

Canada's Venture Capital Industry in 2003: An Overview

Investment activity in Canada's venture capital industry continued to decline in 2003, with disbursements totaling \$1.5 billion at December 31st, down by a substantial 41% from \$2.5 billion in 2002. Consequently, Canadian VC activity hit its lowest ebb since the current slowdown began in early 2001, reflecting rates of capital invested that now approximate those last seen in 1998. Despite the reduction in amounts invested, the number of company financings kept a steadier pace, with a total of 616 Canadian businesses receiving VC, or only 10% shy of the 681 firms in the previous year.

In the fourth quarter of 2003, VC dollars totaling \$532 million flowed to 228 companies. While this level of disbursements was up by 39% from the \$382 million of the third quarter, the final three months tend to be the most active all year, and activity in Q4 2003 was still at some distance from Q4 2002, when \$763 million was recorded.

The modest year-over-year decline in the number of VC-backed companies, relative to dollars invested, points to the lack of "mega-deals" in 2003 that previously dominated industry trends. In fact, there were only 43 deals sized \$10 million or greater this time around, as compared to 71 such transactions in 2002.

The Canadian story of slower VC industry activity had its parallel in the United States (US). The American industry disbursed \$US 18.2 billion in 2003, which represents a 15% decline from the \$US 21.4 billion of the year before (Thomson Venture Economics). As in Canada, year-end results in the US benefited from growth in Q4 capital invested. Also like Canada, US rates of capital invested now approximate those last seen in 1998.

Regarding Canadian VC industry supply, there were significant outflows of capital in 2003, matched by a tough fund-raising climate. As a result, while capital under management, totaling \$22.4 billion, was essentially unchanged between 2002 and this past year, liquidity stocks fell to \$6.2 billion. New capital commitments totaled \$2.0 billion, down by 39% from the \$3.2 billion of 2002, as both LSVCCs and institutionally supplied private limited partnerships brought in fewer new resources this time around.

Notice of Data Changes

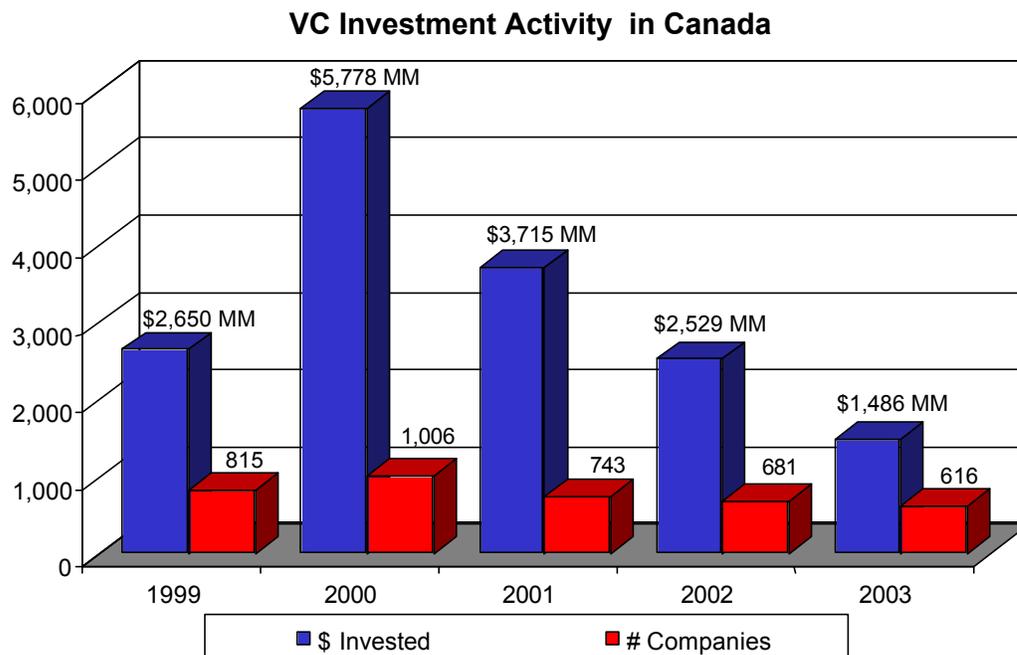
Macdonald & Associates has created a new category of Canadian VC investor: Provincial venture capital corporations (VCCs). Like LSVCCs, provincial VCCs found in BC and Québec typically raise funds at the retail level with benefit of tax assistance. In this Overview, the role of provincial VCCs is discussed only with respect to their 2003 impact on capital supply trends in the industry. Beginning in 2004, Macdonald & Associates will also track the on-going deal activity of this investor group.

