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High-growth companies and how to fund them – a real driver of economic growth?

Corporate Acquisitions and Joint Ventures Commission

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The working session in Prague is entitled "*High-growth companies and how to fund them – a real driver of economic growth?*" In the working session we plan to address funding alternatives for high-growth companies (i.e. companies with significant annual growth over time); opportunities and challenges that both entrepreneurs and investors may encounter in your jurisdiction. The working session will also look at corporate governance issues in connection with investments in high-growth companies. This questionnaire mainly concentrates on these two topics in relation to high-growth companies, but will also cover commercial and regulatory opportunities and constraints.

1. CORPORATE FINANCE – FUNDING ALTERNATIVES

1.1 Which financial instruments are typically used when investing in high-growth companies; ordinary shares, preference shares, convertibles, warrants, stock options, debt instruments such as bonds, hybrid instruments such as participating debentures etc.?

Generally, the following instruments are used when investing in growth companies:

- Common Shares
- Preferred Shares
- Debentures
- Convertible Debt
- Flow-through Shares
- Equity Lines of Credit
- Limited Partnership Units, including flow-through Limited Partnership Units

1.2 Please elaborate on the pros and cons of the instruments used (ref. 1.1 above) (Describe 2-3 most widely used instruments more in-depth (any combinations as well, if applicable). Also other features, i.e. typically electronically registered instruments or not? etc.)

Common share: A common share is a share that has voting rights, including the right to elect directors and to vote on certain major corporate decisions. There is no requirement for companies to pay dividends for common shares, and high-growth companies typically re-invest earnings rather than pay a dividend.

If the company dissolves, holders of common shares are generally entitled to a portion of the company's assets following payment of any liabilities to tax authorities, creditors and holders of preferred shares.

Preferred share: A preferred share is a share that usually pays a set dividend but generally does not carry any voting rights other than for special corporate matters. Preferred shares may also include other special features such as redemption or conversion privileges.

If the company dissolves, preferred shareholders generally have a right to receive up to the face value of their shares from the company's remaining assets. They rank behind tax authorities and creditors but ahead of common shareholders.

Debenture: A debenture is a loan that can be either secured or unsecured by the issuer's assets. Interest is generally paid at a rate determined by prevailing bank interest rates (either fixed or floating) and the credit rating of the issuer at the time the debenture is issued.

If the company is dissolved, holders of debentures have a right to a portion of the issuer's remaining assets. Holders of debentures rank behind tax authorities and creditors but ahead of preferred and common shareholders.

Incurring large amounts of debt is often dangerous for early stage companies, particularly when revenues are limited or impossible to predict; these concerns can be mitigated by allowing interest payments to be payable by shares, etc.

Flow-through share: A flow-through share is a type of common share issued by certain companies to flow through special tax advantages to its shareholders. Companies in the natural resource exploration and energy sectors are typically provided with favourable tax deductions for qualifying capital expenditures. Through the mechanism of a flow-through share, these deductions, if unused, are in turn passed on to the holder of the flow-through share.

Equity line of credit: Equity lines of credit (particularly for growth companies in the biotech and mining sectors) are becoming more popular. A company will enter into an agreement, usually with an institutional investor, under which the investor commits to purchase a set dollar amount of the company's securities over a set period of time. Whether those securities are issued is at the discretion of the company.

Limited partnership unit: A limited partnership unit is a unit in a partnership that provide for the distribution of income and capital gains/losses from a business operation. A partnership will have a general partner, which manages the affairs of the partnership, and a number of limited partners. Generally the liability of a limited partner is limited to the initial investment in the partnership, provided that the limited partner does not take part in the management of the partnership. Partnership structures providing for the issuance of limited partnership units are popular for certain real-estate businesses and private equity funds involved in various high-growth sectors.

1.3 Are there any regulatory constraints to the instruments used (ref. 1.1 above)?

Canada has a federal system of government with power divided between the federal government and provincial governments. Laws governing the issuance of securities are principally governed at the provincial level, so issuers must be aware of all the laws that may affect its offering in multiple Canadian jurisdictions. Securities laws determine whether or not a prospectus is required for a particular offering of securities and set out the forms and procedures that apply to different forms of offerings.

