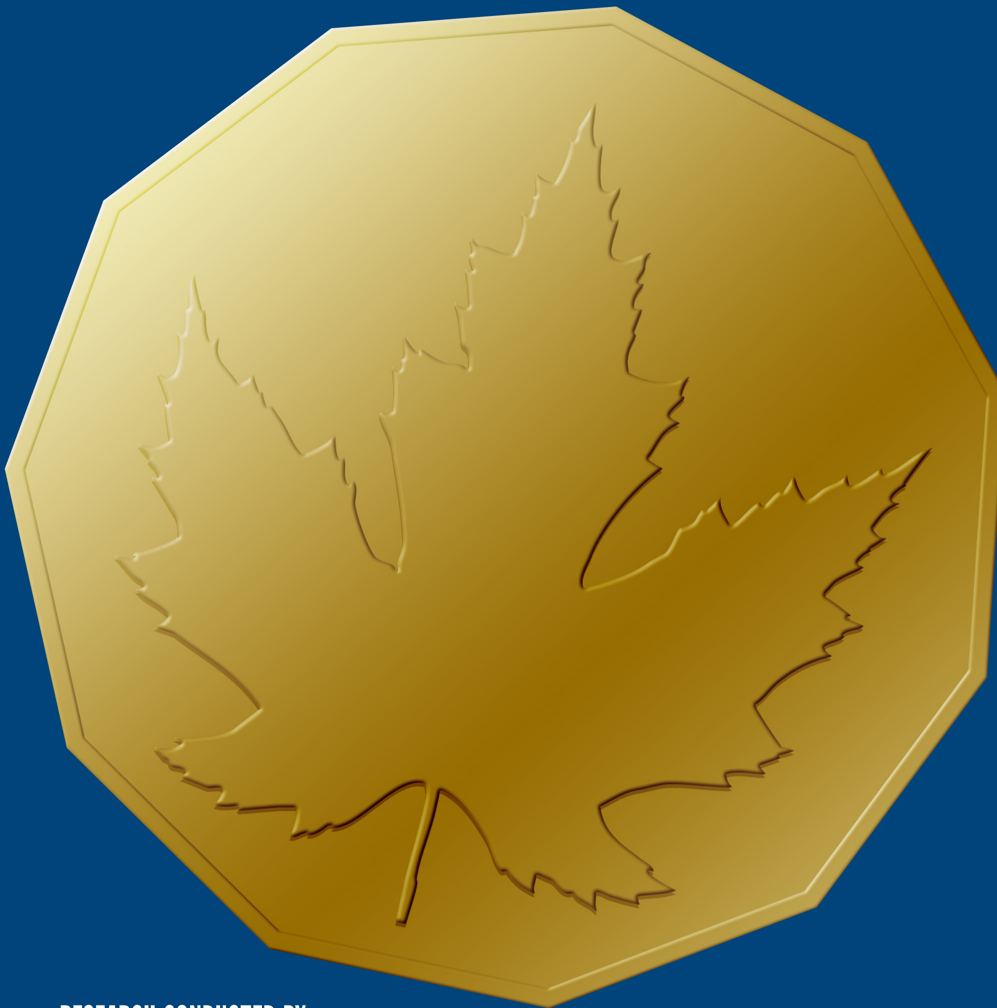
VOLUME 1

THE GOODMAN AND CARR LLP REPORT

PRIVATE EQUITY CANADA 2005

AN IN-DEPTH REVIEW OF THE MARKET



RESEARCH CONDUCTED BY

THOMSON MACDONALD

G&C

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Foreword

This is the fifth installment of the *Private Equity Canada* series produced by Goodman and Carr LLP and McKinsey & Company. Our objective is to provide a fact-based perspective on key trends shaping the Canadian private equity market to help the industry grow and its participants succeed.

We have based our conclusions on Thomson Macdonald's market research conducted in Canada and on McKinsey & Company's proprietary research focused on the United States and Europe. As before, our 2005 survey was consistent with 2004's to permit year-over-year comparisons. The 98 survey respondents represent Canada's largest private equity firms – and over 93 percent of the entire Canadian capital pool.

Private Equity Canada 2005 consists of two volumes:

- Volume 1, produced by Goodman and Carr LLP, provides an in-depth review of key market facts. It describes the main characteristics of Canada's private equity market, the preferences of its participants, and the market activity over the past year.

- Volume 2, prepared by McKinsey & Company, draws on the authors' extensive experience in serving institutional investors and other private equity market participants. It focuses on the buyout industry's growth in the past 5 years and offers a perspective on where the industry is heading and what these trends could hold for GPs and LPs globally and in Canada.

We hope you find *Private Equity Canada 2005* useful, valuable, and thought-provoking.

Gary Luftspring
Managing Partner
Goodman and Carr LLP

Goodman and Carr LLP is a full-service business law firm with a leading Corporate Finance practice and an entrepreneurial approach to business. The firm is based in Toronto. For more information about the firm and its services, please visit us at www.goodmancarr.com or contact us by phone at 416 595 2300 or 1 800 890 7319.

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1.0 Executive summary

The Canadian private equity market benefited from a strong economic climate in 2005, resulting in steady levels of investment activity in some market segments and considerable growth in others. Building on gains achieved in 2004, 2005 witnessed another year of successful fundraising and expansion of the capital pool managed in Canada.

The Goodman and Carr LLP-McKinsey & Company's *Canadian Private Equity Activity Survey 2005*, conducted by Thomson Macdonald, found capital under management totalling $56.5 billion, or 11 percent more than the $51 billion reported in 2004.

Capital managed by buyout funds totalled $29.8 billion in 2005, up a substantial 19 percent from the year before. More significantly, the buyout segment increased its market share to 53 percent of the Canadian private equity pool.

The venture capital industry accounted for $21 billion of capital under management, up slightly from the year before. Venture capital reflected a 37 percent share of the market in aggregate.

The mezzanine segment continued to reflect approximately 10 percent of total capital under management, with $5.6 billion, also up from 2004.

Drawing on supplementary data, Thomson Macdonald estimated the size of the overall private equity market universe in Canada to be $60.9 billion in 2005.

Private-independent funds increased their capital under management to $22.2 billion, up 14 percent from the year before, thanks to the continued fundraising activity. As a result, private funds represented 40 percent of the entire capital pool.

Canada's largest institutional investors also added substantially to their captive fund resources in 2005, increasing their market share to nearly one-third of the total.

By contrast, in 2005, the market share of labour-sponsored venture capital corporations and other retail funds declined to 19 percent, corporate funds to 5 percent, and government funds to 4 percent.