To stay abreast of trends in Canada's venture capital industry, Macdonald & Associates continually updates all company financing information. For this reason, current and historical aggregate data are subject to change. Website users should therefore be alert to revisions to quarterly and annual statistics, in total and across specific categories.

VC ACTIVITY IN 2003 SLOW, BUT STABLE

Investment activity in Canada's venture capital industry continued to decline in 2003, with disbursements totaling \$1.5 billion at December 31st, down by a substantial 41% from the \$2.5 billion of 2002. Despite the reduction in amounts invested, the number of company financings kept a steadier pace, with a total of 616 Canadian businesses receiving VC, or only 10% shy of the 681 firms in the previous year.

As a consequence, Canadian VC activity hit its lowest low ebb since the current slowdown began in early 2001. Reflecting the tangible investor caution that has only grown since that time, rates of capital invested in 2003 approximated those last seen in 1998, when \$1.6 billion was deployed.



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The upswing in activity in Q4 was due primarily to a flurry of transactions by LSVCCs, private-independent funds and other investor groups. The period October-December also witnessed some of the year's larger technology financing rounds, particularly in the life sciences sector.

This point notwithstanding, 2003 remained conspicuous for the absence of mega-deals, at least as compared to prior years. For instance, Canadian VC investment in 2002 included 71 deals sized \$10 million or greater. In 2003, the number of comparably sized deals fell to 43. In addition, while the top 10 deals consumed almost one-quarter of aggregate disbursements in 2002 (with most of the largest telecom financings grouped in the year's first three months), the top 10 grabbed a 17% share in 2003.

The Canadian story of slower VC industry activity had its parallel in the United States (US). The American industry disbursed \$US18.2 billion to 2,235 companies in 2003, which represents a 15% decline from the \$US21.4 billion in 2,552 firms the year before (Thomson Venture Economics). As in Canada, year-end results in the US benefited from a rise in Q4 dollars invested, totaling \$US4.9 billion, as compared to \$US4.4 billion in the third quarter. Also like Canada, US rates of capital invested now approximate those last seen in 1998.

Other indicators also suggest that the North American market may be on somewhat more solid footing. For instance, in the US, merger and acquisition activity involving VC-backed companies appears to have stabilized, while Q4 saw the largest quarterly spate of VC-backed IPOs since 2000.

In Canada, amounts invested per company dropped with the smaller batch of mega-deals. Capital infusions averaged \$2.4 million in 2003, as compared to \$3.7 million in 2002, and \$5.0 million in 2001.

Weaker dollar infusions are linked to the Canadian industry's continuing emphasis of follow-on deals, as many portfolio firms are capturing resources in smaller increments. Transactions involving existing portfolio companies attracted 70% of VC outlays in 2003, though this is down from 74% in 2002. In a stronger market, follow-ons typically receive around 60% of disbursements.

