# Think Canada (Again)

A Presentation by CVCA-
Canada's Venture Capital
& Private Equity Association

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This report has been commissioned by Canada's Venture Capital and Private Equity Association (CVCA) and funded in part by the Government of Canada through the Department of Foreign Affairs and International Trade (DFAIT).

The report is aimed at potential international investors into the Canadian private equity and venture capital market for the purpose of introducing them to Canada as a potential investment destination. For those investors who are thinking about or already have a North American private equity and venture capital allocation, the purpose of the report is to provide more detailed information about the market than has been generally available.

The CVCA was founded in 1974 and is the association that represents Canada's venture capital and private equity industry. Its 136 member funds are firms and organizations that manage the majority of Canada's pools of capital designated for commitment to venture capital and private equity investments. The Association fosters professional development networking, communication, research and education within the venture capital and private equity sector and represents the industry in public policy matters. CVCA members have over $75 billion in capital under management, in distinct market segments.

- Buyout is characterized chiefly by risk investment in established private or publicly listed firms that are undergoing a fundamental change in operations or strategy. Buyout funds are often called such, even if their mandates are not exclusively buyout related.

- Mezzanine is characterized chiefly by use of subordinated debt, or preferred stock with an equity kicker, to invest largely in the same type of companies and deals as buyout funds.

- Venture Capital (VC) is characterized generally by investment in early stage companies, mostly in technology businesses.

Given the different histories and characteristics of the two main market segments, this report discusses VC separately from other segments of the private equity asset class.

All data is from Thomson Reuters, unless otherwise stated. All dollar amounts are in Canadian dollars (as at 31 August 2010, 1 CAD = 0.94 USD), unless otherwise stated.

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# Executive Summary

The Canadian economy is vibrant, has been outperforming the rest of the G7 and is ranked by the Economic Intelligence Unit as the #1 place to do business in the G7 for the next five years. KPMG surveys find Canada leading the G7 in low business costs, especially taxes. The World Economic Forum placed Canada at the top of the rankings for streamlining procedures to set up a business and #1 for the soundness of its banks since 2008. Canada is open for business!

Canada's educated workforce (ranked #1 in the OECD for college completion rates and #3 for the quality of its management schools), abundant natural resources, and easy access to major markets place it in an exceptionally competitive favorable position. The public policy environment is strongly supportive of innovation with Canada #2 in the G7 in the generosity of total R&D tax incentives. In addition to fiscal support, the Government has also provided support by acting as a catalyst to assist in the commercialization of innovation.

The Canadian venture capital and private equity industry enjoys an enabling environment (in terms of regulatory predictability, reasonable supervision, reporting standards, sophistication of financial markets, inter alia) and corporate ethos (in terms of regard for good governance, accountability and transparency) that help ensure that interests between LP's and GP's are aligned. Canadian-based GP's observe Institutional Limited Partnership Association (ILPA) principles as a guide to best practices and as a de facto industry standard to guide the industry. The Canadian industry also endorses the International Private Equity Valuation (IPEV) guidelines that are the international standard for portfolio valuation.

Canada boasts a thriving buyout sector with stellar returns that have outperformed the US and Europe by any measure. Canada's low penetration rate measured by disbursements to GDP suggests the market has been underserved and demand is high. The venture capital market in Canada, which has had numerous technology successes and has experienced returns comparable to the US, has been undergoing significant transformation. A new breed of domain-specific managers is poised to deliver enhanced performance.

Think about including Canada in your investment plans. Canada's private equity and venture capital market is rich with opportunities.


Come in We're
OPEN

## **Part 1:**
## Canada is Open for Business

## A Newly Recognized 'Economic Star' *(The Economist, 06 May 2010)*

What a difference to perceptions a global financial crisis can make. In the case of Canada, perception has finally caught up with reality. That reality has been reflected in Canada's acceptance into the top ten of the World Economic Forum's Competitiveness ranking where it has remained since graduating from 13th place in 2007/08 *(The Global Competitiveness Report)*[1].

This ranking is echoed in a similar survey carried out by internationally renowned Swiss business school, IMD, which recently announced that Canada had moved up from 8th position in 2009 to 7th in 2010. Canada has also enjoyed a Triple A international credit rating from Moody's since 2002.

Praised by the IMF for a track record of sound macroeconomic policies, for a proactive response to the crisis and for maintaining and preserving financial stability *(IMF 2009)*, Canada has been well positioned to weather the economic storm and resume expansion. It is indeed enjoying a 'Goldilocks' recovery *(Economist, 06 May 2010)*. This good news story is based on a track record stemming from a remarkable turnaround in the mid-1990s, following a 1995 editorial in the Wall Street Journal infamously dubbed Canada 'an honorary member of the Third World' due to out-of-control spending resulting in public debt approaching 70% of GDP and an unhealthy economy.

