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2011 Report on emerging Canadian software companies: The CEO perspective

Emerging Company Services

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Contents

Foreword

Back to the "new" normal

Now in its eighth year I am once again pleased to present you with the findings from our annual PwC *Report on Emerging Canadian Software Companies: The CEO Perspective.* This report is designed to help software executives better explore, understand and share ideas on the pressing business challenges and strategic issues Canadian CEOs face in the software industry.

After two years of being significantly impacted by the 2008 to 2009 recession, our survey results demonstrate that Canadian software CEOs are now back to working in the "new" normal that is the environment for emerging software companies in Canada. Many of the challenges are the same that we've seen since our first report eight years ago – growing revenues, building effective sales channel strategies and raising funds. But, our report also highlights some new challenges in 2011. For the first time, CEOs have told us that finding talent is now a significant challenge for Canadian software companies, with 44% describing it as their biggest talent management issue.

Despite these challenges, CEOs are also as optimistic as ever and over 60% expect revenue growth in 2011 to exceed 25%.

Please enjoy our *2011 PwC Report on Emerging Canadian Software Companies: The CEO Perspective.* We hope this report provides interesting, provocative reading and look forward to hearing your success stories in the future.

Peter Matutat
Partner and National Emerging Company Practice Leader
PwC

Summary

The *2011 Report on Emerging Canadian Software Companies: The CEO Perspective* is based on survey responses from over 160 CEOs of emerging Canadian software companies.

The results from the survey show that emerging software companies are looking at the recession from their rear view mirror and are positioning themselves to drive their business forward. To do this, they're focused on innovation, from considering capital raising alternatives to looking at new ways to engage customers and attract talent to adopting emerging technologies.

Revenues increase, and so does confidence

After two years of apprehension and concern over the recession, our CEOs now see themselves operating in a "new" normal environment. More than 80% are taking an aggressive approach to business planning and over 60% expect revenues to increase at least 25% in 2011. Over the eight-year history of our survey, respondents have averaged a forecasted annual revenue growth rate of 45%. The forecasts of this year's respondents are back at historical trends.

While one-third of CEOs reported flat or decreased revenues in 2010, overall revenue growth was approximately 32%, just slightly behind the survey's historical average of 35%. Canadian software companies continue to be focused almost exclusively on the North American marketplace with 89% of 2010 revenues from Canada and the US, the same level as 2009. CEOs also continue to rely heavily on direct sales channels with 82% of 2010 sales coming from direct sales.

Funding challenges persist

The funding environment for emerging Canadian software companies continues to be challenging. Similar to last year, angel investors are now the overwhelming leader as a funding source given the dearth of Canadian venture capital (VC) activity. Fifty-five percent of respondents who raised money last year received their funding from angels (46% in 2010). Only 4% received funding from Canadian VCs. While the availability of angel financing is positive, it tends to be provided in smaller quantities: 80% of 2010 financings totalled less than $2 million.

Exits are on the horizon

Seventy-three percent of respondents expect to be acquired. Of those expecting to be acquired, only 50% expect an exit in four years vs. 25% expecting an exit in 24 months. This has been the story among our CEO respondents over the past five years. Given the return of software and technology mergers and acquisition activity to pre-recession levels, respondents' confidence of early exits appears justified.

The talent race is on

For the first time, access to human resources emerged as a significant challenge. A full 44% of CEOs listed recruiting new talent and management team members as their biggest talent management issue. Last year 40% of CEOs indicated that developing the skills and training of their staff was their biggest talent management issue–only 8% felt the same way this year. While turnover continues to be low, with approximately 70% of respondents reporting less than 5% turnover, availability of new staff has now developed as an issue. It seems the supply of new software developers and management talent is no longer keeping up with demand. This talent shortage will only persist as the economy continues to improve, the workforce ages and Millennials usher in.

Is your company driving digital mobility?

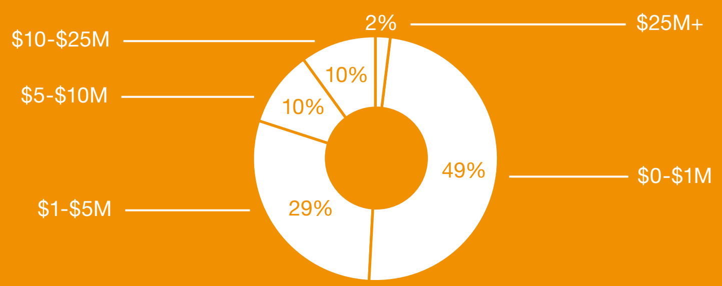
Emerging technology trends are changing the way software companies operate and interact with their customers. Mobility is seen as one of the key trends of the next five years, and respondents couldn't agree more. Seventy-four percent of CEOs describe mobility as essential or important to their business and 73% are developing or have developed mobility solutions for their clients.