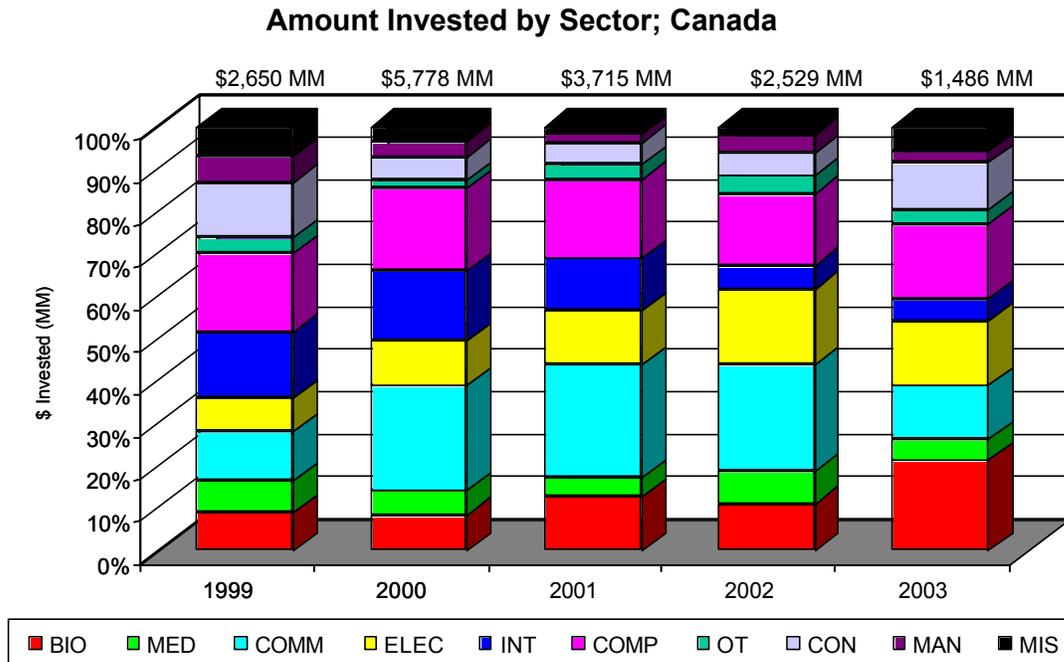
Domestic VC funds also cut back on their overseas activity in 2003. Canadians invested \$262 million outside of the country (or 18% of all VC disbursed by Canadians), in deals valued at \$1.0 billion. One year ago, Canadian investors were responsible for \$525 million (or 22% of all VC disbursed by Canadians) in non-resident transactions of \$1.4 billion.

LIFE SCIENCES AHEAD OF THE PACK

Propelled by a run of major financings completed in the fourth quarter, including those falling behind Adherex Technologies, Chronogen, Neuromed Technologies and Xanthus Life Sciences, firms in biopharmaceuticals and other life sciences led other sectors in industry esteem in 2003. In total, \$392 million was invested in 110 life sciences companies, giving them a 26% share of all disbursements.

In fact, an industry preference for life sciences investment was evident right across North America (in the US, 32% of VC invested went to this sector). This being said, the Canadian sector's gain was a relative one, as 2003 disbursements represented a drop of 18% from the \$479 million that flowed in this direction the year before. In other words, life sciences activity topped activity in other sectors because its year-over-year declines were less steep.

In the technology realm, computer software products took a clear second spot, with \$258 million, or 17% of total capital invested, going to 97 companies. This level of support was off by 28% as compared to the \$360 million secured by software firms in 2002. Nonetheless, the sector featured some important transactions in the past year, including two large fourth quarter deals involving Q1 Labs and Trigence Corporation.



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The Internet-related sector fared less well in 2003, notwithstanding some key company financings in the first six months. In total, \$77 million was attracted to 37 Internet firms, or just more than half of the \$144 million obtained previously.

Despite some major Q4 deals backing Atsana Semiconductors Corporation and Silicon Optix, firms based in computer hardware, electronics and semiconductors also finished the year with less than half of their 2002 take of industry dollars. Activity in the sector reflected \$225 million in 59 companies, down from the prior \$449 million.

In IT, communications and networking absorbed the biggest hit in 2003, with 55 companies receiving \$187 million, off by close to 3.5 times from the \$632 million that streamed to 60 companies in 2002. This occurred despite the boost provided by at least one high profile transaction in Q4, involving BelAir Networks. Consequently, while telecom was at the forefront of industry activity in 2000-2002, the sector attained only a 13% share of overall disbursements in 2003.

With \$45 million reaching 26 firms, the energy and environmental technologies sector also lost some of the relative momentum it had enjoyed in 2001 and 2002.

