



## **Québec's VCs Cautious but Ready for Opportunities**

### **Introduction**

Welcome to our first edition of the Québec Venture Capitalist ("VC") Confidence Survey, produced by Samson Bélair/Deloitte & Touche in conjunction with Réseau Capital, Québec's venture capital association. Québec's venture capital industry is a major catalyst for economic development in Québec, and Réseau Capital, the association that represents it, is an accurate reflection of Québec's dynamic VC industry.

This survey provides a comprehensive snapshot of Québec VCs' expectations for the next six months in:

- Economic and market climate;
- Deal activity; and
- Investment focus.

The VC industry, under a lot of pressure following the boom years of the late 1990s and the subsequent bursting of the valuation bubble, finds itself in the spotlight as it sets its course for the near and medium term.

Some fear that the new mood of caution will result in small- and medium-sized companies missing out on important opportunities and thus discouraging a new generation of ideas. In fact, less than half of our total respondents expect to spend the majority of their time focusing on new investments, as most plan to spend more time managing their existing portfolio companies.

Despite a significant decrease in investments made in the IT and Communications sectors, Québec's VCs have not lost their willingness to make investments entirely. They now are turning their attention to the Life Sciences industries, and positive signs are also discerned in the manufacturing sector. Québec VCs, who still have substantial pools of capital to invest, will gravitate to become more reflective about the innovation process and concentrate on their areas of expertise.

This report aims to isolate results obtained from Québec's VCs for purposes of analyzing the Québec VC industry. Reference can be made to Deloitte & Touche's Quarter 4, 2001 Canadian Venture Capital Association, for survey results pertaining to the whole of Canada.

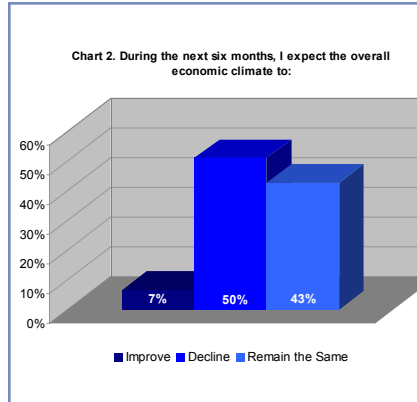
## Highlights

Although the following highlights are derived from the survey results obtained from Québec VCs, they display a strong correlation with the sentiment of VCs across Canada.

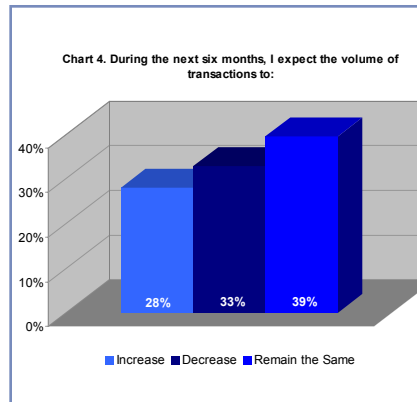
- Québec VCs have lots of cash available for new deals, which combined with lower entry valuations, should lead to significant investment opportunities.
- Due to their negative outlook for the economy and desire to make fewer investments, Québec VCs plan to spend more time assisting portfolio companies to re-engineer their businesses and monitor their cash flow.
- 44% of Québec VCs expect the deal sizes to get larger, compared to only 24% of Canada as a whole. This would contribute to reduce the current gap in deal size in Québec vs Canada, if realized as expected.
- M&A activity is expected to increase, as the IPO market is virtually non-existent, for the time being. Also, more companies are expected to seek this route as an alternative source of liquidity for economic survival and/or enable a rapid commercialization of their products or services.
- As recent breakthroughs in biotechnology are creating numerous opportunities, VCs are looking to make investments in Life Sciences companies to replicate the high returns generated by the IT and related fields of the late 1990s.

## Results

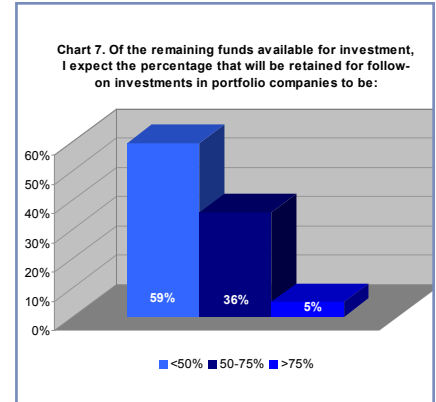
Our survey shows that confidence levels for a speedy economic recovery are very low, with 50% of respondents expecting the economic climate to decline over the next six months.



This negative outlook translates into 72% of Québec respondents unwilling to increase their volume of investments (68% for all Canadian VCs) and 56% believing the size of the investment will either decrease or remain the same, (77% for all Canadian VCs). This can be explained by Québec VCs completing more deals compared to other provinces, but generally at lower dollar amounts.