73% of CEOs expect to be acquired

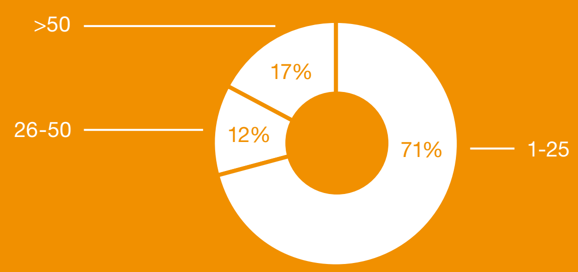
Profiles

The profile of the companies and CEOs in the 2011 survey is as follows:

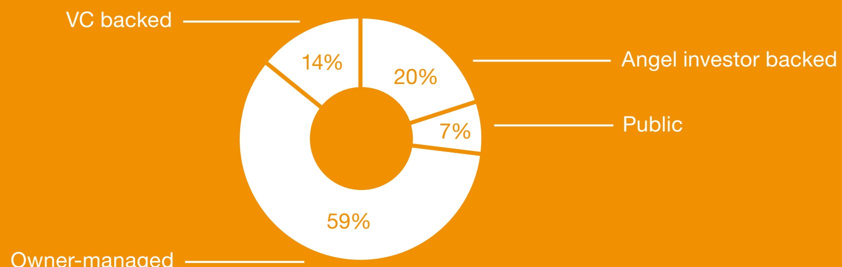
Annual revenues



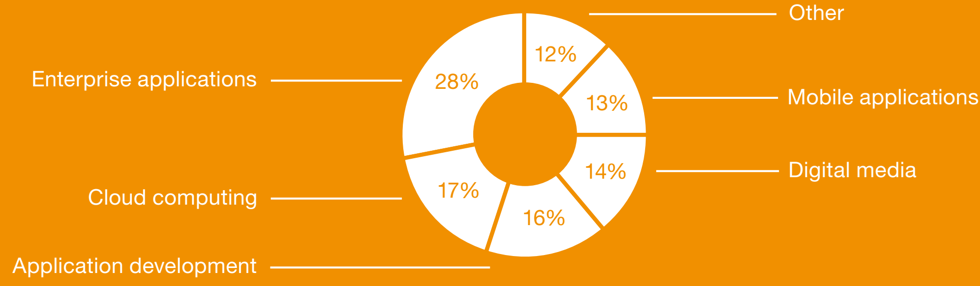
Number of employees



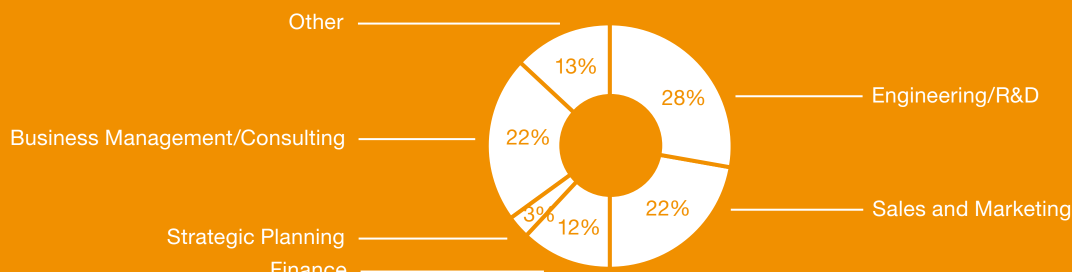
Financing



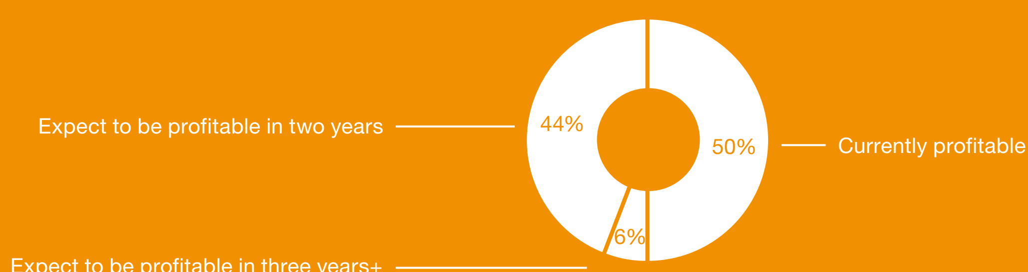
Primary area of business



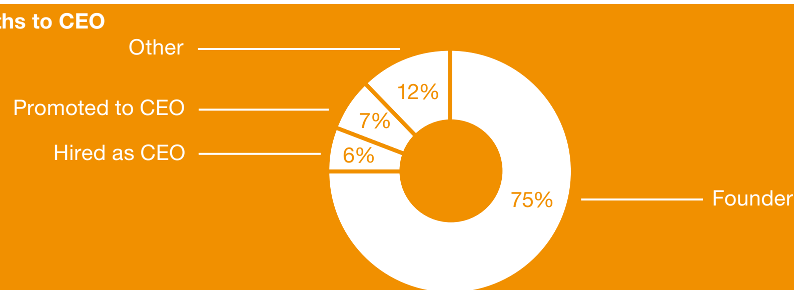
Prior experience of CEOs



Profitability



Paths to CEO



The new growth picture emerges

CEOs are optimistic with over

60%

forecasting revenue growth of over 25% in 2011.