Unless exemptions are available, a prospectus is required for a marketed offering of securities in Canada. A public company which has offered securities via a prospectus is also subject to continuous disclosure requirements; including making prompt disclosure of any material changes and producing publicly available annual and quarterly financial statements and corresponding management discussion and analysis.

Exemptions from the Canadian prospectus requirements are available for distributions to certain buyers, including financial institutions and high net worth individuals. These distributions are generally known as "private placements". The exemptions include sales to "accredited investors", which are defined in a way very similar to the corresponding exemptions from U.S. securities laws for "sophisticated investors", "professional investors" and "qualified investors" under the EU Prospectus Directive. Exemptions are also available for distributions made exceeding certain financial thresholds on the basis that purchasers who can afford to make such investments should be able to protect themselves.

Private placements can be effected very quickly in Canada and there are minimal formal requirements. If an offering memorandum is used to market the securities, there may be statutory rights of action available to the investor in the case of any misrepresentations made in such document (similar to those given in respect of prospectuses).

Securities acquired by the way of a private placement may be subject to a "hold period" during which the securities holder is restricted from trading or selling such securities until the period has lapsed.

Purchases or sales of securities allowing their holders to exercise control over larger issuers (i.e., common shares or any shares that carry the right to change the management of an issuer) may be subject to review under Canadian foreign investment laws if the transaction is made to a non-Canadian buyer. See 2.5.

1.4 Is crowdfunding a funding alternative in your jurisdiction? How wide is the practice? If at all, please describe pros and cons.

The Ontario Securities Commission, one of the principal securities regulators in Canada, is considering changes to its private placement exemption to provide a means for investors who may not currently meet the standards for an "accredited investor" to invest in high-growth companies. These changes could potentially provide for equity crowdfunding in Ontario.

If adopted, this additional exemption will allow companies to sell securities to any investor but investment limits would be imposed on the investment an investor may make in a single issuer and the total investment an investor may make during a calendar year.

The exemption may also provide for investments to be made through a funding portal registered with the Ontario Securities Commission. Such portal will likely be prohibited from offering investment advice or recommendations and paying commissions. The Ontario Securities Commission is also considering the amount of due diligence required of funding portals and what financial information should be provided to prospective investors, as well as continuous disclosure obligations that will be imposed on crowdfunded entities. It is expected that the Ontario Securities Commission will publish the proposed exemption in the first half of 2014 and will consult with market participants on the final form of the exemption.

Separately, in 2013, the Ontario Securities Commission provided a one-off exemption from existing securities law requirements for securities dealer registration and know-your-client processes to MaRS Discovery District ("**MaRS**"), a Toronto based non-profit, focusing on commercializing medical, clean-tech, engineering processes, communications and social innovation research. This exemption allowed MaRS to create a non-profit social venture exchange, the first "impact investing" crowdfunding portal in North America. The internet-based exchange provides "accredited investors" opportunities to invest in small and medium ventures that have demonstrable social and/or environmental impact, community loan funds and for-profit private equity funds. It should be noted that this exemption only relieved MaRS from security dealer restrictions and does not change the restrictions that investment opportunities be offered to "accredited investors" only. However, this may indicate that regulators are becoming more flexible in an attempt to facilitate investments in growth companies.

2. INVESTORS VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

2.1 Who are typical investors into a high-growth company in your jurisdiction? Sources of funding (i.e. founders-family-friends, angel investments, venture capital investments, private equity)

Typical investors in high-growth companies in Canada include:

- founders, friends and family;
- angel investors;
- venture capital funds;
- private equity funds (including private equity search funds);
- pension funds (typically venture capital and private equity divisions of large public sector pension funds)

Though Canada has a mature network of angel investors, venture capital funds and private equity funds, the investor class is generally smaller than in the United States (with the exception of the real estate sector). Accordingly, a sizeable number of Canadian investments originate from outside Canada and primarily from the United States. Similarly, the foreign venture capital funds on average make larger investments into Canadian companies than domestic venture capital funds.[1]

It is estimated that 80% of Canadian businesses are family owned[2] and, accordingly, a number of inter-generational management successions will take place in the coming years as many company founders are expected to retire. This is likely to increase the number of private equity and venture capital investment opportunities in the near future.