The survey also revealed optimistic signs in Canadian private equity fundraising trends. New capital commitments to buyout and mezzanine partnerships and other funds totalled $1.69 billion in the past year, and new commitments to venture capital funds of all types grew for the first time since 2001.

Pension funds accounted for the largest share of new capital (34 percent) raised by buyout and mezzanine funds, followed by foreign investors (32 percent) and corporate sources (22 percent). Individual investors accounted for the largest share of new capital raised by venture funds (58 percent), followed by government sources (15 percent) and pension funds (13 percent).

As 2006 got underway, the survey found more Canadian private equity fund managers on the fundraising trail. In total, 43 fund managers reported they were seeking new capital, compared to 32 the year before.

Capital invested by Canadian private equity funds in total grew significantly in 2005, due primarily to growth in the buyout segment. Capital invested in the venture capital and mezzanine segments remained stable in 2005, compared to the prior year. The survey found that professional managers were increasingly confident about the investment climate and ready to build on recent positive results.

2005 was the third consecutive year of major growth in North American buyout activity. Capital invested by Canadian fund managers rose sharply to $6.42 billion, a 50 percent increase over the $4.27 billion invested in 2004.

Influenced in part by buyout industry trends, disbursements by mezzanine funds also increased slightly on a year-over-year basis to $1.21 billion, compared to 2004's $1.19 billion.

Because of a number of exceptionally large deals, acquisitions captured nearly half of the $7.63 billion invested in total by buyout and mezzanine funds in 2005. Management buyouts (MBOs) accounted for 28 percent.

Venture capital activity remained steady in the past year, with disbursements totalling $1.64 billion, which approximates the $1.69 billion of 2004. Venture investors increased their focus on expansion and other late-stage activity in technology sectors.

As in previous years, the survey asked professional managers for their perspectives on challenges to market growth. Once again, the highest rated challenge was the limited number of institutional investors active in private equity, followed by the limited quality of deal flow and the small size of domestic capital markets. The value of the Canadian dollar was the fourth most influential factor affecting growth, compared to its second highest rating in 2004, and tax barriers to fund commitments again ranked fifth.

If you have any comments or questions about this volume, please contact either of the following at Goodman and Carr LLP:

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1.1 Introduction

The following report, prepared by Thomson Macdonald for Goodman and Carr LLP and McKinsey & Company, is the fifth annual review of key characteristics and trends in Canada's private equity market.

Data analyzed by Thomson Macdonald for this report were drawn from the Goodman and Carr LLP-McKinsey & Company *Canadian Private Equity Activity Survey 2005*, conducted by Thomson Macdonald between December 2005 and February 2006. A total of 132 fund managers were contacted, with 98 completing the survey in the time allotted. The final survey sample represented all of the largest groups – and 93 percent of the entire Canadian capital pool.

The data requested, and the questions posed, in this survey were consistent with those of 2004 to enable year-over-year comparisons. These annual surveys aim to add to, and update, information received from private equity fund managers. Consequently, the prior year's statistics will sometimes reflect changes of note.

As in previous years, Thomson Macdonald provided supplementary data to augment the survey's findings to ensure this report reflects the Canadian market as completely as possible.

Thomson Macdonald developed the research methodology for this survey, and it approximates methodology used in the United States and elsewhere for profiling comparable national private equity markets.

Goodman and Carr LLP, McKinsey & Company, and Thomson Macdonald wish to thank the many Canadian professional managers and staff who gave generously of their time to provide confidential data and share their views on important market issues. This report would not have been possible without their thoughtful contributions.

1.2 Canada's private equity market in 2005

The overall size of Canada's private equity market pool grew significantly in 2005, fuelled particularly by the strength of activity in the buyout segment. Steady fundraising activity and more robust investment trends in the North American market generally played key roles in this market expansion.

According to the survey (and Thomson Macdonald's supplementary data), capital under management in the Canadian private equity market totalled $56.5 billion in 2005. This is up 11 percent from the $51 billion reported in 2004.

In 2004, the survey found that the buyout industry had emerged as the largest segment in the Canadian market. In 2005, total capital managed by buyout fund managers increased 19 percent to $29.8 billion, representing 53 percent of the entire private equity pool, compared to 49 percent the year before.

Several important new partnership closings, which included Birch Hill Equity Partners III LP and ONCAP II LP, were integral to this growth in the buyout segment, as was the increased size of captive funds inside some of Canada's largest pension funds.

The venture capital industry pool in Canada stood at $21 billion in 2005, or 37 percent of the market, up slightly from 2004. Growth in the number of new funds, the largest of which was Celtic House Venture Partners Fund III, once again offset capital outflows elsewhere in the industry.

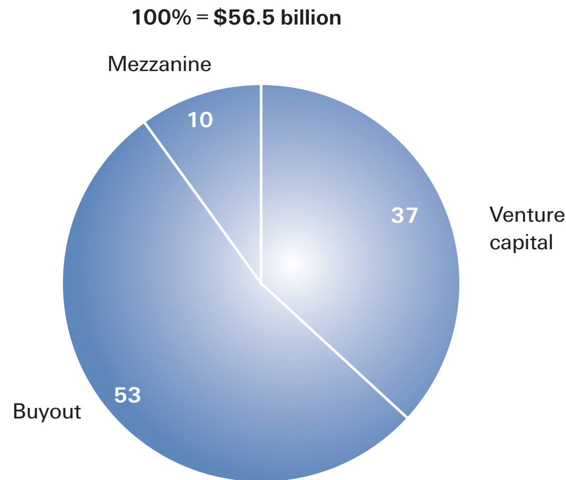
Mezzanine fundraising was fairly quiet in the past year, after a strong 2004, despite the launch of some major partnerships, such as Crown Capital Investment Partners, LP. However, increasing buyout activity, and greater institutional fund exposure to this segment, contributed to capital under management rising to $5.6 billion, compared to $5.1 billion in 2004. As

a result, the mezzanine industry represented 10 percent of the aggregate market pool in 2005, consistent with its 2004 share.

