U.S. tech looks north of the border

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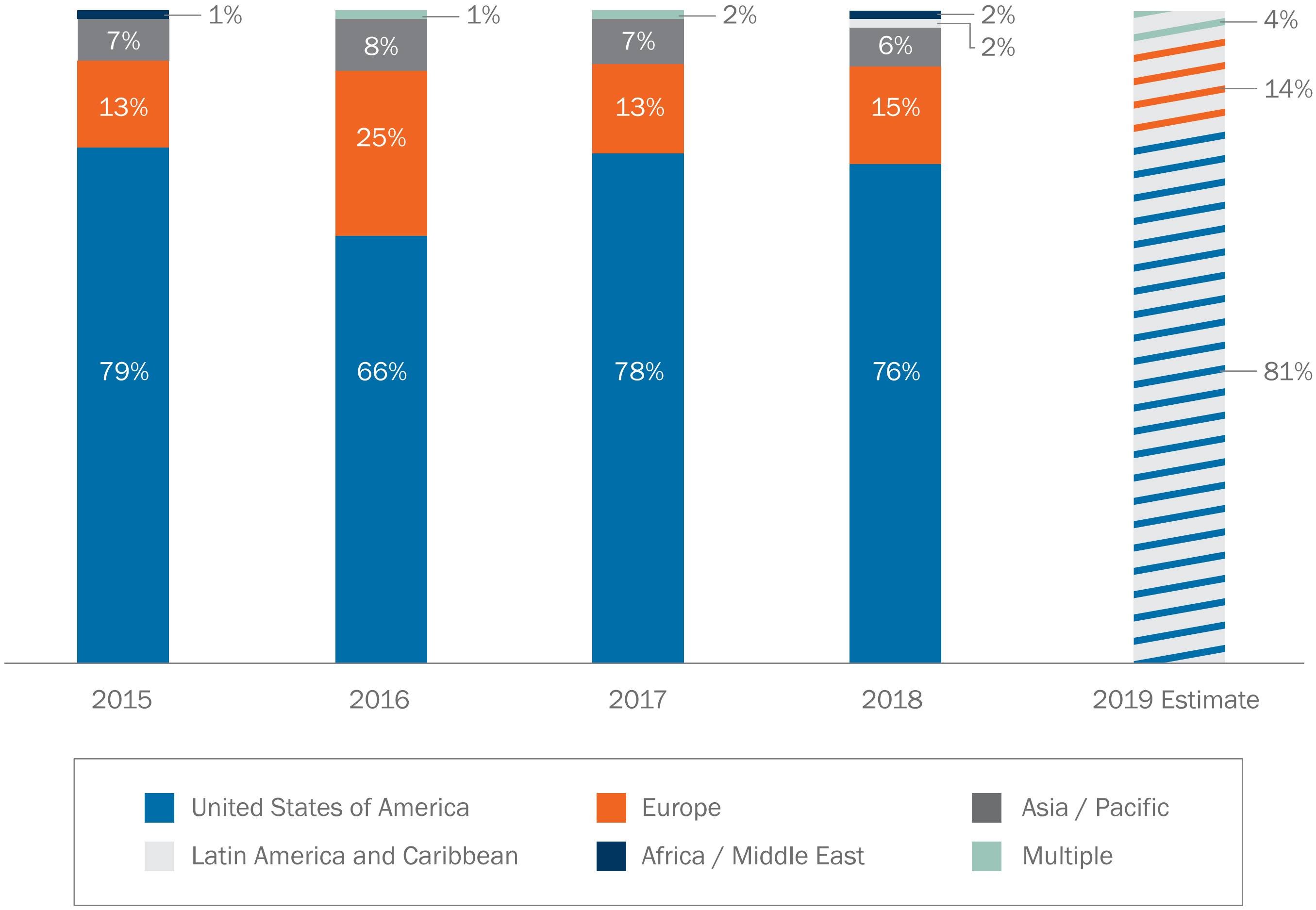
The technology sector in Canada has experienced significant activity and change in recent years. With ongoing, substantial investment from U.S. technology companies in both Canadian startups as well as Canadian tech talent, it is becoming increasingly important for players on both sides of the border to understand the nuances of these Canada-U.S. cross-border transactions and what they may say about where the Canadian tech space is headed.