2.2 Is there a typical size of the investment into a high-growth company in your jurisdiction?

The average venture capital investment in 2012 and 2011 was approximately C$3.7 million. Investments were made primarily in Ontario, followed by Quebec and British Columbia.[3] However, there is an observed trend that venture capital investments are getting increasingly larger.[4]

Recent examples of major investments by venture capital firms into high-growth companies include the investment by the venture capital arm of the Ontario Municipal Employee Retirement System, which invested C$20 million in HootSuite, a social media start-up in Vancouver Canada in 2012.

2.3 Describe the process of documenting the investment (Which documents are typical? Which terms need to be included in the articles to be enforceable? etc.)

Investments by venture capital and private equity firms are usually done by way of investment in preferred shares and/or common shares. In such transactions, investors typically require a shareholders' agreement to be entered into between the investor, the company and its shareholders. Such agreements govern management matters including how the board of directors will be constituted and the conduct of business by the company and, will typically include, rights of first refusal and tag-along rights for the sale of the company's shares.

2.4 Are there incentive schemes for investing into high-growth companies (governmental grants (including co-investment funds, state as a guarantor of loans, etc.)?

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1 Canada's Venture Capital & Private Equity Association and Thomson Reuters, *Canada's Venture Capital Market in 2012,* Canada's Venture Capital & Private Equity Association, 2012, online: < http://www.cvca.ca/files/Downloads/VC_Data_Deck_2012_Final.pdf>.

2 Canada's Venture Capital & Private Equity Association, Think Canada (Again), Canada's Venture Capital & Private Equity Association, June 2012, online: <http://www.cvca.ca/files/Downloads/THINK CANADA AGAIN UPDATE 2013 web.pdf>.

3 *Supra*, footnote 1.

4 "Venture capital investments jump in third quarter, buyouts, equity deals slip", *The Globe and Mail,* November 25, 2013, online: <http://www.theglobeandmail.com/report-on-business/venture-capital-investments-jump-in-third-quarter-buyouts-equity-deals-slip/article15582463/>

The Canadian federal government and many provincial governments provide tax incentives, partnerships with research universities and mentorship opportunities for investments in start-up and high-growth companies. Regional tax incentives include tax holidays and tax credits for specific industries (e.g., aerospace, bioscience, computer animation and media) and activities (e.g., mining exploration and scientific research and experimental development).

Of particular note, is the federal government's Scientific Research and Experimental Development Tax Incentive Program which provides investment tax credits for expenditures such as wages, materials, machinery, equipment and some overheads.

Business Development Bank of Canada, a commercial bank created by statute, also provides subordinated financing and venture capital for small to medium enterprises. In 2013, the Canadian government announced a strategy to deploy C$400 million through the Business Development Bank of Canada's venture capital arm that aims to invest in the country's energy, cleantech, healthcare and information technology sectors.

The 2014 Canadian federal government budget contains several investment programs and tax incentives for small to medium size businesses and for businesses in certain high-growth industries. Announced initiatives include:

- a funding program providing C$40 million to the Canada Accelerator and Incubator Program, which provides financing to incubators and accelerators geared towards helping entrepreneurs create new companies in key high-growth sectors; and
- providing C$500 million over two years to the Automotive Innovation Fund to support significant new strategic reach and development projects and long-term investments in Canada's automotive sector.

2.5 Any instruments referred to in section 1 preferred from the point of view of an investor? Why? Would the answer differ if the investor is international or domestic?

In certain instances, transactions involving foreign investors acquiring control of Canadian businesses may trigger review under federal and provincial statutes. To avoid such review, foreign investors may wish to forego investing in equities that would enable them to have a direct or indirect control of the Canadian business but, instead, to invest in the Canadian business' debt instruments that do not carry any management participation rights.

The primary act governing the investment of Canadian businesses by non-Canadians is the *Investment Canada Act* (the "**ICA**"). Under the ICA, a transaction is reviewable by the Canadian government if, following the transaction, the investor acquires direct or indirect control over an existing Canadian business with assets over a certain threshold (for investors in a WTO member state this threshold was C$344 million in 2013 and C$354 million in 2014; for investors in a non-WTO member state, this threshold is C$5 million) or if the transaction will result in the acquisition of a Canadian business involved in activities relating to Canada's cultural heritage or national identity. In addition, transactions that could potentially raise national security concerns are also subject to additional review.