CEOs continue to focus on North American markets and don't expect a pick-up in revenues from emerging economies.

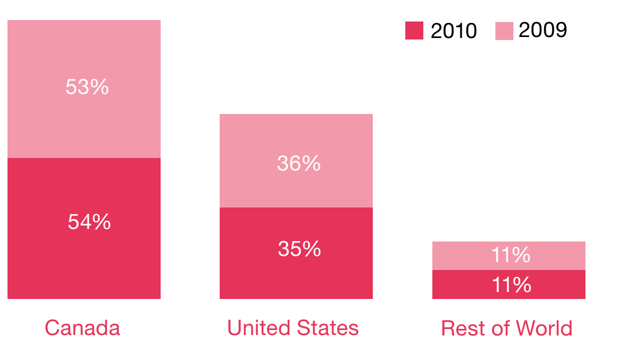
Revenues

2010 continued to be a challenging time for both global and domestic economies. Yet similar to last year's results, Canadian technology companies showed resilience—and optimism—in managing their business. A year ago, many of our CEOs were extremely bullish about their prospects for 2010, with 59% forecasting revenue growth of over 25%. In fact, only 40% achieved this revenue level and 33% reported flat sales or a revenue decrease. Despite this, CEOs are even more optimistic this year with close to 61% forecasting revenue growth of over 25% in 2011.

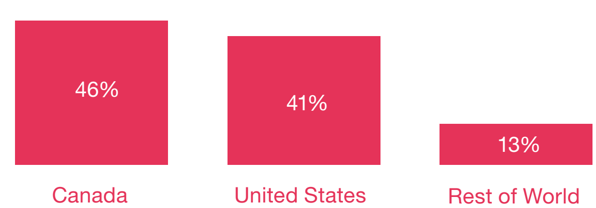
Geographic revenues continued to hold steady year-over-year, with approximately 54% of revenue generated in Canada, with a similar hold for revenue generated in the US (35%) and the rest of the world (11%).

Looking ahead, many CEOs are adopting new approaches to deal with the issues of the global recovery that they hope is underway. In PwC's recent *14th Annual Global CEO Survey*, 84% of CEOs say they've changed their company strategy over the past two years, due to the divergent global economy, with a big emphasis on targeting emerging markets. By contrast, Canadian emerging technology CEOs are forecasting 41% of the revenue coming from the US (similar to 2010), with revenue from the rest of world increasing only slightly to 13% from 11% in 2010. Respondents continue to focus on North American markets and don't expect a pick-up in revenues from emerging economies, like the BRIC countries (Brazil, Russia, India and China).

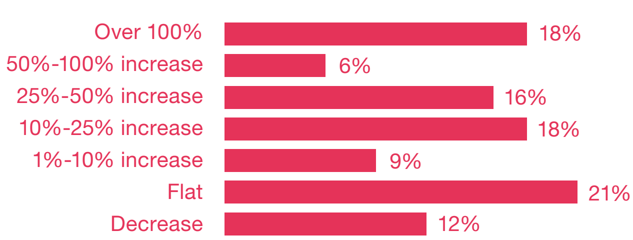
Revenue by geography, 2010 over 2009



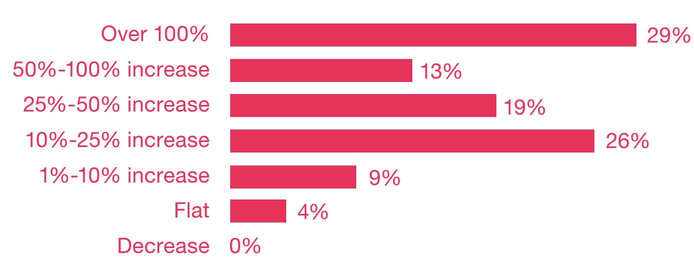
Forecasted revenue for 2011 by geography