Today's Canadian economy is vibrant and has outperformed the rest of the G7, with a 1.7% growth rate over the decade from 2000 to 2009. The most recently revised IMF forecast calls for GDP growth to reach 3.6% in 2010, well above the forecast average of 2.3% for advanced economies and above the forecast for all other members of the G7 *(IMF World Economic Outlook Update 07 July 2010)*. By 2009, Canada's economy, at US $1.3 trillion, was the world's 10th largest on a GDP basis, while on a GDP per capita basis, Canada ranks 4th amongst its peers (developed countries with populations over 10 million) *(Institute of Competitiveness and Prosperity, 2010).*

On the fiscal side, Canada enjoyed eleven consecutive years of fiscal surpluses following deficit reduction efforts implemented in the mid-1990s; these ended only in 2007/08 with stimulus programs introduced in response to the global financial crisis. Notwithstanding, Canada's debt to GDP ratio of 35% is the lowest amongst leading industrial economies *(Financial Times, 25 June 2010)*, a big improvement over the mid-1990s when it was second highest in the G7.

The Economist Intelligence Unit has ranked Canada the #1 place to do business in the G7 for the next five years. This is supported by 2010 surveys by KPMG that find Canada leading the G7 in low business costs. The World Economic Forum and World Bank have both placed Canada at the top of the

[1] The ranking is based on a survey of 133 nations, analyzing 12 factors that are designed to capture the medium- to long-term productivity and growth prospects. Canada ranked 10th in 2008/09, 9th in 2009/10 and 10th in 2010/11.


rankings for streamlining procedures to set up a business. In its Doing Business in 2010 report, the World Bank ranks Canada #2 worldwide for ease in starting a business (behind only New Zealand), measured on the basis of procedures, time, cost and paid-in minimum capital to open a new business, while the World Economic Forum's 2010/11 Global Competitiveness Index ranks Canada #1 for the number of procedures required to start up a business. The message has not been lost on investors: accumulated FDI inflows into Canada between 2000 and 2008 totaled US $363.2 billion, the 6th largest inflows in the world. As a share of 2008 GDP, these inflows placed Canada in 4th place in the world.

# Low Taxes, Strong Financial Sector

With the aim of ensuring that Canada can compete as a low-cost place to do business, the federal government has embarked on a number of recent initiatives.

In the 2010 federal budget, tariffs on all manufacturing inputs are to be reduced to zero by 2015, with most cuts being implemented in 2010, making Canada an effective national 'free trade zone' for investors. These cuts, coupled with a 50% straight-line depreciation method for manufacturing and processing equipment, provide real cost incentives for capital investment.

Canada already has the lowest payroll taxes amongst the G7. Furthermore, as part of an aggressive corporate tax reform initiative, the federal corporate income tax rate will decline from 18% in 2010 to 15% in 2012, less than half the top US federal marginal corporate income tax rate. The objective is to achieve the lowest statutory corporate tax rate in the G7, a commitment made in the 2010 budget.

In fact, according to a 2010 KPMG survey, Canada <u>already</u> offers the lowest effective corporate income tax rate amongst the G7 (based on a ten-year average of combined federal and provincial effective corporate tax rates).

The resilience displayed by Canada's banking sector during the recent crisis has been widely recognized: no banks failed, none required injections of public capital and interbank money markets continued to function. The resilience was 'particularly striking given the close economic and financial links between Canada and the United States' *(IMF Country Report: Selected Issues, May 2009)*.

This strong performance has been credited to a variety of factors including: strong regulation and supervision by a single regulator, high capital requirements, and a cap on leverage. Belying past complaints that the Canadian banking sector was 'too conservative', it is now a source of envy for some and a source of lessons for others. In fact, the World Economic Forum has ranked Canada #1 for the soundness of its banks since 2008, and in 2009 promoted Canada to #3 for the sophistication of its financial market, a jump of three places.

Four of Canada's banks rank amongst North America's top ten by assets, and two of these (Royal Bank of Canada and TD Bank) are amongst only half a dozen banks worldwide that still have a Moody's Triple A credit rating *(Financial Times, 25 June 2010)*.

As to access to finance, Canada leads here too: for the second year in a row Canada leads the Milken Institute Capital Access Index, an annual ranking of entrepreneurial access to capital around the world.