Exhibit 1

TOTAL CAPITAL UNDER MANAGEMENT BY PRIVATE EQUITY MARKET SEGMENT; 2005

Percent



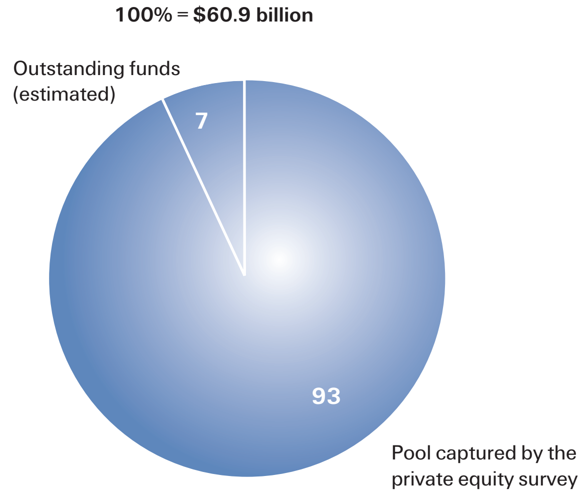
Source: Thomson Macdonald

As in prior years, Thomson Macdonald augmented survey data with proprietary information to estimate the total size of the Canadian private equity universe. For 2005, this estimate is $60.9 billion, up from 2004's $55.4 billion. This indicates the survey captured 93 percent of total fund manager capital based in Canada.

Exhibit 2

TOTAL CAPITAL UNDER MANAGEMENT (ESTIMATED) BY PRIVATE EQUITY MARKET SEGMENT; 2005

Percent



Source: Thomson Macdonald

1.3 Canadian private equity market players in 2005

PRIVATE AND INSTITUTIONAL FUNDS FUEL MARKET GROWTH

In 2005, growth in the private equity capital pool in Canada continued to reveal shifts in the market share of different investor types. Private-independent funds once again exercised leadership in the market's overall expansion, as did institutional funds that added to capital devoted to direct investment activity.

Total capital managed by private-independent funds rose to $22.2 billion in 2005, spurred by a fresh array of buyout, mezzanine, and venture capital partnerships. This is a 14 percent increase over the $19.5 billion reported in 2004.

As a result, private-independent funds accounted for 40 percent of total capital under management in the Canadian market, up from 38 percent the year before. Since the Goodman and Carr LLP-McKinsey & Company survey first began to track these results in 2001, private-independent funds have steadily increased their market share on an annual basis.

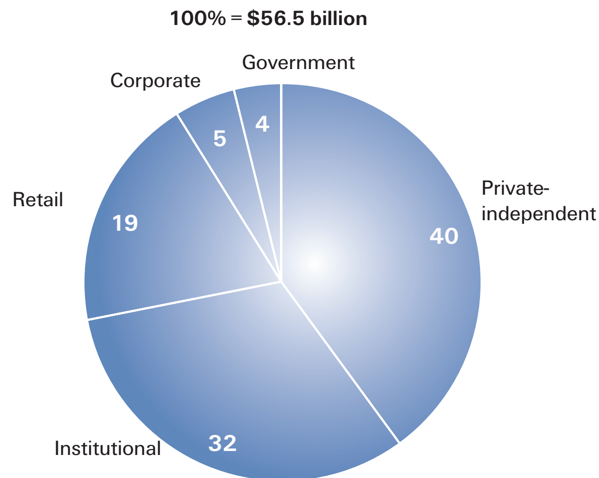
It is anticipated that this trend will almost certainly continue in 2006, as private-independent fund managers in all private equity segments – including several of Canada's top buyout groups, such as Onex Corporation and Richardson Capital Limited – have indicated plans to launch new partnerships.

While Canada's largest pension funds and other institutional investors were helping capitalize new private-independent funds, a few were also adding substantial resources to their internal captive funds. This marked a change from 2004, when several institutional funds, most notably CDP Capital Private Equity, had reduced their capacity for making direct investments.

Exhibit 3

TOTAL CAPITAL UNDER MANAGEMENT BY PRIVATE EQUITY INVESTOR TYPE; 2005

Percent



Source: Thomson Macdonald

In 2005, institutional capital managed in-house reached $18 billion, an increase of 22 percent over the prior year. This growth was led by CDP Capital, Manulife Capital, OMERS Capital Partners, Teachers' Private Capital, and other institutions active in making direct buyout, mezzanine, and venture capital investments in Canada, the United States, and around the world.

Consequently, the survey found the market share of institutional funds rose to 32 percent in 2005, compared to 29 percent in 2004. As some major pension funds have indicated an intention to raise their private equity asset allocation targets, it is anticipated that institutional fund capital will increase again in 2006.

By contrast, the captive funds of Canadian corporations saw their market share decline in the past year. As *Private Equity Canada 2004* detailed, much of the impetus behind this trend has been strategic, as some corporate groups have reorganized or shifted their approach by making commitments to private-independent funds. In 2005, for instance, TD Capital's buyout arm transitioned into Birch Hill Equity Partners Management through a successful MBO.

As a result, corporate funds had $3 billion under management in the past year or 5 percent of the entire market pool, compared to $3.5 billion and a 7 percent share in 2004.

Retail funds supported by government tax incentives remained a sizable market presence in 2005, with their focus continuing to be primarily in the venture capital industry. In total, labour-sponsored venture capital corporations (LSVCCs) and other retail funds managed $10.9 billion, up somewhat from 2004.

Covington Capital Corporation, Capital régional et coopératif Desjardins, FondAction, Fonds de solidarité du travailleurs du Québec (FTQ), GrowthWorks, and VenGrowth Private Equity Partners remained among the most active retail funds, which accounted for 19 percent of the aggregate pool in 2005, compared to slightly more than 20 percent in 2004.

These results suggest the influence of several trends, including recent LSVCC consolidations and reduced or uneven flows of new capital in some provinces. One important development in 2005 was the Ontario government's decision to phase out its LSVCC program by 2011. Another was the increased role of Québec retail funds as limited partners in private-independent funds.

Events in the Québec market were largely responsible for resources inside government funds declining year-over-year. Capital under management totalled $2.3 billion in 2005, giving these funds 4 percent of the market share.

1.4 Trends in private equity fundraising in 2005

MAJOR NEW CANADIAN FUNDS A FEATURE OF 2005

When the market slowdown ended in 2004, many private equity players in North America and internationally took advantage of improving fundraising conditions. This positive trend continued in 2005, particularly in the United States, where market segments, led by the buyout industry, enjoyed considerable success in raising new capital commitments.