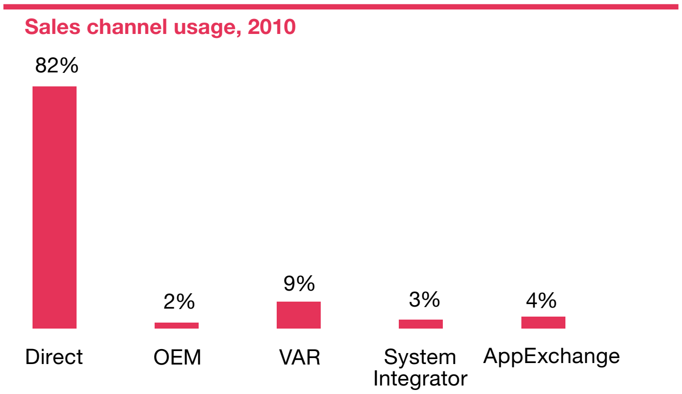


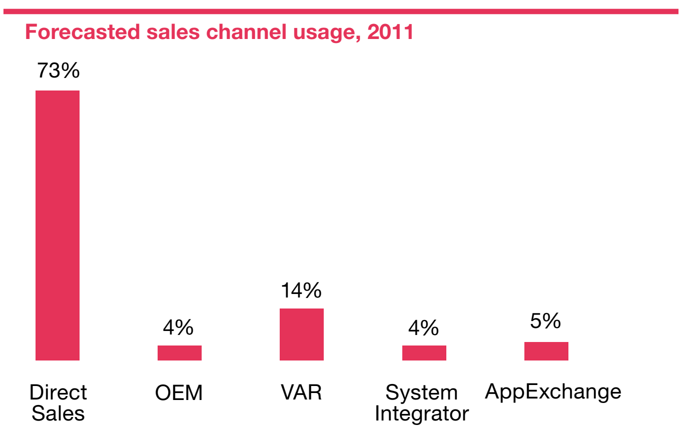
Actual 2010 revenue growth over 2009



Expected 2011 revenue growth over 2010







Sales channels

Approximately 82% of CEOs ranked direct sales as their most important channel to drive company revenue. This is up from 73% last year, and up from 61% of the expected 2010 forecast for direct sales channel revenue. The recession is the likely factor in this regression back to direct selling, as CEOs focused their limited time on driving revenues with their own resources rather than looking to leverage partners to help increase revenue.

Forecasting into 2011, emerging software company CEOs are shifting part of their focus from direct channels to all four alternative channels: original equipment manufacturers (OEM), value added reseller (VAR), systems integration and AppExchange, with VAR as the primary focus. While direct sales channels still reign for the large majority of companies surveyed, only 60% indicate they see results. VAR, on the other hand, ranked 20% effective but surprisingly low on adoption and execution.

LinkedIn **(61%)**, Twitter **(57%)** and blogs **(50%)** are the top choices for CEOs when it comes to social media.

Customers

Last year's survey revealed that 70% of CEOs relied on one-on-one feedback as the number one option to evaluate and measure customer satisfaction. This year tells a different story, with repeat purchases serving as the primary indicator for 44% of CEOs to measure customer satisfaction. Customer loyalty surveys, such as Net Promoter, (27%) and one-on-one/group focus groups (26%) followed.

This result is consistent with the level of repeat business reported. Fifty-six percent of companies surveyed have repeat business with over 76% of their customers and a further 18% have repeat business with 51-75% of their customers. Twenty-six percent have repeat business below 50% or do not track this metric.

Most of the companies surveyed (close to 58%) have less than 50 customers. In terms of selling to these customers, the most popular lead times are 30 to 90 days and 90 to 180 days (both 29% respectively).

Marketing

How are emerging software companies promoting their business to new and existing customers? More companies are using non-traditional avenues of online media, search engines and social media (54%), jumping on this increasingly necessary bandwagon to interact with customers. LinkedIn (61%), Twitter (57%) and blogs (50%) are the top choices for CEOs when it comes to social media. Why is this trend important? Smaller companies, in particular, can increase their brand awareness when they have an online presence, putting them in the same arena as some of the bigger players. Social media is becoming more commonplace, and emerging software companies will likely need to develop social media strategies to effectively engage customers and compete for their attention.

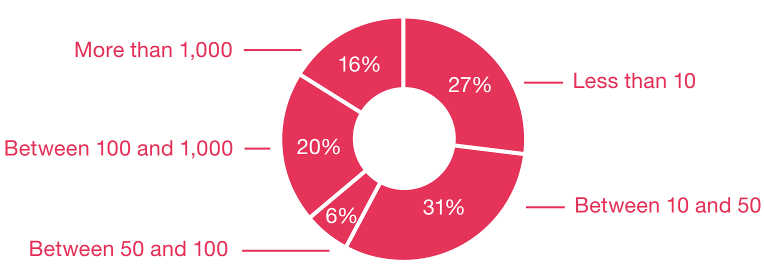
Performance indicators

The most important performance measures used by CEOs in 2010 were revenue related.

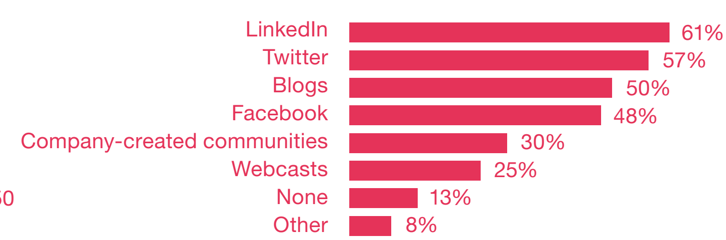
The three most popular key performance indicators were:
1. Total revenue – 18%
2. Revenue growth – 17%
3. Recurring revenue – 12%

The most popular non-revenue related metric was operating cash flow (10%).