# Educated Workforce, Abundant Natural Resources, and Easy Access to Major Markets

While the traditional inputs to economic growth have been labour and capital, knowledge is now widely recognized for the critical role that it plays. Canada's workforce is well-educated, ranking #1 in the OECD for college completion rates (23.7% of working age Canadian have graduated from college) and #7 for university completion rates (24.6% of Canadians have university degrees). And the quality of that education is very good: in 2010 the World Economic Forum ranked Canada #3 for the quality of its management schools and #5 for the quality of its educational system overall.

In this globalized world Canada enjoys a further advantage. As a multi-cultural nation, one in five of Canada's 34 million population has a mother tongue other than English or French, the two national official languages.

Canada has a strong democratic tradition and a stable political landscape; in 2006 The *Economist* ranked it the 3rd most democratic country in the world, ahead of every nation more populous than itself and first in the Americas.

Canada is the second largest country in the world by area, borders three oceans and is richly endowed with natural resources including:

- Oil: 7th largest producer of crude oil in the world and second only to Saudi Arabia in terms of reserves

- Gas: 3rd largest producer of natural gas

- Forestry: largest area of certified forest in the world, and the largest exporter of forest products

- Minerals: reserves of over 60 mineral resources, and within top 5 in production of nickel, zinc, platinum group elements, gold, molybdenum, copper, cobalt, lead and cadmium.

This rich natural resources base and diversity of regional economies are factors in the resilience of Canada's economy.

Through the three-way North American Free Trade Agreement (NAFTA), the largest free trade area in the world, Canada is part of the most lucrative market in the world, providing access to 452 million consumers and a combined GDP of US $17 trillion. The US and Canada are each other's largest trading partners with two-way trade in goods and services amounting to $740 billion in 2008, or about $1.4 million/minute, a trade facilitated by a business-friendly Smart Border Accord.

With 17 of Canada's 20 cities within a 1.5 hours drive of the US border and within a 2 hour flight from major US cities, Canada's production hubs are close to US markets and in many cases closer than US production hubs. In addition, NAFTA provides access to Latin American markets via Mexico, the third partner in NAFTA.

Canada is also in a strategic location at the crossroads of North America and Asia, a position it is enhancing through investments in port and rail in order to create even stronger infrastructure links with its NAFTA partners and the Asia-Pacific.

# A Public Policy Environment Strongly Supportive of Innovation

According to the OECD, total federal and provincial government support to business R&D in Canada, as a percentage of GDP, ranks above that of the United States, UK and Japan amongst others. The center-piece of this support, available to companies in all industrial sectors, is the Scientific Research and Experimental Development (SR&ED) tax incentive; applied to income taxes payable, it provides income tax deductions for allowable expenditures, as well as investment tax credits, generally at a 20% rate. Small firms qualify for additional benefits including an investment tax credit at a rate of up to 35% that is partially or fully refundable. Provincial incentives are also available, making Canada #2 in the G7 in the generosity of total R&D tax incentives.

Canada's record of university-based research activity is particularly strong and ranks among the best of the OECD countries. According to the most recent World Economic Forum survey, Canada ranked #9 in terms of business/university collaboration on R&D. Indeed, in 2007 Canadian university expenditure on R&D, expressed as a percentage of GDP, ranked second in the OECD, behind only Sweden.

In addition to fiscal support, the federal government has also provided support by acting as a catalyst to assist in the commercialization of innovation. This has taken a number of forms including public-private partnerships, procurement while innovation is still at the early stages, as well as facilities and programs oriented to specific sectors.

That is not all. The federal government has pledged to invest an additional $5.1 billion in science and technology as part of its Economic Action Plan. This investment will be targeted at four priority areas identified in the 2007 Science and Technology Strategy: health and related life sciences and technologies; information and communications technologies; environmental science and technologies; and natural resources and energy. Support is being delivered through a range of initiatives including an ongoing programme to fund Research Chairs for 187 renowned international experts at 44 universities across the country, coupled with funding for research infrastructure. In 2008 the federal government funded 20% of all R&D research in Canada, either through direct R&D research carried out by government agencies or through R&D grants to universities and other institutions.

The federal government's premier R&D agency, the National Research Council (NRC), is focusing its industrial R&D efforts in eight key sectors: Aerospace, Agriculture, Automotive, Construction, Information and Communication Technologies, Manufacturing and Materials, Medical Devices and Biopharmaceuticals. Over the past decade the federal government has invested over $550 million to catalyze 11 technology clusters, each dedicated to particular areas of research, bringing together NRC research facilities, universities and business in a cross-fertilizing innovation eco-system.

From low taxes and a strong financial sector; to an educated workforce, abundant natural resources and easy access to major markets; and a public policy environment supportive of innovation, Canada offers the right environment for Canadian private equity and venture capital funds to enjoy success.

