

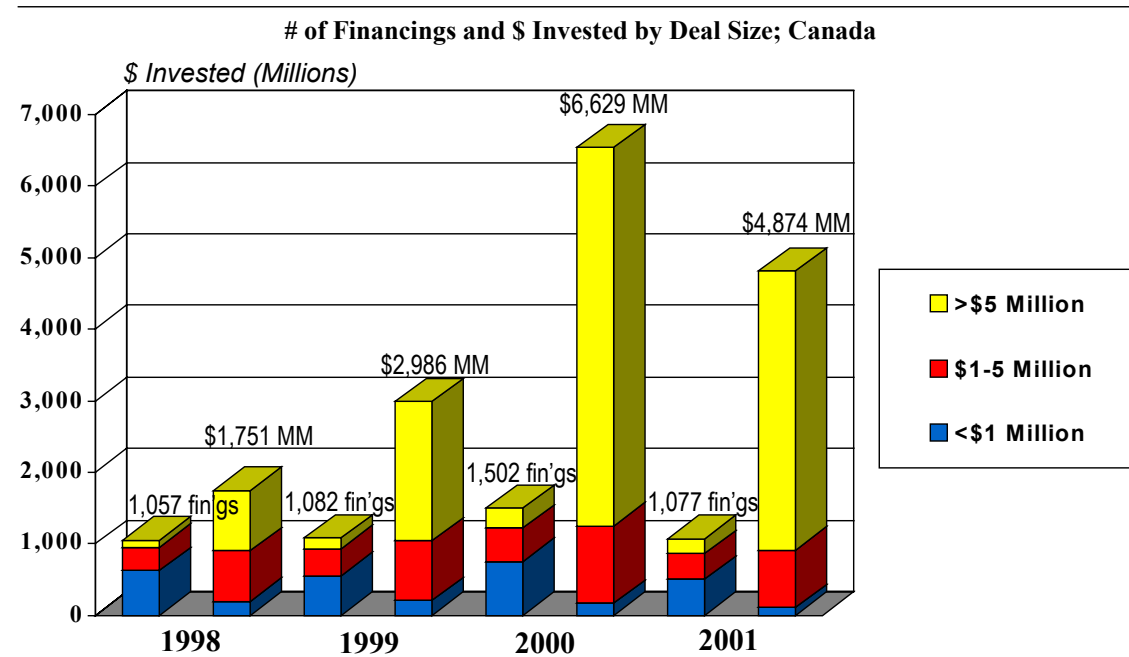
## The Venture Capital Industry in 2001: An Overview

Despite a tough economic climate and shaky public markets throughout 2001, the Canadian venture capital industry enjoyed the second-best year in its history, with disbursements totaling \$4.9 billion, down 27% from the record-breaking 2000, but still well above 1999 levels. These results are in sharp contrast with the situation in the United States, where capital invested fell by 65% from 2000 and now approximates 1998 levels. Interestingly, large numbers of American investors nonetheless continue to focus on cross-border opportunities in Canada's technology sectors, joining with Canadian partners to raise their share of capital invested to an historic 34% of total disbursements.

- The Canadian industry disbursed \$4.9 billion, reflecting a drop of 27% from \$6.6 billion in 2000, but still well above 1999 levels. There were 818 VC-backed companies this time around, compared to 1,132 in 2000.
- By contrast, the capital invested by the American industry in 2001 fell by 65%, from \$US104 billion in 2000 to \$US36.5 billion this past year.
- A driving force in relatively sustained disbursements in Canada have been foreign groups (chiefly US venture/corporate funds), which brought \$1.6 billion to technology deals, which is on par with their activity in 2000. As a result, they accounted for over one-third of the total amount invested, up from their previous 24% share. Though deploying less in the current environment, Canadian venture investors maintained a steady pace, frequently via partnerships with foreign sources.
- The average financing was steady at \$4.5 million, up from \$4.4 million one year earlier.
- Over the year, venture professionals gave increasing focus to existing portfolio companies, with 68% of aggregate disbursements going into follow-on transactions.
- Communications/networking firms once again led other technology sectors, absorbing one-quarter of all disbursement dollars, up from 20% in 2000.
- Computer software firms took second spot, with 16% of disbursements, displacing internet-related companies, which captured 12% of the total. The electronics/semiconductors sector garnered 13%.
- Biotechnology and other life science companies had considerable momentum in the past year, increasing their share of deployments to 22%, up from 18% last year.
- Start-up and other early stage firms in technology sectors benefited from unprecedented industry backing in 2001, capturing 60% of capital invested, or \$2.9 billion, up from 47% in 2000.
- Ontario's share of disbursements dropped to 42%, despite still thriving activity in the Ottawa Valley. Quebec continued to be home to 40% of deals done in the Canadian industry, while BC's share of amounts invested nationwide rose to 10%.
- Along with investment activity, fund-raising slowed for most industry players in 2001, however, increased new capital commitments to certain funds, particularly CDP Sofinov and LSVCCs, ensured that the national total rose to \$4.6 billion. The industry's capital under management now stands at \$20.1 billion, as compared to \$18.6 billion in 2000.
- Industry capital available for investment sits at a 1.3-year level of supply, although this liquidity is also concentrated in relatively few hands.

