals interviewed. This is critical to note, given that perceptions often differ from reality. It is nevertheless the perceptions that drive decision-making.

2. Methodology

This report is based on several lines of research and analysis.

- Data on total and foreign venture capital investment in Canada from MacDonald & Associates were contrasted and compared against data on VC investment in the US from the PwC/Thomson Venture Economics/National Venture Capital Association MoneyTree survey. The findings are presented in Section 3.
- Various studies of the make-up and factors influencing foreign venture capital investment were reviewed and the summary findings are presented in Section 4.
- PricewaterhouseCoopers LLP conducted a series of interviews with key stakeholders in the industry.
 - Four questionnaires were developed to use as a guide for the interviews with Canadian receptors of VC financing and foreign VCs. The questionnaires are included in Appendix B. The questionnaires enquired about topics such as the advantages, disadvantages and challenges associated with obtaining foreign and domestic VC financing, the positive and negative impacts of foreign investment into Canada, the procedures involved in acquiring financing and the impact of newly acquired foreign or domestic financing on a company's operating activities.
 - Approximately 35 interviews were conducted with executives from the following groups: Canadian companies that received foreign VC financing; Canadian companies that received only domestic VC financing; Foreign Venture Capitalist firms (divided into two groups: firms that invested in Canada and firms that did not invest in Canada); Canadian Venture Capitalist firms; and key intermediaries. The list of people and organizations interviewed is presented in Appendix A. The charts on the following page summarize the key characteristics of organizations interviewed. In addition, four key intermediaries were interviewed: Once the interviews were conducted, the information was collected and analysed and the findings are presented in Section 5.
 - Profiles of the interview participants were produced. The profile included a section indicating the name of the individual interviewed along with their position and a link to the company's website. The second section stated the company's mission statement and the year they were founded. The third section provided details regarding the company's rounds of financing and the final section identified imperative issues arising from the interview. Once complete, the profile was sent to the participating company for their approval prior to inclusion in the report. The profiles are included in Appendix C.

The data contained in this report is current as of the spring 2003.

Foreign VC Investment in Canada

Data From Interviewed Firms

	Canadian Companies Receiving Foreign VC financing Only Domestic VC Financing	
# of companies interviewed	8	5
Average VC financing raised		
1998	1.28 MM	0.38 MM
1999	4.6 MM	0.13 MM
2000	29.7 MM	1.7 MM
2001	14 MM	0.45 MM
2002	27.5 MM	5.06 MM
2003	3.75 MM	0 MM
Sector		
Life Sciences	1	3
Information technologies	7	2
Region		
Atlantic Canada	0	0
Quebec	3	1
Ontario	4	1
Western Canada	1	3

See Appendix D for a description of the sectors

	American VCs Investing in Canada Not investing in Canada		Canadian VCs
# of VC's interviewed	10	4	3
Average # of companies financed through venture capital	5	2.5	65
Average Managed Fund per VC (\$)	5.2 billion	2 billion	374 MM
Sectors of investments			
Life Sciences	2	2	3
Information technologies	10	1	3
Other technologies	1	1	3
Traditional	0	0	3

Key Intermediaries	Number
CFO for hire	1
Financial Advisor	1
American law firm	1
Industry Association	1

All figures are quoted in Canadian dollars, based on an exchange rate of \$1.50 Canadian for each US dollar.

3. Foreign VCs are a key source of financing for Canadian Firms

VC financing has grown dramatically over the past eight years, spurred in large part by foreign VC financing. Where corporate, institutional and private independent VCs, combined with Labour-Sponsored Venture Capital Corporations (LSVCC) accounted for 84% of VC financing in 1996, they contributed to 51% of VC financing in 2002. Conversely, foreign VCs' share increased from 3% to 26% over the same period.

Investor Type	1996	1997	1998	1999	2000	2001	2002	CAAG	
								1996-2000	1996-2002
\$000s invested									
Total	\$ 1,032,819	\$ 1,630,986	\$ 1,558,108	\$ 2,649,970	\$ 5,778,221	\$ 3,800,467	\$ 2,465,942	54%	16%
Corporate	\$ 107,786	\$ 124,458	\$ 224,995	\$ 305,431	\$ 502,137	\$ 279,916	\$ 144,248	47%	5%
Government	\$ 61,741	\$ 69,221	\$ 89,647	\$ 132,051	\$ 232,766	\$ 322,612	\$ 329,350	39%	32%
Institutional	\$ 158,804	\$ 232,236	\$ 271,572	\$ 491,522	\$ 1,050,974	\$ 289,137	\$ 182,858	60%	2%
LSVCC	\$ 409,556	\$ 634,044	\$ 461,101	\$ 607,327	\$ 814,082	\$ 649,692	\$ 626,674	19%	7%
Private Independent	\$ 198,140	\$ 281,701	\$ 345,270	\$ 415,217	\$ 864,198	\$ 601,669	\$ 313,451	45%	8%
Foreign	\$ 30,653	\$ 69,909	\$ 40,607	\$ 496,753	\$ 1,451,642	\$ 1,084,015	\$ 650,248	162%	66%
Other	\$ 66,139	\$ 219,417	\$ 124,916	\$ 201,669	\$ 862,422	\$ 573,426	\$ 219,113	90%	22%
% of total dollars invested									
Corporate	10%	8%	14%	12%	9%	7%	6%		
Government	6%	4%	6%	5%	4%	8%	13%		
Institutional	15%	14%	17%	19%	18%	8%	7%		
LSVCC	40%	39%	30%	23%	14%	17%	25%		
Private Independent	19%	17%	22%	16%	15%	16%	13%		
Foreign	3%	4%	3%	19%	25%	29%	26%		
Other	6%	13%	8%	8%	15%	15%	9%		

Source: MacDonald & Associates Inc.

Given that the US VCs are the most important VCs in the foreign investor sector for Canadian firms – all of the top 10 foreign VCs investing in Canada are American, it is worthwhile noting that VC investment in the US fell more sharply in the US over the 2000 to 2002 period than foreign VC investment. Annual foreign VC investments grew at more than twice the rate of VC investments in the US over the 1996 to 2000 period, and while VC investments in the US fell by 80% over the 2000 to 2002 period, foreign VC investments decline by 55%. These calculations are based on an exchange rate of \$1.5 Canadian for every US \$.

Foreign VC Investment in Canada

VC investments	\$ millions							CAAG	
	1996	1997	1998	1999	2000	2001	2002	1996-2000	1996-2002
in the US (1)	17,342,189	22,666,926	32,087,742	82,342,842	159,196,479	61,051,142	31,854,249	74%	11%
in Canada (2)	1,032,819	1,630,986	1,558,108	2,649,970	5,778,221	3,800,467	2,465,942	54%	16%
Foreign VC in Cda (2)	30,653	69,909	40,607	496,753	1,451,642	1,084,015	650,248	162%	66%

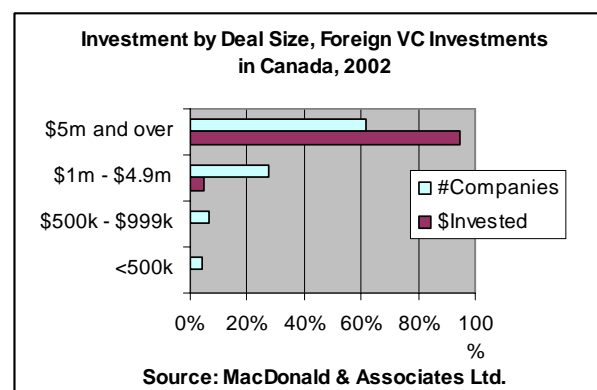
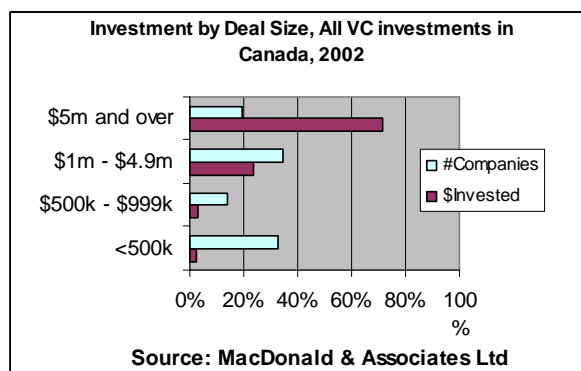
(1) PricewaterhouseCoopers LLP/Thomson Venture Economics/National Venture Capital Association MoneyTree™ Survey,

(2) MacDonald & Associates Inc.

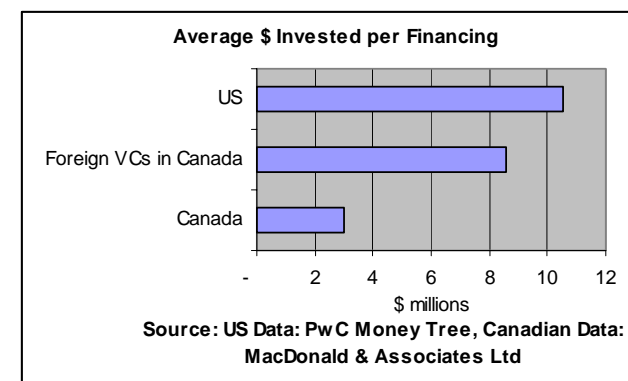
4. Foreign VCs behave differently than Canadian VCs

4.1. Foreign VC deals are more concentrated in the larger deals than domestic VC deals

Larger investment deals (\$5 million and over) represent the majority of venture capital investment dollars in foreign VC investments and total VC investments in Canadian companies. However, the distribution of investments across companies seeking investments of different sizes varies considerably between foreign investments and the average VC investment. Where the average VC investment in Canada is distributed across companies securing investments of all sizes, the number of foreign VC investments is concentrated amongst firms raising over \$5 million. Hence, foreign VCs are a key source of financing for larger deals; they account for about 35% of investments in companies of over \$5 million. Conversely, domestic VCs are the primary source of financing for smaller deals – they account for over 95% of investments of less than \$5 million.



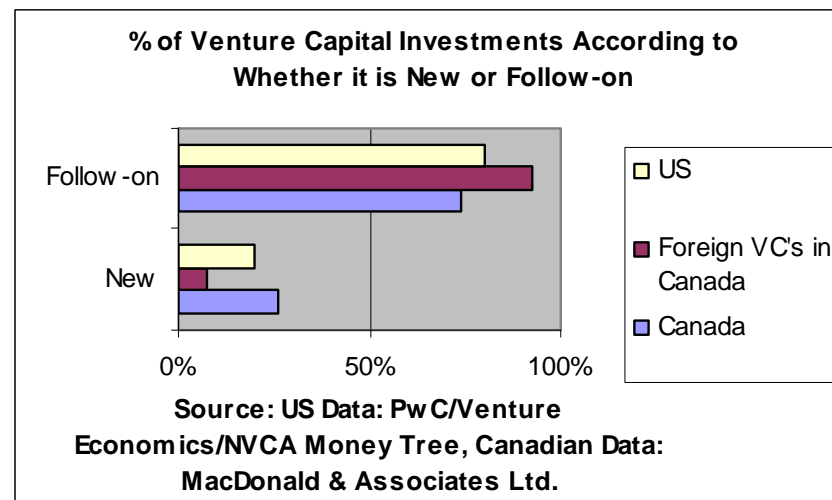
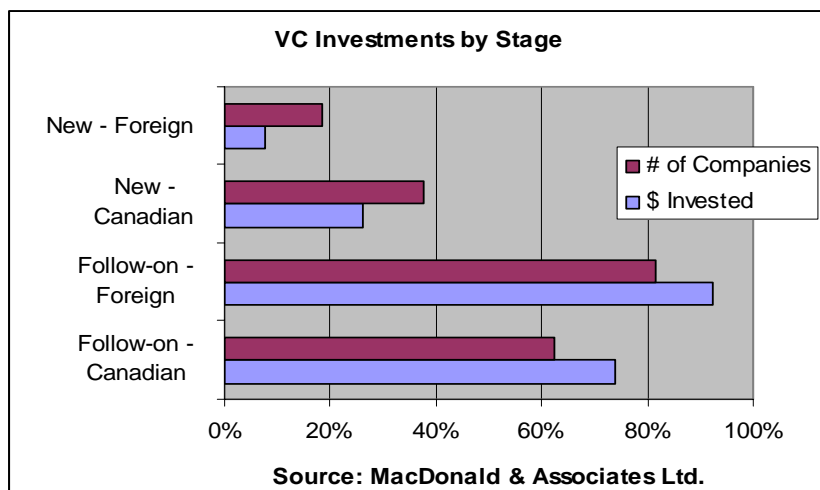
It is likely that the concentration of foreign VC investments in larger deals is due in large part to the fact that US VCs, the dominant foreign VCs investing in Canada, typically invest in larger deals than is the case in Canadian VC investments on average. As shown in the following chart, US VC investments average over \$10 million Canadian (assuming an exchange rate of 1.5), over three times the average Canadian investment of \$3 million Canadian. The difference is also due to the fact that foreign VC investments are more likely to have a larger number of investors than the average deal in Canada.



