

IMPROVING THE LIQUIDITY OPTIONS FOR MID-LIFE HIGH TECHNOLOGY COMPANIES IN CANADA



**An ITAC
Discussion Paper**

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ITAC is the voice of the Canadian information and communications technology industry. Together with its affiliated organizations across the country, the association represents 1300 companies in the information and communications technology (ICT) industry in all sectors including telecommunications and Internet services, ICT consulting services, hardware, microelectronics, software and electronic content. ITAC's network of companies accounts for more than 70 per cent of the 566,000 jobs, \$130 billion in revenue, \$5.2 billion in R&D investment, \$20.7 billion in exports and \$11.5 billion in capital expenditure that the sector contributes annually to the Canadian economy.

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ITAC recognizes that many large foreign-owned multinational companies have established R&D facilities in Canada over the years and is very supportive of such investment. What is of concern is Canada's inability to grow more multinational companies of its own with strategic decision making in Canada and foreign affiliates of their own that perform R&D (and other functions) around the world.

Executive Summary

In a paper published by ITAC in April of 2004 entitled *Growing World Class Canadian High Technology Companies*, it was pointed out that one of the impediments to growing such companies was a dysfunctional Canadian investment industry that had reasonably large pools of venture capital and mezzanine capital but a limited supply of what Thomson Macdonald describes as buyout capital. The result is that many of our high technology companies get purchased by foreign strategic buyers (i.e. companies that are in the same line of business) and become integrated into their worldwide operations. This paper reports on the results of interactions that Doyletech Corporation has had with the various constituents who might be in a position to influence the flow of buyout capital to high technology companies. These constituents include the managers of pools of buyout capital in Canada, the federal government, and the high technology industry.

The main conclusion that can be drawn from those interactions is that there is a need for a more structured and constructive debate on the subject. We believe that:

- a) Our policy makers should be concerned about the liquidity limitations faced by mid-sized technology companies in Canada;
- b) There should be formalized mechanisms for establishing communications between the high technology industry and the buyout segment of the private equity capital market, similar to those that exist for the venture capital segment;
- c) The high technology industry should take steps to improve its image with financial investors in terms of management practices;
- d) It is not inevitable that Canada's primary role in the global high technology industry is to perform research and development for foreign companies; and
- e) Consideration should be given to allow labour-sponsored venture capital companies (LSVCCs) to operate in the buyout market because they are consolidating into larger entities that are capable of playing such a role. LSVCCs were created to fulfill an objective in public policy. As they have evolved, we believe that they may be redeployed to address the problem of a shortage of buyout capital.

1. Introduction

In April of 2004, the Information Technology Association of Canada (ITAC) published a paper entitled *Growing World Class Canadian High Technology Companies*. One of its findings was that a high percentage of Canadian high technology companies get purchased by offshore companies (mostly U.S.) at an early stage in their development and their operations become integrated with those of the acquiring companies. The result is that even though Canadian technology (often developed with significant assistance from Canadian taxpayers) contributes to the growth of the acquiring companies, the acquired companies seldom become multinational companies in which key strategic and operational activities are carried out in Canada. Their most common role is to carry out research and development work for the parent company.

One of the impediments to the building of Canadian-based multinational companies that was identified in the paper was the relatively small size of that component of the private equity capital pool that is known as buyout capital. In the other two components, namely venture capital and mezzanine capital, Canada compares favourably with the United States on a per-capita basis, but its buyout capital pool is less than one-twentieth that of the United States. Its venture capital pool is about one-tenth and its mezzanine capital pool is about one-sixth. The following are definitions of the three types of private equity capital:

- Venture Capital – targeted at new, developing, or otherwise young companies, typically in innovative sectors like high technology.
- Mezzanine – targeted at more developed companies in a variety of sectors but utilizing subordinated debt and related instruments.
- Buyout – targeted at established companies, usually in the more traditional sectors, utilizing a combination of cash and shares of the acquiring company.

This paper will report on some of the dialogue that the above paper has generated and will make recommendations on how further constructive dialogue can be achieved.