## INDUSTRY SHOWS VITALITY IN 2001, DESPITE ODDS

Despite a tough economic climate and shaky public markets, activity in the Canadian venture capital industry was surprisingly red-blooded in 2001. By December 31<sup>st</sup>, aggregate disbursements in Canada reached an impressive \$4.9 billion, down by 27% from the \$6.6 billion of last year, but still well above the \$3.0 billion registered in 1999. Once again, these results are in sharp contrast with the situation in the United States, where industry capital invested dropped by 65%, from \$US104 billion in 2000 to \$US36.5 billion in 2001, and now approximates 1998 levels.



As a consequence, the Canadian industry managed to pull off the second-best year in its history, with only the record-breaking results of 2000 casting a longer shadow.

Much of the strength in Canadian activity came in the first six months when, buoyed by the intense IT focus of late 2000, the industry deployed \$2.6 billion. However, despite growing evidence of a market slowdown, the pace in the second half stayed quite durable, with Q4 reflecting flows totaling \$1.2 billion, up slightly from \$1.1 billion in Q3.

The rate of transactional activity paralleled changes in dollar terms, with 1,077 deals done and 2,282 investments made in 2001, down 28% and 15% respectively from last year's 1,502 deals and 2,671 investments. A total of 818 companies secured venture-backing this time around, as compared to 1,132 in 2000.

As they did throughout 2001, venture professionals gave enthusiastic support to young technology companies in the final quarter, seen in the financings of SS8 Networks, Accelight and Optovation. These deals illustrate another trend characteristic of the past year: an industry preference for follow-ons. On balance, 68% of disbursements went to existing portfolio firms, with this level clearly rising as the year progressed, from 62% in Q1 to 70% in Q4. In 2000, the follow-on share was 60% of capital invested. This indicates a harsher environment for first-time financings than has existed for some time.

Higher average deal sizes continue to be a key factor in the strong showing of the industry in Canada. This average was \$4.5 million in 2001, up from \$4.4 million of one year ago and \$2.8 million in 1999. Doubtless, this trend owes to the growing number and diversity of co-investors in Canadian transactions and, in particular, syndicates formed around large technology financings.

The very different experiences of the two national industries in 2001 have helped to pump up capital invested in Canada relative to the United States. Canadian disbursements currently stand at 9% of those of its neighbour to the south, when exchanges rates are taken into account, up from 4% a year ago.