## Some Canadian Innovators

ViroChem Pharma, Inc.
Anti-infectives - HIV & Hepatitis C

BioChem Pharma
Anti-Infectives - HIV

Cambrian Systems
Optical Communications

MITEL
Simply Communicating
Communications Solutions and Services

AnorMED
Drug Delivery

ARIUS Research Inc.
Cancer Therapeutics

SIERRA WIRELESS
Mobile Communications and Mobile Computing

NORTEL
Telephony, Optical Networks & Mobile Communitations

ROGERS
Cellular Service Provider

SABEX
Generic Drug Manufacturing

RIM
Mobile Communications

COREL
First Computer-based Illustration and Design Software System

Aspreva
Reformulation

CRYOCATH
Medical Devices for Cryoablation

ID BIOMEDICAL
Vaccines

workbrain
Workforce Management Software

ATi
Leading Innovator in Graphics Cards

OPEN TEXT
The Content Experts
Document Management

Entrust
Global Leader in Data Security

BIOWARE CORP
Video Game Developer

SOLECT
Billing & Administrative Software

Hummingbird
Enterprise Software Solutions

QNX
QNX SOFTWARE SYSTEMS
Mobile Operating Systems

Creo
Imaging & Software

NEWBRIDGE
Data Networking

COGNOS
Business Intelligence software

Descartes
Logistics Software

CAE
Simulation Software for Military & Civilian Training

Q9 NETWORKS
Data Colocation

SOFTIMAGE
3D Animation Software

# Part 2:
Canada's Private Equity and Venture Capital Market

# General Overview of the Private Equity and Venture Capital Market in Canada

The Canadian private equity and venture capital market is relatively young compared to the industry in the US and has had a very different history. The performance of the Canadian industry is comparable to that of European countries and the gap with the US has narrowed now that the 10-year US numbers no longer include the huge gains from 1999-2000.

Based on Thomson Reuters statistics, the total estimated size of Canada's private equity and venture capital (VC) resources under management was $76 billion at the end of 2009, up 3% from 2008. The Buyout sector in Canada had about $53.2 billion under management at the end of 2009, while the mezzanine sector had another $7.6 billion; together these two segments accounted for 80% of total funds under management. The VC segment managed about $14.9 billion at the end of 2009, or 20% of the total pool.

Private independent funds accounted for 59% of total funds under management in 2009 or $44.6 billion, while institutional captive funds accounted for $20 billion and corporate captives $2.3 billion. Retail funds were $7.6 billion and government-owned and -directed funds that target the VC segment of the market amounted to $1.8 billion.

## An Underserved Market

Canada's penetration levels (expressed in terms of private equity and VC disbursements relative to GDP) have remained low and in 2009 ranked at the same level as India, while being significantly below the US and the UK. This low penetration signals an underserved market offering significant opportunities for investment in both market segments, especially relative to the US and UK. In Canada, the simple story is that there has been too little money devoted to this asset class, compared to the US where it is argued that there has been too much money chasing too few deals. Moreover, the level in 2009 is about a third of its pre-financial crisis level when disbursements were running at about 0.9% of GDP, albeit significantly less than the US levels of nearly 3.2% at that time.

| 2009 | Disbursements to GDP |
|---|---|
| Canada | 0.30% |
| US | 0.70% |
| UK | 0.57% |
| Europe | 0.18% |
| India | 0.30% |
| China | 0.20% |

*Source: World Bank for GDP data*

With the extensive R&D dollars, government support for innovation and commercialization potential in Canada, the demand for private equity and VC is substantial and the market remains considerably underserved.

## Government Support for the Venture Capital Industry is Strong

There are numerous indications that Canadian federal and provincial governments understand both the needs and the importance of Canada's private equity and venture capital industry. The extent of that support for the industry in setting a helpful policy framework includes an exemption from registration requirements with the securities authorities on behalf of venture capital and private equity funds as the industry argued that active management of portfolio holdings constitutes appropriate diligence. Also in 2009, the federal government overhauled Section 116 of the tax code that had historically reduced the attractiveness of investing in Canada. As a result, there has been a dramatic decrease in reporting regulations for foreign investors.

## Committed to Best Practices and Setting Industry Standards

Canadian-based GP's observe Institutional Limited Partnership Association (ILPA) principles as a guide to best practices and as a de facto industry standard to guide the industry. The Canadian industry also endorses the International Private Equity Valuation (IPEV) guidelines that are the international standard for portfolio valuation. A distinguishing feature of Canadian GP's is their commitment to full and comprehensive reporting, timely disclosure, and close ties with LP's.

