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Searching for the next Research in Motion

U.S. venture capital returns to Canada as government moves to drop tax barrier

By **Liana B. Baker**, MarketWatch

An earlier version of this story incorrectly stated the amount of U.S. venture capital invested in Canadian companies between 2007 and 2009. It has been corrected.

SAN FRANCISCO (MarketWatch) -- After some lean times, venture capital is trickling back into Canada from the U.S., and that pace could quicken thanks to a new piece of tax reform proposed in Canada's annual budget.

Over the last two years, U.S. venture capital in Canadian companies dropped 42%, to \$254.1 million in 2009 from \$440.9 million in 2007, according to data from Dow Jones VentureSource.

While this decline tracked a broader trend in venture capital over the same period, experts say the problem for Canadian firms was exacerbated by tax regulations that punish foreign investors who later want to sell their shares in those companies.



Market Edge: VC's Eyes on Canada

Rob Chaplinsky of Bridgescale Partners, a venture-capital firm, comments on the investment opportunities in Canadian firms specializing in wireless devices, networking gear, and information technology for the health-care industry. Interview by MarketWatch's Liana B. Baker.

capitalist for a decade.

Those hurdles will disappear if the Canadian parliament votes in a budget, introduced earlier this month by Canada's Conservative Party, that includes a measure dropping the income-tax law. It's expected to go through, say Canadian public officials.

"The Government is optimistic that this measure will be passed into law expeditiously," said a spokesperson for Canada's department of finance in an e-mail to MarketWatch.

Zeisig said he's already seen some renewed interest in Canadian tech companies since plans to drop the tax

For years, U.S. venture firms that wanted to invest in start-ups had to deal with a piece of Canadian tax law called section 116. When foreign investors wanted to sell their shares in a corporation, they had to pay a 25% tax on their gains or fill out cumbersome paperwork to get an exemption. It could often take weeks or months before a firm could get ahold of its funds, say lawyers and venture capitalists.

The tax prevented some U.S. venture capitalists from pursuing Canadian investments, they say, despite the well-known successes of Canadian companies such as Research in Motion (NASDAQ:RIMM) (TSX:CA:RIM) .

"I'd have a client say, 'Canada? It has great technology, but thanks, but no thanks, to the administrative burden,'" said Bernhard Zeisig, a venture capitalist now at Cycle Capital Management in Montreal who worked in the U.S. as a venture

requirement became known, and he expects even more when the measure is passed into law.

Stephen Hurwitz, a partner at the Choate Hall and Stewart law firm in Boston, says the change will usher in a new era of cross-border investment.

"Section 116 made international investors go through burdensome hurdles to invest in Canada," Hurwitz said.

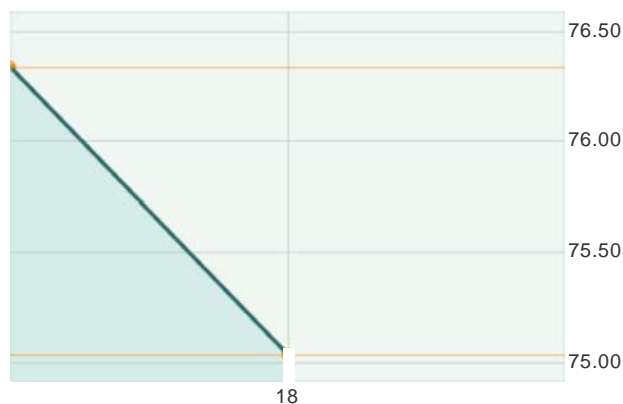
If they no longer have to meet the requirements of Section 116, "it's now as easy for a U.S. venture capitalist to invest in a Canadian company as a U.S. company."

If the measure is passed, it would be retroactive starting March 4. The parliament is expected to vote to pass the budget by the end of this month.

Numbers are up

Even before the tax reform was proposed, investment numbers were starting to show some positive signs for the Canadian tech industry.

RIM **75.37**, +0.13, +0.17%



While tech investments from the U.S. in 2009 fell 52% from the previous year, activity picked up later in the year. In the fourth quarter of 2009, U.S. venture firms invested \$59.56 million in Canadian tech companies, up 54% from the amount raised during the first quarter, according to VentureSource data.

"It's a bit of a comeback story," said Rob Chaplinsky, managing partner at Bridgescale Partners in Menlo Park.

His firm recently invested \$11 million into Toronto-based BlueCat Networks, a company that provides IP addresses and platforms.

"People are waking up to Canada, saying OK, maybe we'll go up there too," Chaplinsky said.

U.S. venture capital is also flowing to industries such as clean-tech. In February, Enerkem, a Quebec-based waste-to-ethanol producer, announced it had raised \$51.5 million from several investors including Waste Management Inc. (NYSE:WM) .

Searching for the next RIM

The new tax reform could make it easier for U.S. venture capitalists to find the next Canadian technology success story, a role that's been dominated by Research in Motion. The designer of BlackBerry devices went public in 1997 on the Toronto Stock Exchange after it raised capital from a variety of sources, including the Canadian federal government, the province of Ontario, and Motorola Inc. (NYSE:MOT) .

By mid-2008, shares had shot up about 100 times from their IPO debut in Toronto. They surrendered much of those gains later that year. But they're still trading well above their earlier levels, and have surged 42% in the past year.

Another successful Canadian tech company is Open Text (TSX:CA:OTC) (NASDAQ:OTEX) , a corporate-software provider that went public on NASDAQ in 1996 and on the TSX in 1998. Its shares have jumped five-fold since its Toronto IPO. Both Research in Motion and Open Text were hatched at the University of Waterloo in Ontario.

Chaplinsky, the Silicon Valley venture capitalist, said U.S. investors are interested in Canada because the country spends a lot on research and development, gives tax credits to tech companies, and can draw on a deep pool of talent. Canada also benefits from having its biggest trading partner, the U.S., right across its border.

Michael Hyatt, CEO of BlueCat Networks, said he comes to Silicon Valley once a month to meet with investors or

companies interested in his product.

He says Canadian tech companies suffer from a tiny pool of domestic venture capital money. Plus, Canadian firms don't have the same exposure or marketing prowess as U.S. companies, he says, and that's the main reason why a "good tech company in Canada goes unnoticed."

"If you're in Boston or California, it's so much easier to get venture capital," Hyatt said.

But will this latest tax reform be enough to get U.S. investors to hop on a plane to Toronto?

"Canada's invented companies like RIM. We're relevant," Hyatt says. "Canada has a lot of great opportunities that can get picked off by American venture capitalists."

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