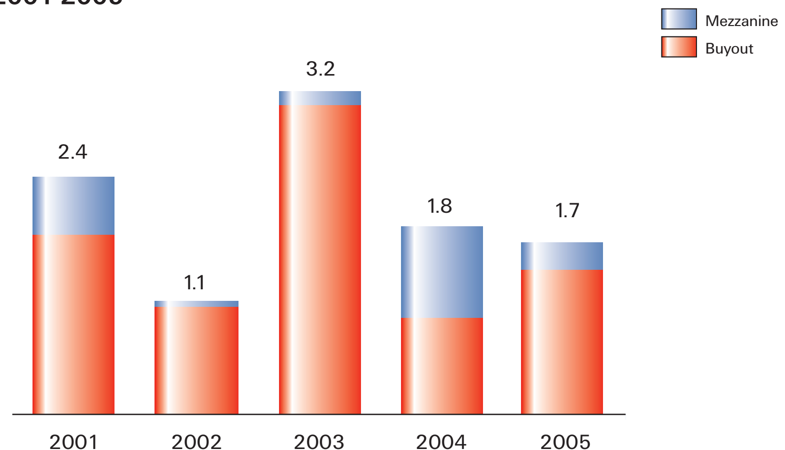
In Canada, the survey found that the combined fundraising activity of the buyout and mezzanine groups came close to matching that of 2004, while new commitments going to venture capital funds increased for the first time since 2001.

Several important new Canadian buyout funds were formed in 2005, and several more are anticipated in early 2006.

Exhibit 4

NEW BUYOUT AND MEZZANINE FUNDS RAISED, PARTNERSHIPS AND RETAIL FUNDS; 2001-2005

$ Billions



Source: Thomson Macdonald

A 2005 highlight was the closing of Birch Hill Equity Partners III LP at $850 million. This is the inaugural fund of Birch Hill Equity Partners Management, following its spinout from TD Capital Canadian Private Equity Partners. It is aimed at core activity in the domestic mid-market, including acquisitions, expansions, MBOs, refinancings, and other event transactions, in investments of up to $200 million.

2005 also featured the successful first close of ONCAP II LP, which brings it within reach of its $500 million target. With these new resources, ONCAP Management Partners will build on its record of North-America-wide buyout activity, with an investing capacity between $15 million and $80 million per deal.

HSBC Capital (Canada) also launched its second partnership, HSBC Capital (Canada) Private Equity Fund 2005. Like its predecessor, this fund will invest between $5 million and $20 million in diverse businesses both north and south of the border.

Other new funds included PRIVEQ Capital Funds' third partnership, geared to investments of $2 million to $6 million in buyout and expansion opportunities in Ontario, and Whitecastle Private Equity Partners Fund LP, which will invest between $5 million and $25 million in deals involving established firms in Canada and the Northeastern United States.

2004 was notable for the creation of some important Canadian mezzanine funds. This trend continued in 2005 with the closing of Crown Capital Investment Partners (CCIP), LP, managed by Regina-based Crown Capital Partners. With $180 million, CCIP will focus on various traditional sector opportunities across Canada, within a range of $5 million to $25 million or greater.

Retail mezzanine funds, such as Ontario's Return on Innovation (ROI) Fund and the VenGrowth Traditional Industries Fund, also attracted fresh commitments from individual investors in 2005.

In total, new commitments to buyout and mezzanine partnerships and other funds stood at $1.69 billion in 2005, as compared to $1.87 billion in 2004.

Several major new venture capital funds were formed in 2005. One of them was the largest institutionally backed partnership in the history of the industry – the $280 million Celtic House Venture Partners Fund III. This fund will allow the Ottawa-based manager to continue its concentration on early-stage IT and telecom opportunities in Canada and the United Kingdom.

Another market veteran, J.L. Albright Venture Partners, also proved successful in its first closing of Fund IV, for investments in new and developing IT firms. Similarly, Propulsion Ventures took the first step toward a targeted $100 million for its third fund product offering, which will focus primarily on software companies located in Québec and Ontario.

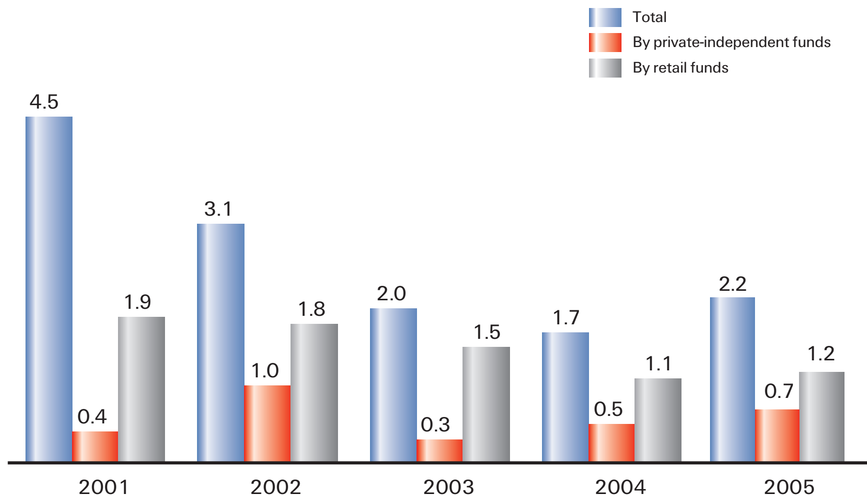
Other new funds included Tech Capital Partners' Tech Capital II LP, which has a mandate for investing in early-stage IT prospects in Southwestern Ontario, and the second partnership of Chrysalix Energy Management, which will make new advances in the emerging clean-tech sector.

The largest source of venture-oriented commitments in 2005 remained LSVCCs and other retail funds, which accounted for $1.2 billion in new resources, up from $1.1 billion the year before. Most of the gains were

Exhibit 5

NEW VENTURE CAPITAL FUNDS RAISED, ALL FUND TYPES; 2001-2005

$ Billions



Source: Thomson Macdonald

realized by Québec fund managers, such as Capital régional et coopératif Desjardins, FondAction, and Fonds de solidarité (FTQ). Elsewhere in Canada, activity was led by GrowthWorks and VenGrowth.

New commitments to venture capital funds of all types totalled $2.21 billion in the past year, up 32 percent from $1.67 billion in 2004, according to statistics produced by Thomson Macdonald.

SOURCES OF PRIVATE EQUITY CAPITAL IN 2005

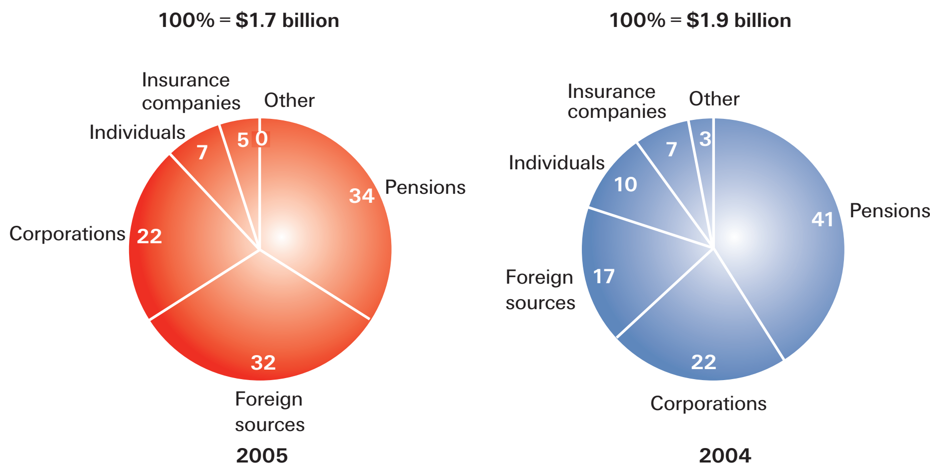
Fundraising in Canada's private equity market continued to rely on a mix of capital sources in 2005. Along with institutional investors that have long been the mainstay of new capital flowing into the American market, Canadian buyout, mezzanine, and venture fund managers drew on a diverse supply base of corporations, foreign investors, governments, and individuals.

