

THE GOODMAN AND CARR LLP REPORT

PRIVATE EQUITY CANADA

2004

AN IN-DEPTH REVIEW OF
THE MARKET

RESEARCH CONDUCTED BY

THOMSON



MACDONALD

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Foreword

This is the fourth installment of the *Private Equity Canada* series produced by Goodman and Carr LLP and McKinsey & Company. Our objective is to provide a fact-based perspective on key trends shaping the Canadian private equity market to help the industry grow and its participants succeed.

We have based our conclusions on the market research Thomson Macdonald conducted in Canada and on McKinsey & Company's proprietary research in the United States and Europe. The 2004 survey was consistent with the 2003 survey to permit year-over-year comparisons, but it also included additional questions exploring the topic of private equity deal management by Canadian investors. The 92 survey respondents represent the firms managing Canada's largest private equity funds – more than 90 percent of the industry's capital pool.

Private Equity Canada 2004 consists of two volumes:

- Volume 1, produced by Goodman and Carr LLP, provides an in-depth review of key market facts. It describes the main characteristics of Canada's private equity market, the preferences of its participants, and the market activity over the past year.
- Volume 2, prepared by McKinsey & Company, draws on the authors' and the Firm's extensive experience in serving institutional investors and other private equity market participants. It offers a perspective on the competitive dynamics in the Canadian private equity market and examines how some investors are seeking to enhance their returns and differentiate themselves through "active ownership."

We hope you find *Private Equity Canada 2004* useful, valuable, and thought-provoking.



Gary Luftspring
Managing Partner
Goodman and Carr LLP

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1.0 Executive summary

In 2004, Canada's private equity market appeared to be coming out of a 3-year down cycle. Investment activity increased across the board, and the capital pool grew once again, spurred by successful fundraising throughout the year.

Goodman and Carr LLP-McKinsey & Company's *Canadian Private Equity Activity Survey 2004*, conducted by Thomson Macdonald, found capital under management in Canada's private equity market totalled \$51.0 billion, up 5 percent from \$48.6 billion in 2003. This growth was due primarily to new capital inflows, which more than offset outflows.

Of that \$51.0 billion, the venture capital segment accounted for \$20.8 billion, or 41 percent, which was down from the previous year.

For the first time in the survey's history, the buyout segment emerged as the largest in the Canadian market, with \$25.1 billion, up 11 percent from the \$22.5 billion of 2003. This gave the buyout segment nearly half (49 percent) of the entire capital pool.

The mezzanine segment experienced the largest year-over-year percentage growth, with \$5.1 billion, or 42 percent more than its \$3.6 billion in 2003.

When Thomson Macdonald added data to the survey findings, the estimated size of the entire Canadian private equity market universe totalled \$55.4 billion in 2004.

The survey also found that private-independent fund managers continued to gain market share in the past year, with capital under management of \$19.5 billion, or 38 percent of the total.

Large institutional investors with in-house private equity programs took second spot, with 29 percent of the capital pool, though this was down from 2003. This group was followed by retail funds (e.g., labour-sponsored

venture capital corporations) with a 21 percent share, corporate funds with 7 percent, and government funds with 5 percent.

Private equity fundraising conditions remained challenging in 2004 but, nonetheless, several prominent new funds were formed in each market segment. New capital commitments to buyout and mezzanine partnerships and other funds totaled \$1.9 billion, while venture capital funds of all types took in \$1.7 billion in new commitments.

Pension funds accounted for the largest share of the \$1.9 billion raised by buyout and mezzanine funds (41 percent), followed by corporations (22 percent), and foreign investors (17 percent). Individual investors accounted for the largest share of the \$1.7 billion raised by venture capital funds (67 percent), followed by pension funds (15 percent).

The survey found evidence that private equity fundraising activity might increase sharply in 2005, as 32 fund managers indicated they plan to raise new funds, a response given by 20 fund managers last year.

In 2004, capital invested by Canadian private equity fund managers grew on a year-over-year basis, and in all market segments. This suggests that professional managers were more confident, largely because of more receptive public markets, a stronger economy, and intensified private equity activity in the United States.

Activity in the venture capital industry showed moderate signs of growth, as fund disbursements totaled \$1.7 billion, up from \$1.6 billion in 2003. A significant increase in deal activity in IT sectors led this trend, and over half of these investments were made in early-stage companies.

The survey found even more substantial expansion in activity in the buyout segment, where dollars invested rose by 46 percent in the past year, reaching \$3.6 billion. This trend built on growth observed in buyout activity throughout North America in 2003.

In tandem with buyout activity, the mezzanine segment saw notable growth in the past year – an upswing of 49 percent in fund disbursements, from \$652 million in 2003 to \$971 million in 2004.

Of the \$4.5 billion invested by buyout and mezzanine funds, the survey found a diverse mix of transaction types, with almost half of the resources going into acquisitions and management buyouts (MBOs).

The survey again featured a series of qualitative questions for private equity professionals. Once again, they were asked to identify the key factors influencing market growth at the time. The highest rated factor was the limited number of institutional investors active in private equity. This was followed by the rising value of the Canadian dollar.

If you have any comments or questions about this volume, please contact either of the following at Goodman and Carr LLP:

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1.1 Introduction

The following report, prepared by Thomson Macdonald for Goodman and Carr LLP and McKinsey & Company, considers key trends in the Canadian private equity market in 2004.

Data analyzed by Thomson Macdonald for this report were drawn from the Goodman and Carr LLP-McKinsey & Company's *Canadian Private Equity Activity Survey 2004*, conducted by Thomson Macdonald between December 2004 and March 2005. In all, 138 management companies were contacted, with 92 responding within the time allotted – this included all of the largest groups. Consequently, the survey's sample reflected over 90 percent of the Canadian capital market pool.

Questions posed in the 2004 survey were consistent with those of 2003 to permit year-over-year comparisons relevant to the national market. A special feature of this latest effort, however, was its focus on longer-term trends observed since the survey was first conducted in 2001. As in past years, Thomson Macdonald provided supplementary data to augment survey findings to ensure the report presents as complete a picture of the Canadian market as possible.

The framework behind the survey was developed by Thomson Macdonald and approximates research methodology used in the United States and elsewhere for describing characteristics of comparable private equity markets.

Goodman and Carr LLP, McKinsey & Company, and Thomson Macdonald wish to thank the many Canadian professional managers and staff that gave freely of their time to provide confidential data and share their thoughts on key issues. This report would not have been possible without these generous contributions.