Foreign VC Investment in Canada

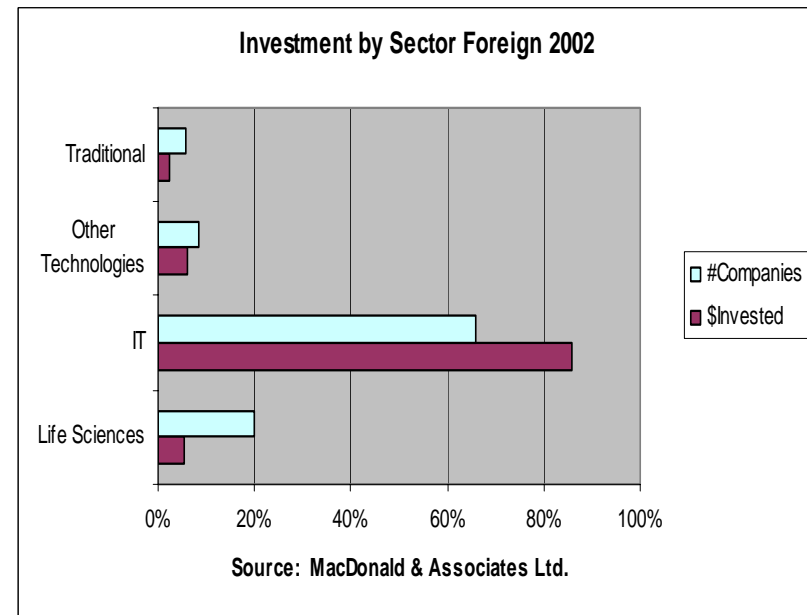
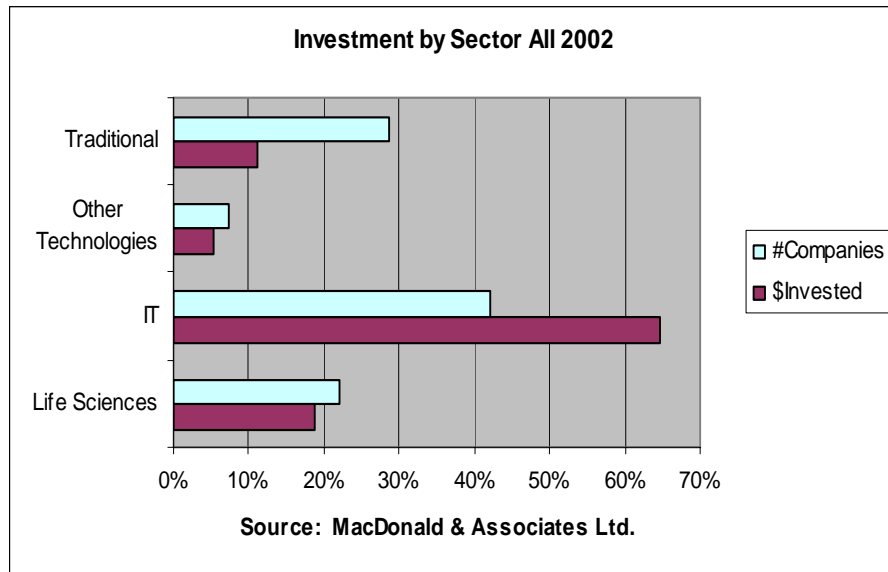
4.2. Foreign VC deals are more concentrated on follow-on investments than domestic VC deals

Follow-on investments account for a significantly larger portion of foreign VC investments (92%), than is the case with the average VC investment in Canada (74%). VC investments in the US are distributed across new versus follow-on financings in about the same proportion as VC investments in Canada. Consequently, the lower proportionate investment in new financings by foreign VCs is unlikely to be due to a tendency by foreign VCs to be more likely to invest in follow-on financings than Canadian VCs. The lower proportionate investments in new financing by foreign VCs is more likely to be attributable to the fact that VCs are more likely to invest in new financings when they are located closer to the investee.



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4.3. Foreign VC financing is more concentrated in the IT sector than Domestic VC financing



Foreign VC financing is a particularly important source of financing for IT firms, especially those in communications and networking and semi-conductors. As illustrated above, while IT investment accounts for almost two-thirds of VC investments in Canada, it accounts for almost 90% of foreign VC investments. As shown in the table opposite, investments in communications and networking and semi-conductors account for 78% of foreign VC financing, compared to 57% of total VC financing in Canada.

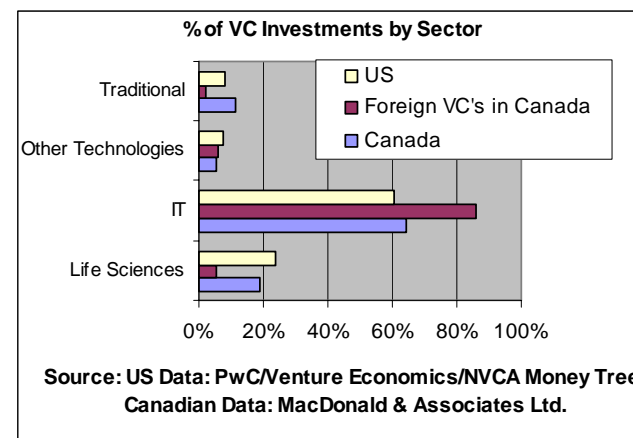
IT Sector	All Investments in Canada	Foreign VC Investments in Canada
Communications and Networking	42%	60%
Electronics/Computer Hardware	8%	6%
Internet Focus	10%	3%
Other IT Services	2%	0%
Semiconductors	15%	18%
Software	22%	14%

Source: MacDonald & Associates

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It is noteworthy that foreign VC financing in Canada in the life sciences sector is disproportionately low, relative to investments in the IT sector in Canada and the US. The IT sector accounts for about 60% of VC financing in each of Canada and the US, but almost 90% of foreign VC financing goes into the IT sector. Conversely, where the life sciences sector accounts for about 20% of VC financing in Canada and the US, it represents only 8% of foreign VC financing.

The difference in financing by sector is likely to be due to two factors. First, VC financing of the life sciences sector is a relatively new phenomena in the US and Canada. In Canada, VC financing fell by 50% from 2001 to 2002 in the IT sector, but almost doubled in the life sciences sector. Similarly, while VC investments in the US fell by 52% in the IT sector, they declined by only 17% in the life sciences sector. Hence, given that foreign VC financing is more concentrated in follow-on financings than is the case for domestic investments, and that the relative growth in financing of the life sciences sector is recent, it is not surprising that foreign VC financing is more concentrated in the IT sector. Second, Canada, and in particular, Ottawa, is particularly well-known world wide for its strength in the IT sector, and those sectors that develop an international reputation are more likely to draw in foreign financing.

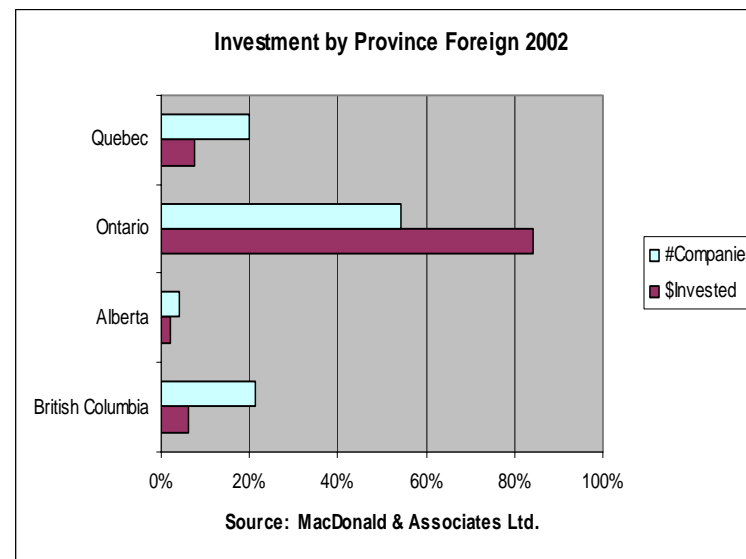
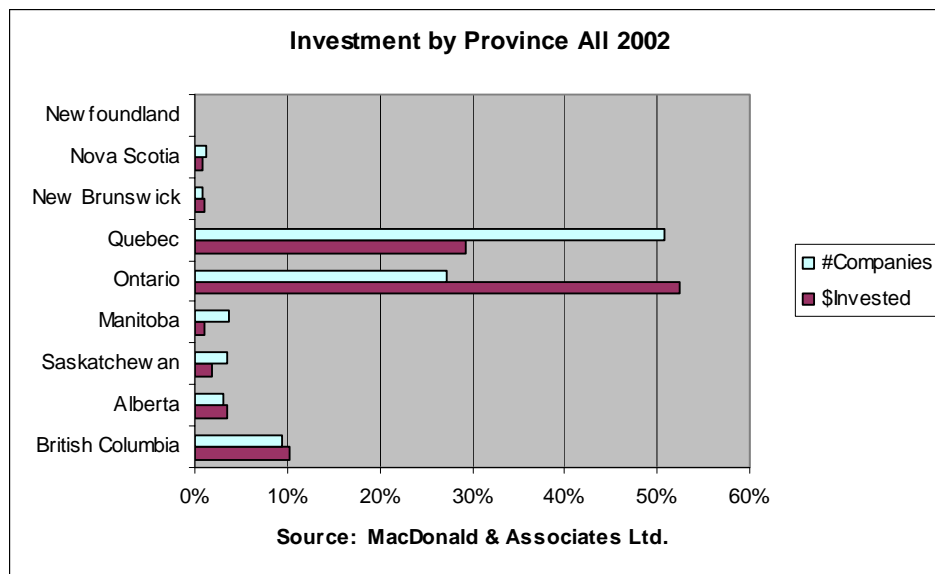


4.4. Foreign VC investments are more concentrated in Ontario than Domestic VC Financing

While Ontario accounts for slightly more than half of all VC financing in Canada, it receives over 80% of foreign VC financing. Similarly, while Quebec accounts for 29% of VC financing in Canada, Quebec accounts for 8% of foreign VC financing.

The importance of the IT sector is a critical factor in explaining some of the regional differences in VC financing between foreign and domestic investments. An important contributor to this is the fact that Ontario accounts for 66% of all IT VC investments in Canada. Furthermore, Ontario accounts for 73% of VC investments in communications, networking and semi-conductors, the dominant area for foreign VC financing. Conversely, Quebec accounts for 22% of IT VC financing in Canada, and 20% of VC investments in communications, networking and semi-conductors. While these sectoral differences do explain some of the provincial differences in foreign VC financing, they do not account for the full difference.

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The following chart illustrates that while Ontario is higher in those sectors where foreign VC financing is highest, the share of VC financing that is accounted for by foreign sources is significantly higher in Ontario and significantly lower in Quebec, than in other provinces. This suggests that the differences in foreign VC financing is not due solely to sectoral differences.