The Canadian enabling environment (in terms of regulatory predictability, reasonable supervision, reporting standards, sophistication of financial markets, inter alia) and corporate ethos (in terms of regard for good governance, accountability and transparency) help ensure that interests between LP's and GP's are aligned and are a key competitive advantage.

# Canada Boasts a Thriving Buyout Sector with Stellar Performance

As a young industry, nearly half of Canadian buyout funds were established after 2000, and over 80% after 1990.

During the 1990s, the number of new partnerships started rising exponentially, leading to significant growth in capital managed by Canadian buyout/ mezzanine funds over the past decade (rising from $10 billion in 2000, to $60 billion in 2010). Today a number of well-known names are operating in the market and on to their 2nd or 3rd fund over a 10-year track, with returns that are world class.

| Date of Establishment | Number of Firms |
|---|---|
| Before 1980 | 6 |
| 1980-1989 | 13 |
| 1990-1999 | 35 |
| After 2000 | 52 |
| With active portfolios in 2010 | 106 |

*Source: Canadian Buyouts, Spring 2010*

## Stellar Returns by any Measure

The Canadian buyout industry has very significantly outperformed all of its benchmarks in the 10-year horizon. This is also true for the 3-year and 5-year horizon returns.

Canada's private equity market has outperformed the US Buyout as well as both the Canadian and US public markets.

Canada similarly exceeded Europe's private equity performance which achieved a net return for a 10-year horizon of 11.9% (compared to 14.2% in Canada) and 5 year of 8.3% (compared to 16.8% in Canada). *(Source: EVCA/Thomson Reuters)*

## Low Penetration Rate and an Underserved Market

Over the past 5 years buyout disbursements have averaged 0.6% of GDP versus 1.7% in US. Industries of interest to investors in Canada include: oil and gas, mining, manufacturing and services.

Historically, Canadian funds have invested considerable amounts abroad. Between 2004 and 2009, the amount invested in international companies ranged between 50 and 60% of the dollar disbursements of Canada's buyout, mezzanine and other funds. In terms of the number of deals done, 8% of 308 deals were international in 2009 compared to 22% of 563 deals in 2008.

## Foreign LPs are Starting to Rediscover Canada

Although fundraising for the buyout and mezzanine segment in Canada is now at ¼ of its peak 2006 level, this is in line with the rest of the world that has seen a severe retrenchment during the economic and financial crisis of 2008-09. Prior to this period, the Canadian private equity market had experienced significant influx of foreign capital. In 2008, foreign LP's accounted for 54% of buyout/ mezzanine fundraising, declining to 31% in 2009.

| Net Horizon Returns 2009 | 10 Years | 5 Years | 3 Years |
|---|---|---|---|
| CANADA | | | |
| All buyout / mezzanine funds | 14.2% | 16.8% | 7.2% |
| TSX benchmark | 3.9% | 4.1% | -2.5% |
| UNITED STATES | | | |
| Small buyouts (USD 0-250 mm) | 3.4% | 4.2% | 0.1% |
| Medium buyouts (USD 250-500 mm) | 4.1% | 8.7% | 3.6% |
| Large buyouts (USD 500-1000 mm) | 4.9% | 6.7% | 2.7% |
| Mega buyouts (USD >1 bn) | 4.7% | 4.8% | -1.0% |
| All buyouts | 4.6% | 5.3% | -0.3% |
| Mezzanine | 2.9% | 2.8% | 0.7% |
| NASDAQ | -5.6% | 0.8% | -2.7% |
| S&P 500 | -2.7% | -1.6% | -8.1% |

*Note 1: net horizon returns calculated as at 31 December 2009*
*Note 2: TSX benchmarks compare the returns for the LPs would have been had those investors invested in the TSX instead of private equity funds.*
*Source: CVCA data (with assistance from Thomson Reuters) and the US VC industry (Thomson Reuters data) and stock exchange benchmarks.*

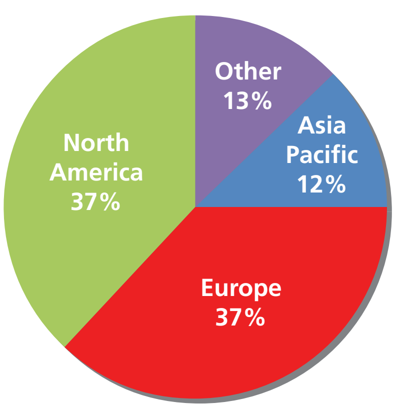
| Source of fundraising | 2009 % of fundraising | 2008 % of fundraising |
|---|---|---|
| Foreign sources | 31% | 54% |
| Corporates | 20% | 12% |
| Individuals | 18% | 7% |
| Pension Plans (domestic) | 14% | 25% |
| Governments | 12% | -- |
| Other institutions | 5% | 2% |
| TOTAL ($bn) | $2.1bn | $5.6bn |

On the basis of a survey of its members conducted by CVCA, the average number of LPs attracted by the private equity industry was 12. Amongst the private equity respondents, one-third claimed to have attracted international LPs and the average number of international LPs that invested in these Canadian private equity funds was 9.