1.2 Canada's private equity market in 2004

CONTINUED EXPANSION OF CAPITAL POOL

In the past year, the overall size of the capital pool managed by Canadian private equity fund managers grew once again, primarily because of new streams of capital flowing into the buyout and mezzanine segments of the market. These inflows more than offset net outflows of capital in the venture capital industry.

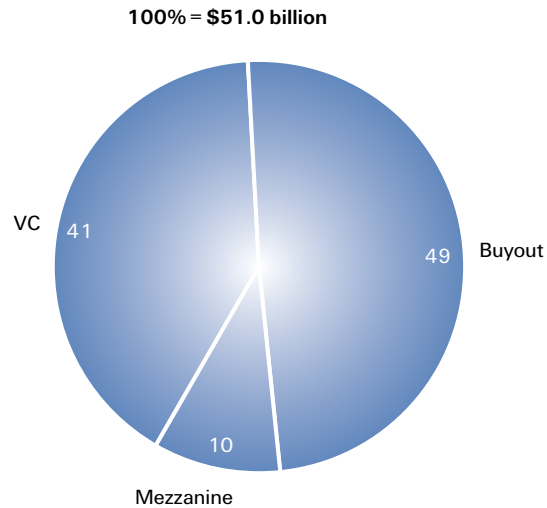
The survey (and supplementary data provided by Thomson Macdonald) found capital under management in Canada's private equity market totaled \$51.0 billion as of December 31, 2004. This is up by 5 percent from the \$48.6 billion recorded in 2003.

In 2004, Canada's venture capital industry had \$20.8 billion under management, or 41 percent of the total capital managed by survey respondents. This was down from \$22.5 billion in 2003, mainly because CDP Capital Private Equity discontinued its extensive program for direct venture investments. Consequently, capital outflows exceeded inflows linked to fundraising despite several major fundraising events, including the final closing of Ventures West 8.

For the first time since the survey was launched in 2001, the buyout segment emerged as the largest in the Canadian market. Capital managed by buyout funds totaled \$25.1 billion in 2004, up 11 percent from the \$22.5 billion of the previous year. As a result, the buyout segment accounted for nearly half (49 percent) of the entire private equity pool, up from its 47 percent share in 2003.

Two important factors contributed to this outcome. First, several new buyout funds were formed in 2004, the largest being Richardson Capital Limited's RFG Private Equity LP No. 1. And, second, several of Canada's

Exhibit 1
**TOTAL CAPITAL UNDER MANAGEMENT BY PRIVATE EQUITY MARKET SEGMENT;
2004**
Percent



Source: Thomson Macdonald

largest institutional investors added substantially to the assets managed in-house in their captive buyout funds.

These same factors were at play in the mezzanine segment, which experienced the largest year-over-year percentage growth in Canada's private equity market. Along with increased asset allocations inside a handful of institutional funds, 2004 featured several new partnership milestones, including the final closings of TD Capital Mezzanine Partners LP and MG Stratum Fund III.

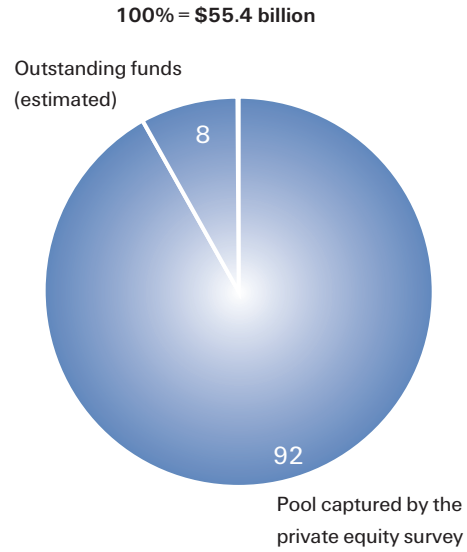
Consequently, mezzanine capital under management totaled \$5.1 billion at the end of 2004, an increase of 42 percent from \$3.6 billion in 2003. This gave the mezzanine segment 10 percent of total capital managed by survey respondents, up from 7 percent in 2003.

As in prior years, Thomson Macdonald has drawn from its database to augment survey responses and estimates that the size of the entire Canadian private equity market universe in 2004 was \$55.4 billion, up from 2003's \$53.0 billion.

Exhibit 2

TOTAL CAPITAL UNDER MANAGEMENT (ESTIMATED) BY PRIVATE EQUITY MARKET SEGMENT; 2004

Percent



Source: Thomson Macdonald

This suggests that the survey captured 92 percent of all capital resources managed by buyout, mezzanine, and venture capital funds with headquarters in Canada.

1.3 Canadian private equity market players in 2004

PRIVATE FUNDS KEY TO GROWTH

Since the inception of the Goodman and Carr LLP and McKinsey & Company survey, clear trends have emerged in the composition of the private equity market by investor type.

A key survey finding has been steady growth in the market share of private-independent funds (typically limited partnerships) since 2001. In fact, by drawing on capital commitments from institutional investors and other sources, private funds have become a major driver of overall market expansion in Canada.

This trend continued in 2004, as new partnerships in the buyout, mezzanine, and venture capital segments increased capital under management in private funds to \$19.5 billion – 38 percent of the total capital pool – by year-end. This is up 11 percent from \$17.5 billion (and a 36 percent share) in 2003.

New commitments to private funds in the past year were spread across the private equity market spectrum. This trend will most likely continue in 2005, given the range of new Canadian fund offerings also found by the survey. (See “1.4 Trends in private equity fundraising in 2004.”)

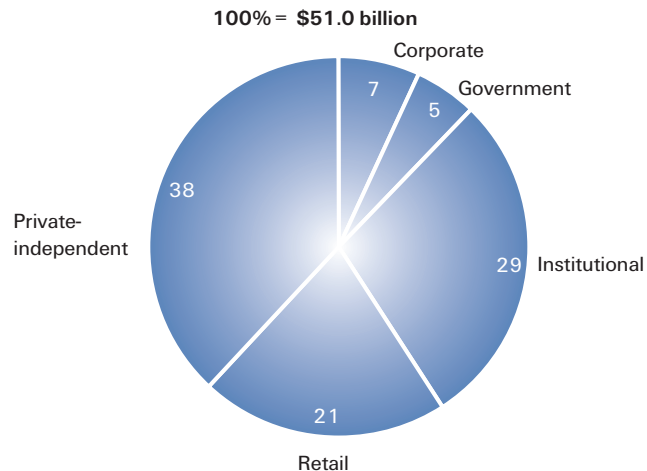
Moreover, growth in the capital under management of private funds served to offset the apparent erosion of capital held in the captive funds of corporate and institutional investors, particularly over the past 2 years.