	Alberta				BC				Ontario				Quebec			
	Total	% of total	Foreign	% of total	Total	% of total	Foreign	% of total	Total	% of total	Foreign	% of total	Total	% of total	Foreign	% of total
Total	\$ 86,570	100%	\$ 14,350	17%	\$ 302,074	100%	\$74,938	25%	\$1,303,632	100%	\$543,659	42%	\$720,386	100%	\$48,814	7%
Life Sciences	\$ 12,571	15%			\$ 73,004	24%	\$4,724	6%	\$132,656	10%	\$4,325	3%	\$216,433	30%	\$26,595	12%
IT	\$ 28,587	33%	\$ 7,600	27%	\$ 185,630	61%	\$51,872	28%	\$1,062,390	81%	\$518,934	49%	\$349,737	49%	\$22,019	6%
Communications and Networking	\$ 15,800	18%	\$ 5,500	35%	\$ 84,275	28%	\$41,372	49%	\$427,222	33%	\$263,330	62%	\$103,336	14%	\$15,144	15%
Electronics and Computer	\$ 3,600	4%	\$ 2,100	58%	\$ 7,147	2%	\$948	13%	\$84,653	6%	\$44,239	52%	\$81,423	11%	\$4,500	6%
Internet Focus	\$ 9,187	11%	\$ 6,750	73%	\$ 8,624	3%	\$100	1%	\$83,135	6%	\$11,878	14%	\$43,401	6%	\$1,125	3%
Other IT Services		0%			\$ 22,815	8%		0%	\$41,571	3%	\$7,867	19%	\$70	0%		0%
Semiconductors		0%			\$ 15,749	5%	\$7,099	45%	\$208,937	16%	\$112,223	54%	\$43,631	6%		0%
Software		0%			\$ 47,020	16%	\$2,353	5%	\$216,872	17%	\$79,397	37%	\$77,876	11%	\$1,250	2%
Other Technologies	\$ 3,059	4%			\$ 29,633	10%	\$10,782	36%	\$50,577	4%	\$17,600	35%	\$19,528	3%	\$200	1%
Traditional	\$ 42,353	49%			\$ 13,807	5%	\$7,560	55%	\$58,009	4%	\$2,800	5%	\$134,688	19%		0%

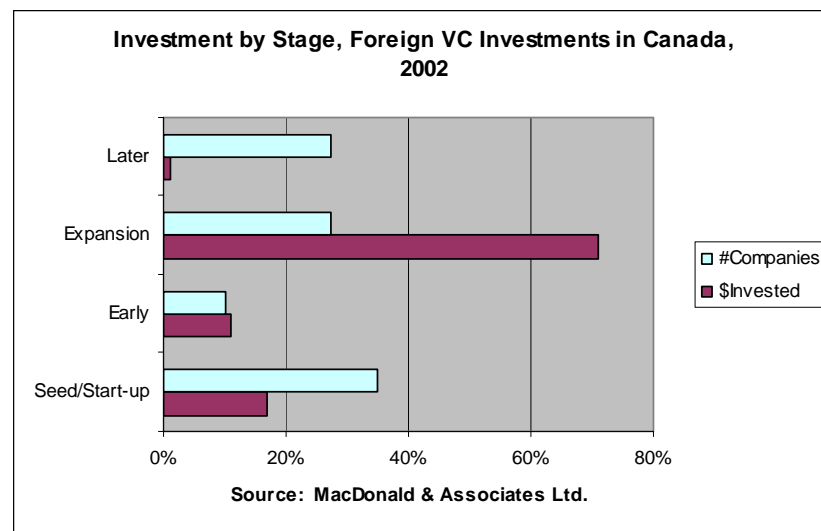
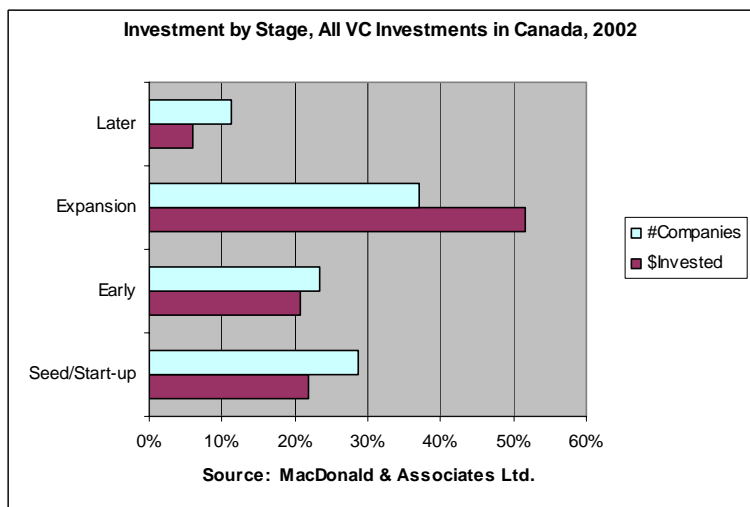
Foreign VC Investment in Canada

The following charts present the major cities that received more than one foreign VC investment in 2002.¹ VC investments are highly concentrated in geographic clusters. For example, while Ottawa accounts for 4% of the Canadian population, it accounts for 30% of total VC financing in Canada and 64% of foreign VC financing. Columns 11 and 12 present the ratio of the share of VC financing to the share of the population for total and foreign VC financing respectively. A figure less than 1 indicates that the region receives a disproportionately low percentage of financing; a figure above 1 indicates that the region receives a disproportionately high percentage of financing. Each of the major cities receiving more than one foreign VC financing, receive a disproportionately high percentage of VC financing. This is most dramatic in Ottawa, where the share of total financing is more than 8 times the share of the population, and the share of foreign VC financing is more than 18 times the share of the population.

	Population			Total VC Financing				Foreign VC Financing			
	Total	% of total	% of province	\$Invested	% of total	% of province	% of VC financing/% of population	\$Invested	% of total	% of province	% of VC financing/% of population
	1	2	3	4	5	7	8	9	10	11	12
Total	31,414.00	100%		\$ 2,465,942	100%			\$ 650,248	100%		
British Columbia	4,141.30	13%		\$ 250,963	10%		0.8	\$ 39,668	6%		0.5
Vancouver Area	2,122.70	7%	51%	\$ 226,079	9%	90%	1.4	\$ 39,668	6%	100%	0.9
Alberta	3,113.60	10%		\$ 85,420	3%		0.3	\$ 14,350	2%		0.2
Calgary Area	993.2	3%	32%	\$ 54,636	2%	64%	0.7	\$ 14,350	2%	100%	0.7
Ontario	12,068.30	38%		\$ 1,298,661	53%		1.4	\$ 547,416	84%		2.2
Ottawa Area	1,128.90	4%	9%	\$ 743,747	30%	57%	8.4	\$ 415,859	64%	76%	17.8
Toronto Area	5,029.90	16%	42%	\$ 466,979	19%	36%	1.2	\$ 130,982	20%	24%	1.3
Quebec	7,455.20	24%		\$ 721,607	29%		1.2	\$ 48,814	8%		0.3
Montréal Area	3,548.80	11%	48%	\$ 533,239	22%	74%	1.9	\$ 48,614	7%	100%	0.7

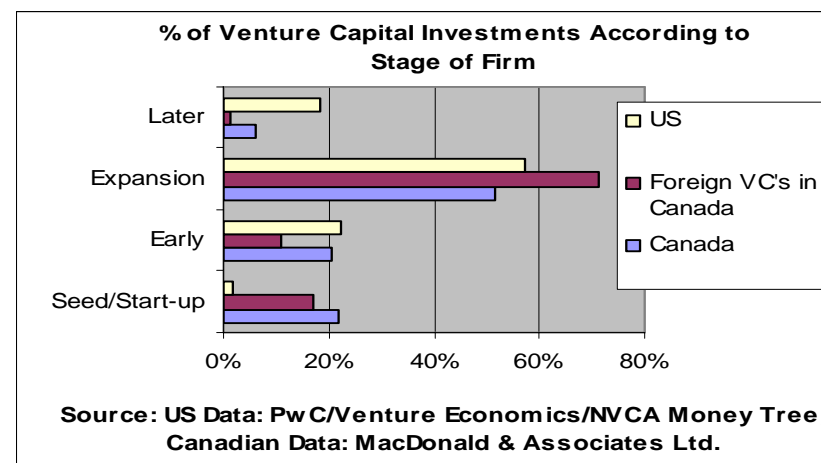
¹ London and a Quebec region outside of Montreal were the only regions to receive 1 foreign VC financing; all other areas received more than one VC financing.

4.4.1. Foreign VC financing is more concentrated on the Expansion stage than Domestic VC financing



VC investments in aggregate are most heavily concentrated in expansion stage companies, although foreign VCs place relatively more emphasis on the expansion phase than domestic VCs. This emphasis on expansion stage investments is likely due to the fact that foreign VCs have so far participated mostly in follow-on deals.

However, it is of interest to note that foreign VCs (most of which are American) invest proportionately more in early stage companies in Canada, than VCs investing in the US. Almost 20% of VC financing goes into later state companies, while less than 5% goes into seed/start-up companies. The numbers are almost the reverse for foreign VC financing in Canada – almost 20% goes into seed/start-up companies, and less than 5% goes into later stage companies. This is likely due to the fact that foreign VC investment is heavily concentrated in ICT sectors that are undergoing rapid change, and thus the investments are typically in companies that are at the early stage of developing the technology.



5. Mid-Tier Foreign VCs are important as well as Top Tier VCs for Canadian firms

Both Top-Tier and Mid-Tier US VCs invest in Canada. Of the top 10 US VCs (those investing in 40 or more deals in the US in 2002), all but one invested in Canada over the last five years, with deals in Canada accounting for 1.7% of all deals in the US in 2002 by top-tier players. The percentage of Mid-Tier VCs (VCs investing in 21 to 39 deals) investing in Canada is significantly lower than is the case for top-tier players (41%). However, in aggregate the number of investments in Canada amounts to 2.2% of all Mid-Tier deals in the US. Consequently, both Top-Tier and Mid-Tier players are critical potential sources of financing for Canadian firms.

VC	State	US # of deals in 2002	Invested in Canada Last 5 years	Canada deals in 2002 as % of US deals	VC	State	US # of deals in 2002	Invested in Canada Last 5 years	Canada deals in 2002 as % of US deals		
New Enterprise Ass	MD	73	Yes	0	0%	Advanced Tech. Ventures	MA	27	Yes	2	7%
Draper Fisher Jurvetson	CA	62	No	-	-	InterWest Partners	CA	26	Yes	1	4%
Venrock Associates	NY	62	Yes	0	0%	Northwest Venture Part's	CA	26	No	-	-
U.S. Venture Partners	CA	59	Yes	0	0%	Oak Investment Partners	CT	26	No	-	-
Intel Capital	AZ	58	Yes	3	5%	Crosspoint Venture Part's	CA	25	No	-	-
J.P. Morgan Partners	NY	47	Yes	0	0%	Versant Ventures	CA	25	No	-	-
Canaan Partners	CT	41	Yes	1	2%	GE Equity	CT	24	Yes	0	0%
Flagship Ventures	MA	41	Yes	2	5%	RRE Ventures	NY	24	No	-	-
Battery Ventures	MA	40	Yes	2	5%	Charles River Ventures	MA	22	No	-	-
Polaris Venture Partners	MA	40	Yes	1	3%	Crescendo Venture Management	CA	22	Yes	0	0%
Bessemer Venture Part's	MA	39	Yes	2	5%	Hudson Venture Partners	NY	22	No	-	-
Morgenthaler Ventures	CA	39	Yes	6	15%	Mobius Venture Capital	CA	22	No	1	5%
Warburg Pincus	NY	39	Yes	0	0%	Three Arch Partners	CA	22	No	-	-
ComVentures	CA	35	No	-	-	Bay Partners	CA	21	No	-	-
Sequoia Capital	CA	35	No	-	-	Cordova Ventures	GA	21	No	-	-
Mayfield Fund	CA	34	Yes	0	0%	Kleiner Perkins Caufield & Byers	CA	21	Yes	0	0%
Austin Ventures	TX	33	No	-	-	Norvus Ventures	CA	21	No	-	-
Domain Associates	NJ	33	No	-	-	Prism Venture Partners	MA	21	Yes	3	14%
St. Paul Venture Capital	MN	33	No	-	-	River Cities Capital Funds	OH	21	No	-	-
Menlo Ventures	CA	31	Yes	2	6%	Trident Capital	CA	21	No	-	-
Sprout Group	NY	31	Yes	2	6%	Ardesta	MI	20	No	-	-
Accel Partners	CA	29	No	-	-	Benchmark Capital	CA	20	No	-	-
Sevin Rosen Funds	TX	29	Yes	1	3%	Crossbow Ventures	FL	20	No	-	-
TL Ventures	PA	29	No	-	-	Highland Capital Partners	MA	20	No	-	-
Alta Partners	CA	28	Yes	0	0%	Lightspeed Venture Partners	CA	20	No	-	-
ARCH Ventures Partners	IL	28	Yes	2	7%	Oxford Bioscience Partners	MA	20	No	-	-
Zero Stage Capital	MA	28	No	-	-	Rho Ventures	NY	20	No	-	-