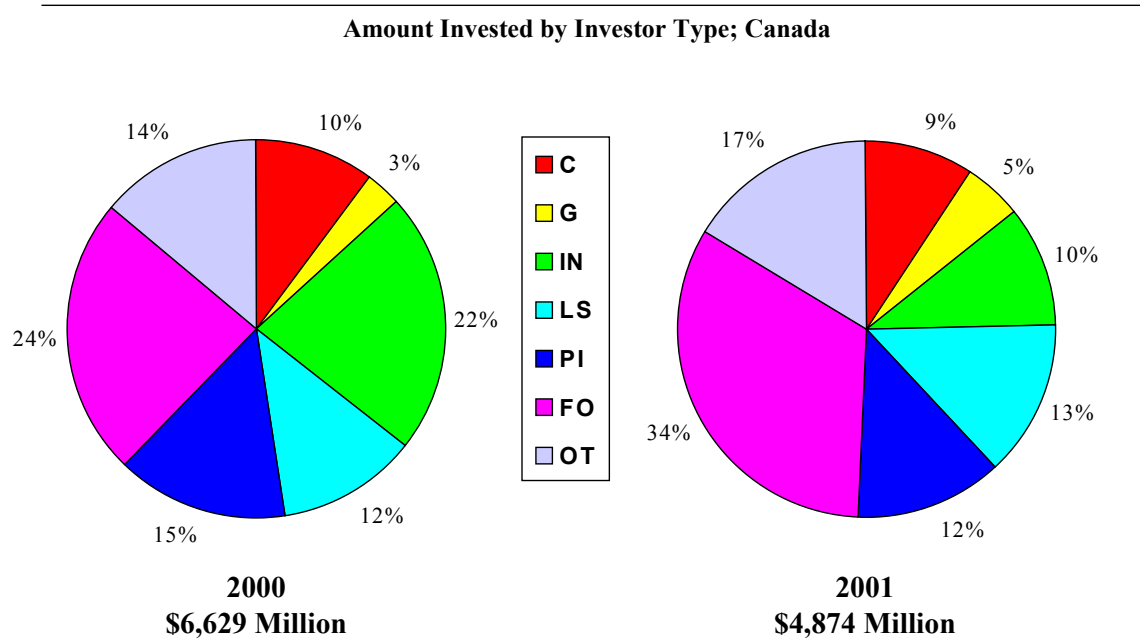
#### **FOREIGN WALLETS OPEN FOR CANADIAN DEALS**

Without a doubt, a driving force in 2001 industry trends has been the unabated interest of foreign investor groups (i.e., primarily American venture funds and strategic corporate investors) in a wide variety of deal opportunities across Canadian IT and life science sectors. By the end of December, these groups had poured a whopping \$1.6 billion into such transactions, most frequently in combination with Canadian partners, a level that matches almost exactly what foreign sources invested the year before.

Considering the drop in capital flows overall, however, the impact of foreign investment is much greater this time around. Indeed, as a proportion of the aggregate amount invested, foreign disbursements have reached an historic high, assuming a 34% share in 2001, up from 24% in 2000. Consequently, they have been integral to ensuring a steady stream of resources to fast-growing Canadian technology companies at a crucial moment in their development.

Not surprisingly, major American names, and other names in international venture capital, are an increasingly common feature of large technology financings in Canada. Among those linked to high profile activity in Q4 were: CDIB Venture Management, Granite Global Ventures, Menlo Ventures, Mitsubishi, New Enterprise, Newbury Ventures, NIF Ventures, Onset Ventures, Redwood, Stonewood Capital Management, Venrock, Vertex Management, Warburg Pincus, Western Technology Investment and Woodside Fund.

“Other” investors (i.e., mutual funds and other institutional investors attracted to certain deals, but typically without a permanent market presence) brought a supplementary \$802 million to Canadian deals. Taken together, foreign and “other” investors positioned outside of the industry were responsible for roughly half of the resources behind 2001 activity.