Given a market context that often prefers traditional businesses, it is not surprising that consumer products, manufacturing, retail and related sectors attracted a high proportion of industry attention in 2003. Traditional companies, totaling 219, obtained \$288 million, or only marginally less than the \$297 million recorded the year before. Such activity therefore represented 35% of all VC-backed firms and 19% of all disbursements – the vast bulk of which was located in Québec.

Top 10 Deals Done (By Size) in 2003

Company	City	Province	\$ Announced	Quarter
Neuromed Technologies	Vancouver	BC	USD\$32,000,000	Q4
Xanthus Life Sciences	Montréal	QC	USD\$30,800,000	Q4
Medicago	Sainte-Foy	QC	CAD\$28,000,000	Q3
Adherex Technologies	Ottawa	ON	CAD\$21,000,000	Q4
Tropic Networks	Ottawa	ON	USD\$20,000,000	Q1
Engim Canada	Kanata	ON	USD\$18,500,000	Q3
Silicon Optix	Toronto	ON	USD\$18,000,000	Q4
BelAir Networks	Kanata	ON	USD\$15,000,000	Q4
Q1 Labs	Saint John	NB	USD\$14,400,000	Q4
Atreus Systems	Ottawa	ON	USD\$13,000,000	Q1

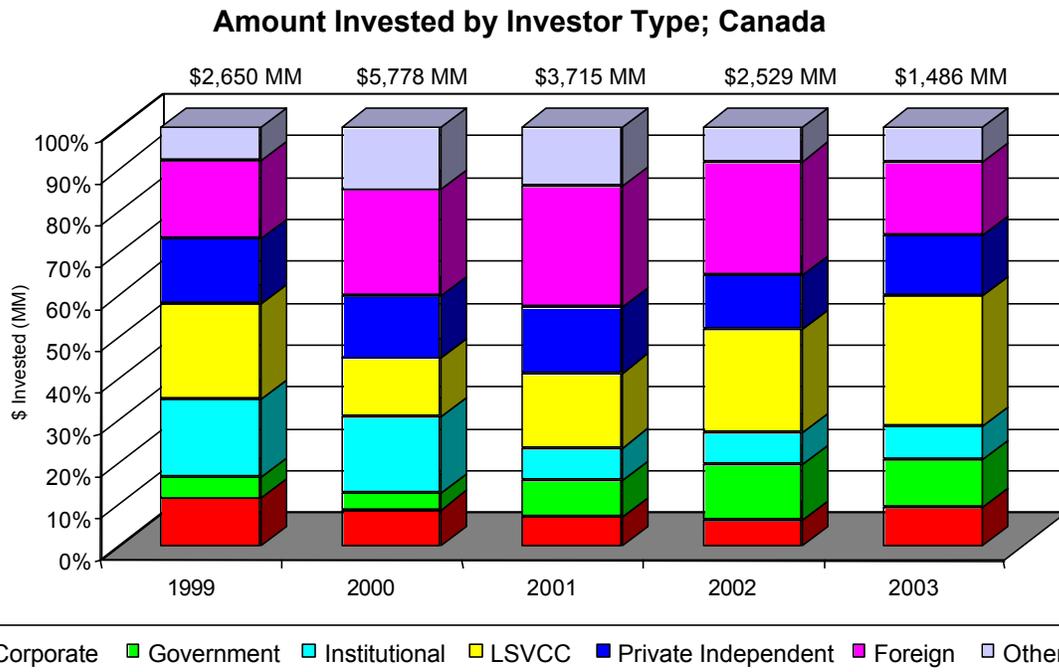
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FOREIGN ACTIVITY DOWN, BUT MORE DIVERSE

American and other foreign sources of VC have heavily influenced Canadian industry activity since 2000. However, foreign disbursements demonstrated clear signs of weakness in the first six months of 2003, a trend that was attributable to fewer large, syndicated telecom deals. To an extent, foreign activity revived in Q3 and Q4, with non-residents investing \$193 million, or 75% of the \$257 million they brought to Canadian VC transactions in January-through-December.

Despite this late-year revival, foreign disbursements as a whole were less than half of the \$682 million recorded in 2002. In addition, their share of capital invested fell from 27%, to a more modest 17%. On the other hand, foreign dollars appeared to be spread over a wider, and more diverse, array of emerging technology companies than has been the case in past.

