

The global trends in the ‘Venture Capital 2007 Survey’ – Venture capital industry backgrounder December 2007

Venture capital in Canada: a broken ecosystem

Converting entrepreneurial ideas into viable, thriving companies requires a succession of funding stages. Each round of investment builds on the next as companies prove their capacity to provide a good return on investment to attract later phases of funding.

To be successful, many Canadian technology companies require a healthy “funding ecosystem” that enables them to grow through successive rounds of financing. Similar to young hockey players who dream of making it to the “big leagues”, but who must distinguish themselves at each level of minor hockey to advance, aspiring companies depend on each round of capital investment to reach their full potential, which often culminates with an initial public offering (IPO) or other exit event. For further details on this ecosystem, see the diagram on the next page.

However, the venture capital (VC) funding ecosystem in Canada has been ailing over the past few years due to various systemic problems. Quite simply, the system is broken, meaning that many aspiring Canadian companies are thwarted at critical stages of growth. Others are forced to leave Canada altogether in search of funding. Fixing the various problems will require the combined efforts of Canadian governments, lawmakers and the financial industry to reinvigorate the health of the Canadian VC industry.

The Canadian VC funding ecosystem

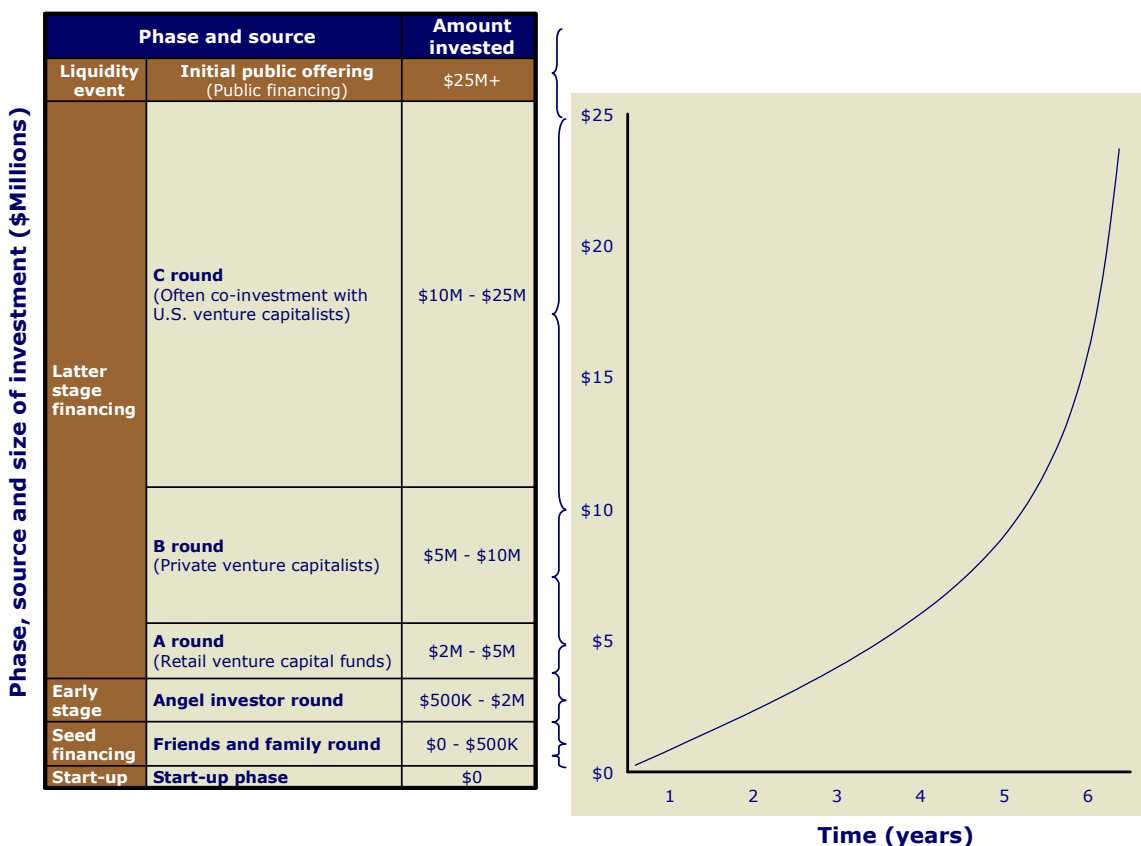
The VC process is a fundraising technique for companies willing to sell equity in their company in return for money to grow or expand their business. Venture capital is invested across phases — from early seed self-funding through successive rounds of institutional VC and syndicated financing, and perhaps, even to an IPO or acquisition.