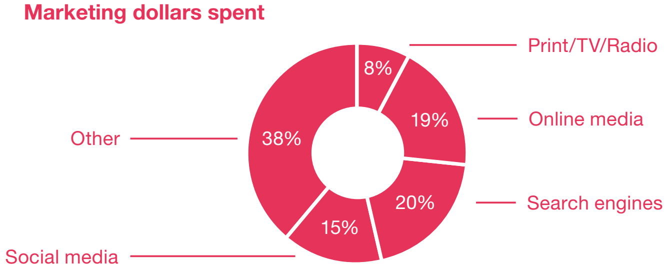
Number of customers



Social media usage



Marketing dollars spent



Revenue by type

For companies with greater than $5 million in revenue, the average revenue is split as follows:

Perpetual license revenue	**12%**
SaaS revenue	**26%**
Maintenance revenue	**11%**
Professional services revenue	**29%**
Hardware	**4%**
Other	**18%**

Cloud computing

Over the past year, cloud computing has continued to cause a great deal of disruptive change. More and more companies are relying on shared resources outside their IT infrastructure to scale IT activities up or down without investing in expanded data centres.

According to the survey, a significant percentage of respondents believe that cloud computing is either very important (38%) or somewhat important (37%) to their overall revenue growth strategy. They view the cloud as either a primary service offering or a significant aspect of their delivery model.

But are they using it? Yes, according to approximately 84% of respondents who use cloud computing in some form. This percentage increased significantly from 52% in 2009. Last year, close to 60% of CEOs believed that software as a service (SaaS) was the most promising application that they planned to use. The trend only grew this year with SaaS being the most common application used by 61% of respondents. Other uses of cloud computing were product development and testing platforms (27%) and platform as a service (25%).

It seems today's emerging software companies are realizing the power of cloud computing to not only cut down on IT costs, but deliver solutions at the new speed of business. Cloud computing has the potential to accelerate innovation and time-to-market, enhance customer engagement and improve connections across different networks.

84% of respondents use cloud computing in some form

Sarah Prevette

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Sprouter

"Having an online presence isn't just a matter of if anymore, it's a matter of when," says Erin Bury, Community Manager at Sprouter. And she should know.

Sprouter provides an online forum for start-up businesses to get the answers they need from renowned entrepreneurs, active investors and experts in small business topics, including law, search engine optimization and marketing. Launched in 2009, thousands of entrepreneurs in over 100 countries have already signed-up with Sprouter to stay informed and make connections.

According to Bury, social media is an inexpensive way to raise brand awareness, engage your customers, and enable everyone—from developers to CEOs—to become a brand evangelist. It can also put emerging technology companies in the same arena as some of the bigger players. "A lot of small businesses feel intimidated when they think of the big competitors, but when it comes to social media it levels the playing field. If you can't afford a television commercial, that's one thing, but everybody can afford to have a Twitter account and start interacting with their followers."

What's made Sprouter so successful is the fact they use a multitude of channels to promote the company and engage their audience. In fact, Bury believes that while the "Big Four" of social media—Twitter, LinkedIn, blogs and Facebook—are valuable, they're not always used to their full potential, and emerging companies could also benefit from more traditional forms of marketing. Sprouter issues a weekly newsletter that has a high-level of engagement from their followers. "We also use email notifications to pull our users back in, to let them know about site changes, to go over new features and to remind them they haven't logged-in in awhile," says Bury. "Email is definitely one of the most effective online marketing tools, when used in the right manner."

But Bury cautions that not all emerging software companies should engage in social media because other companies are in the space. "Brand awareness should be the number one reason why small businesses use social media. If you're begrudgingly getting into it because your competitors are out there, you're never going to use it in an effective way and really understand the value."

In fact, she believes that success all comes down to measurement and testing. "If you're sending out tweets and nobody is retweeting or replying to you, then you should try a new strategy. The same goes with email newsletters. If your open rate is only 6%, then you likely need to switch up your subject line or make your content more valuable. That's the luxury with social media; there are tools that enable all kinds of data and analytics, so you can tell what's working and what's not and try to improve on it."

It's no surprise that search engine optimization (SEO) is one of the biggest areas that start-ups pose questions on Sprouter: How do I rank in Google? What does Google ranking even mean? What are title tags and meta tags? Bury suggests that emerging software companies sufficiently understand these terms before building a website or online presence. Realizing this is an area of concern for start-ups, Sprouter has engaged dozens of skilled professionals to address questions on SEO.

According to Bury, the best thing about social media is that nobody's ever an expert. "You can use the tools and just learn as you go. When Sprouter started two years ago, it was a novelty for a small business to be using social media; but now it's commonplace. The expectation is that your customers will look for you on social networks, and if you're not there, they'll be surprised and wonder why you're not. The thing I always say to emerging companies is: just do it!"

The talent race is on

44%

of CEOs listed recruiting new talent and management team members as their biggest talent management issues.