For transactions under review, the investor and the Canadian government will typically negotiate a suitable set of undertakings to be provided in connection with the government's approval of the transaction. These undertakings generally include commitments by the investor regarding the operation of the Canadian business following the completion of the transaction. Additionally, the government has issued guidelines that apply to state-owned enterprises whereby such enterprises may be subject to certain additional obligations designed to ensure that the Canadian businesses they acquire maintain a commercial orientation.

In addition to the *Investment Canada Act*, other federal statutes regulate and restrict foreign investment in specialized industries and sectors such as telecommunications, broadcasting, rail and air transportation, financial institutions and energy.

3. ENTREPRENEUR'S VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

3.1 Which company form is most popular? (Special company forms for high-growth companies? Tiers of management typical for a high-growth company? Liability point of view?)

Company forms are predominantly dictated by tax concerns. For most small to medium size businesses, a corporate entity with a share capital consisting of common shares, preferred shares and/or debt instruments is the most common.

3.2 What sectors are most preferred by high-growth companies in your jurisdiction (information and communications technologies, biotech, etc.)?

The majority of investments in Canada take place in the mid-size market (C$20 – C$200 million).

In 2012, Canadian venture capital deal making was concentrated in the information technology sector with steady venture capital activity in life sciences sectors. In the information technology sector, a total of C$719 million was invested in 180 companies in 2012, up 6% from the C$678 million invested in 2011. Led by trends involving software and internet-focused firms, which absorbed C$345 million and C$179 million respectively, information technology related activity soaked up 49% of all disbursements in 2012.[5]

Until the third quarter of 2013, software and information technology sectors received 45% of all funding with agribusiness, manufacturing and non-technology companies also receiving a notable share of investments. For the first nine month period in 2013, agribusiness, manufacturing and other non-technology companies received C$337 million or 24% of the total venture capital investment, triple the amount for the same period in 2012. For the same first nine month period ended September 30, 2013, clean technology received C$261 million in funding, up from C$52 million for the same period in 2012. Finally, venture capital investment in biopharmaceuticals and other life sciences sectors captured C$170 million for the third quarter ended September 30, 2013.[6]

Oil and gas transactions led all private equity investments in 2013, representing a reported 17% of all deals, and this level of activity is expected to continue in 2014. Perceiving an opportunity to invest at reduced valuations due to lower commodity prices, sponsors have increasingly looked to Canada's oil patch for acquisitions or investments, including related service sectors. In addition, while private equity funds have traditionally avoided mining investments due to high valuations, commodity price risk and volatility in earnings and cash flows, a number of Canadian and international sponsors have become increasingly focused in the sector, including the raising of dedicated funds and new asset allocations in existing funds. Last year mining was the second largest sector for deployment of private equity capital in Canada and interest from sponsors is expected to continue in the year ahead including in distressed mining investments.

Given the comparative lack of competition for investments by private equity funds in Canada than in the United States, it should be noted that a large number of private equity investors in the high-growth sectors in Canada are American-based.

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5 Canada's Venture Capital & Private Equity Association and Thomson Reuters, *Canada's Venture Capital Market in 2012,* 2012, online: < http://www.cvca.ca/files/Downloads/VC_Data_Deck_2012_Final.pdf>.

6 Canada's Venture Capital & Private Equity Association, *Canada's Buyout-Private Equity & Venture Capital Markets In Q3 2013: Venture Capital Investment Up Sharply, Buyout-Pe Deal-Making Down Slightly*, November 25, 2013, online: <http://www.cvca.ca/files/News/CVCA_Q3_2013_Media_Release_FINAL2.pdf>

3.3 Are there incentive schemes for entrepreneurs incentivising high-growth companies (e.g. accelerators/incubators? Other?)

In many provinces and federally, seed funding is available for businesses in the cleantech, information technology, and life sciences and healthcare sectors.

Public and private sectors funds have also joined together to provide technology start-up funding and mentorship. These sources of funding include:

- Extreme Startups which was founded by a group of Canada's leading venture capital firms including Extreme Venture Partners, Business Development Bank of Canada, Reley Ventures, RHO Canada Ventures and OMERS Ventures;
- C100, a non-profit, member-driven organization that supports Canadian technology and cleantech entrepreneurship through mentorship, partnership and investment, investors include Business Development Bank of Canada, KPMG, the Bank of Montreal and Sustainable Development Technology Canada;
- MaRS Investment Accelerator Fund, a fund that provides, at an early stage, up to C$500,000 to privately held companies with no significant revenue plus mentorship and networking. As at October 2013, the fund had C$36.1 million of committed capital in 72 companies operating in the cleantech, information technology and healthcare sectors (for more information regarding MaRS, see item 1.4); and
- various regional incubators in Toronto, Ontario, Waterloo, Ontario, Montreal, Quebec and Vancouver, British Columbia, providing funding of up to C$50,000, advisory services, office space and entrepreneurship mentoring.