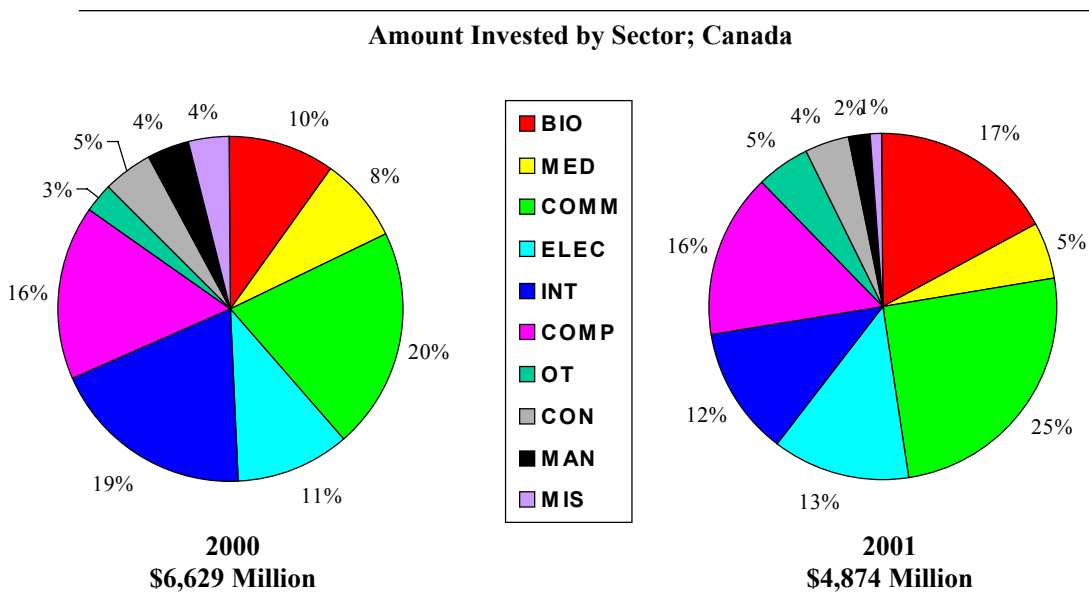
Within the Canadian industry, LSVCCs led other investor groups, disbursing \$652 million, followed closely by private independent funds, which were responsible for \$608 million. At \$501 invested, institutional investors with a direct market role (i.e., CDP Capital, OMERS, Ontario Teachers, et al) also remained active, followed by corporate venture groups with \$459 million. As compared to 2000, levels are down in most cases, indicating a more conservative investor stance in the present circumstances, characterized in part by follow-on financings of small dollar value.

### **IT ON TOP, BUT LIFE SCIENCES GAINING**

This country’s increasingly diverse array of IT companies remained the central focus of Canadian and foreign investor groups in 2001, attracting \$3.2 billion in all, or close to two-thirds of the capital invested. For the second year in a row, communications and networking was the sector of choice, reflecting 132 financings completed totaling \$1.2 million. In relative terms, this is greater backing than communications firms enjoyed in 2000, as such firms took 25% of industry resources this time around, compared to the previous 20%.

Once again, fibreoptics/photronics grabbed the most cash, followed by wireless communications equipment, wireless service providers and telecommunications equipment. High profile sector financings in 2001 included those for Ceyba – the single largest transaction in the history of the Canadian industry – as well as SS8 Networks and Tropic Networks. Deals of this variety ensured that the average communications deal rose in size to \$9.3 million, up from \$9.0 million the year before.

Over the course of the past year, computer software firms displaced companies focused on the internet in IT's number two spot. Indeed, the computer-related sector finished with 191 deals done, totaling \$715 million, or 16% of disbursement streams overall, compared to its \$1.0 billion take and the same share in 2000. The average software financing was \$3.7 million, driven by such particularly large transactions as those for DWL, Worldinsure and Espial.