6. Factors Influencing Foreign VC Investment in Canada

6.1. Findings from Previous Studies

6.1.1. Commonalities among Canadian companies that received VC financing from the Tri-state Area

A 2002 Study by the Canadian Consulate General in New York, entitled “Tri-State Area Venture Capital Report”, cited the commonalities in VC financing from the Tri-State Area in Canadian Companies

- Early stage or expansion stage are more likely than other companies to receive financing, due primarily to two factors:
 - Seed stage investments are often funded by angels, for whom out-of country investments would be more risky and complex; and
 - Geographic distance is likely to be more important for seed stage companies, due to the higher monitoring requirement
- Companies in Ontario are more likely to receive financing than companies from other provinces. The high concentration of high-tech firms and close proximity, combined with the regular direct air flights are believed to be the driving factors
- US VCs that have invested in Canadian or foreign companies:
 - Are typically global;
 - Have established business relationships in Canada – According to a survey of New York VC firms, 76% of firms responded that “Canadian partner participation in the same deal was somewhat to very important”; and
 - Have internal resources capable of navigating international laws

6.1.2. Attractions to Investing in Canadian Firms

A 2002 Study by the Canadian Consulate General in New York, entitled “Tri-State Area Venture Capital Report”, cited the following attractions of Canadian firms:

- Local market dynamics favour entrepreneurs;
- Solid technical skills/proficiency;
- Close proximity to the US;
- Low labour costs;
- Government sponsored technology subsidies;
- Track record of success with Canadian investments;

- Regulatory flexibility; and
- The absence of structural impediments, whether legal, political, or trade-based that prevent US investors from investing in Canada

The study also notes that the strengthening of relationships between US firms and Canadian VCs has been critical for sustaining interest in Canadian firms while investments in the US have fallen sharply.

6.1.3. Barriers to Investing in Canadian Firms

In a survey of VC investors in the Tri-State area, 17.6% of firms indicated that they would not consider Canadian deals (Canadian Consulate General in New York, Summer 2002). The most common reasons why investors were reluctant to invest in Canadian deals are:

1. Geographic proximity - Half of the firms who were not interested in Canadian deals cited geographic proximity as their principal reason.
2. Outside mandate - Some VCs are specifically mandated to invest within their region.
3. Lack of knowledge - Unless firms plan to do several Canadian deals, it is not worth the cost of developing the expertise and networks with experts in cross-border investments. “In the VC Survey, a large majority of the firms who had no interest in investing in Canada rated their knowledge of the Canadian venture industry to be low”.

6.1.4. Consideration of tax policy by the CVCA

The Canadian Venture Capital Association (CVCA) has identified a number of concerns regarding taxation policies that it believes may pose a barrier to foreign VC financing. These are summarized as follows:

The Income Tax Act currently imposes a withholding tax of 25% on interest payments made to foreign creditors. The rate is reduced to 10% if the recipient of the interest is a resident of the U.S. The CVCA is concerned that the withholding tax imposed on interest payments made to non-residents discourages U.S and other foreign lending institutions from making loans to Canadian companies thus increasing the cost of borrowing in Canada and reducing the pool of affordable capital available to Canadian companies. The CVCA recommended revising the withholding tax provisions to make it easier and cheaper for Canadian Companies to access U.S and other foreign capital.

The Income Tax Act contains the concept of “associated corporations”. Associated corporations must share a small business (a reduced tax rate on the first \$300,000 of taxable income. More importantly, association can increase a corporation’s liability to pay large corporations tax and reduce its ability to access SR&ED tax credits. The CVCA recommended that investments made by “Canadian venture Capitalist” in corporations should be ignored for purposes of the association rules.

When Canadian investors hold shares in Canadian companies which merge with other Canadian companies, the investor receives a roll-over treatment such that no cash tax is payable until the investor actually receives cash proceeds for his investment. Similarly, when Canadian investors hold shares in non-Canadian companies, which merge with other non-Canadian companies, roll-over treatment is also available. However, when a Canadian company completes a merger with a non-Canadian company, no such rollover is currently available. The CVCA recommended that cash taxes should not be payable prior to the time when cash proceeds are received by the taxpayer.

In summary, the clarity, simplicity and consistency of the tax regulations is a key influencer on foreign VC investments. The importance of the clarity and simplicity of the tax system is further demonstrated by the European Venture Capital Association (EVCA) (2003), where the key concern of the newly elected-EVCA Chairman is the promotion of harmonization and transparency with the objective to make the private equity and venture capital industry in Europe more understandable and a more favourable place to invest.

6.2. Interview Findings from the Current Study

In order to better understand the profile of foreign VCs and Canadian firms receiving foreign VC financing, as well as to understand the barriers and enablers to add advantages and disadvantages of foreign VC financing, PwC interviewed a host of representatives in the following areas.

- Foreign VCs that had invested in Canada
- Foreign VCs that have not invested in Canada
- Domestic VCs
- Canadian firms that received foreign VC financing
- Canadian firms that received domestic only financing
- Foreign and Canadian intermediaries

6.2.1. Typical Methods of Learning about Investment Opportunities

Participants in the interviews reported that there is no one rule of thumb for learning about investment opportunities. VCs rely on a variety of sources of information as outlined below.

- They typically have their own research staff that actively look for companies. VCs are continually reading sector specific magazines and more general ones, such as the Red Herring, to keep up to date on new opportunities.
- They rely heavily on referrals from other VCs. They look particularly favourably on referrals on first round investments, as they can be assured that the referring VC is not seeking to disburse the risk from an investment that they have already lost money on.
- They try to attract investees through marketing pull. This includes being visible at events and having an accessible web site.
- Networking and referrals from organizations other than VCs, such as legal firms and intermediaries are key sources of information.

It is important to note that while VCs actively look for companies and invite companies to approach them directly, participants from the interviews indicated that it is still critical that the company be referred by a reputable VC or professional services firm. Most participants from the interviews suggested that no matter how good the opportunity, if a company does not have a referral when approaching the foreign VC, they will not get serious consideration.

6.2.2. The Importance of a Canadian VC in the deal

The importance of a Canadian VC as part of the syndicate varies significantly. In general, most participants in the interviews indicated that it is advantageous to have at least one of the VCs in the investment active in the same area as the company, so that they can check on the company, create buzz, and know the local market and the availability of talent. Consequently, having a co-investor that is familiar with the region is likely to be important for drawing them in for their first investment in the region. The importance of a local player tends to decline with the number of deals by foreign players. The more that the US VC invests in the region, the less important it is to have a Canadian VC involved, as the foreign VC would know the local market anyway.

Participants in the interviews indicate that the involvement of Canadians is important for raising awareness about Canadian opportunities and advantages. For example, US VCs that have Canadian expatriates on their team (e.g. Battery Ventures, Newbury Ventures) tend to be the most active foreign VCs investing in Canadian firms.

One VC from the US noted that he believed that it was difficult for US VCs to crack into the Canadian market, as Canadian VCs prefer to co-invest with other Canadian VCs. While the small sample size for the survey means that it is impossible to estimate how pervasive this thinking is, the absence of the comment from any of the other interviews suggests that it is not likely to be a significant issue.

6.2.3. Factors encouraging or discouraging Investment in Canadian Firms

Without exception, all of the players in the industry believe that the most important factor in attracting the VC is the business opportunity – they are seeking companies that have developed leading-edge technology for a large and ready market, and can successfully and profitably grow the business. VCs are typically looking for a 30% to a 50% annual return on their investments. In general, it is the business opportunity that will drive this number. Other factors, such as taxes or travel costs may be seen as influencing factors that may tip the scale, but they do not act as barriers to an investment.

Technology and Technical Expertise

Findings from the interviews indicate that Canadian firms are well known for their excellence in developing IT. It is well known for developing leading edge technologies, and for being able to integrate technology development with good business decision-making (i.e., planning, timing, cash flow management) In addition, the relative cost of Canadian engineers is believed to be very competitive. It is this reputation for being able to develop good technology at a reasonable cost that has attracted significant foreign VCs.

However, it was noted that Canada cannot rely on its excellence in IT R&D as a growth driver going forward. Interview participants indicated that countries like India and Pakistan are becoming very attractive from an R&D cost standpoint, and in order to remain competitive in the future, Canada must build the capacity and infrastructure around its current excellence in IT development, and build competitive advantage in other areas (management, marketing).

Management and Marketing Expertise

Various participants in the interviews indicated that one of the most common deterrents to investing in Canada is that Canadian firms are seen as having good technology but are perceived to be weak on the management and marketing side. As noted in the interviews, there are several reasons for this.

- **Market size:** The sheer size of the market in the US relative to Canada means that the number of companies launching and achieving significant growth is smaller in Canada than the US. Hence, the critical mass of entrepreneurial experience is smaller

in Canada. Secondly, in order for a Canadian company to achieve the success of an American company, it must sell to a significant market; typically it must sell into the US. Hence, Canadian companies, which often lack experience in selling into the US are perceived to be weaker in marketing and sales. Finally, US companies tend to operate on a larger scale, and make larger buying decisions than Canadian companies. As a result, Canadians typically have less experience in larger deals and less experience in building powerful networks than their US counterparts.

- **Culture:** Participants in the interviews noted that they believe that the network between Canadian companies and the Canadian community is less prominent compared to other cultures. Specifically, they indicated that Israeli and Indian entrepreneurs are more aggressive and tenacious than Canadian entrepreneurs, and consequently, are more successful in financing, launching and growing companies. Canadians are also generally perceived as more risk averse than Americans. However, risk-taking is inherent to successful entrepreneurial activity.

As a result of all those factors, interview participants indicated that US investors will typically want an American to lead the management/marketing activities of the firm, and will often want this led out of the US. Consequently, if the management team seems like it would resist management from the US running the company, this would be a strong deterrent to a US VC.

Kirk Falconer, with MacDonald & Associated Ltd., has noted that the disproportionately high representation of investments in Ottawa suggests that, “by voting with their dollars, a great many US VCs have found a strong entrepreneur base in at least one Canadian community – the Ottawa Valley”. Falconer states that this is consistent with what US VCs have repeatedly told MacDonald & Associates throughout their surveying activity. He claims that is an illustration of the continuous synergies between an increasingly sophisticated community of investors and entrepreneurs.

Exit strategy

The top two exit routes for a US VC are: acquisition & IPO. Many US VCs perceive more risk on the exit of Canadian firms than for American firms on both of these routes. The most common exit strategy for VCs, particularly when investing in Canada, is through the sale of the company, as many VCs feel that the Canadian security regulations are not strong enough, and they do not see an IPO in Canada as potential exit strategy. It is sometimes difficult to find companies that will acquire a Canadian company, due to the regulatory problems associated with cross-border deals and operations, and this weighs into the investment consideration by the US company.

Tax rates

Foreign VC Investment in Canada

The importance of the tax regime cannot be understated. A taxation policy can serve as an incentive (in the case of the SR&ED program) to invest in Canada, a mild deterrent (in the case of capital taxes, personal & corporate income taxes) or a show stopper in the case of capital gains taxes that can result in double taxation or taxable events in the case where individuals will have no funds to pay taxes. This area needs serious consideration if foreign funds are to be a continued source of funding for Canadian firms.

