

**Canadian Venture Capital Opportunities
for
Japanese Investors and Enterprises**

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Introduction

This presentation discusses Canadian venture capital opportunities for both Japanese enterprises and Japanese investors.

My first topic concerns opportunities for Japanese enterprises to source investment capital in Canada and, in particular, the opportunities which the new Canadian Venture Exchange presents as a unique source of potential venture financing for early stage Japanese companies.

My second topic highlights opportunities for Japanese venture investors to co-invest in Canadian technology enterprises.

Historically, the focus of Japan-Canada economic relationships has been on Canada's natural resources and Japan's manufactured goods. In recent years, however, there has been a dramatic structural shift in the Canadian economy towards knowledge-based industries, but this basic shift has not yet been reflected in a similar shift in the nature of the business activities between our two countries. Currently, only about 4% of Canada's foreign investment comes from Japan (representing 1.5 percent of Japan's overseas investment), while Canada sends only one percent of its foreign investment to Japan (representing about 5% of Japan's inflow of foreign investment). I believe there are major unexploited opportunities for investment between our two countries, particularly venture investment in the technology sector.

Sourcing Venture Capital in Canada for Japanese Enterprises

On my first topic, the subject of sourcing venture investment funding in Canada, I would like to highlight the opportunity presented by the launch of the new Canadian Venture Exchange ("CDNX"). Later this month, as part of an overall reorganization of Canada's stock exchanges, the Vancouver Stock Exchange ("VSE") and the Alberta Stock Exchange ("ASE") will be merged to create the new Canadian Venture Exchange. The new Exchange is scheduled to commence trading and operations on November 29, 1999. The Canadian Venture Exchange will provide a source of early stage public venture capital financing which I believe is unique in the world and will be the preferred choice for venture enterprises looking for a stepping stone to The Toronto Stock Exchange or Nasdaq. In particular, the new Canadian Venture Exchange is an attractive alternative to the U.S. Over-the-Counter Bulletin Board ("OTC:BB") and the U.S. pink sheet market for companies that do not meet the Nasdaq small cap listing requirements (i.e., a market cap of U.S.\$50 million and share price of U.S.\$4.00).

CDNX will combine the best of existing VSE and ASE systems and practices and will feature harmonized trading, corporate finance and compliance rules as well as a variety of world-class market information services and products. Junior issuers from The Toronto Stock Exchange, the Montreal Stock Exchange and the Canadian Dealing Network will also be transferred to the new venture exchange.

CDNX Listing Requirements

The new Canadian Venture Exchange will initially list approximately 3000 companies categorized in three tiers. Tier 1 will consist of advanced companies meeting minimum listing requirements of \$100,000 of pre-tax earnings and \$1 million in net tangible assets or \$200,000 earnings or \$5 million of net tangible assets. Tier 1 is intended for advanced companies which are attractive to institutional investors. Tier 2 will include the majority of listings and is intended for venture companies with an active business as well as for Capital Pool Companies, an interesting category of junior issuers which I will discuss

in more detail later in my remarks. Tier 2 companies must have either \$50,000 of pre-tax earnings and \$500,000 of net tangible assets or \$750,000 of net tangible assets without earnings. Tier 3 will host special situation issuers that are too early-stage to meet the listing requirements for the other tiers. Tier 1 and Tier 2 will operate as a continuous auction market and Tier 3 will operate as a dealer quotation driven market.

The CDNX will, I believe, be deservedly perceived internationally as a well-regulated, fair and accessible, liquid securities market with uniform regulatory standards, consistent enforcement and good market information.

Capital Pool Companies

A particularly interesting opportunity for Japanese enterprises seeking public capital in Canada is the Capital Pool Company concept of the CDNX. The Capital Pool Company ("CPC") mechanism permits a venture enterprise to go public on CDNX in a two-stage process.

In the first stage, a new company is formed, with a board of experienced public company directors with a track record of success, and then taken public with a small (\$200,000 to \$400,000) public offering designed to achieve the CPC listing requirements and to provide capital to be used by the directors of the company to identify and investigate business opportunities.