2. Current Liquidity Options

As was stated in the paper referred to above, the liquidity options available to the early investors in Canadian high technology companies fall into four main categories:

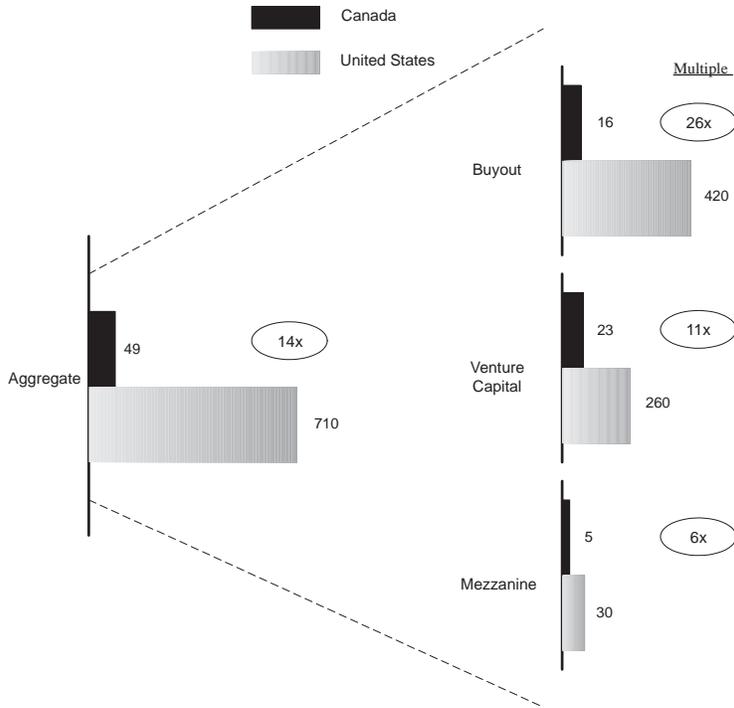
- a) Sell controlling interest to a strategic buyer. Unfortunately, Canada has very few large high technology companies that can evaluate and acquire mid-sized companies.
- b) Sell controlling interest to a financial buyer. While Canada does have financial institutions that are capable of playing this role, they are more comfortable with investing in companies outside the high technology sector.
- c) Sell controlling interest to current management and employees. This usually requires an investment by a venture capital company whose mandate allows it to buy secondary shares. LSVCCs, which are now the single largest source of Canadian venture capital, are only allowed to buy treasury shares.
- d) An initial public offering (IPO) of its shares. Many investors are cautious about IPOs because of the length of time required for them to liquidate their holdings on a stock exchange and because of the high legal and administration costs.

3. The Need for a Strong Buyout Capital Market

If Canada is to be successful in growing more world class high technology companies with corporate decision-making in Canada, the financial buyers offer the best prospects because they are less likely to split up the purchased companies and integrate them into other companies outside of Canada. They typically allow them to grow as corporate entities with most of the existing management personnel in place. Their skills are in financial evaluation and management. They usually rely on the boards of directors of the acquired companies to give them strategic direction, whereas strategic buyers rely on senior managers in the acquiring companies to do so. Financial buyers are in the business of buying and selling companies and they receive their payback either in the form of dividends or capital gains. The capital gains are usually achieved through an IPO but by that stage in their development, the companies are more likely to survive as corporate entities.

Since a large percentage of Canada's pool of buyout capital is controlled by financial buyers, the size of that pool is an indicator of Canada's ability to finance the growth of its high technology companies beyond the stage where venture capital companies operate. As shown in Figure 1, Canada's pool of buyout capital is considerably lower than its U.S. counterpart on a relative basis. Even though it has been increasing in recent years, very little of it goes toward investment in high technology companies. We believe that improved communications between the two communities would result in an increased flow of buyout capital.

Figure 1: Comparisons of Capital Pools (CDN. vs. U.S. \$ Billion, 2002)



Sources: Thomson Macdonald, Venture Economics, McKinsey & Company.
 (Modified to reflect \$16 billion buyout capital, the revised figure for 2002).