Several important trends emerged in the community of large Canadian institutions with internal private equity funds in 2004. Among these was CDP Capital Private Equity’s decision to suspend operation of its venture arm and to focus instead on making commitments to private funds. In addition, OMERS’ subsidiary, OMERS

Exhibit 3

**TOTAL CAPITAL UNDER MANAGEMENT BY PRIVATE EQUITY INVESTOR TYPE;
2004**

Percent



Source: Thomson Macdonald

Capital Partners, and Borealis Capital Corporation commenced implementation of new strategies. It is likely that these trends will increase market exposure for pension funds over the long term.

Mainly because of CDP Capital's decision, institutional investors reduced their overall fund resources managed in-house. In addition, various changes in institutional fund programs suggest direct investments in the buyout and mezzanine realms will become more concentrated in the future.

The survey found capital under management in institutional funds of \$14.7 billion in the past year, a 29 percent market share. This is down from \$15.4 billion and a 32 percent share in 2003.

A move away from in-house programs toward increased limited partner activity also contributed to the recent reorganization of some corporate funds (i.e., divisions of Canadian financial or industrial corporations). TD Capital has been at the forefront of this trend. It closed TD Capital Mezzanine Partners LP in 2004 and will launch Birch Hill Equity Partners III LP in 2005, the successor of buyout-oriented TD Capital Canadian Private Equity Partners.

Other corporate funds, such as BMO Nesbitt Burns Private Equity Partners and RBC Capital Partners, have opted to gradually wind down their private equity operations altogether.

On balance, the survey found that corporate funds accounted for 7 percent of the entire pool, or \$3.5 billion, down from \$4.1 billion in 2003. Most of these resources continued to be located in corporate-financial funds active in one or more market segments, while corporate-industrial funds (e.g., BCE Capital) continued to be essential to trends in the venture industry.

After private and institutional funds, the largest market player category in 2004 was tax-assisted retail funds, including labour-sponsored venture capital corporations (LSVCCs) and provincial venture capital corporations (PVCCs). The survey found retail funds managed \$10.7 billion, up from \$8.6 billion in 2003. Consequently, retail funds accounted for just over one-fifth of the capital managed by survey respondents, up from 18 percent in the previous year.

The Fonds de solidarité du travailleurs du Québec (FTQ), GrowthWorks, VenGrowth Capital Partners, and other LSVCCs continued to be among the most active venture investors in Canada in the past year, while PVCCs were active only in British Columbia and Québec.

Government funds had \$2.6 billion in managed capital in 2004, or 5 percent of the aggregate amount, which approximates survey findings of 2003.

1.4 Trends in private equity fundraising in 2004

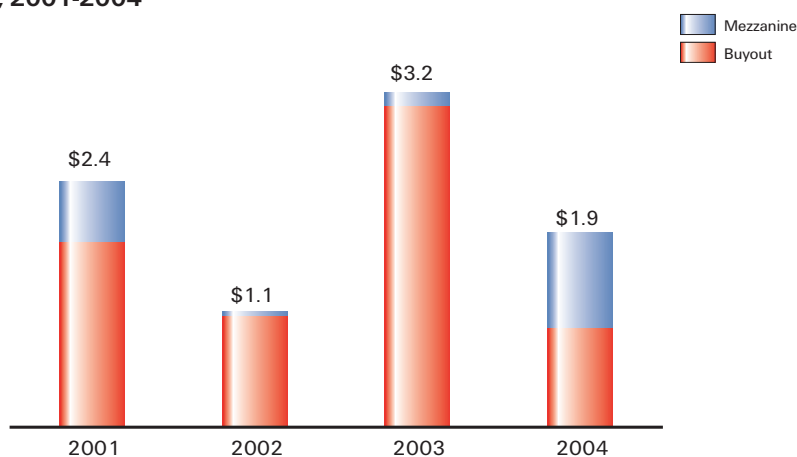
MEZZANINE FUNDS SCORE

During the 3-year market slowdown in North America, a shadow was cast over the fundraising efforts of many buyout, mezzanine, and venture capital industry players. However, 2004 signaled a climate change in the United States, as private equity funds of all types attracted the largest volume of new capital commitments seen since 2000.

In Canada, fundraising conditions appeared to remain more challenging. The mezzanine segment, however, featured some milestones in fund formation during the past year.

In fact, the survey found that new commitments to limited partnerships and other funds in the Canadian mezzanine industry in 2004 easily surpassed those recorded in prior years, with \$912 million raised in total. Contributing substantially to this outcome were the final closings of two of the largest institutionally supplied mezzanine partnerships in the market's history.

Exhibit 4
NEW BUYOUT AND MEZZANINE FUNDS RAISED, PARTNERSHIPS AND RETAIL FUNDS; 2001-2004
\$ Billions



Source: Thomson Macdonald

Closing at \$500 million, TD Capital Mezzanine Partners LP emerged as Canada's biggest private-independent fund in the mezzanine realm. Concentrating on a diverse range of mid-market deal opportunities in this country and the United States, this fund typically targets individual investments of between \$20 million and \$75 million.

In addition, McKenna Gale Capital's MG Stratum III LP closed at \$305 million. This fund invests in both the buyout and mezzanine segments of the market, in traditional North American businesses, at a preferred investment range of \$7 million to \$75 million.

Fundraising by mezzanine and other quasi-equity investors also included Wellington Financial, which successfully closed its Fund II, and a Manitoba-based fund manager, Frontier Capital Partners, which launched its premier FCP I.

The first retail mezzanine funds were created in 2004, including the Return on Innovation (ROI) Fund and the Traditional Industries Fund of VenGrowth Capital Partners, both in Ontario. At the same time, VenGrowth successfully formed its first limited partnership for related activity – VG Mezzanine I LP.

Canadian buyout fund managers raised nearly \$1 billion in 2004, including several prominent new partnerships. For example, Richardson Capital Limited introduced RFG Private Equity LP No. 1, which closed at \$325 million. This fund will invest in a range of event transactions (e.g., expansions, MBOs, recapitalizations, and restructurings) of between \$10 million and \$65 million in diverse Canadian sectors.