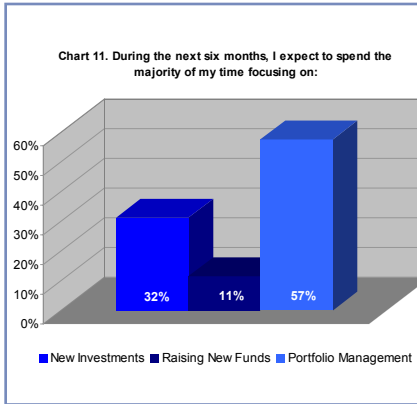
Regardless of the negative economic sentiment, most VCs still have substantial funds available to invest. In fact, 81% of respondents have more than a third of their original funds still available. A majority of these VCs (59%) expect most of their remaining funds to be used for new investments rather than be held back for follow-on investments, with a further 36% expecting 25%-50% of funds available to go to new investments.



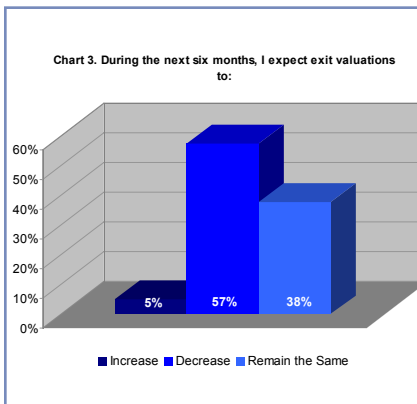
The dichotomy that 72% of Québec VCs will not increase their deal volume, yet 59% of them are keeping their cash for new deals is explained by the fact that many large Québec VCs are evergreen in nature. Generally, in Québec the rate of new capital formation is higher than the rate of investment. Therefore, reserving funds for future follow-on rounds is not as critical because most funds have a constant flow of new money to invest and are not limited to their initial funds raised.

However, the bar for companies seeking capital is getting higher. In addition to products and sales, investors are looking for companies that have complete management teams, to be cash flow positive within nine months, and operate in an existing market.

As reduced number of deals and dollars are a natural outcome of the present economic environment, 57% of VCs will spend the majority of their time with their existing portfolio companies, either revising their business models, assisting in setting-up strategic alliances or monitoring their cash flow.



Because the valuations have decreased substantially in the public market, they are down on the private equities as well. Fifty-seven percent (57%) of respondents expect exit valuations to decrease, while 38% expect them to remain the same. These lower valuations are creating opportunities for the patient VC who can identify the new business idea backed by the strong entrepreneurs.

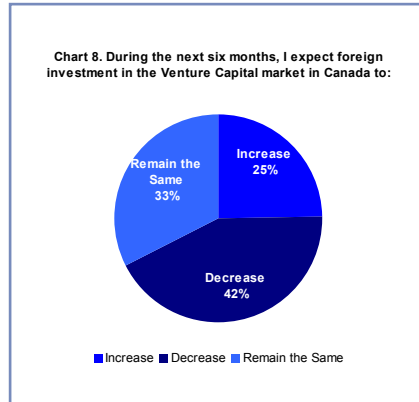


However, entrepreneurs and companies seeking capital should not delay the process in the hope of a quick improvement in market conditions, if that capital is required to fully develop their business.

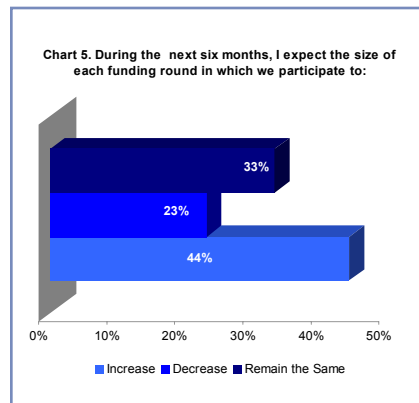
At 321 financings completed in the first nine months of 2001, Québec continues to be home for much of the transactional activity in the Canadian industry (40% of the aggregate). Québec-based firms were also the recipients of \$792 million, or 21% of the total amount invested in Canada (second to Ontario at 41% for 218 deals), which remains on par with trends over the last two years<sup>(1)</sup>.

(1) Macdonald & Associates Ltd. (November 2001)

Seventy-five percent (75%) of respondents expect foreign investment in the VC market in Canada to decrease or stay the same. Although Québec is still the leader in terms of start-ups financed, it is definitely behind when it comes to attracting funds from outside the province.