The largest portion of new commitments to buyout and mezzanine funds in 2005 originated with pension funds, which contributed $571 million, or 34 percent of the total; however, this was down from $766 million in 2004. By contrast, foreign investors greatly increased their commitments, accounting for $535 million, or a 32 percent share – up substantially from 2004's $310 million.

Exhibit 6

SOURCES OF BUYOUT AND MEZZANINE FUNDS RAISED

Percent



Source: Thomson Macdonald

Other sources included corporations that committed $379 million, or 22 percent of new buyout and mezzanine capital raised, which is comparable to their 2004 contribution, while individual investors committed $123 million, and insurance companies, $81 million.

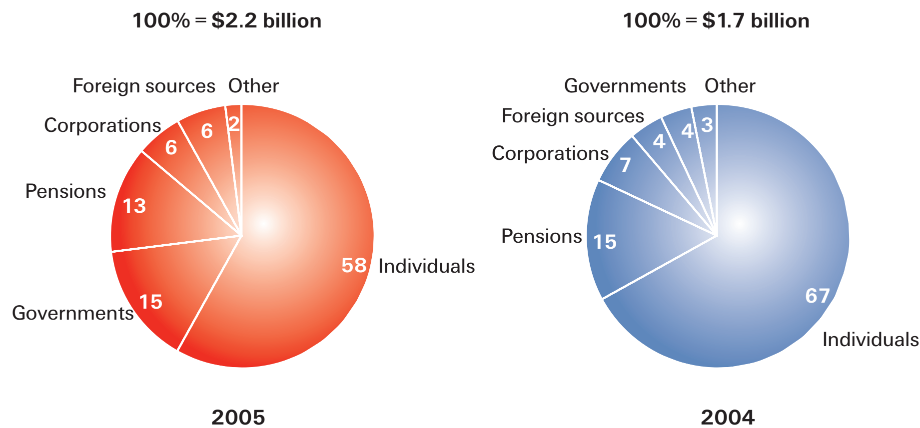
Year-over-year growth in LSVCC-retail fundraising ensured that individual investors once again proved a major capital provider to the venture capital industry. In 2005, these investors accounted for $1.3 billion of new commitments, or 58 percent of the total. However, this share is lower than in 2004, when individuals accounted for 67 percent of capital inflows, and in 2003, when their share was 76 percent.

Government sources contributed $327 million, or 15 percent of the total amount going to venture capital funds, while pension funds contributed $306 million, or a 13 percent share. Corporate sources followed with $139 million in new resources, and then foreign investors with $125 million. All of these commitment levels surpassed those witnessed in 2004.

Exhibit 7

SOURCES OF VENTURE CAPITAL FUNDS RAISED

Percent



Source: Thomson Macdonald

FUNDRAISING OUTLOOK FOR 2006

Last year's survey found the number of Canadian private equity fund managers actively seeking new commitments in 2005 had increased significantly over 2004. As 2006 got underway, it appears that even more were on the fundraising trail.

The survey found 43 fund managers planning to launch or close a new product offering in the coming months, compared to 32 fund managers that indicated similar plans for 2005.

Nineteen buyout or mezzanine funds were identified as actively raising new resources. These included Onex Corporation, which after creating Onex Partners I LP in 2003 – the largest partnership in the history of Canadian private equity – is now simultaneously marketing Onex Partners II LP and nearing the final close of ONCAP II LP. Joining them will be RFG Private Equity LP No. 2, the latest offering from Richardson Capital Limited.

There are 24 venture capital funds seeking new commitments, such as J.L. Albright IV Venture Fund and Propulsion Ventures III LP, both of which are positioned for final closings, as well as the sixth fund of GTI Capital, geared to activity in young IT firms in Ontario, Québec, and Europe. Others include the early-stage Garage Technology Ventures Canada LP and the life-sciences-oriented GeneChem LP II.

2005 saw new Canadian private equity partnerships that were larger – and in some cases considerably larger – than comparable funds in prior years.

The evidence suggests that this trend will continue in the year ahead, as the survey found many new buyout funds were targeting between $300 million and $800 million, and many new venture capital funds between $100 million and $200 million – ranges that exceeded those reported for 2005.

Fundraisers will encounter several important new capital sources in 2006. For instance, along with managing CPP Investment Board's account for committing $400 million to Canadian buyout and venture capital funds, TD Capital Private Equity Investors has already completed a first closing of US $250 million on its second global fund-of-funds.

After closing its Private Equity Program II in 2005, Kensington Group is also marketing a new $500 million Program III. This fund-of-funds will reflect a broad private equity focus, with domestic commitments managed by Kensington and foreign commitments managed by Harbourvest Partners, LLC.

1.5 Private equity investment activity in 2005

DEAL ACTIVITY STABLE – OR ON THE RISE

The Canadian private equity market benefited from a strong economic climate in 2005. Investment activity in all segments was much healthier than it was 2 years ago, when the sustained downturn felt here – as well as in the United States and worldwide – was at its lowest point.

In the past year, disbursements in the buyout industry proved to be the major story, as fund managers greatly accelerated their activity. This was part of a broader North-America-wide trend, where buyout investments enjoyed a third consecutive year of growth.

The evidence suggests that, for many other private equity professionals, improved market conditions in the past year meant a renewed ability to dispose of portfolio assets and return to higher – and generally more stable – levels of activity. The survey found that, in general, the majority of Canadian professional managers were increasingly confident about the investment climate and ready to build on recent positive results.

VENTURE DISBURSEMENTS HOLD STEADY

Venture capital activity stayed steady in the post-slowdown market environment of North America in 2005.