Other major fund closings included Banyan Capital Partners, which succeeded in attracting new commitments to its second LP, for buyout activity in Western Canada and the Northwestern United States. Western deal opportunities, averaging \$2 million to \$20 million per investment, are also the focus of Yellow Point Equity Partners' inaugural fund. Argosy Partners raised fresh capital for its unique array of specialized funds, known as the Shotgun and Succession Funds II.

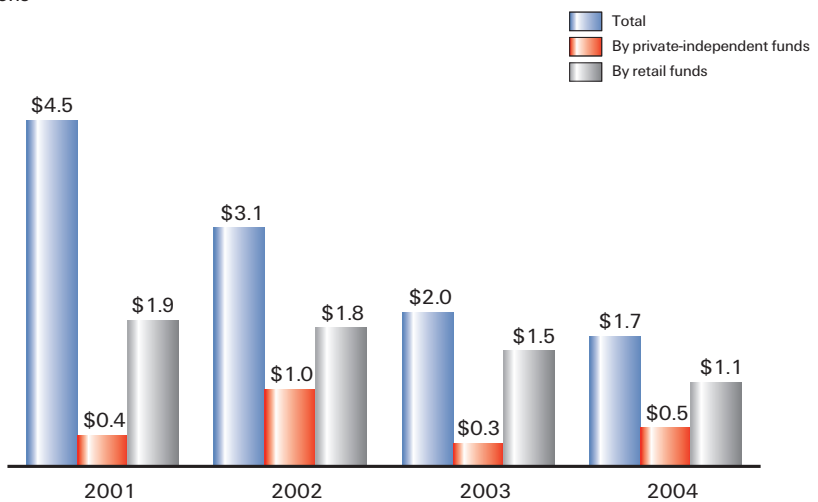
In aggregate, new Canadian buyout and mezzanine limited partnerships and other funds obtained \$1.9 billion in new commitments in the past year, down from \$3.2 billion in 2003.

Fundraising activity in Canada’s venture industry was also relatively quiet in 2004, with \$1.7 billion in new capital commitments, according to annual statistics produced by Thomson Macdonald, down by 15 percent from \$2.0 billion raised in 2003.

Exhibit 5

NEW VENTURE CAPITAL FUNDS RAISED, ALL FUND TYPES; 2001-2004

\$ Billions



Source: Thomson Macdonald

Much of the decline is attributable to lower sales by LSVCCs. Overall retail funds captured \$1.1 billion in new commitments, down 22 percent from the \$1.5 billion raised in 2003. Fundraising continued to be led by the Fonds de solidarité (FTQ), along with Canadian Medical Discovery Corporation, Capital régional et coopératif Desjardins, FondAction, GrowthWorks, and VenGrowth Capital Partners.

However, new commitments to venture capital limited partnerships increased to \$443 million in 2004, as compared to \$266 million in the prior year.

Major venture-oriented partnership closings in the past year included the \$250 million raised by Ventures West 8, representing a major achievement for Ventures West Management. This veteran fund manager will continue to observe a balanced mandate for investing in early-stage and expanding technology businesses based primarily in Canada.

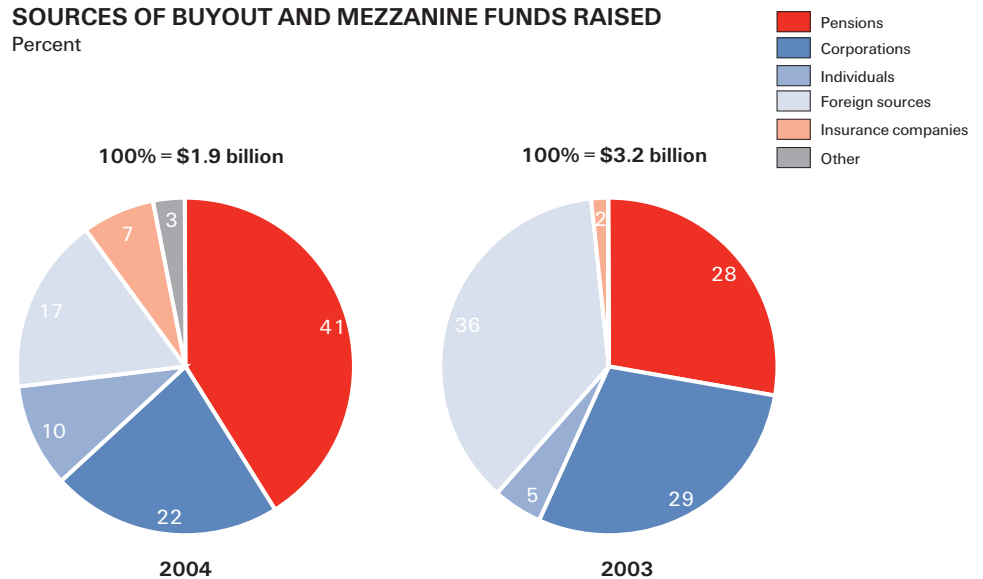
Other major fundraisings included the initial closing of the early-stage software investor EdgeStone Capital Venture Fund II LP at \$102 million. In addition, the unique seed and startup investor Brightspark Ventures proved successful in closing its latest fund, as did the comparably mandated Québec-based MSBi Capital. MMV Financial, which brings a particular brand of venture debt to its technology transactions, also raised new capital in 2004.

SOURCES OF PRIVATE EQUITY FUNDS RAISED IN 2004

Unlike the US private equity market, where institutionally supplied limited partnerships dominate, the market in Canada relies on a broader base of capital supply sources. Along with endowments, insurance companies, pension funds, and other institutional investors, Canadian fund managers seeking fresh resources also focus on corporations, governments, individuals, and non-resident investors.

Exhibit 6

SOURCES OF BUYOUT AND MEZZANINE FUNDS RAISED
Percent



Source: Thomson Macdonald

For instance, sources of the \$1.9 billion raised by buyout and mezzanine funds were diversified, with pension funds being responsible for \$766 million in new capital commitments, or 41 percent of the total, down from \$895 million and a 28 percent share in 2003. Corporations contributed over one-fifth of new commitments.