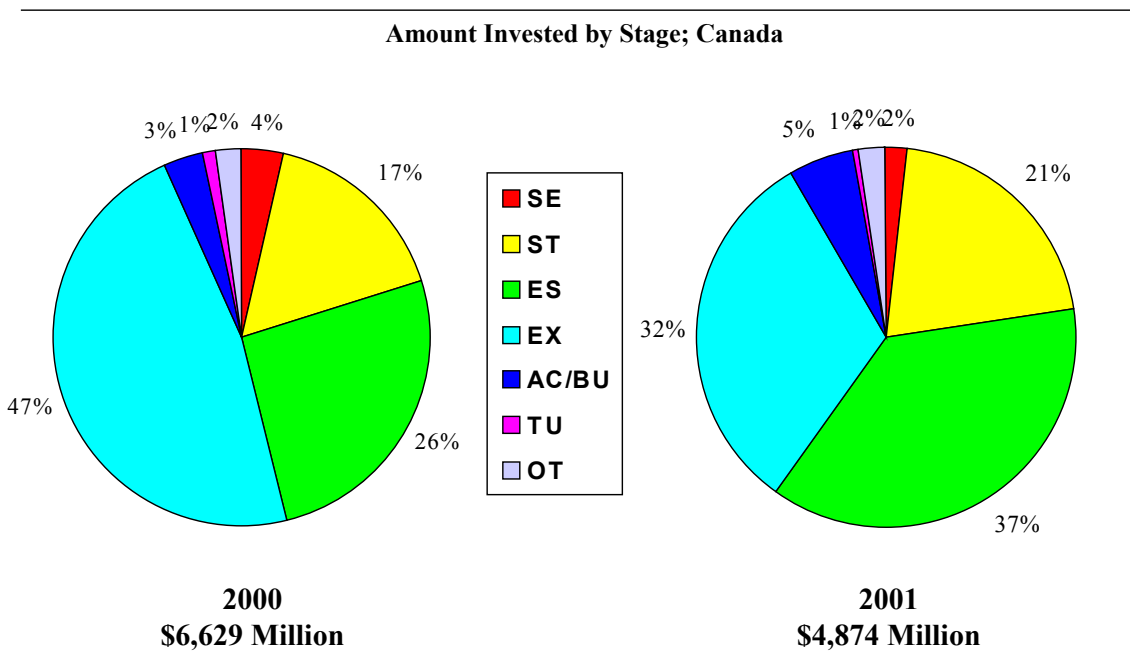
Capturing \$586 million through 125 rounds of financing, the position of the internet-related sector has eroded substantially since 2000. Then, internet-related companies garnered a whopping \$1.3 billion and 19% of total amounts invested. At 12% of industry disbursements in 2001, this sector has absorbed the biggest blow of the market slowdown, despite the success of certain companies, including Q9 Networks and RecruitSoft.com. The average internet-related financing was sized \$4.7 million.

Firms concentrating on electronics/semiconductors closed 121 transactions in 2001 involving \$618 million, giving this sector 13% of industry resources in 2001, up from 11% last year. Influencing this relative upward movement were such major company financings as Quake Technologies and Sibercore Technologies, bringing the deal average to \$5.1 million.

2001 marked a revival in life science investment across North America, in part because of the slightly reduced IT emphasis. 196 deals involving biopharmaceutical and other life science companies obtained \$1.1 billion, down only moderately from \$1.2 billion in 2000, accounting for 22% of disbursements, up from 18% in 2000. Firms such as Xenon Genetics and Celmed Biosciences benefited from this trend, although Canadian investing in companies based in the United States contributed heavily to this final result.

**YEAR OF THE EARLY STAGE DEAL**

At the core of Canadian industry activity in 2001 has been an unprecedented emphasis of start-up and other early stage transactions. One measure of this can be seen in the largest technology financings, which feature a sizeable number of exceptionally young companies. In addition, early stage deals, totaling 569, succeeded in capturing \$2.9 billion, which comes close to matching the \$3.1 billion of 2000, and an astonishing 60% share of aggregate disbursements, up from 47% in 2000.



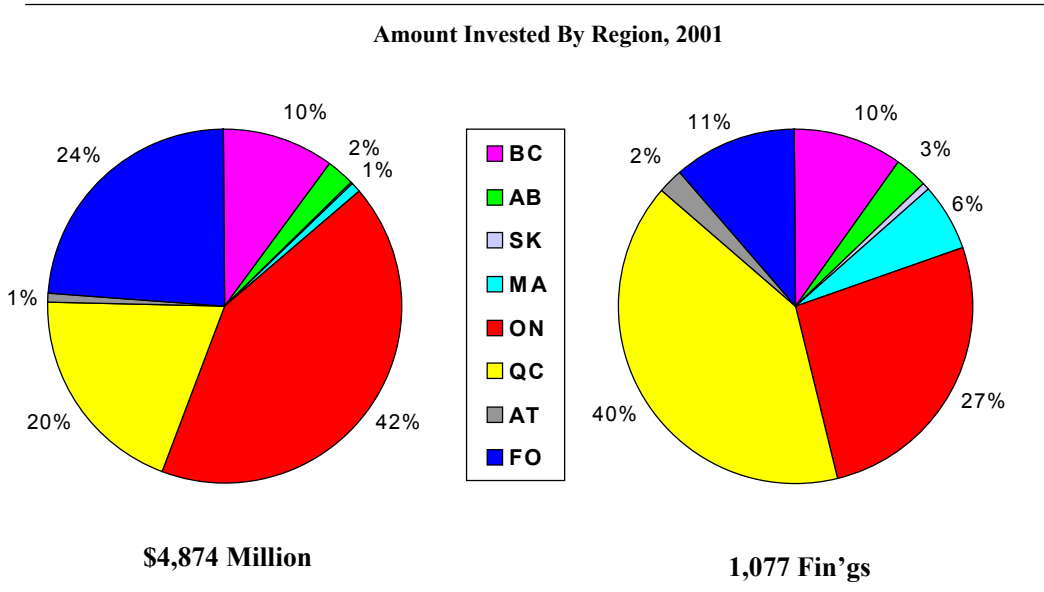
Only seed financings failed to enjoy this momentum at the early stage end of the spectrum, attracting only \$90 million this time around, as compared to an impressive \$232 million last year.