At the second stage, once the VCP has identified an attractive business opportunity, it carries out a merger with the active business, in the form of a reverse takeover whereby the owners of the technology business become controlling shareholders of the public company. The independently appraised value of the active business, together with any concurrent public or private financing, must be sufficient in size to permit the company to graduate to a full Tier 2 listing on CDNX. Financial statements of the operating company audited in accordance with Canadian GAAP and an independent valuation will be required.

Canadian Venture Capital Investment Opportunities for Japanese Investors

My second topic is a discussion of the opportunities that exist for Japanese venture capital investors to invest in Canadian venture enterprises and to provide an introduction to typical Canadian venture capital deal structures and documentation. In the first half of 1999, the Canadian venture finance industry completed 518 new and follow-on financings, investing a total of over one billion dollars in start-up and emerging companies.

Overview of the Canadian Venture Capital Industry

Canada has a large and rapid growth Information Technology ("IT") IT community centered principally in Vancouver and Ottawa, but also in Toronto, Montreal, Calgary and the Kitchener/Waterloo area. Each geographic area has a distinct focus and culture. A half dozen major venture capital firms are prominent across Canada, with numerous other venture funds adopting a focussed approach in geographic proximity to their investee companies.

Venture investment opportunities in Canada have never been greater. Generally, Canadian technology companies have not, to date, seen the same run-up in values as has characterized U.S. opportunities. At the end of 1998, the Canadian venture capital industry had in excess of \$10 billion under administration. An additional \$2 billion of venture capital money is expected to be invested in Canadian venture capital opportunities by the end of 1999. These funds are coming from a variety of sources including pension plans, private venture capital funds (typically organized as limited partnerships) and labour sponsored and government subsidized funds (which account for approximately 50% of funds invested). As well, corporations and financial institutions are becoming active in the sector.

Approximately half of these funds are currently being invested in IT, software, e-commerce and Internet-related companies, with life science companies also being popular investments. Almost half of Canadian

venture capital investments are in small enterprises with revenues under \$1 million and less than two dozen employees. Currently about 60% of deals and 70% of funds are being devoted to follow-on or expansion investments.

Most Canadian venture capital investment opportunities involve co-investment by 2 to 3 or more venture investors. Such co-investment permits the lead investor to test the reaction of their industry colleagues to the investment opportunity and to spread investment risk. Foreign, and particularly Asian, co-investment is welcomed by the higher quality Canadian IT companies whose strategic marketing plans typically include the rapid development of foreign, including Asian, markets. Such companies frequently look to foreign venture capital participation in their investment opportunities as a way of validating the international component of their business plan and to access the foreign venture capitalist's business network and financial, business and legal expertise in foreign countries. At the same time, the typical Japanese venture capitalist is likely to want to partner in its investments with knowledgeable and experienced local venture capital firms with the expertise necessary to evaluate and the proximity necessary to monitor prospective investment companies.

Japanese venture capital investments in Canada may be structured as either the participation by Japanese venture capital funds and investors in co-investment opportunities with their Canadian counterparts in high-prospect Canadian technology and life science companies or as direct collaborative joint ventures between Japanese and Canadian enterprises. Such cross-border venture capital investments raise complex structuring issues, particularly to ensure that the foreign investment does not taint the Canadian company's access to tax benefits derived from the status of "Canadian controlled private corporation". These tax benefits include enhanced R&D tax credits, lower federal and provincial income tax rates, and the availability of capital gains tax exemptions and preferred tax treatment of employee stock options.

Canadian Venture Investment Criteria

The typical Canadian venture capital investment is in either a privately held or small-cap public company which possesses a unique and highly marketable proprietary technology; sound, achievable business and marketing plans; and a management team with a proven ability to think strategically, to execute on a business plan, and to motivate knowledge workers. Other prerequisites include the potential for going public within a 3-8 year timeframe, given favourable market conditions; the opportunity to exceed \$50-100 million of revenue within five years and a capital requirement between \$1 million to \$20 million. Also key is a network of strategic relationships: an ability to satisfy and garner the loyalty of customers and to forge strategic relationships with world-class business partners; a Board consisting of seasoned, independent directors; and world-class financial, legal and accounting advisors. The Company, if not first in its market space, should be strategically placed among the top three, with a good understanding of distribution channels and how to capitalize on market potential.