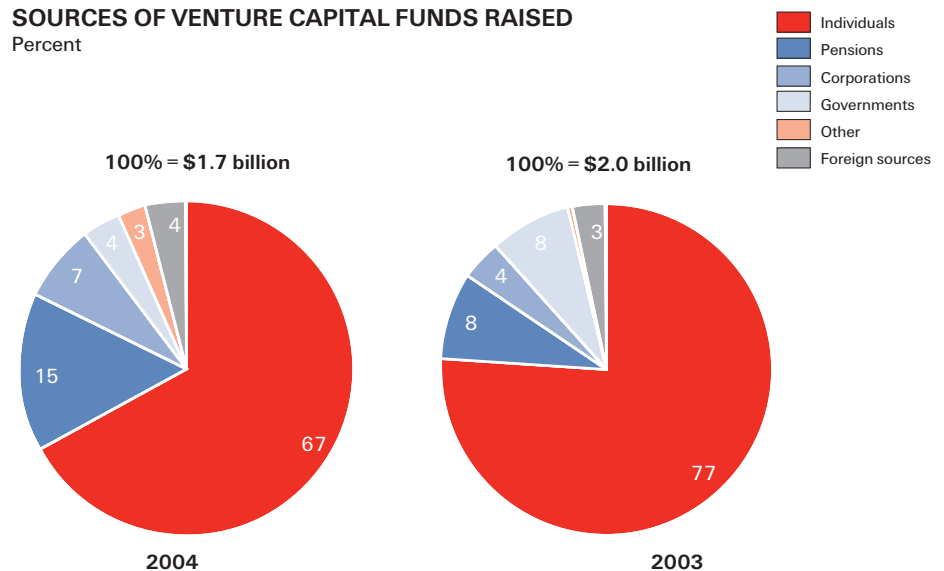
Foreign investors remained important in 2004, particularly for Canadian buyout funds, and accounted for a 17 percent share of new commitments to buyout and mezzanine funds. In 2003, non-residents played the lead role in supplying new buyout and mezzanine capital commitments.

Because of the continuing influence of LSVCCs and other retail funds in the venture capital segment of the market, individual investors continued to be the major source of new commitments in 2004. Individuals committed \$1.1 billion to venture funds, accounting for over two-thirds of the total amount raised. However, this share was down from 2003, when individuals were responsible for 77 percent of new commitments.

Pension funds made \$260 million in new commitments to venture capital funds in 2004, or 15 percent of the total amount – up from 8 percent the year before – followed by corporations with 7 percent, and foreign sources with 4 percent.

Exhibit 7

SOURCES OF VENTURE CAPITAL FUNDS RAISED
Percent



Source: Thomson Macdonald

PRIVATE EQUITY FUNDRAISING OUTLOOK IN 2005

The evidence suggests that 2005 should see a much higher rate of activity than 2004 for Canadian private equity fund managers seeking capital commitments for their latest fund product offerings.

The survey found that 32 management firms were either in the fundraising market or were planning to enter the market with a new partnership launch in the next few months. This level is significantly higher than the 20 firms that indicated they were raising funds a year ago.

A dozen buyout and mezzanine groups identified themselves as being in fundraising mode. These included Birch Hill Equity Partners III LP (the successor to TD Capital Canadian Private Equity Partners), as well as Integrated Partners Private Equity Fund II, ONCAP LP II, and PRIVEQ III LP – all major buyout partnerships with a diverse focus on acquisitions, expansions, MBOs, and other event transactions involving traditional businesses.

Currently, 20 firms raising new funds are in the venture capital realm. These include EdgeStone Capital Venture Fund II LP, which will move toward a final closing in 2005, two early-stage technology specialty funds, DFJ Primaxis LP II and Garage Technology Ventures Canada LP, and two life sciences specialty funds, GeneChem LP II and Haywood Life Sciences LP I Fund.

The survey found that the intended sizes of funds were getting larger. New buyout partnerships were targeting between \$200 million and \$700 million in size, new mezzanine partnerships between \$100 million and \$200 million, and new venture partnerships between \$50 million and \$200 million.

1.5 Private equity investment activity in 2004

DEAL ACTIVITY UP ACROSS THE BOARD

When the Goodman and Carr LLP and McKinsey & Company survey was first undertaken in 2001, private equity market activity in Canada, the United States, and around the globe had dropped considerably compared to activity in the late 1990s and 2000. The overall investment climate has remained relatively weak over the past 3 years as fund managers observed greater caution.

A shift in market conditions was suggested by activity in 2003 in the Canadian buyout segment when the survey found a significant rise in capital invested as compared to 2002. This shift was consistent with activity in the United States.

One year later, evidence suggests the market might finally have turned a corner. The survey found activity increasing across the board in 2004, with moderate-to-substantial growth in disbursement levels in Canada's buyout, mezzanine, and venture capital segments.¹ These results are primarily due to increased professional manager confidence, based on more receptive public markets, a stronger economy, and intensified private equity activity south of the border.

MORE VENTURE DOLLARS INVESTED

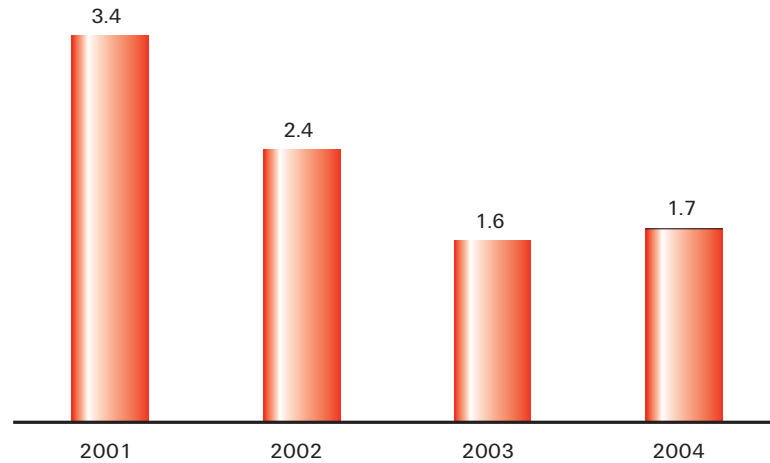
In 2004, activity in Canada's venture capital industry showed moderate signs of growth. Data drawn from the survey and the annual statistics of Thomson Macdonald show Canadian venture fund disbursements to domestic and foreign businesses totaling \$1.7 billion in aggregate, up from the \$1.6 billion recorded for 2003.

¹ Data presented here reflect the individual fund disbursements of survey respondents. Other investors active in Canada between 2001 and 2004 – such as foreign investors – but not part of the survey sample are not represented in statistical aggregates. For this reason, the data should be viewed as only one indicator of total Canadian private equity activity.