Large financings of start-ups and other early stage firms in 2001 included Ceyba, SS8 Networks, Accelight, Q9 Networks and Xenon Genetics. As a consequence, the average early stage transaction jumped to an historic high of \$5.1 million. In 2000, this average was \$4.2 million.

Despite the prominence of such expanding companies as Tropic Networks and Xantrex Technology, among many others, the industry did not favour expansion transactions in 2001 as it has in previous years. Expansion financings completed stood at 380 at year's end, and totaled \$1.5 billion, reflecting a dramatic decline from 683 deals, totaling \$3.1 billion, in 2000. As a result, their share of total capital invested fell from 47% last year to 32%. Part of the explanation lies in relatively smaller deal sizes, which averaged \$4.1 billion in 2001.

**OTTAWA VALLEY, BC WEATHER SLOWDOWN**

Despite securing an impressive \$2.0 billion, or 42% all dollars invested, backing of Ontario-based companies was down in 2001, when compared to their take of \$2.9 billion and a 44% share last year.



Swimming against the tide were IT firms located in the Ottawa Valley region, which managed to attract undiminished support from Canadian and foreign investors, totaling \$1.1 billion, representing over half of all capital invested in the province this past year. This should not be surprising given the long list of Ottawa-situated company financings that count among the industry's largest, including Ceyba, SS8 Networks, Tropic Networks and Accelight.

Capturing 433 rounds of financing in them, Quebec-based companies continue to absorb the lion's share of transactional activity in the Canadian industry, or 40% of the aggregate. Quebec also captured 20% of disbursements as a whole, though in absolute terms, this points to a drop from \$1.4 billion in 2000 to \$956 million in 2001. In relative terms, however, amounts invested in the province remain on par with trends over the past two years.

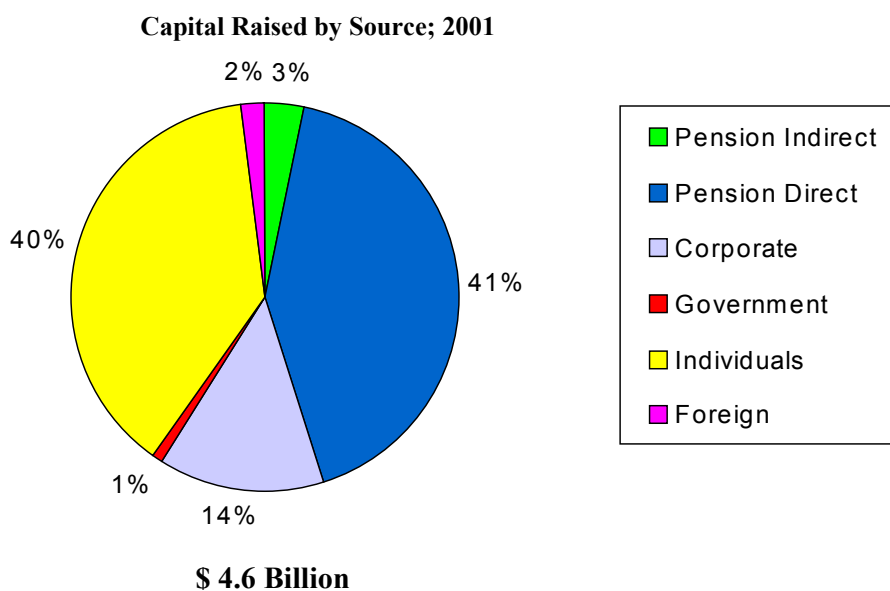
Since the beginning of January, activity in British Columbia has demonstrated considerable potency, with capital flows to provincially based companies reaching \$502 million by the end of December. This level is only slightly below the \$540 million of 2000, giving British Columbia 10% of capital invested nationwide, up from its previous 7%.