- **General** – There is a general perception on the part of foreign VCs that Canadian tax rates are higher and significantly more complicated than American tax rates.
- **Corporate taxes** – With respect to corporate tax rates, while differential tax rates represent a fixed difference in the cost of doing business, many believe this is not a strong deterrent to investment. The primary example of this is that one US VC noted that California has relatively high tax rates, and receives more VC investment than any other region in the world. The primary reason is likely to be that VCs are looking for a sufficiently high return on their investment that differences in tax rates would have a minimal effect on their overall return.
- **Personal taxes** – Some participants, particularly Canadians, stated that they believe that high Canadian personal tax rates serve as a strong disincentive to entrepreneurial activity.
- **R&D credits** – US VCs are slowly recognizing the benefits of the various tax credit policies (e.g., SR&ED tax credits) available to Canadian private companies and are beginning to view this as a positive investment characteristic. However, tax credits are perceived as a “nice-to-have”, as the viability of the business and technology must exist.
- **Capital taxes** – Capital taxes are seen to be punitive to successful firms and the location of assets in Canada. Interview participants believe that the move to eliminating/reducing them should be accelerated.
- **Capital gains taxes** – Many US investors have experienced significant adverse, and unexpected, tax consequences upon their exit from Canadian investments. However, the tax environment is creating significant problems that may reverse the trend of growing foreign VC investment. This is due both to problems associated with existing tax law that VCs have encountered on exiting their investments, and to the perceived impacts of changes in legislation.
 - Canada Customs and Revenue Agency (“CCRA”) takes the position that LLC's are not eligible for benefits under the Canada-US Tax Convention, with the result that many US VCs structured as LLC's may be subject to tax on capital gains realized both in the US and Canada. Many US VCs that invested in Canadian firms only learned of this after the fact, and will be weary of investing in Canada again.
 - Other tax issues arise when a US VC that is structured as a LLP intends to dispose of its Canadian investment and applies to CCRA to obtain a certificate for the proposed disposition. This certificate allows the purchaser to pay the full purchase price to the US VC. In the absence of such a certificate, a purchaser is required to withhold and remit 25% of the purchase price to CCRA as a prepayment of the estimated taxes payable in Canada by the foreign VC. CCRA requires each partner of the LLP to provide evidence that they are residents of the US for tax purposes. They will not accept a statement from the general manager of the LLP. It is the general partner of the LLP who generally manages this type of activity on behalf

of the limited partners to alleviate their requirement to perform administrative functions. Hence, requiring all of the partners of an LLP to provide evidence is counter to their business model and becomes a significant administrative burden.

- CCRA has recently taken the position that shares of a Canadian company that are exchangeable into shares in a US company are foreign property to certain Canadian investors. This can deter investment significantly.

Regulations

Some interview participants reported that they believe that Canadian corporate statutes are not ‘series friendly’ in the sense that they do not permit different liquidation preferences, as is common in the US.

Competitive Valuations

The Canadian investment industry is significantly smaller and newer than the US industry on a relative basis. Where the Canadian population is about one-tenth of that of the US, total VC investments in Canada were less than 1% of the total amount of VC money invested in the US until 2001. As a result, interview participants indicated that they believed that there are typically fewer VCs competing to invest in Canadian companies, and US VCs can secure better valuations than would be the case in the US. It is important to note as well that, participants in the interviews indicated that the timing restriction on investments (i.e. LSVCCs) artificially inflates valuations near the end of the period thus – discouraging US VC investment into Canada. It is not clear what effect this would have on the average valuation.

6.2.4. Key Terms and Conditions for Foreign VC investment in Canadian Firms

Participants in the interviews indicated that one of the most common terms for investing in Canadian companies is insistence on a provision that allows the VC to put in place management from the US, due to less experienced management expertise of most Canadian companies as compared to U.S companies. Foreign investors believe that the R&D management expertise is excellent in Canada, but the supply of experienced marketing and sales executives is limited. Depending on its main customer base (US market, Canadian market), Canadian companies had mixed feelings about the proposition of recruiting US management (or establishing a management office in the US).

Furthermore, the restriction on LSVCCs against investing in Canadian “Delaware” companies, even among those that operate solely in Canada, significantly restricts the amount of Canadian VC funding that can be co-invested with VCs from the US who want to

avoid significant adverse tax consequences of investing in a Canadian company. It has been suggested that LSVCCs could enable better leveraging of other Canadian VCs if permitted to invest in these funds.

6.2.5. Sectoral issues

One US VC noted that energy is a rapidly emerging area for potential innovation. For example, the number of products that are coming out that are battery-powered is growing rapidly, but battery technology has remained unchanged.

During the course of interviews with Canadian and foreign VCs and intermediaries, PricewaterhouseCoopers LLP raised the point that the life sciences sector receives a disproportionately low share of foreign VC financing. We enquired as to the participants' views on this. The interview participants offered three potential reasons for this.

- Participants indicated that Canadian governments fund proportionately less R&D than many OECD countries. Moreover, what is funded is underfunded relative to the US – grants are spread across many projects and are small in size, limiting their effectiveness. The average grant size in Canada is significantly smaller than the average grant size in the US. This puts a heavy

Factors encouraging or discouraging Investment in Canadian Firms

Tax rates

- **General** – There is a general perception on the part of foreign VCs that Canadian tax rates are higher and significantly more complicated than American tax rates.
- **Corporate taxes** – While differential tax rates represent a fixed difference in the cost of doing business, many believe this is not a strong deterrent to investment. The primary example of this is that one US VC noted that California has relatively high tax rates, and receives more VC investment than any other region in the world.
- **Personal taxes** – Some participants, particularly Canadians, stated that they believe that high Canadian personal tax rates serve as a strong disincentive to entrepreneurial activity.
- **R&D credits** – US VCs are slowly recognizing the benefits of the various tax credit policies (e.g., SR&ED tax credits) available to Canadian private companies and are beginning to view this as a positive investment characteristic. However, tax credits are perceived as a “nice-to-have”, as the viability of the business and technology must exist.
- **Capital taxes** – Capital taxes are seen to be punitive to successful firms and the location of assets in Canada. Interview participants believe that the move to eliminating/reducing them should be accelerated.
- **Capital gains taxes** – Many US investors have experienced significant adverse, and unexpected, tax consequences upon their exit from Canadian investments.
- **Regulations** - Some interview participants reported that they believe that Canadian corporate statutes are not ‘series friendly’ in the sense that they do not permit different liquidation preferences, as is common in the US.

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burden on researchers to always be applying for

grants. It also discourages large, risky projects relative to small, incremental, predictable research.

- There are few big successes. Biochem Pharma and QLT Phototherapeutics are really the only Canadian start-ups that have grown to a significant size. Conversely, the IT industry has numerous “home-runs” such as Mitel, Nortel, Newbridge, JDS Fitel, etc.
- Canadian companies are at an earlier stage than their US counterparts. While many US life sciences companies are third generation, Canadian life sciences companies are first generation. US VCs that are investing in life sciences tend to invest in companies that are at least at Phase II clinical trials.

6.2.6. Regional Issues

One factor that is mentioned as a deterrent to investing in Canada is distance. Many VCs only invest in their region. In some cases, this is because their mandate is to invest in their state, region or country. Other VCs like to invest in companies that they are close to. Some have even suggested (somewhat jokingly) that the required ROI is directly related to the driving distance.

However, many interview participants countered this viewpoint. They pointed out that given the size of the US, and the location of most Canadian companies near the border, many Canadian investees are closer in distance to US VCs than American companies. For example, Ottawa is closer to Boston than California. Secondly, one participant noted that the second largest region for attracting VC financing in the world is Israel, a significant distance from the many US VCs that invest there.

While the importance of distance varies, industry experts agree the location of the company is critical. VCs want to be assured that as the company grows, there is an appropriate infrastructure surrounding it to allow it to grow. Several factors were noted as being important:

- **Strong research base:** Research and development is the basis of innovation and growth. In order for a sector to achieve sustained rapid growth, there must be a significant amount of research. All of the leading areas for IT and biotechnology have a significant amount of leading edge research.
- **Strong record of commercialization activity:** The ability to leverage the research base and commercialize the activity is critical to achieving growth. The co-location of significant buying power is critical to this.
- **Local availability of skilled labour:** VCs are unlikely to invest in a company that is rooted in an area that has little skilled labour around it to draw on as part of its growth strategy. Hence, the strength of the local cluster is critical to investing.

Quebec receives significantly less foreign VC financing than other provinces. PricewaterhouseCoopers LLP probed on this fact during interviews with VCs. In general, the primary response was that they are not concerned with what province they are investing in – they are seeking high-quality opportunities in strong regional clusters. Nevertheless, several points from reviewing the data and the discussions with VCs are worth noting.

- First, as noted in section 3.3 and 3.4, foreign VC financing is concentrated in certain segments of the IT sector, and activities in these segments are concentrated in Ontario.
- Some of the VCs in Canada and the US indicated that they believe that the involvement of the Government in providing financing distorts the market. It does not necessarily pick winners, nor does it encourage rational business decision-making (e.g. many government funds require that the company locate operations in Quebec, rather than where it is best for the company). The subsequent success of these under performers tends to taint the image of all Quebec start-ups.
- The language issue is perceived as a barrier by some participants, but was seen as secondary to these other issues.

6.2.7. Benefits to Canadian Firms/Canadian economy

Responses from the interviews clearly indicate that most participants believe that foreign VCs provide a host of benefits to Canadian firms.

- **Larger pool of capital.** US firms, by the very virtue of their larger market, provide an expanded pool of capital from which Canadian firms can draw on. Many participants suggested that there is simply not enough VC capital in Canada to fund the growth of Canadian companies, and accessing foreign VCs is critical to enabling the continued growth of Canadian companies.
- **Positive influence on Canadian VC financing.** While interview participants believe that the pool of capital is larger in the US than Canada, and Canadian companies need access to this, increasing involvement of foreign VCs could have additional benefits as well. It was frequently stated that increasing foreign VC financing could also increase the amount of domestic VC financing by making Canadian VCs feel more comfortable investing alongside a US VC in Canada.
- **Risk-taking.** Interview participants reported that US VCs tend to be bigger risk-takers than Canadian VCs. They tend to consider a longer time frame, and invest a larger dollar amount to increase the likelihood of success. In comparison, Canadian VCs tend to provide a smaller amount of financing, and see what the companies can do with the investment. More specifically, many people argued that US VCs provide enough financing for the firm to make significant steps forward, while Canadian VCs underfund, “giving companies just enough to fail”.
- **Valuations.** Many companies believe that they will get better valuations from US VCs than Canadian VCs. US VC survey participants explained that the growth of the VC industry in the US has created strong demand, thereby enabling companies to drive up valuations. They noted that in Canada, with fewer VC investment dollars, Canadian companies have to compete harder for a share of those dollars, and that this puts downward pressure on their valuation.
- **Connections.** Most interview participants stated that investments by foreign VCs provide direct links to key suppliers, customers, and sources of management and marketing expertise. This networking activity allows the company to grow more rapidly, and with a greater likelihood of success. However, a small number of the Canadian organizations interviewed noted that foreign VCs often do not deliver on their promise to provide the benefits of their network.
- **Better linkages to future financing.** Interview participants reported that the US industry is better stratified into different types of financiers, which enables a clearer growth plan. Smaller VCs tend to fund early stages of investment, and have connections with the larger VCs that would fund larger later stages of investment. The public equity market is seen to be much stronger and more rigorous than the Canadian market. Hence, in order to achieve liquidity and get access to larger markets for financing, many Canadian companies and VCs believe that companies need to list in the US. Financing from a US VC provides an easier stepping-stone to the US public equity market.