Exhibit 8

VENTURE CAPITAL INVESTED BY CANADIAN FUNDS; 2001-2004

\$ Billions



Source: Thomson Macdonald

Consistent with other reports of venture activity by Thomson Macdonald, these results attest to the first year-over-year increase in capital invested since 2000, suggesting the market may now be slowly reversing a multi-year down cycle.

Consistent with prior years, venture investment in 2004 focused on young businesses in this country's emerging technology sectors. Activity in Canadian IT firms accounted for much of the market's overall growth, as illustrated by one of the year's largest deals, the US \$40 million financing of Toronto-based Silicon Optix by a syndicate of US funds – Apax Venture Partners, Canaan Partners, Focus Ventures, InterWest Partners, and Polaris Venture Partners.

In the communications and networking sector, Tropic Networks of Ottawa secured US \$33 million from Alcatel Canada, Celtic House Venture Partners Fund II, Goldman Sachs, and Teachers' Private Capital, along with US co-investors Crescendo Ventures and Kodiak Venture Partners.

Venture activity in the life sciences sector also held its own. Indeed, the largest deal done in 2004 was a US \$57 million investment in the biopharmaceuticals startup Aspreva Pharmaceuticals Corporation of

Victoria. This backing came from another syndicate of non-resident funds, including Axiom Venture Partners, BioAsia Investments, HBM Partners, InterWest Partners, Sprout Group, and Thomas Weisel Venture Partners.

Another major life-sciences-oriented deal was Montréal-based ViroChem Pharma, which received \$36.5 million from BDC Venture Capital Group, CDP Capital – Technologies, Fonds de solidarité (FTQ), Picchio Pharma, and other investors.

The Aspreva, Silicon Optix, and Tropic Networks illustrate another significant trend evidenced in 2004 venture capital activity – increased involvement by non-Canadian investors.

On the whole, the Canadian venture capital industry trends approximated those in the American industry, where disbursements also grew for the first time since 2000 (Thomson Venture Economics).

WHERE DID VENTURE MONEY GO?

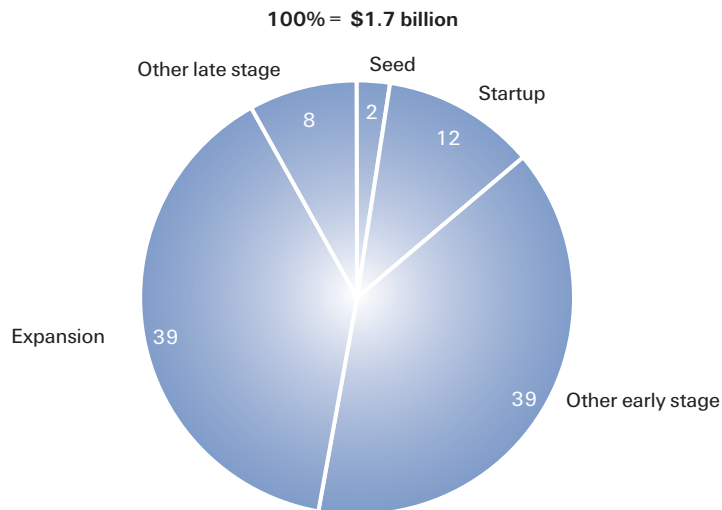
A key finding of past Goodman and Carr LLP and McKinsey & Company surveys has been clear demarcation in the market focus of Canadian venture capital funds, by sector and by stage of company development. As noted in previous reports, this occurred because of the increasingly diverse array of innovative products generated by entrepreneurs, research laboratories, and other sources of deal flow.

Venture professionals require expertise and specialization in their skill sets to effectively develop fledgling businesses and help them achieve rapid growth.

Consequently, the Canadian industry has witnessed a steady increase in the number of funds that operate with specific sector mandates (e.g., clean technology, IT, life sciences) and by stage mandates (e.g., early, late).

A major development in recent years has been the evolution of balanced and specialty funds with an in-house capacity for investing in seed and startup deals, including groups such as BDC Venture Capital Group, Brightspark Ventures, Celtic House Venture Partners, Genesys Capital

Exhibit 9
VENTURE CAPITAL INVESTED BY STAGE; 2004
Percent



Source: Thomson Macdonald

Partners, GrowthWorks, Innovatech, Skypoint Capital Corporation, T2C2 Capital, and Ventures West Management.

The activity of these and other venture capital funds ensured that seed, startup, and other early-stage transactions remained a feature of market trends in 2004. Indeed, just over half of total Canadian fund disbursements in this country, the United States, and other foreign locales in the past year favoured firms at an early stage of development.

The balance of Canadian venture capital resources went into foreign or domestic companies that were expanding or at later stages of development.

BUYOUT DISBURSEMENTS EXPERIENCE SHARP GROWTH

Buyout activity increased substantially across North America in 2004, building on the growth observed during the previous year. According to Thomson's *Buyouts* Newsletter (Vol. 18, No. 1, January 2005), American buyout funds increased their disbursements by 45 percent, taking advantage of improved conditions in the United States and around the world.

The Canadian market experienced some of this enhanced US buyout appetite. Some of the largest Canadian mergers and acquisitions of 2004 involved US investors, including the \$3.1 billion purchase of Mississauga-based Masonite International Corporation by Kohlberg Kravis Roberts & Co., and the \$2.0 billion purchase of Burnaby-based SuperPages Canada by Bain Capital from Verizon Communications.

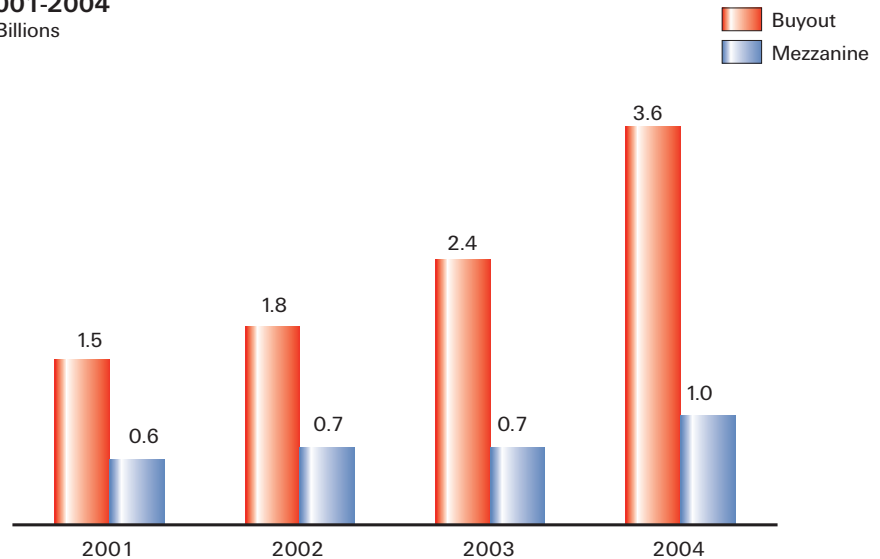
Canadian buyout industry players were also very active in 2004, in transactions both at home and abroad. Buyout fund capital invested in domestic and foreign businesses grew to \$3.6 billion in the past year, surpassing by 46 percent the \$2.4 billion invested in 2003.