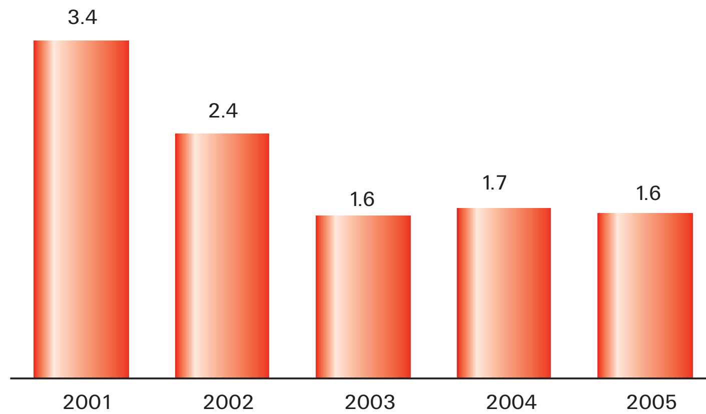
Survey data and the annual statistics of Thomson Macdonald show disbursements by Canadian venture fund managers to domestic and foreign companies as totalling $1.64 billion, which almost equals the $1.69 billion invested in 2004.[1] A similar pattern of activity was evident in the United States where, according to Thomson Venture Economics, dollars invested were effectively unchanged on a year-over-year basis.

1 Data presented here reflect the individual fund disbursements of survey respondents. Other investors active in Canada since 2001 – such as foreign investors – that did not form part of the survey sample are not represented in the statistics cited. For this reason, the data should be viewed as only one indicator of total Canadian private equity activity.

Exhibit 8

VENTURE CAPITAL INVESTED BY CANADIAN FUNDS; 2001-2005

$ Billions



Source: Thomson Macdonald

Some of 2005's largest deals involved companies possessing apparent IPO potential. Among these were a few Ottawa telecom firms, including Meriton Networks, which received US $54 million from Desjardins Capital de risque, Newbury Ventures, Primaxis Technology Ventures, RBC Capital Partners, Skypoint Capital Corporation, VantagePoint Venture Partners, VenGrowth Private Equity Partners, and other investors.

Another communications firm, Dorval's Simpler Networks, also secured an additional round of financing of US $25 million from BCE Capital and Fonds de solidarité (FTQ), as well as non-resident co-investors Highland Capital Partners, Kodiak Venture Partners, and Lothian Partners.

Young Canadian life sciences companies were also attracting significant interest. An example is the Ottawa-based biopharmaceuticals innovator Zelos Therapeutics and its US $42.5 million deal with BDC Venture Capital, Teachers' Private Capital, VenGrowth, along with several American investors, including Alta Partners, Frazier Healthcare Ventures, Prospect Venture Partners, Seaflower Ventures, and SR One.

Early-stage biopharma featured in other major 2005 transactions as well, including the US $40 million invested in Vancouver-headquartered Celator

Technologies by BDC, GrowthWorks, Quaker BioVentures, TL Ventures, Ventures West Management, and others.

This activity points to a continuing emphasis on up-and-coming firms in IT, life sciences, and other technology sectors, and well-syndicated deals involving major US funds. According to Thomson Macdonald, foreign investors now typically account for one-quarter of the venture capital invested in Canada.

WHERE DID VENTURE MONEY GO?

Last year, the survey found venture capital funds disbursing over half of their resources to new and fledgling businesses at home or abroad. This was consistent with Thomson Macdonald data, which have indicated a strong industry focus on early-stage activity in recent years – a trend related in part to increased numbers of balanced and specialty funds with the in-house capability to do these deals.

However, in 2005, there was a distinct shift toward later-stage activity, and particularly toward domestic or foreign companies that were expanding. The latter category alone captured 46 percent of total capital invested by Canadian fund managers in 2005, compared to 39 percent a year ago.

One factor contributing to this trend has been the strength of exit markets; there are a number of recent examples where venture capital investors have completed follow-on financing rounds to prepare portfolio firms for acquisition, IPO, and other liquidity events.

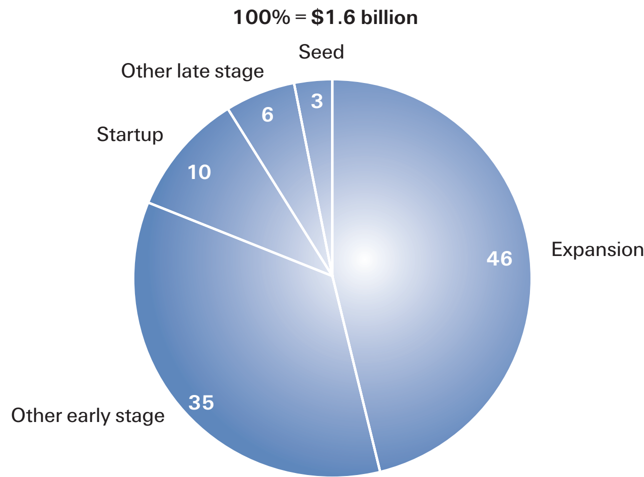
BUYOUT ACTIVITY RED HOT

The survey found Canadian buyout industry disbursements to domestic and foreign businesses increased a remarkable 50 percent to $6.42 billion in 2005, from the $4.27 billion invested the year before.

Exhibit 9

VENTURE CAPITAL INVESTED BY STAGE; 2005

Percent



Source: Thomson Macdonald

This intensified level of activity is consistent with that in the United States in the past year where, according to Thomson Financial's *Buyouts* Newsletter (Vol. 19, No. 1, January 2006), buyout funds invested 44 percent more than they did in 2004.

American market activity was fuelled by some of the largest acquisition deals of all time. Many of them resulted from corporate carve-outs involving familiar names such as Hertz and Toys "R" Us. Moreover, some of Canada's largest buyout fund managers were among those finding attractive opportunities in the United States.

For instance, Onex Corporation saw an attractive opportunity in The Boeing Company's commercial aero-structures design and manufacturing facilities in Kansas and Oklahoma. In 2005, Onex Partners I LP completed an acquisition of these Boeing operations, renamed Spirit AeroSystems, in a transaction valued at $1.5 billion.

Teachers' Private Capital also zeroed in on American deal flow. One notable example was its $1 billion purchase of Doane Pet Care Company from a group of investors led by J.P. Morgan Partners. The Brentwood, Tennessee,

manufacturer of private label pet food aims to expand on the leading positions it has already established in North American and global customer markets.