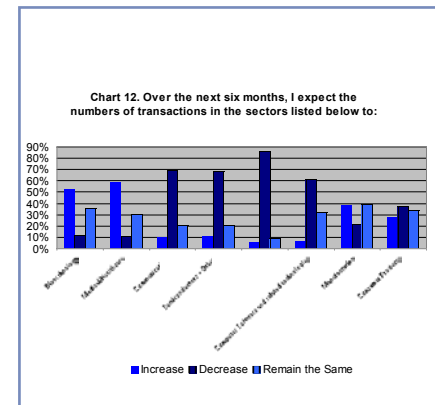


There are some positive signs however. For instance, almost one third of Québec VCs will spend most of their time focusing on new investments, while 44% of VCs expect the size of each funding round to increase and 33% expect it to remain the same. Therefore, an increase in market confidence should not take long to translate into increased investment activity.



The number of private companies created in the 1990s will be reduced through M&A driven consolidation, a key step in clearing the stage for the next generation of innovators. Unsurprisingly, 68% of respondents expect to see more liquidity events through M&A than IPO over the next six months.

As Québec VCs proceed to systematically reduce their exposure to the Communications and IT related sectors, they, similar to all Canadian VCs, appear eager to fund companies with the next biotechnology breakthroughs. Our survey found that 53% and 59% of respondents respectively, expect to see an increase in investments in the Biotech and Medical industries. The manufacturing sector is also showing positive signs with 40% of respondents expecting an increase in activity, while only 21% foresee a decrease.



## Recommendations for Survival

- Carefully reduce non-contributing overhead costs and exercise stricter cash management practices (i.e. shorten collection cycle of receivables).
- Sell or spin-off non-core assets in order to raise cash to reduce debt obligations or invest in profitable and growing core businesses.
- For start-ups, revise business model to begin earning revenues as soon as possible.
- Due to lower interest rates, consider debt whenever possible, as an alternative cost-effective source of financing.
- Capitalize on existing strategic partnerships to share costs on projects or generate alternative sources of cash, such as the sale of licenses or of the technology outright.

# VC Confidence Survey: Detailed Results – Québec

## Economic Activity

## Deal Activity

## Investment Focus

Chart 1. During the first six months of 2001, Canada's venture capital industry posted strong results, I expect this trend to:

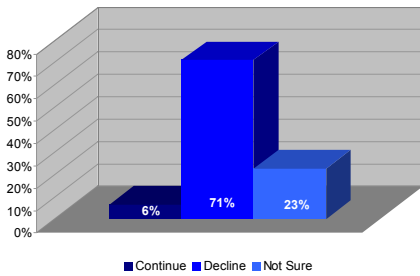


Chart 5. During the next six months, I expect the size of each funding round in which we participate to:

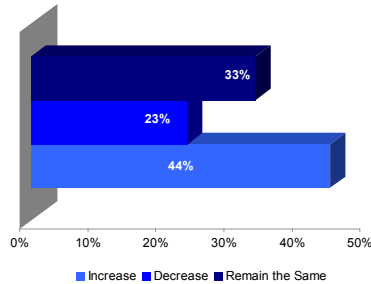


Chart 9. At the present time, the percentage of total funds raised invested in portfolio companies is:

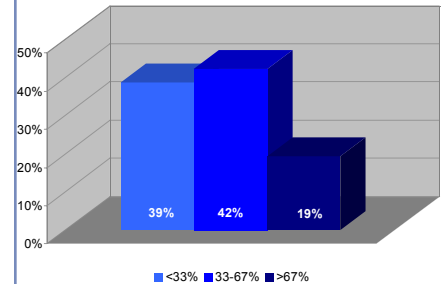


Chart 2. During the next six months, I expect the overall economic climate to:

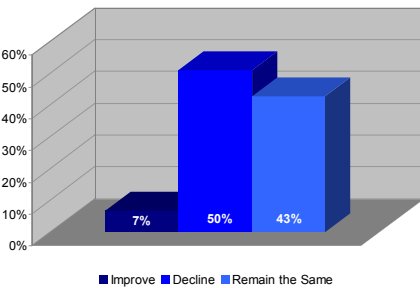


Chart 6. During the next six months, I expect to exit more investments through:

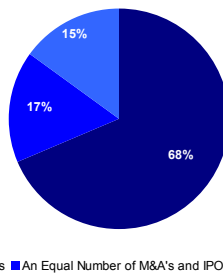


Chart 10. During the next six months, I expect the amount of time spent with portfolio companies to:

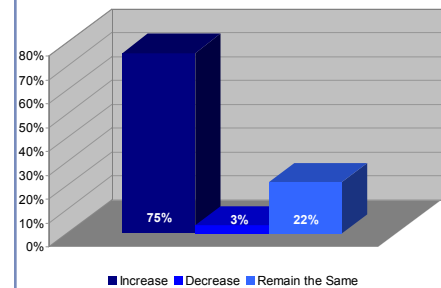


Chart 3. During the next six months, I expect exit valuations to:

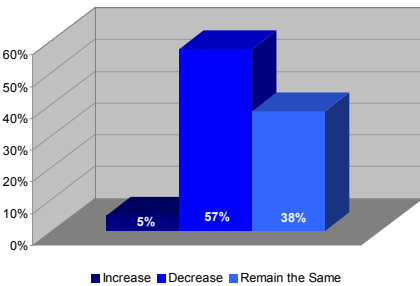


Chart 7. Of the remaining funds available for investment, I expect the percentage that will be retained for follow-on investments in portfolio companies to be:

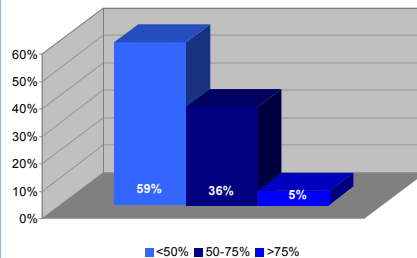


Chart 11. During the next six months, I expect to spend the majority of my time focusing on:

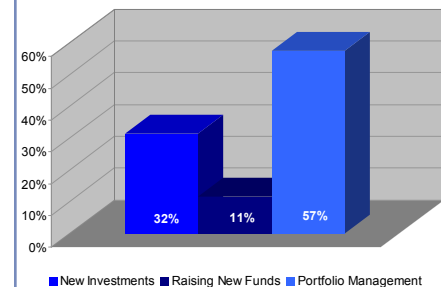


Chart 4. During the next six months, I expect the volume of transactions to:

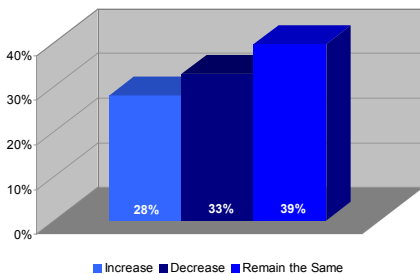


Chart 8. During the next six months, I expect foreign investment in the Venture Capital market in Canada to:

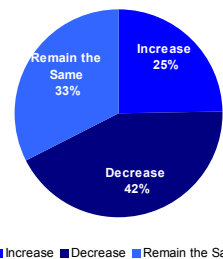
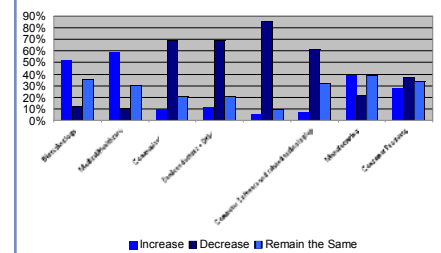


Chart 12. Over the next six months, I expect the numbers of transactions in the sectors listed below to:



## Contacts

Deloitte & Touche Corporate Finance initiated this survey and collected results from October 18 through October 31 2001. The VC Confidence Survey is conducted on a quarterly basis.

For more information about this survey or to find out more about how Samson Bélair/Deloitte & Touche can assist the deal initiation and execution process, please contact us.

We welcome suggestions for issues to be addressed in future VC Confidence Surveys.

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## About Deloitte & Touche Corporate Finance

Deloitte & Touche Corporate Finance provides deal initiation and lead financial advisory services for private equity and venture capital firms as well as growth companies. Main service areas include acquisitions, sales/divestiture, and corporate finance advisory. Deloitte & Touche Corporate Finance has a presence in all key global and U.S. financial centres.

Samson Bélair/Deloitte & Touche is the largest professional services firm offering assurance and advisory, tax, financial advisory services and management in Québec. Some 1600 people regularly use their expertise to serve clients from all sectors of the economy. Outside Québec, the firm operates as Deloitte & Touche with over 5,400 people in more than 44 locations across the country. Our firm's professionals have been developing effective business solutions for Canadian and international companies for more than 150 years. We are dedicated to helping our clients and our people excel, and have been recognized as one of the 35 best companies to work for in Canada by Report on Business magazine. Our firm is part of Deloitte Touche Tohmatsu, a global leader in professional services with more than 92,000 people in over 130 countries.

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## About Réseau Capital

Réseau Capital, the Québec Venture Capital Association, has more than 550 members from investment companies and professional firms. Its mission is to advance the development of the industry and its members through training, information, networking and promotion of their interests. By helping to create an environment conducive to equity financing of businesses, Réseau Capital is proud to contribute to the economic growth of its members and their portfolio companies. In comparison with the major international venture capital associations, Réseau Capital is noted for the size of its membership, the quality of its services and the investment activities of its members.

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