Many Canadian buyout funds found quality deal opportunities in the traditional landscape of this country’s mid-market, to which approximately 60 percent of buyout capital is typically targeted.

Exhibit 10

**BUYOUT AND MEZZANINE CAPITAL INVESTED BY CANADIAN FUNDS;
2001-2004**

\$ Billions



Source: Thomson Macdonald

For example, TD Capital Canadian Private Equity Partners, together with co-investor OMERS Capital Partners Inc., formed the Cookie Jar Group to complete a \$165 million acquisition of CINAR Corporation, a Montréal-based company that produces children’s entertainment and educational programs.

The special-situations investor, Tricap Restructuring Fund, also completed a number of Canadian transactions over the past year. For example, Tricap led the \$200 million restructuring financing of Concert Industries of Gatineau, a global manufacturer of fabrics used in personal and home care goods.

Canada's largest buyout funds continued to target both domestic and international deal opportunities. For example, in addition to its Canadian deals, ONEX Corporation actively competed in the US buyout space in 2004 – via ONEX Partners LP – making several investments in established healthcare firms. This included sponsoring Magellan Health Services of Farmington, Connecticut, through its restructuring, in which the ONEX fund made its debut investment of US \$102 million.

MEZZANINE ACTIVITY ALSO ON THE RISE

In tandem with buyout activity, Canadian mezzanine financing saw notable growth throughout the past year – in contrast with 2003, when dollars invested declined. In 2004, the survey found an increase of 49 percent in mezzanine fund disbursements going to domestic and foreign businesses, from \$652 million a year ago to \$971 million in 2004.

Data drawn from the survey and Thomson Macdonald suggest that this growth is linked to larger-sized transactions and a few mega-deals. For example, Teachers' Private Capital led a mezzanine syndicate investment totaling \$350 million that was part of a \$610 million refinancing of Parmalat Dairy and Bakery, the Etobicoke-based dairy and food producer.

Other mezzanine transactions reflect the industry's traditional scope of \$20 million or less. A major deal in 2004 was the \$15 million invested by Penfund Mezzanine Fund II in PetValu of Markham, a specialty retailer of pet food and supplies in North America, which helped finance a buyout of existing shareholders.

These deals also illustrate the geographic focus of most mezzanine funds, which typically focus 80 percent of their capital on companies with headquarters or significant operations in Canada.

WHERE DID BUYOUT AND MEZZANINE MONEY GO?

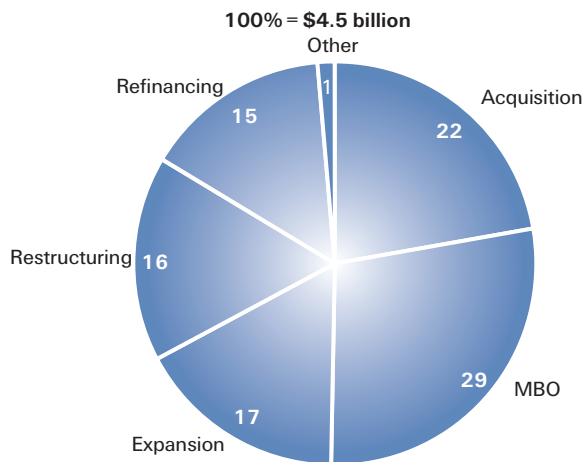
In past years, the Goldman and Carr LLP and McKinsey & Company survey questioned buyout and mezzanine fund managers about their deal and sector preferences. The answers painted a picture of primarily balanced funds, with a broad focus on well-established private and public firms in mature sectors.

In 2004, the survey asked respondents to indicate where actual capital was invested in the past year according to key event transaction types – acquisitions, expansions, financial distress or restructuring situations, MBOs, and refinancings.

Of the \$4.5 billion disbursed by Canadian buyout and mezzanine funds in 2004, the survey found a diverse mix of investments by event transaction, with close to half of the capital going into MBOs and acquisitions.

Exhibit 11

BUYOUT AND MEZZANINE CAPITAL INVESTED BY EVENT TYPE; 2004 Percent



Source: Thomson Macdonald

Activity in MBOs captured the largest share, with 29 percent of total amounts invested. “Generic” acquisition activity (where substantial equity or quasi-equity stakes are used to add value in a business to achieve any number of objectives) followed with a 22 percent share. Assuming third spot was expansion deals, at 17 percent.

Respondents in the buyout and mezzanine realms have consistently indicated that an essential driver of market position is the preferred size of fund investments. In 2004, most buyout industry players indicated a preferred range of \$10 million to \$50 million, and most mezzanine groups a preferred range of \$5 million to \$20 million.

A small number of much larger Canadian institutional and private-independent funds have the capacity to undertake investments of greater than \$100 million.

SOME TRACTION IN EXIT ACTIVITY

The survey once again found that most Canadian private equity fund managers expected their liquidity events to take place primarily through mergers and acquisitions and, to a lesser extent, IPOs. Thomson Macdonald data indicate that investors had cause for some optimism in 2004, given an increased number of disclosed venture-backed acquisitions and IPOs.

American technology firms featured prominently as acquirers in exits in the venture realm, including CIENA Corporation, which purchased the Ottawa-based telecommunications company Catena Networks from BCE Capital and a syndicate of US funds. Similarly, Cray bought OctigaBay Systems Corporation of Burnaby, which had been backed by the BDC Venture Capital Group, Celtic House Venture Partners, GrowthWorks, and Ventures West Management.

The income-trust market also continued to be a source of cash-outs, particularly for buyout and mezzanine funds. For instance, ONCAP LP sold its interest in Armtec in an IPO of income trust units in 2004. Guelph-based Armtec is a steel manufacturer and distributor acquired by ONCAP and senior company managers in 2001. Tricor Pacific Capital and McKenna Gale Capital also successfully exited Ag Growth Industries, a manufacturer of grain-handling equipment in Rosenort, Manitoba.