Most surprising was the fact that the preferred sector of non-residents in 2003 was Canadian life sciences, which captured \$82 million, or 32% of all cross-border resources. Most of this money was concentrated in a handful of major financings, including those in the fourth quarter that supported Adherex Technologies, Neuromed Technologies and Xanthus Life Sciences. This indicates that US and other foreign VC funds may finally be looking beyond their traditional focus on communications and networking located chiefly in the Ottawa Valley.



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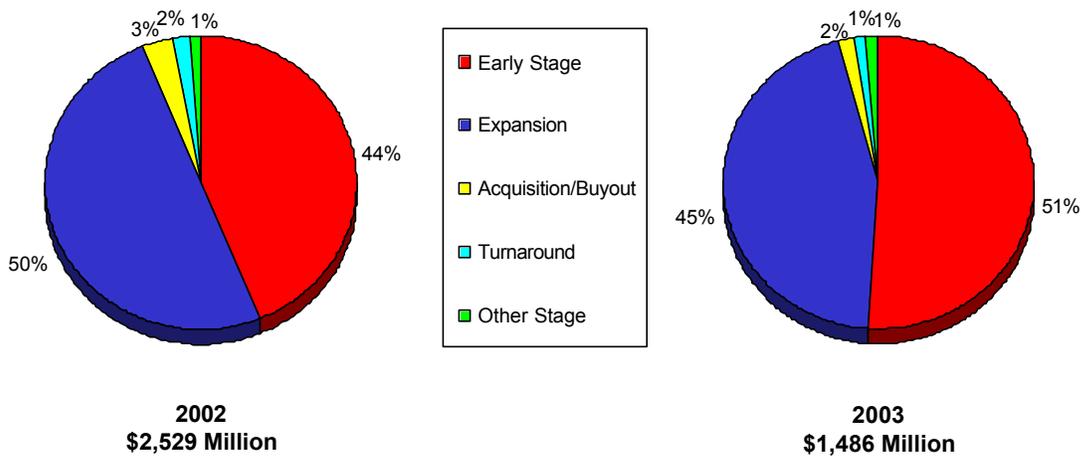
LSVCCs increased their share of Canadian VC invested in the past year. While their disbursements fell by 27%, from \$630 million in 2002 to \$458 million in 2003, the LSVCC portion of the total rose from 25% to 31%. Over 40% of fund resources were deployed in final three months of the year, when the investment pacing rules of government statutes are believed to play a significant role.

With the exception of government funds, which invested their \$171 million over the course of 2003, other industry players tended to increase their activity as the year progressed. After LSVCCs, private-independent funds expended the most money – \$218 million – 69% of which reached VC-backed companies between July and December. Corporate funds accounted for \$138 million on balance, and institutional funds, \$121 million. All of these levels were well short to those of 2002.

EARLY STAGE FIRMS STILL ON TOP

In contrast with the US VC industry, where expansion and other late stage transactions have been prominent for several years, the Canadian industry stayed at the early stage end of the financing spectrum in 2003. In total, 319 young companies, or 52% of the aggregate number, secured \$758 million, or 51% of all disbursements. The latter share is even higher than that of the year prior, when early stage firms garnered 44%, or \$1.1 billion. In Q4, major early stage deals involved such companies as BelAir Networks, Q1 Labs and Xanthus Life Sciences.