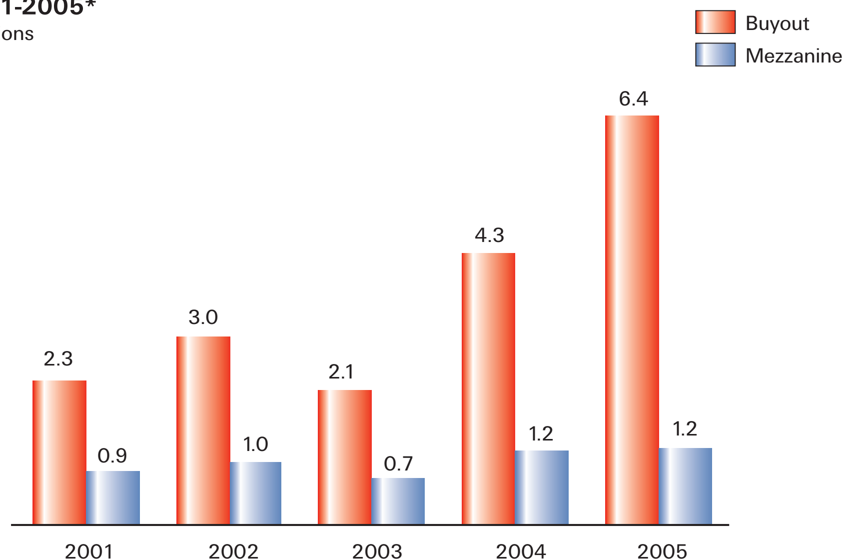
Comparatively large-sized buyout activity also took place in Canada, as illustrated by a transaction involving the financial distress and restructuring investor Tricap Management. In the past year, Stelco Inc.'s creditors approved Tricap's $1.4 billion plan to recapitalize and turn around the Hamilton-based integrated steel producer.

Similarly, in addition to its activity south of the border, Onex Corporation helped engineer the combination of two of Canada's largest movie theatre chains. Under the terms of this $500 million deal, Onex's Toronto-based, publicly traded Cineplex Galaxy acquired Famous Players from Viacom.

Exhibit 10

BUYOUT AND MEZZANINE CAPITAL INVESTED BY CANADIAN FUNDS; 2001-2005*

$ Billions



* Goodman and Carr LLP-McKinsey & Company's annual survey regularly updates investment data obtained from respondents. For this reason, and the fact that the survey aims to increase its market coverage each year, aggregate buyout and mezzanine data reflecting activity in prior years are subject to change.

Source: Thomson Macdonald

MEZZANINE INVESTMENTS ALSO INCREASE

Driven by many of the same factors influencing activity in the buyout segment, mezzanine activity also rose in 2005. The survey found disbursements by Canadian mezzanine fund managers totalled $1.21 billion, up slightly from 2004's $1.19 billion.

Relatively high disbursement levels in recent years are chiefly due to the greatly increased size of institutional and private-independent funds focused on this market segment. While there is growing evidence of cross-border transactions, most activity remains targeted at deal opportunities in the domestic mid-market, sized according to the industry's traditional investment range.

For instance, McKenna Gale Capital provided a total of $17 million of subordinated debt and equity to assist American buyout group Sentinel Capital Partners with its 2005 acquisition of Nanaimo's Madill Equipment, a major manufacturer of specialty equipment for North America's forest products sector.

Wellington Financial LP also led a $20 million financing of CrossOff Incorporated of Sydney, which focuses on corporate education and IT training. Syndicate resources came from VenGrowth Traditional Industries Fund and other investors. This deal facilitated CrossOff's purchase of the domestic assets of IT and training provider CDI Education.

WHERE DID BUYOUT AND MEZZANINE MONEY GO?

In 2004, the survey found the activity of most buyout and mezzanine fund managers was focused on a broad menu of deals by event type, including acquisitions, expansions, MBOs, and refinancings, as well as restructurings and turnarounds.

In 2005, because of the exceptionally large sizes of particular transactions on both sides of the Canada-US border, nearly half of all Canadian fund disbursements were captured by activity that was essentially acquisition-related.

MBO-related activity also consumed substantial buyout and mezzanine resources in the past year – 28 percent. Expansions followed with a 9 percent share and refinancings with 6 percent. Financial distress and restructuring situations and all other event types accounted for the balance.

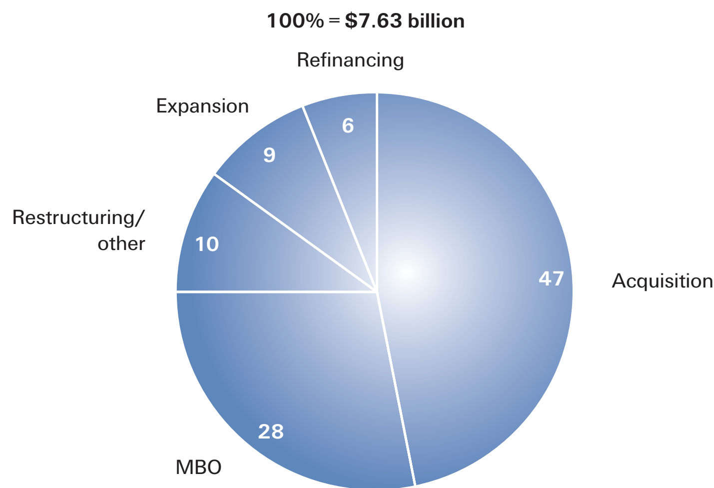
Ever larger Canadian fund sizes have impacted average preferred investment ranges, which remain a key indicator of activity in these two market spaces. Many buyout industry players have raised preferred investment levels to between $20 million and $70 million, while several have pushed their upper limit to $200 million or greater.

Moreover, the increased size of partnership targets for 2006 suggests that the number of Canadian buyout and mezzanine fund managers able to undertake investments greater than $100 million will increase as well.

Exhibit 11

BUYOUT AND MEZZANINE CAPITAL INVESTED BY EVENT TYPE; 2005

Percent



Source: Thomson Macdonald

EXIT ACTIVITY KEEPS PACE

In addition to making investments, Canadian private equity fund managers also took advantage of liquidity opportunities in 2005, as acquisitions, IPOs, and other exit market avenues continued to offer good cash-out prospects.

In Canada's venture capital segment, Thomson Macdonald data showed an upswing in the rate of acquisitions in the past year, illustrated by CYBIRD's purchase of the Montréal-based wireless content provider, Airborne Entertainment. Airborne obtained prior financing from Bell Mobility Investments, Insight Venture Partners, Propulsion Ventures, and Wellington Financial LP.

There were also several major IPOs, including the NASDAQ listing of Victoria's Aspreva Pharmaceuticals, which had scored the industry's largest startup deal in 2004. Aspreva was previously backed by Discovery Capital Corporation, and by the American funds Axiom Venture Partners, InterWest Partners, Sprout Group, Thomas Weisel Venture Partners, and Vivo Ventures.