Assuming this number to be representative of the entire Canadian industry, it demonstrates that international LPs have already begun finding their way to Canada.

Based on the CVCA survey population, the geographical distribution of international LPs invested in Canadian buyout funds was as follows, with the US and Europe having the largest (and virtually equal) shares.

If one outlier (a single capital commitment for $400 million) is eliminated from the survey results, the average capital commitment per LP amounted to $12 million (while the value of the average investment by international LPs was nearly double, at $22 million). According to the survey, 75% of the international LPs invested in successor funds.




The active presence of international LP's in Canada's buyout and mezzanine funds, together with the substantial international investment presence of Canadian funds, is testament to the ability of the Canadian industry to successfully conduct business across national borders and still deliver solid returns performance.

## Opportunities for Purchase and Exit Opportunities Abound

In Canada there were around 2,000 M&A transactions conducted in 2008 representing 7.7% of the total number of Canadian companies, versus the US at 4.1%. But according to Thomson Reuters, only 3% of Canadian target buyouts were sold via a buyout deal in 2009 versus 8.3% in the US. Canada has a well-developed M&A culture but there is considerably more market potential to unlock these values via Private Equity.

In the coming years, there is an inter-generational change of some magnitude coming - one that presents huge opportunities in terms of management succession, management buyouts and the like. It is estimated that over 80% of Canadian businesses are family-owned. These firms range from the smallest enterprises to major corporations with an international reach and together they generate over half of Canada's GDP.

In addition, as of 31 July 2010 there are 1,488 companies listed on the Toronto Stock Exchange and another 2,348 on the Toronto Venture Exchange which also could present important opportunities for the buyout sector.

| Year of Transaction* | Number | Volume (US$ billion) | Average deal size (US$ million) | PE Buyout share of total M&A transactions |
|---|---|---|---|---|
| 2004 | 40 | 7.6 | 190 | 13% |
| 2005 | 27 | 2.8 | 104 | 3% |
| 2006 | 40 | 9.1 | 267 | 6% |
| 2007 | 71 | 16.7 | 235 | 8% |
| 2008 | 40 | 8.6 | 215 | 10% |
| 2009 | 41 | 2.5 | 61 | 3% |

**Disclosed Transactions*
*Source: Canadian Buyout PE Activity in 2009 – Thomson Reuters- page 5*

**Some Buyout Success Stories**

| Year | INVESTEE | Multiple of Capital | IRR |
|---|---|---|---|
| **2010** | Building Products | 8.5x | 127% |
| | Resources | 2.3x | 90% |
| **2009** | Shepell Fgi | 6.6x | 108% |
| | Energy | 6.4x | 131% |
| **2008** | Gateway Casinos | 9.0x | 50% |
| | Waste Management | 4.1x | 196% |
| **2007** | Encore Group | 10.0x | 231% |
| | Inventory Services | 8.0x | 72% |
| **2006** | Healthcare Products | 4.0x | 116% |
| | Staffing Provider | 3.0x | 86% |

# After 25 years, a Maturing VC Industry Maps a Pathway to Performance

Canada's venture capital industry is also relatively young, especially compared with that of the US, and while its performance has been less strong than the Private Equity side, Canada's top performers have still generally outperformed most benchmarks.

In fact, net returns for the first quartile of Canadian VC firms have exceeded the TSX, NASDAQ and S&P 500, in addition to all stages of VC in the US, over the 3-, 5- and 10-year time horizons. There are indications that 10-year Canada returns for VC are not out of line with emerging 10-year returns from other jurisdictions, for instance, numbers to March 31 2010 released in the United States indicate the 10-year total number for VC returns was -3.9%.

| Net Horizon Returns 2009 | 10 Years | 5 Years | 3 Years |
|---|---|---|---|
| **CANADA** | | | |
| First Quartile VC | 5.1% | 8.1% | 10.5% |
| All VC | -1.4%* | -1.2% | -3.3% |
| TSX benchmark | 4.4% | 4.2% | -2.9% |
| **UNITED STATES** | | | |
| Early /Seed VC | -0.3% | 0.9% | -1.0% |
| Balanced VC | 2.3% | 6.8% | 0.9% |
| Later stage VC | 1.7% | 7.6% | 5.6% |
| All VC | 1.1% | 4.3% | 0.9% |
| NASDAQ | -5.6% | 0.8% | -2.7% |
| S&P 500 | -2.7% | -1.6% | -8.1% |