“Canadians go for the base hits; Americans go for the home runs.”
Jeffrey Dale,
President, OCRI

6.2.8. Drawbacks to Canadian Firms/Canadian firms

Participants in the interviews indicated that there are a number of drawbacks of foreign VC funding:

- **Limitation of Canadian equity market development.** US VCs reported that they do not want their investee companies to list on the TSE. Consequently, this may limit the strength and the growth of the Canadian equity market.
- **Pressure to become a US Company.** One of the most commonly cited disadvantages of foreign VC financing is that it often results in the movement of the head office of the Canadian company to the US. This creates a number of challenges for Canadian firms. First, many interview participants (particularly Canadian firms) noted that the movement of a head office to the US causes the company to suffer the loss of certain tax advantages available to CCPCs, the most significant loss being that of the SR&ED tax credits. Several survey participants suggested that the SR&ED tax credits should still be made available to firms operating in Canada, particularly those that have their operations concentrated in Canada. Many interview participants noted that the pressure to become a US company, and locate in the US is often just with respect to the management and/or marketing and sales head office; most US VCs are satisfied to have the engineers continue working in Canada, due to the prevalence of high-quality, low cost engineering talent in Canada. However, some of the Canadian companies reported that the geographic separation of the sales and engineering teams can lead to disconnected communications within the company. Finally, the movement of Canadian companies (or parts thereof) may involve the loss of human capital and knowledge. However, some US VCs see many benefits to having their investment remain in Canada, due to the availability of R&D tax credits, good University systems and reliable pools of human capital, and do not insist on moving the company.
- **Higher costs.** Most participants in the survey acknowledged that when a company has both domestic and foreign capital, professional fees often skyrocket due to increased legal fees. For example, cross-border deals typically involve both US and Canadian lawyers, different and more elaborate reporting requirements (e.g., Canadian and US GAAP reporting), and increased travel costs (e.g., investors from various locations, more presentations and meetings). This can be particularly burdensome for small high growth companies that are already facing significant cash flow pressures.
- **Less forgiving.** Representatives of Canadian firms noted that US VCs operate on a portfolio model, where the human aspect is less visible. Some of the representatives believe US VC can be less forgiving on problems in delivering results.

7. Conclusions and Recommendations from VCs and Canadian Firms

7.1. Key Findings

Foreign and domestic VCs serve a symbiotic role in providing the resources for Canadian companies to grow. Domestic VCs are critical for supporting new and small ventures. This is key to building a critical mass of companies and clusters of skilled talent. Foreign VCs are critical for providing an expanded pool of financing, and providing links to suppliers, customers and additional sources of talent.

7.2. Participants in the survey provided numerous recommendations for Canadian firms

- **Build a strong management team.** All companies agree that building a strong management team is the central feature to success. Most companies advise that bringing in a senior person from the US can provide the company with more experienced entrepreneurial leadership and connections than is possible with most senior people from Canada. Companies should either build a strong management team or make it clear that the existing management team is willing to work with a more experienced senior team.
- **Have a presence in the US.** This is critical if the business strategy is focused on the US customer.
- **Leverage domestic VCs.** Not only are these an important source of financing, they have connections to foreign VCs.
- **Go directly to foreign VCs, but with a referral.** It is worthwhile to develop a strong referral to the US VC (e.g., through current investors), as “going in cold” can often produce a negative outcome. Many US VCs will look at all companies that present themselves; however, the decision makers from the US VC will typically only spend time on those companies that were referred to them by someone they trust.
- **Follow the American start-up model.** US VCs recommended that Canadian companies present themselves in a similar way that American companies present – they recommend that they are very polished and strong on marketing.

7.3. Participants in the survey provided numerous recommendations for Canadian governments

- **Reform taxation policy.** Reductions to personal, corporate and capital taxes are all expected to have a positive effect on entrepreneurial activity. However, the most significant barrier to foreign VC investment is the issues surrounding foreign property classification and capital gains taxes. Many US investors have experienced significant adverse, and unexpected, tax consequences upon their exit from Canadian investments that could have been addressed through proper planning (e.g. get a Section 116). As a result, the tax environment is creating significant problems that may reverse the trend of growing foreign

VC investment. This is due both to problems associated with existing regulations that VCs have encountered on exiting their investments, and a lack of awareness about investment and taxation policies, and the consequences of adopting alternative structures. In summary, changes to the taxation system and/or clear publication of the guidelines and the options, could significantly increase the amount of foreign VC investment in Canada.

- **Fund/coordinate university research.** The Canadian university system is highly regarded by US VCs. However, Canadian governments fund proportionately less R&D than many OECD countries. Moreover, what is funded is underfunded – grants are spread across too many projects and are too small in size to be effective. The average grant size in Canada is significantly smaller than the average grant size in the US. This puts a heavy burden on researchers to always be applying for grants. It also discourages large, risky projects relative to small, incremental, predictable research. In addition, potential young entrepreneurs become discouraged, which leads to “brain drain” across the border.
- **Market to foreign VCs:** Canadian governments, media and companies should promote past successes, and existing opportunities in high-profile areas. Many investor misconceptions (e.g., higher tax rates) of Canadian investments can be resolved through marketing programs that would provide clarity to foreign investors.
- **Facilitate the building of management capability.** Canadian firms are well known for developing good IT. However, they are perceived to suffer from a lack of experienced entrepreneurial management, which limits the growth of companies. Several suggestions were offered to overcome this problem.
 - Reward entrepreneurial activity through lower taxes/tax credits.
 - Increase immigration from countries with entrepreneurial background
- **Invest strategically on a cluster basis:** The strength of the local cluster is a key factor in the investment decision. Survey participants recommended that when making decisions to establish research facilities, and launch and invest in companies, such investment should be done on a cluster basis.
- **Limit influence on investment decisions.** Some VCs reported that they believe that Government-regulated VC investments distort the market and damage the likelihood of firms attracting private financing, particularly from the US.
- **Buy from Canadian start-ups.** Several survey participants indicated that the US Government actively promotes innovation in start-ups by being among their first willing purchasers, and that Canadian Governments are seen to be risk averse.

7.4. Next Steps

Based on the information gathered throughout this engagement, the following steps are recommended.

- The critical next step would be to assess the net economic benefit of foreign VC investment in Canada. This project has sought to profile the basic elements of foreign investment in Canada. It has also identified some of the issues that may further drive foreign investment in Canada. Prior to further investigating the detailed measures that can be taken to encourage additional foreign investment in Canada, the estimated net benefit of foreign investment should be investigated. This estimation should include consideration of local job creation (particularly high-quality, high-income jobs), gross and export revenues and personal, corporate and sales tax revenue. The estimation should take into account the direct, indirect and induced effects of any incremental activity incited by foreign VC investment.
- It is also critical to investigate the longer-term impacts on the entrepreneurial and innovative capacity of the Canadian economy. For example, it is important to consider the extent to which foreign investment in Canada leads to increased transfer of head offices south of the border. Clearly, the findings from the interviews suggest that foreign investment in Canada may be lead to management and sales moving south of the border. It is critical to investigate whether this is indeed true, and whether this activity creates more jobs, and in particular more high-quality jobs, than would be the case without the foreign investors. It is also important to consider whether the movement of management and marketing expertise south of the border serves to increase the ties between Canadian business and the market power of American organizations, or whether it serves to marginalize Canadian companies.
- It is also important to consider the stimulative effect of foreign VC financing on domestic VC financing activities. Many of the interviews suggested that the opportunity to leverage foreign VCs increases the comfort level of domestic VCs, thereby further stimulating domestic investments.
- On balance, the comments from the interviews seem to suggest that the net benefit of foreign investment in Canada is positive. Several options should be examined to increase the level of foreign investment in Canada as follows:
 - Amendments to tax/investments regulations and policies.
 - The generation of clear and concise documentation on structuring options and associated tax impacts
 - Educational or accreditation criteria for VC specialists
 - Marketing material regarding the benefits associated with Canadian opportunities.

Appendices

Appendix A: List of Interviewees

Canadian Companies – Receiving Foreign Financing

1. Godfrey Marchand, Zelos Therapeutics Inc.
2. Hélène Baril, Hyperchip Inc
3. Jim Grey, Radiant Communications
4. Gord Wyse, Tropic Networks Inc.
5. Steve Bower, SiGe Semiconductor
6. Brian Joe, Rev D Networks
7. David Case, Signiant
8. ITF Optical

Canadian Companies – Receiving Domestic Financing

9. Dr. Mayer, Celator Technologies
10. Chris Shelton, BigBangWidth
11. Eugen Bacic, Texar Instruments
12. Dr. Bin Huang, Cytovax Biotechnologies
13. Lorne Meikle, BCY LifeSciences
14. Graeme McRae, Bioniche Life Sciences

Canadian VCs

15. Nancy Harrison, Ventures West
16. Rod Anderson, Ventures West
17. Minhas Mohamed, MM Venture Partners
18. Andrew Waitman, Celtic House

Canadian Intermediaries

19. Bonnie Wright – Virtual CFO
20. Evan Kelly, Corporate Finance, PricewaterhouseCoopers LLP
21. Jeff Dale, Rob Woodridge, OCRI

Foreign VCs that have invested in Canada

22. Charles Chi, Greylock Ventures
23. Jim Orlando, Battery Ventures
24. Matt Lori and Chris Albinson, JPMorgan Partners
25. Nick Darby, Dow Venture Capital
26. Max Straube, OCG Ventures Inc.
27. Amit Srivastava, Entrepia Ventures
28. Rick Ratner, Transamerica Technology Finance
29. Patrick Keefe, Atlas Ventures
30. Ravi Jacob, Intel
31. Ken Wigglesworth, Newbury Ventures

Foreign VCs that have not invested in Canada

32. Eric Young, Canaan Partners
33. Austin Ventures
34. Sydney Shepard, Kinetic Ventures
35. Murray Metcalfe, Lee Munder Capital Group

Foreign Intermediaries

36. Stephen Hurwitz, Testa, Hurwitz, and Thibeault

Appendix B: Questionnaires

Questionnaire for Foreign VCs that have invested in Canada

1. Confirm length of time investing, sector, etc.
2. How do you typically learn about investment opportunities? How do you typically learn about Canadian investment opportunities (e.g. local operation, syndicates, research, alumnus, management, newsletters/magazines, professional firm referral, etc.)? How important are intermediaries? Are you typically the lead?
3. Do you only invest if there is a Canadian VC involved?
4. What are the key factors that have attracted you to investing in Canadian firms (e.g. technology, business opportunity, R&D tax credits, low cost of labour, quality of skilled labour, etc.)?
5. How important are direct flights
6. What are the key factors that dissuade you from investing in Canadian firms (e.g. technology, business opportunity, taxes, legal or regulatory issues, lack of skilled personal, lack of awareness of opportunities, distance, lack of knowledge of legal, tax and regulatory issues, lack of relationship with local professional services firms, repatriation of investment)?
7. Does your fund have any restrictions on its investments – e.g. 10% to 15% limit on companies domiciled outside of the US? Ensure no requirement to file income taxes in Canada?
8. Are there certain regions they would be more apt to investing in, and why? Are clusters or a critical mass of firms in an industry in a region an important factor?
9. How do your key terms and conditions for investing in Canadian firms differ from those for American firms?
10. What is your exit strategy (M&A, IPO, cash flow from operations)? How does this differ for domestic firms?
11. How does a prospective Canadian firm have to rate relative to an American firm in order for you to consider investing (e.g. does it have to have a higher expected ROI)?
12. What can Canadian firms do to increase financing from VCs
13. What can the Canadian government do to encourage foreign VC financing in Canada?

Questionnaire for Foreign VCs that have not invested in Canada

1. Confirm length of time, sector of investment.
2. How do you learn about deals (e.g. referrals, other investors)?
3. Have you ever considered investing in a Canadian Company?
 - a. If yes, how did you learn about them?
4. Why did you not invest (too far to travel, preference for domestic/regional location, lack of awareness of deals)?
5. What are the key advantages that you see regarding investing in Canadian firms (e.g. technology, business opportunity, R&D tax credits, low cost of labour, quality of available talent pool ,etc).
6. What are the key factors that dissuade you from investing in Canadian firms (e.g. technology, business opportunity, taxes, legal or regulatory issues, lack of skilled personal, lack of awareness of opportunities, distance, lack of knowledge of legal, tax and regulatory issues, lack of relationship with local professional services firms, repatriation of investment)?
7. Are there certain regions they would be more apt to investing in, and why? Are clusters or a critical mass of firms in an industry in a region an important factor?
8. What are your key terms and conditions for investing?
9. What is your exit strategy (M&A, IPO, cash flow from operations)? How does this differ for domestic firms?
10. How would a prospective Canadian firm have to rate relative to an American firm in order for you to consider investing (e.g. does it have to have a higher expected ROI)?
11. Is there anything that would increase your interest in investing in Canadian firms (e.g. closer ties with domestic VCs)
14. What can Canadian firms do to increase financing from VCs
15. What can the Canadian government do to encourage foreign VC financing in Canada?