Exit Strategies

Canadian venture investors typically exit from successful investments either through a going public transaction, once the company has established the size necessary to achieve a stock exchange listing, or through a strategic divestiture of the company. In 1998, Canadian venture capital investors exiting through the initial public offering route earned an average return multiple over their original investment of 3.77 times and those exiting by way of a strategic divestiture earned an average return multiple over their original investment of 2.36 times.

Recently, there have been some very notable success stories. For example, earlier this year, Broadcom Corp. acquired Hothaus Technologies Inc., a Vancouver-based software company, for \$414 million, providing early stage venture investors a 25 times return on their initial investment. This summer, two Vancouver-based software companies went public on Nasdaq. Pivotal Corporation (PVTI on Nasdaq) is a leading, Vancouver-based developer and distributor of

customer relationship software to the mid-enterprise market with over 260 employees and annualized revenues of approximately U.S.\$30 million. The second, Creo Products Inc., is a developer and manufacturer of computer-to-plate digital printing products which automate the prepress phase of commercial printing. Pivotal successfully completed a U.S.\$47.7 million initial public offering and Creo successfully completed a Can.\$113.3 million initial public offering.

Canadian Due Diligence Procedures

The typical Canadian institutional venture capital investor or fund will vigorously pursue due diligence of all aspects of the investment opportunity, typically over a one to two month period prior to funding the investment. This will include an exhaustive review and assessment of the prospective investment Company's technology, business strategy, management team and market potential.

At minimum, the due diligence review process will involve a review of a business plan that states clearly the business strategy the Company intends to pursue and the resources (including people, plant, intellectual property and funding) required to achieve success. Patent or trademark searches or opinions of patent counsel or other third party evaluations of the basic technology and intellectual property will be commissioned to ensure that the Company's rights to its primary intellectual property (patents, copyrights, trade secrets, etc.) are clear and protected. Key employees must be covered by proprietary rights and non-disclosure agreements and the founders should have assigned all relevant intellectual property to the Company (typically without reservation of royalty).

The Company's organizational documents (charter, bylaws and director and shareholder minutes) should be clear, complete and up to date with no unusual provisions. All equity interests should be held by the founders and the senior management and by small group of 'angel' or seed investors. All share issuances must be properly documented and structured in accordance with all corporate and securities law requirements. All such prior share issuances should be subject to vesting

arrangements, transfer restrictions, rights of first refusal in favour of the Company and rights of the Company to acquire the stock on termination of employment. There must be no unusual prior history to the Company which could give rise to unknown risks or unasserted claims. There should be no litigation of any material nature including intellectual property disputes and entangled relationships between employees and their prior employers.

Typical Canadian Deal Documentation

Standard Canadian deal documentation includes a securities purchase or investment agreement, a shareholders agreement and/or a registration rights agreement. In addition, founders and key employees will typically be subjected to a proprietary rights and confidentiality agreement containing non-compete covenants and restricted stock provisions.

The investment agreement will include the principal terms of the transaction including the financial commitment of investors to purchase securities (with payments to be funded either at closing or over time, upon the achievement of certain milestones), representation by the Company of the material facts relating to its organization and business and affirmative and negative covenants including limitations on debt, mergers and acquisitions, changes in business focus, transactions with affiliates and changes in compensation for key managers, as well as provisions for certain information rights (financial statements, board participation, inspection rights, etc.).

The shareholders agreement between the Company, the venture capital investors and the principal management shareholders will typically contain transfer restrictions, rights of first refusal on proposed transfers, voting agreements (to effect the agreed upon board representation) and contain 'tag along' rights which permit investors to participate in stock sales by the founders or other key management and 'drag along' rights which permit venture investors to force founders and management to participate in any sale of their stock.