A characteristic of the US market in the past year was the use of secondary transactions whereby one or more buyout funds sold their equity stakes in

firms to other private equity investors. A notable example was the sale by ONEX Corporation and its partner Oaktree Capital Management of the non-Canadian assets in Loews Cineplex to Bain Capital, The Carlyle Group, and Spectrum Equity Investors.

1.6 What factors influence private equity market growth?

INSTITUTIONAL INVESTORS, RISING DOLLAR TOP LIST

Private equity professionals believe the greatest influences on market growth in Canada are the limited number of institutional investors with exposure to the market and the appreciating value of the Canadian dollar.

The survey asked buyout, mezzanine, and venture fund managers to rank a list of issues identified as factors in market growth. Ratings of 1 to 5 pertained to the emphasis on those issues at the time.

For the second year in a row, the respondents' primary concern was the reluctance of many pension funds, endowments, insurance companies, and other institutions to participate in the private equity market as limited partners. Professional managers have argued that this has led to a much more challenging fundraising environment in Canada compared to that in the United States. Venture professionals gave this issue a somewhat higher rating (3.0) than buyout and mezzanine professionals (2.8).

A few new market entrants joined Canadian institutional investors in 2004, including PSP Investment Board. It is hoped that the recent federal decision to remove the foreign property ceiling will encourage more institutions to embrace private equity as an asset class.

Not far behind was the issue of the Canadian dollar steadily rising in value against the American dollar during 2004. Once again, survey responses were split on this topic by market segment, with buyout and mezzanine professionals according the variable much greater emphasis (3.2) compared to venture professionals (2.3).

The meaning of a stronger currency appeared to vary among respondents. For buyout and mezzanine investors, diverse effects were possible, including the impact on manufacturers and other mature, export-intensive firms in portfolios, given the dollar's importance as a source of cost

Exhibit 12

**FACTORS INFLUENCING GROWTH OF THE CANADIAN PRIVATE EQUITY MARKET;
SURVEY RESPONDENT RATINGS BY IMPORTANCE**

5 = Very important; 1 = Not important

Limited participation of institutional investors	2.9
Rising Canadian dollar	2.7
Limited quality deal flow	2.6
Small domestic capital markets	2.6
Government tax policies	2.3
Lack of domestic high-yield debt market	1.9
Government intervention in the market	1.9
Challenges to investment in foreign markets	1.6
Provincial securities regulation	1.3

Source: Thomson Macdonald

advantage. At the same time, this circumstance might also create new deal opportunities.

Some weight was also attached by survey respondents to the limited quality of deal flow by Canadian businesses and entrepreneurs, as well as the relatively small size of domestic capital markets, which can significantly influence the scope of liquidity alternatives.

Interestingly, only four growth factors attracted above average rankings (2.5 or greater) by respondents, as compared to the previous year when the survey found comparable importance given to six factors.

1.7 Conclusion

Data drawn from Goodman and Carr LLP-McKinsey & Company's *Canadian Private Equity Activity Survey 2004*, as well as supplementary information provided by Thomson Macdonald, indicate across-the-board growth in investment activity in Canada's private equity market in 2004, following a sustained period of slower activity.

Higher disbursement levels in the buyout, mezzanine, and venture capital segments of the market appeared to be based on a renewal of the North American market as a whole. Investors gained confidence, in part because of improved conditions in exit activity. Canadian private equity professionals are well positioned to make further advances in 2005, though intensified deal activity must ultimately be coupled with comparable growth on the fundraising front.

APPENDIX

CONTRIBUTORS TO THE GOODMAN AND CARR LLP-McKINSEY & COMPANY *CANADIAN PRIVATE EQUITY ACTIVITY SURVEY 2004*

ACF Equity Atlantic Inc.	CDP Capital Private Equity
ARC Financial Corporation	Celtic House Venture Partners
Argosy Partners	Clairvest Group Inc.
AVAC Ltd.	Covington Capital Corporation
Axis Capital Corporation	Crocus Investment Fund
Banyan Capital Partners	Crown Capital Partners Limited
BC Advantage Funds (VCC)	Dancap Private Equity Inc.
BCE Capital	Desjardins Capital de risque
BEST Investment Counsel	DSC Partners
BMO Capital Corporation	EDC Equity Fund
Borealis Capital Corporation	EdgeStone Capital Partners
Brascan Financial Corporation	ENSIS Management Inc.
Brightspark Ventures	Equinox Management
Business Development Bank of Canada	FCC Ventures
CAI Private Equity	First Ontario Labour Sponsored Investment Fund Ltd.
Callisto Capital LP	FondAction
Canadian Medical Discovery Corp.	Fonds de solidarité (FTQ)
Capimont	Frontier Capital Partners
CCFL Mezzanine Partners	Fullarton Capital Corporation
	GeneChem

Genesys Capital Partners Inc.	Penfund
Greenstone Venture Partners	Primaxis Technology Ventures Inc.
GrowthWorks	PRIVEQ Capital Funds
GTI Capital	Propulsion Ventures Inc.
HSBC Capital (Canada) Inc.	Richardson Capital Limited
Hydro-Québec CapiTech	ROI Fund Inc.
Innovatech	RoyNat Capital
Integrated Partners	Schroders & Associates Canada Inc.
J.L. Albright Venture Partners	Skylon Advisors Inc.
Jefferson Partners	Skypoint Capital Corporation
Kilmer Capital Partners Ltd.	T2C2 Capital
Lawrence & Company	TD Capital
Manulife Capital	Teachers' Private Capital
McKenna Gale Capital	Tech Capital Partners Inc.
McLean Watson Capital	TechnoCap Inc.
MDS Capital Corporation	TORQUEST Partners Inc.
MedTech Partners Inc.	TriWest Capital
Mercantile Bancorp	VanCity Capital Corp.
MMV Financial Inc.	VenGrowth Capital Partners Inc.
MSBi Capital	Ventures West Management Inc.
MWI & Partners	Wellington Financial LP
New Brunswick Investment Management Corporation	Westcap Management
Norvest Capital Partners Inc.	Yaletown Venture Partners Inc.
Novacap	Yellow Point Equity Partners LP
OMERS Capital Partners	
ONCAP Investment Partners LP	
ONEX Corporation	
Orchard Capital Group Inc.	
PenderFund Capital Management Ltd.	