Amount Invested by Stage; Canada



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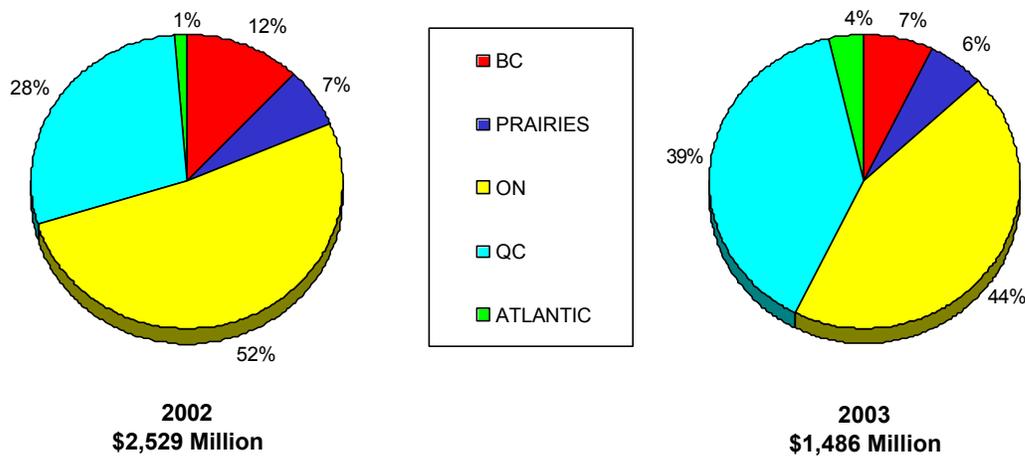
As compared to 2002, when they took one-half of industry resources (\$1.3 billion), expanding companies lost ground in the past year. Expansion transactions engaged 255 firms this time around, and represented \$666 million invested, or 45% of the total. Illustrative of this trend in October-December were financings of Adherex Technologies, Chronogen, Neuromed Technologies and Silicon Optix.

MOST VC-BACKED FIRMS IN QUÉBEC, DOLLARS IN ONTARIO

Relatively intense activity in the life sciences sector, among other factors, gave Québec some impetus in 2003, at least as compared to other regions in Canada. There were 331 companies financed in Québec, more than all other parts of the country – 54% of the total. In addition, Québec-based transactions captured \$575 million, or 39% of the aggregate, which exceeds the 28% share obtained in 2002. Two-thirds of dollars invested was attributable to activity in Greater Montréal.

VC investment in Ontario experienced a dry spell in the first six months in 2003. However, activity in telecom and other IT sectors contributed to an improved situation in the second half. Ontario disbursements reached \$661 million in the past year, or 44% of the total, two-thirds of which was invested in Q3 and Q4. VC-backed companies in the province totaled 165. With \$314 million, activity in Greater Toronto this time surpassed that in the Ottawa Valley, which reflected \$276 million.

Amount Invested in Canada By Region



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By the end of 2003, British Columbia held a 7% share of capital invested on a national basis, down from 12% one year ago, or \$108 million, which streamed to 42 companies based in the province. The Greater Vancouver region accounted for a whopping 97% of amounts deployed.