Influx of U.S. inbound investment

U.S. investment continues to dominate inbound activity in Canada's tech sector (Figure 1), averaging 76% of all inbound M&A activity between 2015-2018. Current 2019 estimates put the share of U.S. investors representing over 80% of all M&A deals this year. U.S. tech investors, including from some of the largest players in the United States, are coming into Canada as acquirors, requiring all parties involved to focus on cross-border issues such as tax structuring related to entering Canada.

Figure 1: Inbound investment activity in Canada



Source: S&P Capital IQ. Announced transactions to October 1, 2019 involving a Canadian target in the tech sector. Cancelled transactions are excluded.

Rise of acqui-hires

For many U.S. tech companies looking north for acquisitions, the acqui-hire has proven a popular transaction type in a sector that is seeking top development, design, engineering and other specialized talent for a competitive advantage. Acqui-hires are acquisitions that are focused primarily on the hiring of a target's talent (and sometimes its IP assets) as opposed to the product or service of the target company.

A number of hot markets for tech talent in Canada that have been attractive targets for U.S. investors include the Kitchener-Waterloo corridor, Toronto, Montréal and Vancouver. Both parties in an acqui-hire scenario will need to carefully think through various considerations involved in this type of transaction, one of the most notable of which is which party bears the responsibility for the historical employment obligations of the employees that are the subject of an acqui-hire transaction.

Legal considerations for Canada-U.S. tech M&A

Plans of arrangement. One difference U.S. buyers will notice is frequent use of the court-ordered "plan of arrangement" process available under most Canadian corporate statutes which can be very advantageous in its flexibility. In addition to its traditional role in public company transactions, this helpful tool is also increasingly used in more complex private deals (e.g., where the interests of larger numbers of stakeholders need to be addressed to implement a clean exit). Tech companies that have undergone multiple rounds of financing can often have an expansive shareholder base making a plan of arrangement an attractive option in a purchase and sale transaction.

Tax. U.S. companies intending to offer share consideration to the shareholders of a Canadian target will need to carefully consider the Canadian tax implications and consider strategies such as the use of an exchangeable share structure. U.S. buyers will also need to consider Canadian tax implications for the ongoing operations of the Canadian target; for example, Canadian tech targets will frequently be entitled to scientific research and experimental development (SR&ED) investment tax credits that can be affected by changes in control. Employee stock options are also typically subject to special Canadian tax rules beneficial to Canadian employees, making it important for transaction structures to preserve these benefits. Similarly, the holders of shares of certain qualified small business corporations may be entitled to tax breaks if a sale is structured appropriately.