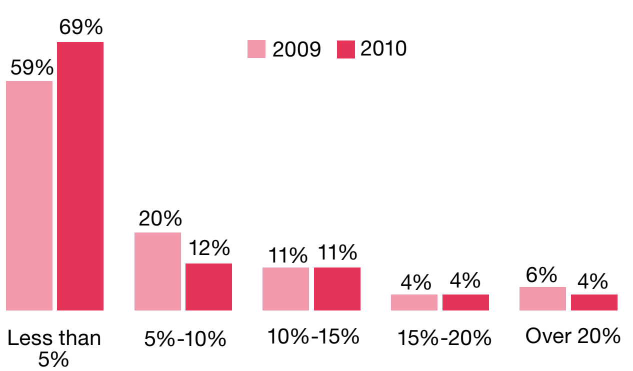
Talent is truly the lifeblood of any organization. The good news is that just like previous survey results keeping talent is not seen as a major problem for Canadian emerging software companies. This year, 81% of the companies surveyed had less than 10% turnover (79% in 2010), with 69% at less than 5% voluntary turnover (59% in 2010). The primary reasons for voluntary staff turnover over the past year were opportunity for higher compensation (21%) and new challenging opportunities (21%).

Poor performance (32%) was the leading reason for involuntary staff turnover over the past year. Only 11% of involuntary turnover was attributable to direct cost containment, which is consistent with CEO views that they're now focusing on growth with the recession in their rear view mirrors. In addition, 35% of respondents indicated they had no involuntary turnover over the past year.

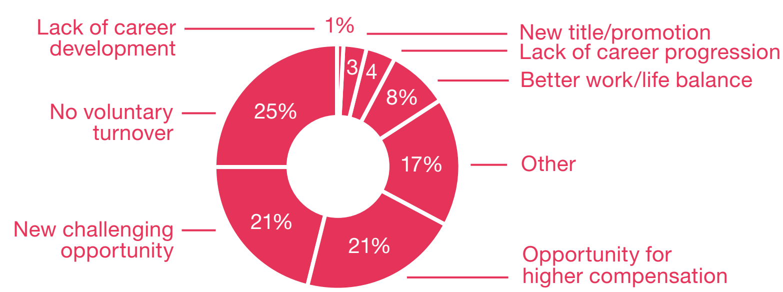
While this is encouraging news, for the first time since we began this survey in 2004, attracting talent has become a significant challenge for CEOs. This year, 44% of CEOs stated that recruiting new talent and management team members were their biggest talent management issues. Indeed only 8% of CEOs this year were concerned with developing skills and training staff, which was the hottest talent issue on the minds of 40% of CEOs in 2010.

Availability of the right people with the right skills is also a top concern for CEOs around the world. According to PwC's *14th Annual Global CEO Survey*, 66% of global technology CEOs report there's a limited supply of candidates with the right skills and 64% see the shortage of talent as the most serious threat to their companies' growth.

Voluntary turnover



Reasons for voluntary turnover



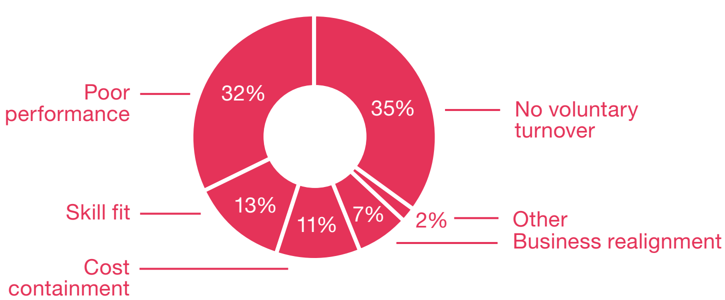
> One of the key talent management success factors is to have an effective total rewards strategy program in place, which focuses on both monetary and non-monetary rewards.

As global economies recover, attracting talent will only develop more significantly as a major challenge. This is causing many companies to demand a rethink of their entire people strategy, and 85% of Canadian CEOs across all industries surveyed in the Global CEO Survey said they intend to make "some" or a "major" change to their strategies.

When it comes to Canadian emerging software CEOs, only 28% highlighted they have an effective talent management strategy in place and key metrics to measure it. A combined 72% either don't have a plan in place or are not sure if it's effective. With so many emerging and established technology companies on the scene, this certainly puts pressure on those companies with no plan to make their organizations the most attractive to the best talent.

So, how can you not only keep your people, but keep your people happy? First and foremost it's important to understand who your key talent is, how engaged they are and the impact on your business of losing that talent. This also means taking into account strategies to address the aging workforce and the expectations of the new generation of workers. One of the key talent management success factors is to have an effective total rewards strategy program in place, which focuses on both monetary and non-monetary rewards. Non-financial incentives, such as training and mentoring programs, challenging assignments and flexible work schedules, can go a long way to motivate staff and help balance the needs and aspirations of employees.

Involuntary turnover



Outsourcing: Delivering value beyond cost savings

Increased competition and the need for cost-effective services have left many technology companies leaning towards outsourcing. Surprisingly though, outsourcing operations isn't on the radar for the majority of respondents. Approximately 35% of CEOs don't outsource any portion of their organization. For the 65% of respondents who do outsource, the leading activities are IT storage (39%) and administrative functions (26%).

What are the top outsourcing locations? The most common is North America (78%). Unlike other industries, outsourcing to developing countries isn't significant for Canadian emerging software companies. This trend is likely due to the capital investment required to commence outsourcing activities outside of North America. According to respondents, the most common location to outsource activities outside of North America is India (14%), with R&D and IT storage as the chief activities.

35%

of CEOs don't outsource any portion of their organization.