Employment agreements typically deal with the duties, responsibilities, compensation (including bonus and incentive stock or option compensation) and termination of employees. Typically rights to cheap stock or options will be vested over a three to five year period with transfer restrictions and call rights in favour of the Company upon termination or death.

Finally, the registration rights agreement permits the venture investors to control the timing and manner of their exit through 'demand' and 'piggyback' registration rights which permit them to require the Company to go public and give them the rights to sell their shares in subsequent offerings. Typically, venture investors will also negotiate a put right which gives them the right, after a prescribed period of time, if no other liquidity event has occurred, to sell their investment back to the Company at a price equal to fair market value, as fixed by appraisal or formula.

Typical Canadian Venture Deal Terms

Canadian venture capital investors are generally seeking a deal that will (i) maximize their financial returns, (ii) provide priority downside and protection against loss, (iii) allow them to manage and control the investment if the Company starts to fall seriously offside its business plan; and (iv) provide exit rights after 5-7 years through an IPO or other value maximizing transaction.

Typical deal terms in a Canadian venture capital investment include the following:

1. Capital Structure: Venture capital investment typically takes the form of convertible preferred shares, but may also be structured as a common share, convertible debt or subordinated debt investment. In a convertible preferred share offering, the principal terms of the investment security will be incorporated into the Company's corporate charter and will cover voting rights, dividends, liquidation preferences and conversion, redemption and/or put rights, as well as any special rights relating to board representation and rights to assume control in event of

defaults. Each tranche of venture investors receives a different class or series of preferred shares. Canadian venture capital investors expect to derive their financial returns primarily in the form of capital appreciation of their preferred stock. Typically, therefore, the preferred shares will be non-dividend bearing since typically the Company's cash flow (if any) will be best dedicated towards funding future growth. Sometimes, however, a "current pay" dividend will be included in later stage and expansion financing where the Company's projected cash flow is strong enough to provide investors with a current return. Sometimes also, the structure will provide for a cumulative dividend payable upon redemption or liquidation. This builds in a minimum rate of investor return into the investors liquidation preference upon sale or redemption. The venture investors have voting rights as shareholders equal to the votes carried by the common shares into which their shares are convertible, as well as the right to require redemption of their preferred shares at a premium to their issue price. This buyback right is exercised in approximately half of Canadian deals; with an average exit multiple of 1.3 times original investment cost. The preferred shares are convertible into common shares at the option of the investors and automatically converted to common shares on a mandatory basis in event of a qualified initial public offering (typically on Nasdaq, at a minimum specified share price and for minimum specified net proceeds) or in the event that the Company receives a takeover bid for its shares at no less than a minimum specified price. The conversion rate (and the consequent percentage of the Company that the investors are purchasing for their investment) is set at a rate such that the risk adjusted projected value of the Company, assuming that it achieves its business plan, results in the venture capital investors receiving a sufficient portion of the projected future sale to permit them to achieve their required rate of return on invested capital. The analysis is complex, taking into account the projected dilution of the percentage ownership of the venture capital investors that will arise from second and third round anticipated follow-on financings. The percentage ownership of the Company acquired by venture capital investors will depend on the pre-money valuation of the Company and the dollar amount of the venture investment.

2. Board Representation: Significant venture investors will require Board representation and smaller venture investors will seek at least observer status on the Board. In addition, venture investors will typically insist, as a matter of good corporate governance, that the majority of the Board be experienced directors independent of management and that the audit and compensation committees of the Board consist solely of independent directors.

3. Management: Venture investors will typically require a willingness of the founders to relinquish management control to an experienced professional chief executive officer and to subject their founders stock to escrow arrangements, frequently for a 4-5 year period. Key management and employees will be required to sign proprietary rights, non-disclosure and devotion of time agreements. Key man insurance will also be required. While often not perceived by founders of high tech companies as such, the general philosophy of Canadian venture capital investors is typically to leave the management team free to control and operate the Company without interference from investors, for so long as the Company is operating in accordance with and achieving the objectives set forth in the business plan. However, if the Company falters or materially fails to achieve milestones, or violates covenants, Canadian venture investors, particularly if they own a majority of the equity, will expect the right to take control of the board (including the right to remove existing management upon relatively short notice without cause, but subject to severance and buy back rights). Minority venture investors typically negotiate put rights so that they can require that they be bought out in such circumstances.