However, according to Canada’s Venture Capital & Private Equity Association (CVCA), Canadian entrepreneurs receive much less capital funding than their U.S. competitors who are typically backed by around three times the amount of financing as their Canadian peers at each round of development.

In addition, problems in Canada’s ability to raise venture capital suggests that our companies will soon face significant funding hurdles in their pursuit of world-class status. Canadian companies that don’t have access to capital are unlikely to evolve into globally competitive enterprises. As a result, while the best Canadian entrepreneurs continue to raise funds, the financing process increasingly encourages emerging new businesses to leave Canada.

U.S. VCs bring more to Canada than just their money. The United States accounts for nine tenths of the North American marketplace, U.S. VCs bring both a wealth of contacts and deep pockets to Canadian companies. They also bring a huge network of customers, leading U.S. marketers and distributors, as well as key capital market contacts to fund future stages of growth and help Canadian companies establish global technological leadership.

The Canadian venture capital funding ecosystem



Canadian investment ecosystem

The seven phases of venture capital funding

1. Start up phase

Self-funding based on savings, credit cards and early revenues reinvested in the company.

2. Friends and family round (Up to \$500,000)

Friends and family are an important source of capital for many small entrepreneurs. They are a readily accessible source of funds, with less complexity compared to formal lending institutions and formal investors.

- **Health of this capital source in Canada: GOOD** – Favourable federal tax rules that allow for low capital gain tax rates and a lifetime total capital gains exemption of \$750,000 support this critical initial level of funding.

3. Angel investor round (\$500,000 to \$2 million)

Working with angel investors means acquiring venture capital from wealthy individual investors or pools of angel investors. Angel investors look for companies that exhibit high-growth prospects, have a synergy with their own business or compete in an industry in which they have succeeded.

- **Health of this capital source in Canada: FAIR** – Lower capital gains tax rates have played a role in this important second level of funding. Angel investment sets the stage for a company to prove its growth potential as part of attracting more formal sources of venture capital funding from banks or investment firms in later phases.

4. 'A round': Retail venture capital funds (\$2 million to \$5 million)

Retail Venture Capital Funds (RVCF) are similar to mutual funds but generally invest in high-risk smaller businesses and are open to investment by the general public. Investors in RVCFs are eligible for fairly generous tax credits that are not available to mutual fund investors.

- **Health of this capital source in Canada: POOR** – Investments in labour sponsored investment funds (LSIFs) qualify for a federal RVCF tax credit. Seven provinces (Nova Scotia, New Brunswick, Quebec, Ontario, Manitoba, Saskatchewan and British Columbia) also support the industry by offering an additional tax credit of 15%, bringing the total benefit to 30% of their RVCF investment. However Ontario's plans to phase out the RVCF tax credit by 2011 puts the health of this critical stage of venture capital investment in jeopardy (particularly in Ontario) as poor returns on investment have made it difficult for such funds to attract new sources of investment capital from the public.

5. 'B round': Private venture capital funds (\$5 million to \$10 million)

Private venture capital funds invest in companies that have demonstrated a continued track record of success. These funds are generally structured as limited partnerships and investors are typically large tax exempt entities (e.g. pension funds) or large financial institutions (e.g. banks or insurance companies).

- **Health of this capital source in Canada: POOR** – This sector has suffered as a result of the technology bubble and is still trying to rebuild. Poor returns have made it very difficult for such funds to attract new sources of investment capital from limited partners.