Questions for Canadian firms that have received foreign VC financing

1. How has your company raised financing to launch and grow the business (e.g. founders, friends and family, angels, customers, etc.)? What procedure do you typically go through when seeking financing (e.g. direct to VCs, lawyers, intermediaries)?
2. Did you see financing from both Canadian and foreign VCs? Why?
3. What are some of the advantages of obtaining financing from foreign VCs?
4. What are some of the disadvantages or challenges associated with obtaining financing from foreign VCs?
5. How do the terms and conditions vary between Canadian and US VCs?
6. Are you a CCPC? Was the maintaining of CCPC status an important issue for the US Investors? Were you designed with incoming US VCs in mind, or did how was the structure changed when the US VC round closed.
7. How is your company operating differently than it would without the US VC financing (e.g. larger, purchasing more from the states, etc).
8. What are the positive impacts of foreign VC investment in Canada?
9. What are the negative impacts of foreign VC investment in Canada?

Questions for Canadian firms that have not received foreign VC financing

1. How has your company raised financing to launch and grow the business (e.g. founders, friends and family, angels, customers, etc.)? What procedure do you typically go through when seeking financing (e.g. direct to VCs, lawyers, intermediaries)?
2. Did you seek financing from American VCs? Why/why not? Have you had any offerings from US VCs and if so, why did you turn them down?
3. What are some of the advantages of obtaining financing from American VCs?
4. What are some of the disadvantages or challenges associated with obtaining financing from American VCs?
5. How does your company operate differently than it would with US VC financing (e.g. larger, purchasing more from the states).
6. What are the positive impacts of foreign VC investment in Canada?
7. What are the negative impacts of foreign VC investment in Canada?

Appendix C: Profiles

Canadian Companies that have received foreign VC financing

Hélène Baril, Director Finance, Zelos Therapeutics - www.zelostherapeutics.com
Company Summary Zelos Therapeutics Inc., founded in 2001, was a spin-off from the NRC
Financing – The company completed a Series A financing in December 2002 for \$14 million Canadian with Canadian and US VCs. The company had completed an earlier seed round of \$1 million in the form of a convertible debenture.
Key points <ul style="list-style-type: none">• Securing US VC financing has enabled them to raise more money and develop more US contacts than would have otherwise been the case.• US VCs take a strong interest in the company, and provide a significant amount of information on an ongoing basis.• US VCs are better stratified than Canadian VCs. Smaller VCs tend to fund early stages of investment, and have connections with the larger VCs that would fund larger later stages of investment.
Hélène Baril, Director Finance, Hyperchip Inc. - www.hyperchip.com
Company Summary Hyperchip is delivering revolutionary technology that is the cornerstone for Next Generation Networks - the core infrastructure that addresses the convergence of voice, video, and data with efficient scaling and truly manageable IP networks.
Financing – Hyperchip is backed by some major names in the investment community, and has raised some US \$140 million in financing since its inception. Its leading investors include TechnoCap, Siemens Venture Capital, Argo Global Capital, Vertex Technology Fund, Advent International, Optical Capital Group, Altamira, Amerindo, Artemis, JT Ventures, Morgan Stanley, Pilgrim Baxter, Putnam Investments, and Van Wagoner Capital Management.
Key points <ul style="list-style-type: none">• It is critical for Canadian companies to attract foreign VC financing in order to compete on the global stage. Foreign VCs with a wide network of contacts, including potential customers and partners, provide Canadian companies with the opportunity to expand sales and attract additional resources.• In order to attract foreign VC financing, Canadian companies require a strong management team, good local support and an innovative product or service addressing a growing market niche with world-class potential.• Canada is a great place for small innovative start-ups with a pool of very talented people. The next step is to put additional effort and resources to create specific technology clusters that will help small players to emerge from their start-up stages and compete at an international level.

Foreign VC Investment in Canada

Jim Grey, President and CEO, Radiant Communications, Vancouver, BC

Company Summary – Founded in 1996, provides Internet services specifically for the business market. Those services include Internet connectivity, web hosting, website development and design, as well as e-commerce services, application hosting services, and the full spectrum of web-based and traditional marketing and advertising.

Financing – Trades on TSX Venture Exchange (RCX).

- Prior to 2000, received minimal financing from friends and family (approx. \$250K)
- Dec 2000 - 1st round - \$5M USD – Encompass, Cascadia, GrowthWorks
- 2002 Amalgamation with Castle Bay Enterprises Ltd., a capital pool company. Castle Bay had no cash, but was a clean shell.
- Raised \$5M in going public (through Cannacord Capital). \$2.5 million from public issue, \$2.5 from CEO and current investors.
- Converted \$6M in loans at \$1.25/share

Key points

- Contacts are extremely important” - Financed with US VCs (Seattle-based) in first round. Talked to Canadian VCs as well. However, US VCs, attracted through a relationship with one of the company’s high-net worth investors. High-net worth investor believed in company’s story, and introduced the company to Encompass. Cascadia historically invests with Encompass. US VCs seem to attract other US VCs.
- Many companies will experience longer financing periods as VCs are conducting more elaborate due diligence. Companies should ensure that they have enough money to achieve their goals before the next financing round.
- Looking for financing is similar to selling your product, but the product is your company. Mr. Grey did not feel that the business plan was as important as the presentation to investors. The quality of the presentation and the timing that the presentation is made is very important.
- US VCs usually want the Canadian company to set up as a US company as it would help attract more US investors and position the company better to sell to US customers.

Chris Shelton, General Manager, BigBangWidth

Company Summary - BigBangwidth is developing nanomachining of all-optical grids for fiber-optic telecommunication networks

Foreign VC Investment in Canada

Financing – The company has been through seven rounds of financing

Seed round - \$0.5 million from founders and Canadian VC financing

6 additional rounds – totalling \$6.2 million in Canadian VC financing

Management:

- Dan Gatti, President and CEO – former experience – President and CEO of MAYAN Networks (American)
- Brian Moore, Co-founder and CTO – former experience - founder and chief engineer for Tsiger Systems Ltd (Canadian?)
- Chris Shelton, General Manager - Vice President, Finance and Administration for the Software Systems Division. ADC Telecommunications.

Key points

- There are significant benefits to increasing foreign VC investment in Canada. Local investors feel much more comfortable if they think they are co-investing with a US VC – they want the validation of a US expert. This enables more capital to be generated overall. As well, US VCs may generate more attractive exits for the entrepreneur which ultimately benefits the Canadian economy.
- US VCs learn that the only economic place to do a start up is in Canada. The cost of doing R&D in Edmonton versus Silicon Valley is about 80% less. This does not even include the savings from an IRAP grant or a regional grant that reduce the actual cost even further.
- Canadian government should embark on a major education strategy for US VCs. They should contract somebody like our CEO, who is an American doing a startup in Canada, to go around and talk to all of the VCs. This would be supported with educational materials, case studies, etc.
- Canadian firms also need to be educated on the potential objections that US VCs are bound to make. A marketing document, supplied by the government should outline all of the objections along with the standard messaging.

Eugen Bacic, Texar Corporation

Company Summary - Texar Corporation is an infrastructure software company that builds information security products for user authorization. Texar's products enable businesses to securely share information with anyone, from anywhere at anytime; regardless of platform, server, or application, by implementing and enforcing their business rules.

Foreign VC Investment in Canada

Financing - Launched in 1998, sold in 2002 for assets plus servicing of its \$5 million debt

Key points

- The success or failure of any company is always dependent, in part, on the market, and the luck of the company in timing.
- The key step that the company could have taken to ensure its success was to have a senior management team on board at its inception so that it could thoroughly understand the product, technology and customers, and therefore have the expertise, experience and market comprehension necessary to lead the company through its initial growth.
- There are various ways the Government could facilitate stronger growth in Canadian companies.
 - Be less risk averse, and more like the American Government and buy from small Canadian companies.
 - Offer tax breaks for companies that buy from small companies.
 - Increase the tax incentives for rolling the gains from company investments into new companies.

Dr. Bin Huang, President & CEO, Cytovax Biotechnologies, Edmonton, AB, www.cytovax.com

Company Summary - Cytovax is a biotechnology company focusing on the development and commercialization of vaccines and therapeutics products for the prevention and treatment of infectious diseases. Cytovax has signed a licensing and co-development agreement with BioChem Pharma Inc. for its lead product, Cytovaxine.

Foreign VC Investment in Canada

Financing – The company has had five rounds of financing and an IPO:

- 1998 - \$1.5 million, RBC Ventures and Business Development Bank of Canada
- 1999 - \$1 million in bridge financing (same VC investors)
- 1999 - \$2 received by BioChem Pharma Inc. as part of license agreement
- 2000 – \$8 million private placement
- 2001 – \$10 million IPO on the TSE – symbol CXB
- 2002 - \$5.3 million private placement

Key points

- Cytovax was pleased with its relationship with its VC investors as they understood Cytovax’s business and supported their efforts.
- Canadian companies need to have a good management team in place that is experienced, well respected in their specific industry, and is well respected by the financial community. Canadian companies must also have great intellectual property and product that is packaged in a very compelling story (and is understandable by a wide audience). When approaching VCs for the first time, management must have a “long-term view”, as financing rounds take much longer than anticipated to close.
- Government must help build the biotech sector in two ways: 1) people and 2) money.
 1. **People.** The government should develop policies to attract skills into Canada, such as senior management with the experience of bringing biotechnology to the market. Government must recognize that many Canadian communities are isolated or “off the map” to US investors.
 2. **Money.** The government should evaluate the current policy of the loss of SR&ED tax credits for public companies. Refunds should still be allowed to publicly-traded Canadian companies. Other suggestions include matching VC investment into Canadian companies, and flow-through share structures.

Lorne Meikle, BCY LifeSciences Inc. www.bcylifesciences.com

Company Summary - BCY's corporate focus is the acquisition of novel pharmaceutical technologies and the subsequent development of these technologies in a timely and cost effective manner. The Company intends to acquire technologies that have been developed to at least the point that drug candidates have been identified and for which some proof of principle in animal experiments has been demonstrated.

Financing – The company has been through only one round of VC financing as it has been primarily financed from the public sector by private investors, as the company is publicly traded. In the one VC investment, this was for \$3 million and it was completed in September of 2002.

Foreign VC Investment in Canada

Key points from Interview

It is very difficult to attract US VC financing if you require a small amount of capital. VCs, whether they are in Canada or the US consume the same amount of time for large investments as they would for smaller ones. The smaller US deals can be, generally speaking, the size of many larger Canadian deals. As a result, the US VC's show little interest in Canadian investments, tending to focus more on the larger deals in order to maximize their portfolios.

Canadian VC's tend to be more selective when responding to enquires for investment. This could be a result of the Canadian VC's possessing smaller pools of available capital and because they seem to have a more narrow focus.

Graeme McRae, Bioniche Life Sciences Inc., www.bioniche.com

Company Summary - Bioniche Life Sciences Inc. is a fully integrated, Canadian biopharmaceutical company engaged in the research, development, production and commercialization of proprietary technologies for human and animal health markets worldwide.

Financing – The Company has been through three rounds of financing:

September 2000: \$6.45 million in Canadian VC financing

June 2001: \$10 million in Canadian VC financing

May 2003: \$13.5 million in Canadian VC financing

Key point

When investing in Canadian companies, foreign VC firms have the tendency of moving Canadian companies outside of Canada in order to foster growth and exert control. As a result, Bioniche has deliberately avoided foreign financing. With Bioniche's extensive R&D activity in Canada, it is critical that the company attempts to commercialize and manufacture its products in Canada in order to achieve the required returns. Domestic financing therefore allows Canadian companies to retain control of all marketing and manufacturing activities.