3.4 Any instruments referred to in section 1 preferred from the point of view of an entrepreneur? Why?

We have observed that many entrepreneurs prefer issuing debt and preferred shares over common shares or any other securities with management participation rights. These instruments provide an effective way to raise capital and will not dilute the existing management powers of the equity holders.

4. CORPORATE GOVERNANCE – CONTROL ISSUES

4.1 In a typical investment into a high-growth company, whether a loan related investment or equity investment, how much control would a typical investor take? and what is of particular importance to an entrepreneur? In particular, please elaborate on the following terms from the perspective of your jurisdiction and practice:

Typically for a minority investment in a high-growth company, investors will request:

- anti-dilution measures for any convertible or exchangeable securities being required (e.g. warrants);
- rights of first refusal, pre-emption rights (including rights to provide additional financing) and tag-along and drag-along rights; and
- non-competition and non-solicitation covenants in employment agreements for each of the chief executive officers and any employees in any critical research or business development roles.

5. EXIT STRATEGIES AND TIME HORIZON

5.1 Type of exit which is most common (sale to venture capital/private equity firms/funds, trade sale, write-off, initial public offering)? Typical transaction length?

Strategic acquisitions accounted for 87% of total exits in Canada by venture capital funds in the first three quarters of 2013.[7] This is consistent with 2012, where venture capital backed exits were primarily done by the way of strategic acquisitions.

Initial public offerings ("**IPOs**") or other "going public" events for growth companies have been uncommon in recent years, although this is changing. For example, in 2013, the 11 "going public" events for life sciences companies reported by the Toronto Stock Exchange and TSX Venture Exchange were more than double the number in the prior year. This number does not take into account Canadian companies, such as Acquinox Pharmaceuticals, that elect to pursue a U.S.-only IPO (the U.S. capital markets can offer greater publicity and liquidity). However, it is important to recognize that, while this increase represents a significant improvement over past years, it does not match the approximately five-fold increase in the number of life sciences IPOs seen in the U.S. in 2013.[8]

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7 Canada's Venture Capital & Private Equity Association, *Canada's Buyout-Private Equity & Venture Capital Markets In Q3 2013: Venture Capital Investment Up Sharply, Buyout-Pe Deal-Making Down Slightly*, November 25, 2013, online: <http://www.cvca.ca/files/News/CVCA_Q3_2013_Media_Release_FINAL2.pdf>

8 Blake, Cassels & Graydon LLP, Life Sciences Insights and Developments 2013.

The majority of private equity investments in Canada are initiated by US based funds with plans to build up and expand the business into the United States after which an exit strategy will be implemented involving the sale of the business to strategic investors. Accordingly, the exit horizons for Canadian investments are generally between four to seven years, longer than for similar investments in the United States.

5.2 How are new investors dealt with in your jurisdiction? How would the issues set out in section 5.1 above be dealt with? Are initial investment and shareholders' agreements/shareholders' agreements upheld in the next round, or new agreement is entered into?

In Canada, as the pool of potential investors is limited, a company often has limited bargaining power. As a result, the introduction of a new investor will often change the legal framework with agreements amended to result in less power and ownership for existing investors and founding shareholders.

6. REGULATORY ISSUES

6.1 Any tax implications (positive or negative) that a high-growth company encounters in your jurisdiction?

Tax incentives are available for certain industries at both the federal and provincial levels. See Section 2.4.

6.2 In addition to any of the issues set out above, any other regulatory incentives or constraints with respect to high-growth companies? Any constraints deriving from obligation for local participation in a high-growth company? Co-investment obligation? etc.

See discussions above.

7. OTHER

7.1 Please elaborate on any other issues relevant to your jurisdiction with respect to high-growth companies which have not been discussed in responses to earlier questions (if any).

Nil.