The income-trust market continued to be responsible for much of the growth in overall Canadian IPO activity in 2005 and remained an important exit vehicle for buyout and mezzanine funds. For instance, MWI & Partners sold its shares in Somerset Entertainment Income Fund at the time of the Toronto communications and media company's public equity offering.

Sales of assets between private equity funds were also a key source of liquidity. This was apparent in the secondary acquisition of the property and casualty firm GCAN Insurance Company of Toronto by Teachers' Private Capital, which gave former deal leader TORQUEST Partners, along with CIBC Capital Partners and Newport Partners, a successful exit in 2005.

1.6 Factors influencing private equity market growth

INSTITUTIONAL INVESTORS KEY TO MORE GROWTH

Once again, senior Canadian professional managers said they thought that the most important obstacle to growth of the private equity market in Canada was the limited participation of domestic institutional investors.

As in previous years, the survey asked buyout, mezzanine, and venture fund managers to rank a list of issues identified as factors in market growth and development, 1 being the lowest and 5 the highest.

For the third year in a row, survey respondents expressed most concern about the low number of pension funds, endowments and foundations, insurance companies, and other institutional investors willing to commit capital to private equity funds. Venture professionals gave this factor a somewhat higher rating than buyout and mezzanine professionals.

Exhibit 12

FACTORS INFLUENCING GROWTH OF THE CANADIAN PRIVATE EQUITY MARKET; SURVEY RESPONDENT RATINGS BY IMPORTANCE

5 = Very important; 1 = Not important

Factor	Rating
Limited participation of institutional investors	2.9
Limited quality of deal flow	2.7
Small domestic capital markets	2.7
Rising Canadian dollar	2.6
Government tax policies	2.6
Government intervention in the market	2.2
Provincial securities regulation	1.8
Challenges to investment in foreign markets	1.7
Lack of domestic high-yield debt	1.7

Source: Thomson Macdonald

It will be interesting to see whether newly capitalized funds-of-funds managed by Kensington Group and TD Capital Private Equity Investors and the market entry of such pension funds as OP Trust will help address this situation in 2006.

Sharing second spot in respondent concerns was the limited quality of deal flow from Canadian businesses and the relatively small size of domestic capital markets. These factors were given most emphasis by venture investors, many of whom remain cautious about new deal activity and focused on maximizing exit opportunities.

Not far behind was concern about the continuing strong value of the Canadian dollar against the American dollar. Buyout and mezzanine investors remain most interested in this factor, given its importance to the cost-competitiveness of portfolio companies involved in heavily export-oriented traditional sectors.

Also of importance to survey respondents are tax policies that impact the flow of new capital to private equity funds. Cross-border tax issues are a growing concern, particularly *Canada-US Income Tax Convention* provisions that negatively affect American institutional investor commitments to Canadian funds.

1.7 Conclusion

Data drawn from Goodman and Carr LLP-McKinsey & Company *Canadian Private Equity Activity Survey 2005,* along with supplementary data provided by Thomson Macdonald, point to a second year of steady or expanding investment activity across the private equity market spectrum.

The survey's findings of increased rates of capital invested in the buyout and mezzanine segments, as well as a return to more stable activity in the venture capital industry, suggest that all market players were taking steps in 2005 to build on positive activity seen in 2004.

The prospects for overall activity in 2006 are also positive, due in part to several major new private equity partnerships formed in 2005 and the large number of fund managers actively seeking new commitments in the months ahead. If economic and financial conditions remain strong, the Canadian private equity market in 2006 may very well continue to build on the momentum displayed over the past 2 years.

APPENDIX

CONTRIBUTORS TO THE GOODMAN AND CARR LLP-McKINSEY & COMPANY *CANADIAN PRIVATE EQUITY ACTIVITY SURVEY 2005*

ARC Financial Corporation

AVAC Ltd.

Banyan Capital Partners

BCE Capital

BDC Subordinate Financing

BDC Venture Capital

BEST Investment Counsel

Birch Hill Equity Partners Management

BMO Capital Corporation

Brightspark Capital Partners

CAI Private Equity

Callisto Capital LP

Capimont

CastleHill Ventures

CDP Capital Private Equity

Celtic House Venture Partners

Chrysalix Energy Management

Clairvest Group Inc.

Covington Capital Corporation

Crown Capital Partners Inc.

Dana Naye Ventures

Dancap Private Equity Inc.

Desjardins Capital de risque

Discovery Capital Corporation

EDC Equity Fund

EdgeStone Capital Partners

ENSIS Management

FCC Ventures

First Ontario Management Ltd.

FondAction

Fonds de solidarité du travailleurs du Québec (FTQ)

Foragen Technologies Management

Frontier Capital Partners

Garage Technology Ventures (Canada)

GeneChem

GrowthWorks

GTI Capital

HSBC Capital (Canada) Inc.

Hydro-Québec CapiTech

Innovatech du Sud du Québec

Innovatech Québec et Chaudiere-Appalaches

Investment Saskatchewan

Jefferson Partners

J.L. Albright Venture Partners

Kensington Group

Kilmer Capital Partners Ltd.

Latitude Partners
Lawrence & Company
Manulife Capital
Manvest Inc.
McKenna Gale Capital
McLean Watson Capital
MDS Capital Corporation
Medical Discovery Management Corporation
Medical Innovations Management
MedTech Partners Inc.
MMV Financial Inc.
Multiple Capital
MWI & Partners
NDI Capital
New Brunswick Investment Management Corporation
Norvest Capital Partners Inc.
Novacap
OMERS Capital Partners
ONCAP Management Partners LP
Onex Corporation
Orchard Capital Group Inc.
Pangea Ventures
PenderFund Capital Management Ltd.
Penfund
Perseis Private Equity Partners, Inc.
PFM Capital
Primaxis Technology Ventures Inc.
PRIVEQ Capital Funds
Propulsion Ventures Inc.
Richardson Capital Limited
ROI Management Ltd.
Roynat Capital
Skypoint Capital Corporation
T2C2 Capital
TD Capital Mezzanine Partners
TD Capital Private Equity Investors
TD Capital Ventures
Teachers' Private Capital
Tech Capital Partners Inc.
TechnoCap Inc.
TELUS Ventures
TORQUEST Partners Inc.
Tricap Management
TriWest Capital Partners
VanCity Capital Corporation
VenGrowth Private Equity Partners Inc.
VentureLink LP
Ventures West Management Inc.
Wellington Financial LP
Westcap Management
Whitecastle Investments Limited
Yellow Point Equity Partners LP

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