Tobi Day-Hamilton

Director of Advancement, Waterloo Stratford Campus and Faculty of Arts at University of Waterloo

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University of Waterloo

Bridging the talent gap to build stronger Canadian companies.

Hiring the right talent is becoming increasingly challenging, as software companies look to get the skills they need and put the right management team in place. Is it simply a matter of equipping students with valuable skills to help them better enter the workforce?

For the University of Waterloo, the answer may be in part "yes". Over the past four years, Canada's most innovative university[1] has been working with different companies to identify their talent gaps—and develop innovative solutions to help fill the void. "Companies are no longer looking solely at technical skills," says Tobi Day-Hamilton, Director of Advancement at the Waterloo Stratford Campus and Faculty of Arts at the University of Waterloo. "They're looking for people who can think outside the box, be creative and manage various teams at once. People who have both the technical knowledge and business background."

To do this, the University of Waterloo has partnered with a number of colleges to give students access to the best of both academic institutions. "Universities are very theory based; but what we're seeing is that you have to marry that with technical skills and more hands-on abilities that typically come from colleges," says Day-Hamilton. The university currently has joint-programs in a number of disciplines, including technology, engineering and computer science, and are continually expanding.

They've also redesigned their curriculum around multidisciplinary skills in business, technology and creativity, often working with technology companies on specific projects. "Many of our programs are project based, where companies come to us with specific issues in mind and look to the students to develop solutions" says Day-Hamilton. "It's a unique way for students to get experience and work with an industry mentor; but also for companies who are on the leading edge to stay competitive and work with young, creative minds that will be entering the business."

Does keeping up with rapid changes in the technology sector come into play? According to Day-Hamilton it's a huge issue. "You don't want to create a program around one focus that might not be relevant a few years from now. That's why we look to different technology companies to keep us at the forefront of what's going on, to be able to address trends and issues through projects and help educate students."

With an aging workforce retiring, there's no better time to equip the Millennials generation with well-rounded skills to enter the workforce. "There's going to be a whole bunch of jobs out there," says Day-Hamilton. "Students with the right skills are going to have their choice of where to go. The more we can work together to help students gain these skills, the more we can bridge the talent gap and build stronger Canadian companies."

1 According to *Maclean's* 2010 reputational survey

Steve Byrne

CEO, ThinkWrap Solutions Inc.

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Thinkwrap

In the constantly evolving world of digital media, ThinkWrap Solutions Inc. has certainly found their niche.

As one of Canada's fastest growing technology companies, they design, implement and manage e-commerce, portal and location services for leading companies that help advance business activities and deliver customer value. The lifeblood of their business is truly the team of software developers, engineers, architects, strategists and designers who create these web environments for millions of users.

Much like other emerging technology companies, ThinkWrap is pursuing talent management strategies to not only attract the right people but truly make them feel part of the business. The company realized early on that the skills they needed, particularly for their e-commerce practice, were extremely rare. "We knew that if we could gain some capacity and market share in this area, it would be very difficult for competitors to break-in because there wasn't an abundance of talent," says Steve Byrne, CEO of ThinkWrap.