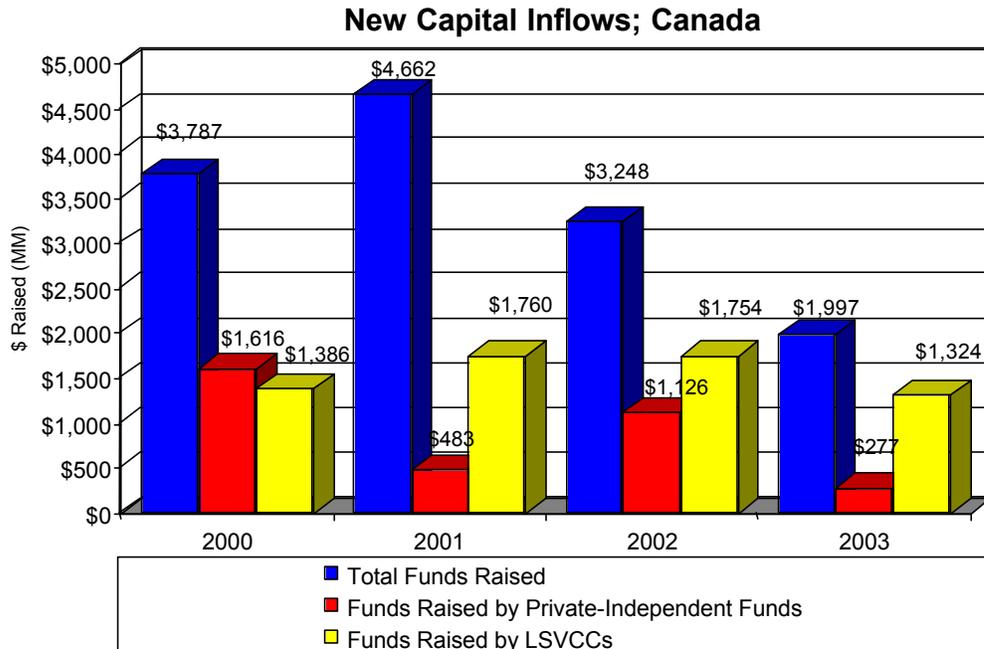
CANADIAN VC POOL SIZE UNCHANGED IN 2003

A large volume of resources flowed both in, and out of, the Canadian venture capital industry in the past year. As of December 31st, the industry commanded a total of \$22.4 billion under management, virtually unchanged from the \$22.5 billion of 2002. The continuing process of VC fund mergers, consolidations and liquidations, precipitated by the market slowdown, had the effect of offsetting capital inflows. In 2003, much of this scaling-down embraced corporate funds, and particularly those owned by banks.

The slowdown also had a dampening effect on industry fund-raising. In total, only \$2.0 billion in new capital commitments was added to the national pool, down by 39% from the \$3.2 billion of 2002.

The inhospitable fund-raising climate was tough for private-independents, which accumulated \$277 million in 2003, or only one-quarter of the \$1.1 billion raised in the better environment of the year before. Given this situation, the high profile closings of limited partnerships (LPs) managed by Jefferson Partners, Neuro Discovery, Ventures West Management and Yaletown Venture Partners, among others, emerge as particular achievements in 2003.

A decisive variable in private LP fund-raising has been the much greater restraint exhibited by Canadian institutional investors. Many institutions with private equity programs (including even those that launched programs very recently) were inclined to reduce new commitment levels in 2003, or suspend them altogether. The results were apparent in the market participation of pension funds, represented by \$175 million in new capital, down by 66% from the \$510 million they committed in 2002.



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Retail fund-raising also realized fewer new resources, chiefly because of the deep freeze in public markets that was evident in Q1. LSVCCs brought in \$1.3 billion, or 25% shy of the \$1.7 billion of 2002.* As in the past, the Fonds de solidarité (FTQ) of Québec led all other funds, based on a pattern of continuing sales throughout the year. Indeed, FTQ now manages \$5.0 billion, giving it a major fraction of the entire pool. Other top LSVCC fund-raisers included Canadian Medical Discovery Corporation, FondAction, GrowthWorks, Skylon Advisers, Triax-Covington Corporation and VenGrowth Capital Partners.

Provincial venture capital corporations (VCCs), or funds based in Québec and British Columbia that also raise monies on a retail basis with tax incentives, accounted for another \$177 million. The lion's share of this VCC amount accrued to the new Capital régional et coopératif Desjardins, managed by Desjardins Venture Capital.

The retail activity of LSVCCs and provincial VCCs ensured that individual Canadians remained the primary source of new capital for the industry. Individuals contributed \$1.5 billion to industry coffers in 2003, or 76% of all sources of new capital, though this is down from the prior year, when individuals injected \$1.8 billion.

Resources added to the direct investment programs of BDC Venture Capital and other government funds augmented industry resources by a further \$151 million.

Fund-raising in Canada continues to be out-of-cycle with fund-raising in the US. While new commitments to American private LPs flat-lined in 2002, Canadian private LPs enjoyed the second-best year in the industry's history. This past year, US VC funds experienced a small increase, attracting \$US10.8 billion, while Canadian activity declined.

When reduced Canadian fund-raising and outflows – which in many cases meant the evaporation of entire liquidity stocks in some VC management firms – are reconciled with disbursements in the past year, the result is a major drop in capital available for investment in future. In fact, national VC industry liquidity fell by 25%, from \$8.3 billion in 2002 to \$6.2 billion at the end of 2003.**

** LSVCC funds raised data reflect gross sales in 2003. Fund redemptions for this period totaled \$402 million.*

*** Estimates of capital available for investment in 2002 have been revised upwards to address a restatement of the Fonds de solidarité (FTQ)'s liquidity in that year.*