Buyout capital, from whatever source, is essential to the success of the Canadian venture capital industry because the other liquidity options mentioned above are not as readily available as they are in the United States. Our capital market is younger and smaller than that of the US. Even if the companies do reach a level of sales that would justify an IPO, the public market seldom provides the volume of trading in mid-sized companies that would allow the venture capital companies to sell all of their holdings in them over a reasonable period of time. There are some examples of Canadian companies being “taken private” by their VC backers when they became dissatisfied with the public market as a liquidity option. As was stated above, Canada does not have enough large technology-based companies that can act as strategic buyer receptors for such companies.

4. A Need for Further Dialogue

Since the release of the April 2004 report, ITAC and Doyletech Corporation have received considerable feedback on its contents. If the feedback did nothing else, it told us that this is a very difficult topic to discuss in a rational manner. Even though the paper emphasized that it did not call for any controls on foreign investment in Canada, it was referred to as a “rant against foreign ownership” by one industry representative and a call for a return of FIRA (The Foreign Investment Review Agency) by another.

The paper was published by ITAC because it feels an obligation to discuss what it considers to be a major impediment to the building of world class Canadian high technology companies and clusters, namely a shortage of liquidity options in Canada for their early investors. It cited a number of possible reasons for the shortage, like inadequate financing of companies when they are first launched, a shortage of Canadian companies that could act as strategic buyers, and a very small pool of Canadian buyout capital.

The main focus of this paper is on the pool of buyout capital. Because of all of the options, it is the one that could be most easily influenced by government legislation. However, if there is one message that we have received from the buyout managers with whom we were able to communicate directly, it is that they do not want the government to make any changes to the rules under which they operate at this time. One buyout manager cited the LSVCC program as an example of what happens “when the government tries to change the rules of supply and demand”. The fact of the matter is that the government had a good reason for intervening; the institutional investors were not investing in venture capital and a retail option was pursued. Also, notwithstanding its limitations, it has created a pool of venture capital expertise that will (hopefully) be passed on to future generations. To quote a phrase often used by Dr. Douglas Barber, an advisor to ITAC, it should help Canada develop a “culture of commerce”.

The discussion which follows will be segmented into three main components: (1) “dialogue within government”, (2) “dialogue within the high technology industry”, and (3) “dialogue within the financial community”.

5. Dialogue within Government

The basic question to be addressed by government should be whether or not it is satisfied with the current structure of the country’s high technology industry and the obvious trends that will determine its future. It is evolving into a supplier of R&D services to multinational companies.

It is beyond the scope of this paper to discuss all of the pros and cons for such a role. An obvious pro is that it allows the typical Canadian subsidiary to develop a high level of expertise in R&D and it may even grow faster as it takes on new missions for the parent company. An obvious con is that it leaves the Canadian subsidiary very

vulnerable to policy shifts at corporate headquarters. Another con is that by focusing on such a limited role, the Canadian high technology industry will not provide the diversity of employment opportunities that exists in the head offices of the acquiring companies.

Another concern that policy makers should have is that there are now other countries (e.g. Poland and Hungary) that are actively pursuing R&D opportunities around the world and Canada will find it difficult to compete with them unless our R&D tax incentives are enriched even further.

ITAC recognizes that many large foreign-owned multinational companies have established R&D facilities in Canada over the years and is very supportive of such investment. These companies are important contributors to the Canadian innovation ecosystem. Many of them are highly respected members of the Canadian technology community. They create many good, high value jobs. They are also important sources for much needed management talent experienced in the business operations of global technology ventures. Many executives now leading Canadian technology firms learned the ropes during their tenures with multinational firms.

Multinationals are important to the innovation ecosystem. But we believe there should be a better balance between global multinationals headquartered in Canada and those headquartered elsewhere. We also believe there should be a better balance between large Canadian technology ventures and smaller developing ones. To achieve this balance we need to pay more attention to growing our mid-sized, more mature technology centres. And, we need to understand the factors that impede this growth. What is of concern is Canada's inability to grow more multinational companies of its own with strategic decision making in Canada and foreign affiliates of their own that perform R&D (and other functions) around the world.

We recommend that the federal government host a series of workshops that would examine in detail the pros and cons of "truncated" companies, as they were referred to in the earlier paper. The dialogue should be elevated well above whether or not Canada is being "hollowed out" by the removal of head office functions from Canada to the U.S. One problem with that debate is that it makes no sense to continue classifying a company as a head office after it has been integrated into a strategic buyer's worldwide operations.