4. Control: Venture capital investors on the Board will want a role, or possibly veto rights, with respect to the approval of annual budgets, management hires and dismissals and compensation matters, including employee share ownership and incentive stock ownership plans. As well, venture capital investors, in their capacity as shareholders, will want the right to approve changes in capital structure, sales of control, amalgamations and substantial asset sales.

5. Information and Monitoring Rights: Venture capital investors will typically insist on monthly and quarterly management financial statements and annual financial statements which have been audited by an independent accounting firm.

6. Pre-emptive Rights Investment Rights: Venture capital investors will typically insist on rights of first refusal, including a pre-emptive right with respect to future treasury issuances and a right of first purchase of the shares of selling shareholders. Venture investors will typically seek protection not only from dilution resulting from capital alterations but also from "economic" dilution such that both their shareholdings and conversion formula will be adjusted if the Company issues additional equity in subsequent rounds of financing at less than the price paid by the venture investors. A typical economic anti-dilution clause gives the investors the right to obtain more common stock, without additional aggregate consideration, in the event that the Company subsequently issues new common stock or common stock equivalents at a price below the effective "as converted" common stock price paid by the investors based either on a full ratchet or weighted average formula.

7. Registration Rights: Typical venture capital deal terms will include "registration rights": provisions which grant the venture capital investor the right to either demand that the issuer qualify the venture investor's shares for public distribution (thereby dictating the timing of a going public transaction) or permit the venture investor to piggyback on a distribution initiated by the issuer. Such provisions are intended to give the venture capital investor liquidity at the time of the issuer's initial public offering when the prospective return potential attributable to an ongoing investment in the company is reduced below the venture capital investors' threshold return requirements. At this point, the venture capital investor may realize its return by liquidating its investment and deploying its funds in alternative early stage opportunities.

Conclusion

Canada is gaining world prominence in the venture capital community. In recognition of this status, the Canadian, U.S., European and Asian venture capital associations have chosen to hold their Year 2000 millennium summit in Montreal, Quebec between July 11-13, 2000. Over 2000 venture investors, investment banks, mutual funds and other institutional investors are expected to attend the summit to explore opportunities for global investment partnerships. Davis & Company will be an active participant in this summit and would be pleased to assist any of you wishing to attend the summit.

Davis & Company is probably the most active law firm in Western Canada in negotiating and documenting venture capital transactions. We can provide advice on: (i) the Canadian Venture IT scene and players; (ii) typical Canadian and cross-border institutional venture capital transaction structures; (iii) typical Canadian venture investment criteria and due diligence procedures; and (iv) typical Canadian deal documentation. We can assist in introducing Japanese corporations and venture capitalists to Canadian institutional venture capitalists with whom they could partner in Canadian investment opportunities and can introduce to prospective Canadian IT investor companies.

Davis & Company also regularly co-sponsors venture investor forums profiling high prospect venture investment opportunities and providing an opportunity to network with the Canadian venture investment community. If you are seeking venture investment opportunities in Canada, we would be pleased to involve you in an upcoming session. For those seeking to source venture financing in Canada, we would be pleased to provide introductions to the Canadian Venture Exchange, as well as to Capital Pool Companies looking for offshore investment opportunities and their sponsoring brokers.

Further Information

For more information on the Davis & Company Technology Business Group see www.davis.ca. Further information on the new Canadian Venture Exchange can be obtained at www.cdnx.ca. For a statistical review of the Canadian venture capital industry and a listing of industry participants see www.cvca.ca. For an internet site tracking the fundraising and investment activities of Canadian venture capital and private equity investors see www.Canadavc.com and for a site providing a gateway to company profiles of Canadian IT companies see www.CanadaIT.com. For information on The Capital 2000 Summit to be held in Montreal July 11-13, 2000 see www.capital2000montreal.com. For information on venture investor forums co-sponsored by Davis & Company to profile high prospect venture investment opportunities see www.financingforum.com.