6. 'C round': Usually co-investment with U.S. partners (\$10 million to \$25 million)

Once a company has proven itself to a venture capital firm in Canada, the next step is to attract new rounds of investment from a syndicate of partners that often includes U.S. venture capital firms. This level of investment would usually see a Canadian venture capital firm act as lead investor by coordinating funding deals and representing the group's members.

- **Health of this capital source in Canada: POOR** - The Canadian industry is often unable to lead international co-investment initiatives because there are neither enough syndicates nor funds in Canada. As a result, U.S. companies often become the lead syndicate, which can result in Canadian companies moving to the U.S. to be closer to their source of funding.

7. Initial public offering: (\$25 million and up)

An initial public offering (IPO) is the first sale of stock to the public by a private company. IPOs are only possible after a company has proven itself through several successive rounds of funding, and is seen as having long-term potential. To reach this phase, a company must have had several successful rounds of financing.

- **Health of this capital source in Canada: FAIR TO GOOD** – Several Canadian technology companies have achieved some success in 2007, but if systemic problems are not fixed in earlier stages of VC funding in Canada companies won't have the financial backing to make it to this stage in the future.

Tax barriers preventing foreign investment in Canada

- **Withholding and section 116 certificate process** — The overwhelming majority of foreign VCs are not subject to Canadian tax when they sell an investment, but face a delay of many months to work through the Section 116 tax clearance process until funds can freely flow to them. Many foreign VCs are structured such that each of the investors in the VC — sometimes hundreds or even thousands — is subject to this clearance process as if they held the investment directly. This delay results in lower returns and frequently causes direct financial loss to investors. Canadians

who invest in the United States, the United Kingdom and other major global markets do not face such taxes or delays from red tape.

- **Requirement to file Canadian tax returns by foreigners who don't owe taxes creates hundreds of pages of unnecessary paperwork** — Canada continues to impose tax filing requirements in circumstances where no taxes are payable by these investors. When a foreign VC sells an investment, they must file a Canadian tax return even if they do not owe any taxes. Each of the investors in some of these foreign VCs may also need to comply with these filing requirements, which can result in literally hundreds of pages of documents that are required for signature and processing for a single sale. This tax return filing issue can also apply to certain Canadian public companies.
- **Barriers to liquidity also affect Canadian investors** — it is also critical to defer the taxes incurred by Canadian investors when a Canadian company they have invested in is sold to a foreign company, and when no cash proceeds are paid to the investor. Current Canadian cross-border merger tax rules limit foreign capital flows for Canadians and require the use of cumbersome exchangeable share structures. This not only discourages foreign investors from participating in these structures, but also encourages Canadian companies to relocate their businesses outside of Canada. Once again, Canada is unique in this distinction.

The Canadian government has taken a few small steps but needs to start taking strides

The recent decision to recognize U.S. limited liability corporations (LLCs) as flow-through entities and eliminate non-resident withholding tax on interest payments under the Protocol to the Canada-U.S. tax treaty was very welcome. Given that the LLC structure is a common form of corporate organization among U.S.-based private equity firms, U.S. resident investors will no longer incur Canadian taxes from the disposition of their Canadian investments. However, it is important to note, that the treaty is not yet effective and it is unclear when it might take effect.

Other solutions are needed to fix the industry's broken ecosystem

The Government of Canada can remove the tax barriers preventing the flow of direct foreign VC investment into the country, and it can also play a critical role in reviving the Canadian domestic VC ecosystem. At the seed and early stage financing rounds, both federal and provincial governments could provide incentive tax credits, flow-through tax deductions, and/or reduced capital gains taxes for investors. At the first round of institutional VC funding, the federal and provincial governments could also improve retail venture capital programs, particularly for provinces where such programs have been curtailed (e.g., Ontario) or do not currently exist (e.g., Alberta). In addition, at the latter round of institutional VC funding, the government can play a pivotal role as a source of capital for these VCs.

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