A key development in the Canadian industry continues to be growing investor participation in transactions outside of the country. Large financings in technology-intensive firms situated in the United States, as well as in several European and Asian countries, obtained \$1.2 billion in 2001, or 24% of deployments.

## FUND-RAISING SLOWS FOR MOST PLAYERS IN 2001

Along with investment activity, a key indicator of the health of the Canadian industry is the rate at which new resources are introduced to the market. For this reason, Macdonald & Associates will report fund-raising trends on a quarterly basis, beginning in 2002. To do this, historical tables reflecting funds raised, capital under management and liquidity, which previously stated supply on an annual basis, have been recompiled. The most important change involves capturing LSVCC fund-raising in the quarter in which it actually took place.

Consistent with a slower market in the past year, inflows of new capital were lower for most Canadian venture funds. Nonetheless, a total of \$4.6 billion in fresh supply was added, up from \$4.2 billion in 2000. Of this, over two-thirds or \$3.0 billion was raised by Quebec-based funds. However, the single largest factor influencing fund-raising in 2001 was a major commitment of \$1.9 billion to CDP Sofinov, which alone accounted for 63% of all new capital brought in by Quebec-based funds. At the national level, new CDP Sofinov resources accounted for 41% of the \$4.6 billion of inflows, while LSVCCs accounted for another 38%.



The bulk of new capital came from individuals (mostly into LSVCCs) and from direct commitments (as opposed to fund commitments) by pension funds, and primarily CDP. Commitments from pension funds and other institutional sources to private independents accounted for only 4% of new capital. In short, the vast majority of industry players did not raise new capital in 2001, but the success of a handful of large funds did lead to a reasonably stable inflow at the aggregate level. The net result was an 8% increase in the total pool managed by the industry, from \$18.6 billion in 2000 to \$20.1 billion in 2001.

Among the few private funds that successfully raised capital from institutional and other sources in 2001 were EdgeStone Capital Partners, Novacap, Skypoint Capital Corporation and VenGrowth Capital Partners. Several new corporate funds also impacted appreciably on overall supply conditions, including Bell Mobility Investments and OPG Ventures.

2001 was notable for the tendency of many investor groups/funds to conserve their resources for follow-on activity and the next market upswing. Consequently, the industry's liquidity reserves are in fairly solid shape, totaling \$6.2 billion, up from \$4.2 billion a year ago, although much of this increase was driven by the increased allocation to CDP Sofinov. Based on recent disbursement trends, this suggests the industry has 1.3 years of supply as it enters 2002, but a significant portion of this liquidity is concentrated in relatively few hands.

Fund-raising in the United States was down in 2001, with the American industry attracting \$US40.6 billion in total, as compared to \$US104.6 billion in 2000.

Top 10 Deals Done (By Size) in 2001			
Company	City	Province	Invested \$ (CAD)
Ceyba Inc. (Formerly Solinet Systems Inc.)	Ottawa	Ontario	144,500,000
SS8 Networks Inc.	Kanata	Ontario	96,100,000
Tropic Networks Inc.	Kanata	Ontario	93,000,000
Accelight Networks Inc.	Ottawa	Ontario	93,000,000
Q9 Networks	Toronto	Ontario	88,500,000
Mobile Satellite Ventures	Gloucester	Ontario	85,250,000
Celmed BioSciences Inc.	Saint-Laurent	Quebec	60,000,000
Xantrex Technology Inc.	Burnaby	British Columbia	58,500,000
DWL Incorporated	Toronto	Ontario	48,050,000
Quake Technologies Inc.	Kanata	Ontario	46,500,000

*Note: Certain deals converted from US dollars at 1.55 (Bank of Canada) 2001.*