



CANADA'S VENTURE CAPITAL & PRIVATE EQUITY ASSOCIATION
ASSOCIATION CANADIENNE DU CAPITAL DE RISQUE ET D'INVESTISSEMENT

December 20, 2005

The Honourable Dwight Duncan
Minister of Finance of Ontario
c/o Budget Secretariat
Frost Building North, 3rd Floor
95 Grosvenor Street
Toronto, ON
M7A 1Z1

Dear Minister,

On behalf of Canada's Venture Capital and Private Equity Association (CVCA), I am pleased to provide you with our views concerning the steps that can be taken by the Government of Ontario to create a new generation of economic growth.

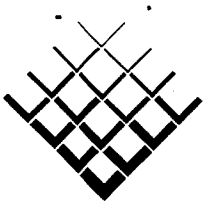
Headquartered in Toronto, the CVCA represents the interests of Canada's venture capital and private equity industry. Its 1,000-plus membership includes the large majority of venture capital and private equity funds who collectively have over \$50 billion in capital under management. 55% of the CVCA's members are located in Ontario.

We believe that the path to prosperity necessarily involves public policies to stimulate the birth and maturation of paradigm-altering companies that can compete against and beat the best in the world. Simply put, Ontario needs to foster the growth of the next generation of world leading innovative growth companies – the Microsofts, Intels and Googles of tomorrow. These kinds of innovative high growth companies are essential to the future success and prosperity of Ontario in today's flat world.

One critical step on the path to our future prosperity is to ensure that today's entrepreneurs seeking to build these new market leading businesses can access the capital they need to compete head-to-head with their generally better financed competitors in the United States. The relative shortage of venture capital in Ontario, and in the rest of Canada, is a major roadblock on the path to prosperity. The CVCA believes that removing that obstacle will require public policy support to enable the venture capital industry to tap existing pools of capital that are, by and large, locked in pension funds.

The Situation Today

Our venture capital industry today is considerably smaller than our U.S. counterpart. This means that we are less able to provide the financial support required to fund high growth, high potential companies at all stages of development.



At the macro level, the federal government's November 14, 2005 document, "A Plan for Growth and Prosperity" shows that venture capital investment in Canada (average annual disbursements) from 1995-2004 was only two-thirds of that in the U.S. (Chapter 7, "Building the Right Investment Environment" – page 140).

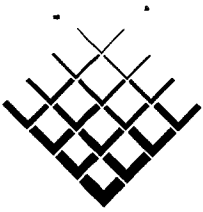
At the individual firm level, our data reveals that average venture capital investments per portfolio firm, which in Q3 2005 stood at \$1.6 million, range from one-third the amount provided by U.S. venture capital funds to their companies at the early stages to one-quarter the amount at later stages.

Simply put, our high potential companies that need to compete world-wide are being hamstrung by a relative lack of financing. Their U.S. competitors have more capital to invest in product development and marketing and can outlast our firms. Even where a Canadian firm is first to innovate, the U.S. competitor can frequently surpass the Canadian firm, or acquire its core technology, when it has access to three to four times the amount of risk capital as its Canadian counterpart, leading inevitably to the southern migration of the business. This challenge is particularly acute in the life sciences and biotechnology fields where firms can require up to \$50 million in financing prior to actually generating revenues – an amount that is largely beyond the financial capacity of most venture capital firms in Canada. In this regard, it is worth noting that venture capital investments in Ontario totalled only \$88 million in Q3 2005 – the lowest level in several years and lower than the comparable figure for Québec, where venture capital funds invested \$118 million.

The root problem is the under-funding of the venture capital industry in Canada. Our data show that the venture capital industry has been raising less money in every year since 2001. In 2001, venture capital funds raised \$4,548 million in Canada compared to \$1,668 million in 2004. All indications are that 2005 will not see any appreciable difference from the 2004 number.

At the same time, demand for financing from entrepreneurs remains quite strong – and there are signs that it is poised to pick up considerably. Most observers believe that the current market environment is exactly the right time to invest aggressively for the next economic growth cycle in technology. For example, in the telecommunications sector telco's and cableco's are locked in a battle for market dominance that is fuelling an increasing appetite for new technologies.

A relatively untapped source of capital for the venture capital industry itself resides in pension funds. CVCA data shows that institutional investors, particularly pension funds, only supply a small portion of the incoming capital in the Canadian venture capital industry. In 2004, \$1,132 million was raised from individuals and \$259 million from pension funds. The overwhelming majority of that pension fund investment comes from a small handful of very large organizations, including Ontario Teachers, OMERS, the Caisse de Depot and the Canada Pension Plan Investment Board.



Over the past several years, individual retail investors have provided important capital investment to the sector by means of their participation in the Labor-Sponsored Venture Capital Corporation (LSVCC) vehicle. However, there are several indications that this supply channel too may be drying up.

Once again, the contrast with the U.S. could not be any starker where institutional sources are the dominant providers of capital to the venture capital industry. The “Finding the Key” report (2004) that was commissioned by the federal government and six provincial governments, including Ontario, found that Canadian pension funds were considerably less involved in the venture capital and private equity industry than their U.S. counterparts.

A Solution: The Venture Capital Incentive Plan (VCIP)

The CVCA has devised the Venture Capital Incentive Plan (VCIP) to attract more pension funds, endowments and other institutional investors into the venture capital asset class, thereby increasing the supply of venture capital available to promising high growth firms in Ontario. The VCIP is a market-driven plan that would not apply to retail investors.

The VCIP is structured as follows:

Step 1 – Market Test: A venture capital firm must successfully raise a minimum of \$40 million from at least three arm’s length investors, such as pension funds;

Step 2 – Government Leverage: Government provides financial support in the form of a loan guarantee equal to an additional 30% of the amount raised in the market;

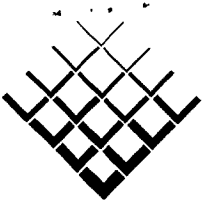
Step 3 – Investment: The venture capital firm now has 130% of funds raised for investment in high growth businesses;

Step 4 – Returns: As investments generate financial returns, capital is then distributed:

1. Initially to arm’s length investors until they have recovered all of their original capital invested;
2. Then, to fully repay the outstanding loan; and,
3. Finally, the profits are shared between the institutional investors and the venture capital firm only after the loan is fully repaid.

The benefits of the VCIP would include:

- Immediate increase in the capital available to high growth companies. The CVCA estimates that an incremental \$1 billion of capital in Canada, or roughly \$500 million in Ontario alone, would be generated by the VCIP over five years;



- Increased participation in the venture capital asset class has the potential to increase returns and reduce portfolio risk of institutional investors – to the ultimate benefit of pensioners;
- The market test described above insulates government from significant financial exposure, since government is not “picking winners”, but following the market;
- Significant leverage is provided by the guarantee mechanism, with no initial outlays of government funds and a long-term venture capital industry track record of returning capital to its investors.

We would be pleased to elaborate on this description of the VCIP with you and/or your officials. We have already discussed its architecture with the Risk Capital Working Group and with senior officials from the Ministry of Research and Innovation.

The CVCA believes that Ontario has an opportunity to provide leadership in providing a significant boost to the high growth, high innovation and high productivity sectors of the new economy that would result from the major infusion of capital provided by the VCIP.

Please do not hesitate to contact either me or Richard Rémillard, Executive-Director of the CVCA.

Yours truly,
Canada's Venture Capital and Private Equity Association

Rick Nathan
President