*Note 1: net horizon returns calculated as at 31 December 2009*
*Note 2: TSX benchmarks compare the returns for the LPs would have been had those investors invested in the TSX instead of private equity funds*
*Source: CVCA data (with assistance from Thomson Reuters) and the US VC industry (Thomson Reuters data) and stock exchange benchmarks.*

** Refers to Evergreen Funds which are the single largest component of the industry.*

Canadian venture capital investing has been focused mostly within Canada: of the 408 deals done in 2009, 88% were in Canadian companies, representing 86% of the dollar amounts invested. Early stage investments have accounted for around 50% of total disbursements between 2004 and 2009. The average investment per deal for domestic funds has been $1.04 million (compared with $3.76 million per deal for foreign funds).

## There have been Numerous Technology Successes

Investments made by VC firms in Canada have focused primarily in three areas of strength for Canada: IT, biotechnology and clean tech, with IT alone accounting for 53% of disbursements in 2009 and 47% in 2008.

| Venture Capital Sector | Disbursements 2009 ($ million) | Number of transactions | Disbursements 2008 ($ million) |
|---|---|---|---|
| IT | 489 | 129 | 655 |
| • Communication | 180 | 18 | 139 |
| • Software | 142 | 47 | 177 |
| • Semiconductors | 39 | 11 | 82 |
| Pharmaceuticals & other life sciences | 215 | 57 | 365 |
| Energy & environment technology sectors | 102 | 21 | 189 |
| Non technology sectors | 135 | 116 | 190 |
| Total | 941 | 323 | 1399 |

### Biggest Canadian Tech IPO in a Decade

Shares of Smart Technologies Inc. SMA-T began trading in New York and Toronto Thursday morning in a $660-million offering that ranks as the biggest Canadian tech IPO in a decade. The Calgary-based company makes electronic whiteboards that combine characteristics of a traditional whiteboard display with a computer. By touching the surface of the product, a user can control computer applications, access the Internet, write in digital ink and save and share work. The company was founded 1987 and for the fiscal year ended March 31, Smart Technologies posted a profit of $142-million on sales of $648-million. It has traditionally boasted an annual growth rate of between 20 and 30 per cent. Last year sales rose by 38.4 percent.

*Globe and Mail, Published Thursday, Jul. 15, 2010*

The exits of Canadian VC portfolio companies have been primarily through M&A, and to a lesser extent IPOs.

| | Number of IPO exits | Number of M&A exits | Average IPO size $ million | Average M&A size $ million |
|---|---|---|---|---|
| 2003 | 2 | 24 | $40 | $39 |
| 2004 | 14 | 39 | $38 | $90 |
| 2005 | 9 | 45 | $67 | $52 |
| 2006 | 7 | 29 | $20 | $78 |
| 2007 | 12 | 37 | $61 | $104 |
| 2008 | 1 | 21 | $33 | $64 |
| 2009 | 1 | 23 | $29 | $120 |

## The venture capital market is undergoing significant transformation and a new breed of domain-specific managers is poised to deliver enhanced performance.

Canadian venture capital managers are evolving from generalists with a regional focus willing to tackle any type of prospective investment opportunity, to specialists with a North American and global focus targeting specific sectors or domains for their funds. Firms themselves are consolidating and specializing, and they are seeking broader and deeper sources of venture capital with which to work.

A new breed of domain-specific managers is poised to deliver enhanced performance. These VC firms are now beginning to attract international LP attention and are able to source deals globally. Using Canada as a beachhead for a number of focused sectors has been a compelling story , given the national development strategies around and expertise within these sectors in addition to Canada's proximity to major US centers. Three leading examples are discussed below.

## Health and life sciences

Health and life sciences (comprising pharmaceuticals and biotechnology) is the most R&D intensive sector of the Canadian economy. In 2009, health-related R&D was estimated at almost a quarter of Canada's total R&D expenditure of $24 billion. The bulk of this R&D is funded by universities and governments, although in terms of the pharmaceutical industry specifically, Canada placed #7 globally for its share of business expenditure on R&D[2]. Canada was ranked #3 for innovation in biotech in 2010 by Scientific American.

Canada also has one of the most favorable R&D tax incentive programs in the world, allowing companies to receive rebates of up to 35% of eligible R&D expenditures. Government funding for research has increased threefold over the last two decades and no other sector has benefited from this level of public sector R&D support. The sector has also been singled out as one of four priority areas under the federal government's Science and Technology strategy and Canada has recently enjoyed recognition as one of the top five countries for biotech innovation, coming third to only the US and Singapore.