Another argument for the status quo is that Canada's direct foreign investment (DFI) in the U.S. is approximately equal to the U.S. foreign direct investment (FDI) in Canada and that we should not be concerned about one particular sector like high technology. However, the dynamics of DFI and FDI are very different in the high technology sector than in most others. When a Canadian company buys a U.S. company it usually does so to establish a strategic presence in the U.S. and that typically involves more than a single function like R&D. In fact, what typically happens is that a senior Canadian executive is dispatched to the U.S. to manage it. The reverse scenario is very improbable. For a variety of reasons, it is difficult to attract senior U.S. managers to Canada and so the Canadian subsidiary is left only with those functions that can be managed from the U.S. This does little to enrich the talent pool of skilled people who can combine commerce expertise with technological expertise.

6. Dialogue within the High Technology Industry

The most basic question to be asked by the high technology industry is: “Are we as badly managed as the buyout capital managers say we are, and if so, what can we do about it?” In our dialogue with buyout fund managers, poor management was cited as the main reason for lack of interest in the sector. “We are looking for managers who know how to generate cash on a consistent basis because we use some of that cash to buy the companies” was one response.

It is easy to see why the industry can attract such a label. The CEO of a high technology company that is ready for buyout is typically many years younger than the CEO of a more traditional buyout company and has not encountered some of the governance disciplines (e.g. a seasoned board of directors) that the more conventional CEO has. Also, the very short product life cycles of the high technology industry are a deterrent to such investors. To the high technology industry, rapid product obsolescence is essential, but to traditional financial buyers, it often indicates a blurred strategic vision. There is a cultural mismatch that is very difficult to deal with.

The management issue is a multi-faceted one and it is difficult to specify which facets to tackle first. However, the board of directors issue would warrant very high priority. The industry, through trade associations like ITAC, might convene “best practices” sessions that apply specifically to the high technology industry. The managers of pools of buyout capital might even be invited to such sessions as guest speakers.

7. Dialogue within the Financial Community

The most obvious question that the buyout managers might be asking themselves is: “Are we missing out on something good?” The authors of this paper are familiar with an Ottawa-based high technology company bought by a U.S. buyout fund in 2001 for \$15 million U.S. and being sold in 2005 for \$25 million U.S. after having declared significant dividends along the way. That particular company was heavily “shopped” to Canadian buyout managers on both occasions with no success.

Such stories are well known to anyone who has dealt with both U.S. and Canadian buyout funds. They therefore lead to another question for the managers of buyout capital, namely “Is the federal government likely to put pressure on us to engage in this business?” It is a question that will become more and more relevant as the federal government begins to realize the importance of liquidity options to its commercialization agenda. Without easier access to liquidity at the mid-life of a company, the venture capital industry will stagnate. Obviously, the federal government had its reasons for implementing the LSVCC program. The alternative would have been to rely on the U.S. venture capital industry. ITAC believes that a strong Canadian buyout industry is as important as a strong Canadian venture capital industry.

One of the reasons for the poor performance of the LSVCCs is that the rules under which they operate are too restrictive. Allowing them to buy secondary shares (in addition to treasury shares to which they are now restricted) would be a first step in allowing them to fill the buyout capital void. This is an option worth considering because the LSVCCs are undergoing massive consolidation at this time and this will result in larger pools of capital that can become involved in buyouts.

Another initiative that might be undertaken is a “buyout capital” convention similar to the “venture capital” conventions that are held across the country. It would focus on companies that are at the buyout or mezzanine stage of their financing.

8. Conclusion

If there is one recommendation that should override all of those mentioned above, it is that all of the parties with an interest in the subject participate in the debate and that they do so with an open mind. We believe that Canada should have more Canadian-based multinational companies. While the industry appears to have the potential of capturing a great deal of R&D activity, it will create limited wealth and limited career opportunities for Canadians. It will not enrich the pool of seasoned technology managers skilled in finance, accounting, marketing, sales and other business skills. The Canadian industry has a critical need for this kind of expertise. The shortage places limits on our ability to build strong, world-class technology enterprises. Also, while Canada currently has a cost advantage in performing R&D, that advantage is threatened as other less developed countries enter the market.