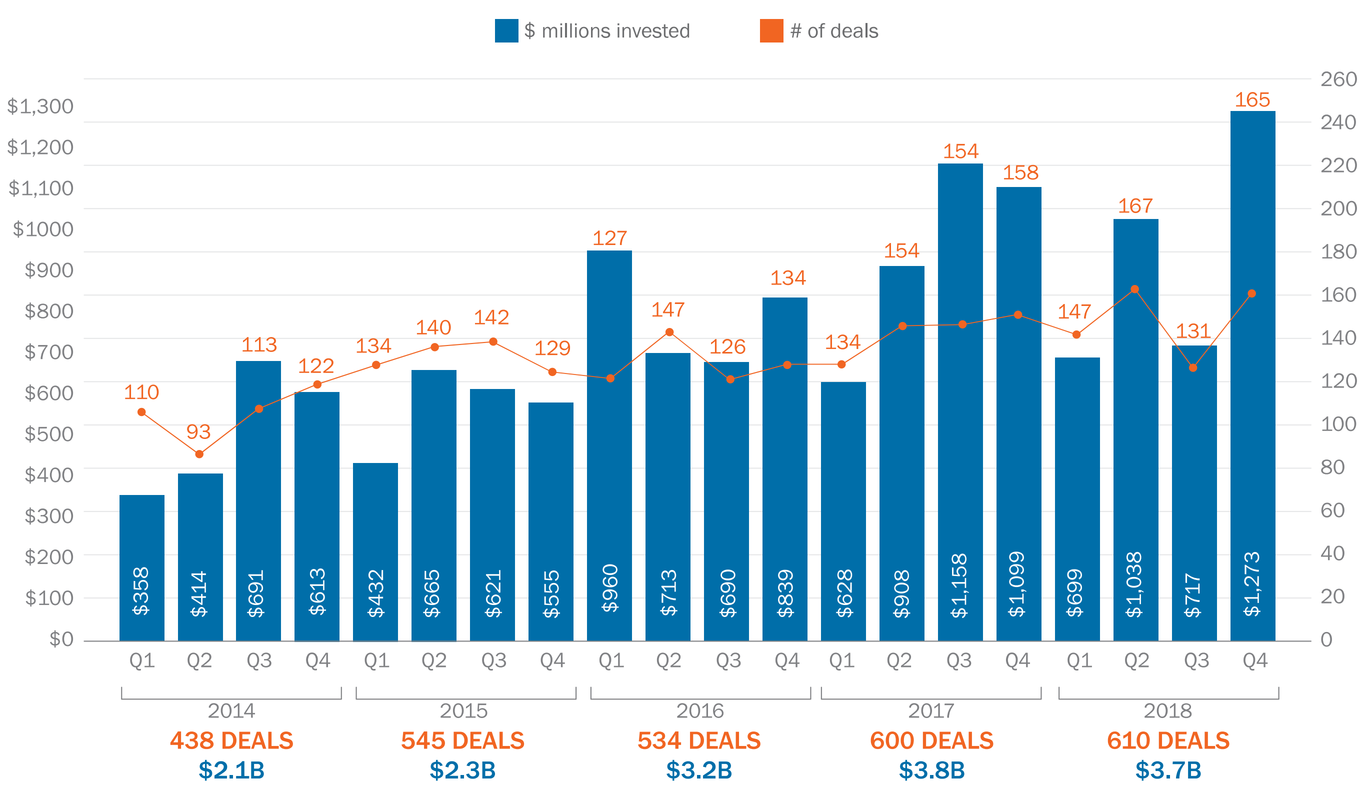
Employment issues. Understanding distinctions in Canadian employment law will also be very important for U.S. buyers. There is no concept of "at-will" employment in Canada, and termination without cause or notice will typically trigger significant financial obligations for the employer.

The role of venture capital

Canada is considered to have a healthy VC ecosystem, with a VC sector that has grown steadily in recent years. Canada ranks second place among all OECD countries (as of 2017) in absolute dollar amounts available for VC investments (and ranks third when calculating VC investments as a percentage of GDP among OECD countries).[1]

In 2018, Canada saw 610 venture deals with an aggregate value of $3.7B and average deal size of $6.1M (Figure 2). While these data points are in line with 2017 numbers, it's a large increase from recent years: in 2014 for example, there were 438 deals with an aggregate value of $2.1B. A CVCA report states that 2019 numbers for Canadian VC activity are on track to exceed 2018 numbers.[2]

Figure 2: Quarter-over-quarter VC investment activity



Source: Canadian Venture Capital and Private Equity Association, VC & PE Canadian Market Overview, Q4 2018.

U.S. funds as a source of capital

A recent report shows that a prevalence of foreign VC funds, particularly U.S. funds, in Canada, is helping fill the funding gap in Canada both at the seed and growth stages. In a review of 257 single investments made by a VC in one fundraising round of a Canadian company, the study found that Canadian VCs invested in 100 rounds, while U.S. and other international VCs invested in 86 and 36 rounds, respectively. In other words, U.S. investors participated in almost as many rounds as Canadians VCs. This trend in the VC world is familiar, as we see the same U.S. influence in inbound tech M&A (as discussed above).

U.S. and other international funds are also investing more money per deal: Canadian startups that only raise from Canadian VCs raise on average $4.4M in a Series A round, while Canadian startups that only raise from U.S. and/or other foreign funds raise on average $11.9M in a Series A round. One reason for this may be that the pool of available money in Canada is fragmented across too many funds, and that while Canada has many funds, since they're each relatively small, they operate with more constraints.[3]

Canada also faces challenges in terms of startup investment: despite the availability of venture capital in Canada, Canada has not produced a proportionate number of startups with a valuation of US$1B or more—so-called "unicorns".

While there remains good reason for excitement around the growth in Canadian tech, the data show that it is still very early days. Larger venture capital funds, and U.S. investment more broadly, will likely remain necessary, at least in the short term, to help fund and accelerate more successful companies, including future unicorns.

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[1] "Canadian Venture Capital Sufficiency", Narwhal Project.

[2] CVCA Report, Q4 2018, p.8

[3] "Canadian Venture Capital Sufficiency", p.11