Canada now ranks as the world's eighth largest world market in terms of pharmaceutical sales and is in fact the fourth fastest growing pharmaceutical market after China, Mexico and Spain. Some of the specific innovations in the making include:

- cancer-fighting therapies, including cancer vaccines
- vaccines to combat bacterial infections

[2] Innovation And Business Strategy, Council Of Canadian Academies, 2009

- medical devices such as implantable bio-materials, surgical robotics, and bio-sensors

- a virtual reality neurosurgical simulator

- a robotic arm for brain surgery, guided by an imagining system and surgeon at a computer

## Information and communications technology

The information and communications technology (ICT) sector in Canada matches, and in some cases exceeds, the United States in terms of R&D intensity (measured as the ratio between R&D and sector GDP). Canada enjoys a strong base of R&D in universities and also in established companies like IBM and RIM, located mainly in technology clusters such as Waterloo, Ottawa and Moncton/ Fredericton. As one of the four science and technology priority areas, ICT benefits from a number of specialized government laboratories and programmes in addition to other tax incentives.

Canada's greatest strength to date has been in communications equipment, with RIM, inventor of the Blackberry, being only one of the most recent success stories. Canada's geography and the need to communicate across vast distances led to the development of other mobile communication technologies with companies such as Nortel and Sierra Wireless. Of note is the major contribution to global communications is the Canadian inventions in satellite and microwave communication: for example, through a public-private partnership, Telesat, launched the world's first commercial domestic communication satellite in geostationary orbit, while a number of successful companies resulted from activities in space-based communications, including the former Spar Aerospace which developed the famous 'Canadarm' used extensively aboard the Space Shuttle and the Space Station.

## Clean Technology

Clean technology is an emerging industry in Canada, with a broad base across the country.[3] The majority of Canadian clean technology companies were established to commercialize a founder's invention, while less than 10% were based on commercialization of technology developed by an academic institution. The average age of these companies is 15 years and most are actively engaged in commercialization of their products, with exports accounting for about half of total sales. Despite the recent financial crisis and economic slowdown, the sector grew 47% annually, and that growth rate is expected to more than double between 2010 and 2012.

The industry spans nine different sectors, with five of these sectors accounting for more than three-quarters of companies (with more than 50 companies each):

- Water and wastewater

- Process efficiency and abatement

[3]Sustainable Development Technology Canada's 2010 SDTC Cleantech Growth and Go-To-Market Report.

- Power generation
- Recycling and waste
- Energy efficiency

The other four sectors are: transportation, biofuels and biotechnology, remediation and energy and infrastructure.

**Some Recent VC Success Stories**

| Year | INVESTEE | Multiple of Capital | IRR |
|---|---|---|---|
| **2010** | Software Healthcare | 13.3x | 39% |
| | Social Media Analytics | 9.2x | 307% |
| **2009** | ViroChem Pharmaceuticals | 5.4x | 68% |
| | Communications | 3.5x | 40% |
| **2008** | Plate Spin Ltd. | 18.0x | 117% |
| | Solar energy | 2.6x | 33% |
| **2007** | Galleon Energy | 7.6x | 134% |
| | Network Equipment | 6.0x | 48% |
| **2006** | Aspreva Pharmaceuticals | 23.4x | 272% |
| | Software/Networks | 5.8x | 100% |

# Considering Canada GPs as Part of Your Private Equity and VC allocation is a Smart Choice.

Canada's governmental, economic and financial structure is one of the most stable and soundest in the world and promises continued strength into the future. There are significant opportunities in Canada to reap rewards from a diversified, healthy and growing economic base that is well-integrated into the global economy.

The venture capital and private equity industry enjoys a supportive environment, in the form of favorable regulatory and tax systems, and a cooperative approach with federal and provincial governments which allows the industry the freedom to maximize opportunities and growth potential.

The basic building blocks are in place for further cultivation of innovation and commercialization and these opportunities are being developed by a new generation of venture capital fund managers with domain-specific expertise and an international focus.

The generational changes taking place in family-owned business and the thousands of publicly-listed companies means demand for private equity will continue to be strong. But, private equity disbursements to GDP remain low compared to other developed countries. This suggests the market remains underserved and will create unprecedented opportunities to capitalize on Canada's past record of success in delivering exceptional value to investors.

Think about including Canada in your investment plans. Canada's private equity and venture capital market is rich with opportunities.

**For a complete list of CVCA members who are Canadian Venture Capital, Mezzanine and Buyout funds and fund managers and services providers to the industry, visit our web site**

**www.CVCA.ca**

# Notes

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