Canadian Venture Capitalists

Nancy Harrison, Ventures West – www.ventureswest.com

Established in 1968, Ventures West has over 100 companies in their portfolio, and over \$400 million under management

Sectors of investment: Information Technology, Telecommunications, Biotechnology, Energy

Key points – Nancy Harrison – Senior Vice-President

Foreign VC Investment in Canada

- VenturesWest actively co-invests with US VCs. Co-investing with US VCs is important for Canadian VCs because many US VCs have deep pockets and can provide follow-on financing for significant high growth opportunities and they have deep connections that can facilitate the growth of Canadian companies.
- The life sciences sector is still in its infancy – we need more home runs like Biochem Pharma and QLT Therapeutics before the industry will develop the reputation required to attract significant foreign funds.
- The key role that Governments should play is to focus on goods of a public nature, and fund more university research.

Minhas Mohamed, MM Ventures Partners – www.mmvp.com

Company Summary – GATX/MM Venture Partners is a \$250 million Canadian partnership between GATX Financial Corporation (a unit of GATX Corporation) and MM Venture Partners. The Partnership focuses exclusively on public and private technology companies in Canada. The Partnership provides financing to early and mid-stage Canadian information technology and biotechnology companies. GATX/MM’s portfolio currently includes 40 investments totalling over \$130 million, with a targeted investment program (including follow-ons) of \$40-\$50 million annually.

Sectors of investment – Life Sciences, High Technology, Communications, Software and Services

Key points

- Canadian firms are viewed as the best producers of technology in various sectors (e.g., telecommunications, semiconductor, financial services technology), with very strong management in R&D. Canadian firms, however, are weaker in sales and marketing management and lack 2nd and 3rd generation entrepreneurial class.
- Canadian firms must realize that the US VC market are currently in a “bloodbath”, and be reasonable with its financing objectives and valuations. Companies also need to “spend more time” in the foreign markets (particularly in the US) to build stronger relationships with customers and investors, and learn from US marketers.
- Government should consider equalizing tax rates between Canada and the US, and make major strides in creating a “transparent” border between the two countries. Government should also be more supportive of the independent VCs and funders.

US Venture Capitalists that Have Invested in Canada

Matt Lori and Chris Albinson, JPMorgan Partners – www.jpmorganpartners.com

Founded in 1984, JPMP has invested in over 30 countries with approximately \$23 billion under management.

Canadian start-ups that JPMorgan has invested in: Xenon Genetics Inc., Catena Networks and Sleep Canada

Ranked 4th among US VCs in number of deals in 2002 according to PwC MoneyTree

Foreign VC Investment in Canada

Sectors of investment: Biopharmaceuticals, Electronics and Computer Hardware, Energy and Environmental Technologies, Internet Sector, Communications Infrastructure and Software

Key points

- Canadian companies are particularly strong at combining business and technical considerations to develop products in a cost-effective, timely fashion however they are weak in the area of sales and marketing
- The network between Canadian companies and the Canadian community is not as strong compared to other cultures. Indian and Israeli companies do a better job of leveraging relatively lower cost R&D, while leveraging their ex-pat community in the US to accelerate sales and financing.
- Cracking into the Canadian deal flow is difficult, as Canadians like to co-invest with Canadians. The situation is improving with technology companies in the east working with Boston, however other private equity is still a closed and thin market.
- Investment in the Canadian market requires a higher ROI than similar foreign investments. This is due to the limitations and costs associated with various regulatory issues and adverse tax consequences.
- Labor sponsored funds (LSFs) are hurting the Canadian private equity market by their structure. Year-end spent mandates and restrictions on placement cause funds to place capital blindly at the end of the calendar year. This is likely to result in many failed companies and a failure of the LSFs themselves in the medium term. Two changes would help mitigate this. First, relax the placement window for the funds to a three-year term. Second, allow the LSFs to act as fund of funds and place the capital into early stage venture firms similar to what CPP is doing. (I.e. Skypoint, Celtic House, Ventures West.)

Max Straube, General Partner, OCG Ventures– www.ocgventures.com

Formed in March 2000, OCG has made investments in companies with the potential to establish leadership positions in major segments of the global market for communications equipment and services.

Canadian start-ups that OCG has invested in: Hyperchip and YottaYotta.

Sectors of investment: data, cable and telephony communications infrastructure companies.

Key points

- Canadian firms historically have had a reputation of being “promotional” – over-promising and less execution. This may be the result of the company being located in a remote location, thus creating the belief that the company needs to make a big impression. This is not viewed as beneficial to the US investor.
- Canadian firms should try to maintain the advantages of being a Canadian company (e.g., SR&ED tax credits, lower cost of product development, strong University system). When approaching US VCs, the Canadian company must demonstrate a conventional business with a capital efficient and fully-funded business plan, realistic milestones and funding requirements,

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and a clear path to profitability. The promotional “sizzle” is not required by a US VC, as conservatism is more appropriate.

- Government should address the issue of inconvenience for US VCs travelling into Canada (e.g., more efficient travel routes through Canadian airports). There should be seamless travel across borders, thus reducing the inconvenience to US VCs travelling north.

Amit Srivastava, Chief Investment Officer, Entrepia Ventures – www.entrepia.com

Entrepia Ventures invests in private, technology-based, expansion-stage companies that stand to benefit from market or technology affiliation with Japan. Established in November 15, 1999, Entrepia has 2 funds: **Fund I** was US\$30 MM, invested in 21 portfolio companies (including Convedia and TeraXion), and is now closed for new investment. Entrepia has raised US\$50MM (out of a final target of US\$100MM) for its **Fund II**, for which they are just beginning to invest. Entrepia Fund II is actively considering investment opportunities worldwide in IT, communications, electronics and core technologies, and seeking to partner with early stage VC funds seeking value creation in their portfolio companies through business development in Japan.

Canadian companies that Entrepia Ventures has invested in: Convedia (Vancouver, BC), and TeraXion (Saint-Foy, Quebec).

Sectors of investment – Next generation communications network related products and services, wireless network related products and services, broadband network related products and services, semiconductors and electronics, and internet-based technologies and services.

Key points

- Entrepia has recently opened an office in Montreal, and with on-the-ground presence in Canada, Entrepia anticipates making more Canadian investments in the future.
- US VCs would be vary of the extent of government involvement in the VC investment arena; however, it should continue to support Canadian private companies in the early stages and work to improve perception and reality of the risk/return trade-off for foreign investors.
- Entrepia does not distinguish between investments in Canada or the US, and will invest in Canadian companies as long as the investment is compelling. The “border” is irrelevant.

Rick Ratner, Managing Partner, Transamerica Technology Finance – www.transamericafinance.com/ttf

Transamerica Technology Finance has committed \$1.5 billion in debt financing to venture backed, technology-based companies in the US and Canada. The company provides senior term loans, equipment and leasehold financing, revolving credit facilities, and bridge loans. The company is a member of Transamerica Finance Corporation’s family of businesses.

Transamerica has invested in approximately 10 Canadian companies.

Sectors of investment – Information Technology, Life Sciences and other Technology

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Key points

- Transamerica Technology Finance provides debt-financing to companies that have received equity financing from venture capitalists. The company tracks investment opportunities by monitoring companies that receive equity financing in both the US and Canada. Therefore, strong support from the initial investors is a key criteria for investment. Transamerica Technology Finance continues to be aggressively looking for investment opportunities in Canada.
- There are more debt players in the Canadian market in the current environment, yet Canadian companies have been less inclined to use debt instruments for their financing needs than US companies.
- Canadian companies need to focus on increasing their exposure in the US market in order to attract US investors. US investors tend to invest close to home, although US vc investment activity and presence in Canada (conferences, etc.) is on the rise.
- Government should evaluate how their funding programs and policies impact and prevent investors from making investment in Canada (e.g., Quebec government have aggressive loan programs that offer favourable terms that keep other investors from participating in the market. Either the investors cannot compete with the terms or they cannot secure enough assets in the transaction to meet their investment criteria)
- Certain regulations and policies differ between the Canadian and US equity markets (e.g., TSX, TSX Venture, NASDAQ), and this may hinder foreign investment into Canada (e.g., TSX Venture limits warrant terms to 2 years).

Patrick Keefe, Associate, Atlas Ventures – www.atlasventure.com

Founded in 1980, Invested in over 150 companies worldwide, manages over \$2.1 billion in committed capital

Canadian start-ups that Atlas Ventures has invested in: Allelix Biopharmaceuticals Inc., Neurochem, Inc.

Sectors of investment: Information technology, communications, life sciences

Key points

- Atlas Ventures is aggressively looking for opportunities in Canada. Commonly cited barriers to investment (e.g., taxes, proximity of investment) do not play a role in the company's decision to invest. However, Canadian companies need to be flexible to the idea of opening a business office in the US if it makes good business sense.
- Canada cannot rely solely on its R&D excellence in the future. It must build capacity on all fronts (e.g., management human capital, risk capital, major corporations, etc.) as it will not be able to compete on a cost basis with countries such as China, Paskistan and India.
- There are not a lot of barriers to investment in Canada. The government should focus primarily on building a talent pool that stays in Canada, improve the capacity of domestic risk capital, and look at ways to fund indigenous Canadian corporations.

US Venture Capitalists that Have Not Invested in Canada

Eric Young, General Partner, Canaan Partners – www.canaan.com
Founded in 1987 – Invested in companies from US, Europe and Israel
Ranked 7 th among US VCs in number of deals in 2002 according to PwC MoneyTree
Sectors of investment: Information Technology, Life Sciences
Key points <ul style="list-style-type: none">• Canaan Partners likes to invest in companies where they can be close to the people running the organizations• In order for an investee company to be successful, they must be successful in the US market. They will invest in foreign companies to help them establish a US presence.• Canadian companies seeking to obtain US VC financing should have a plan for being successful in the US marketplace, and establish a presence in the US.

US Intermediaries

Canadian Intermediaries

Jeffrey Dale, Rob Woodridge, Ottawa Carleton Research Institutes, www.ocri.ca
The Ottawa Centre for Research and Innovation (OCRI) is one of Canada's most successful partnership organizations. The OCRI is the rallying point for business, education and government to advance Ottawa's globally competitive knowledge-based economy. With and through its members and partners, OCRI brings people, ideas and resources together - through connectivity - to build wealth and quality of life in Ottawa. The OCRI's contribution includes: <ul style="list-style-type: none">• Developing and enriching Ottawa's talent• Marketing Ottawa to attract talent, investment and business• Enabling entrepreneurs to establish and grow their businesses• Meeting Canadian and global demands through intellectual and technological innovation• Facilitating collaborative, leading edge research

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- Fostering lifelong learning
- Developing infrastructure and online service delivery for a 21st century City

Key points

- Canadian expatriates located in the US have been key to bringing US VCs into Canada
- Canadian companies offer good valuations, great products with ready customers, and a skilled workforce. We are sometimes our own worst enemy. Many of the Canadian companies that have moved their head offices to the US have not done any better than Canadian companies.
- Canadian companies need the foreign dollars to continue growing. We need to develop stronger relations between Canadian and US VCs
- We need to improve the climate for entrepreneurs and corporations. We need to remove punitive taxes, create special provisions for risk-taking financiers, create a way to crystallize capital losses improve the regulatory climate.
- Foreign VC's have invested in Ottawa based companies because of the quality of the opportunity, including our technology, people and the local infrastructure.

Appendix D

Life Sciences

- Biopharmaceuticals
- Healthcare
- Medical Devices and Equipment
- Medical/Biotech Software and Information Services

IT

- Communications and Networking
- Electronics and Computer Hardware
- Internet Focus
- Other IT Services
- Semiconductors
- Software

Other Technologies

- Energy and Environmental Technologies
- Other Technologies

Traditional

- Consumer and Business Services
- Consumer Products
- Manufacturing
- Miscellaneous
- Retailers

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