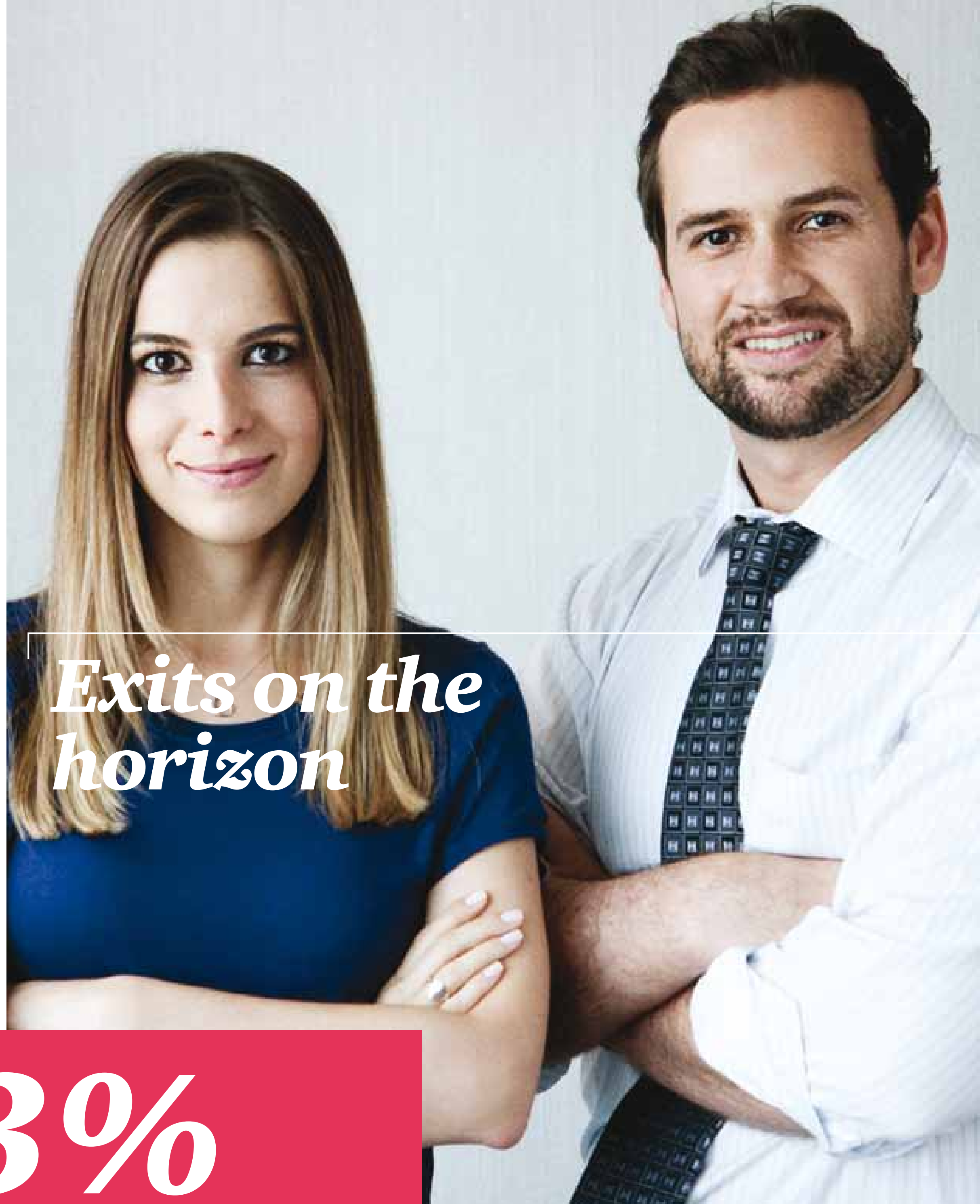
To tackle these barriers, ThinkWrap developed a talent map that directly outlines the capabilities they're looking for. "It starts with hiring and having a process with clear guiding principles for your selections," says Byrne. "This helps to find the right fit as far as competencies and specific requirements of the job, so you can then focus on cultural fit." For certain areas of their business, ThinkWrap's unique skill requirements dictate the need for senior technical hires with 10 to 20 years industry experience. In other scenarios, campus recruiting from leading universities and colleges is a big target for the company, who believe that new recruits often bring young energy and fresh knowledge to the office.

But, hiring the right people is one thing. Retaining top talent is another. While the company has experienced a lot of success since being founded in 2004, they still maintain their entrepreneurial spirit—and try to bring this out in their employees. "We focus on fostering owners' mentality, that who, no matter what their position, will make customers feel like they're dealing with the owner of the company. If the selection process is sound and leads to hiring the right people, retention is easy" says Byrne.

So what tactics are ThinkWrap using to draw out this owners' mentality? "We promote open communication and encourage transparency. We bring our employees into our strategic planning sessions so that every employee can have their input and feel like they're contributing more." A big part of this is also fair compensation and giving employees the option to have ownership in the company.

For ThinkWrap, knowledge is truly power, which can go a long way to motivate—and make the most of—their employees. And in Byrne's eyes, professional development and communication are the two areas that you can never do enough. They're also the issues that consistently come up in their employee satisfaction surveys. That's why ThinkWrap instituted a number of initiatives to help address these areas. "Professional development for us goes beyond just training. We instituted a private Yammer account within the company where everyone is active, and provides an equal, open forum that encourages knowledge sharing and support," says Byrne. "We also have Lunch and Learn training sessions where colleagues present some form of knowledge to the rest of the team. Food for Thought, our evening events focus on innovation and driving opportunities for the company, where we invite both internal and external speakers." For ThinkWrap, these are essential initiatives that help to build confidence, presentation and leadership skills. Formal (e.g. conferences and courses) and on-the-job training and mentorship are also big focus areas.

Realizing the potential from their workforce, and driving programs and initiatives to help get and keep them are likely part of the reason why ThinkWrap has successfully grown their employee base from four to 65 in only seven years. According to Byrne, "Never stop paying attention to the team and how they're engaging with clients. It's really important that we learn from each other and help each other learn. It's about creating unity and being a team member, rather than having the boss-universal equity. We try to motivate everyone, everyday, to think in terms of how we can make the most for ThinkWrap, which is something that we believe we all own together."



Exits on the horizon

73%

of CEOs believe M&A will be their company's most likely exit scenario.

Canadian companies receive only 39% of the dollars that go to their American competitors.

Raising capital

In the face of another challenging year for the Canadian VC market, we're pleased to report that nearly three-quarters (74%) of the 47% of respondents who attempted to raise capital in 2010 were successful. For the second year in a row, private angel investors were the dominate source of needed capital. Not surprisingly, there was a sizable decrease in the number of companies that accessed traditional Canadian VC funds in 2010 (from 16% to 4%), as investment activity from traditional Canadian venture capitalists remains stagnant.

For those businesses that were unsuccessful in raising funds, the reasons were relatively evenly split between internal factors (e.g. product immaturity) and market factors (e.g. lack of available funding).

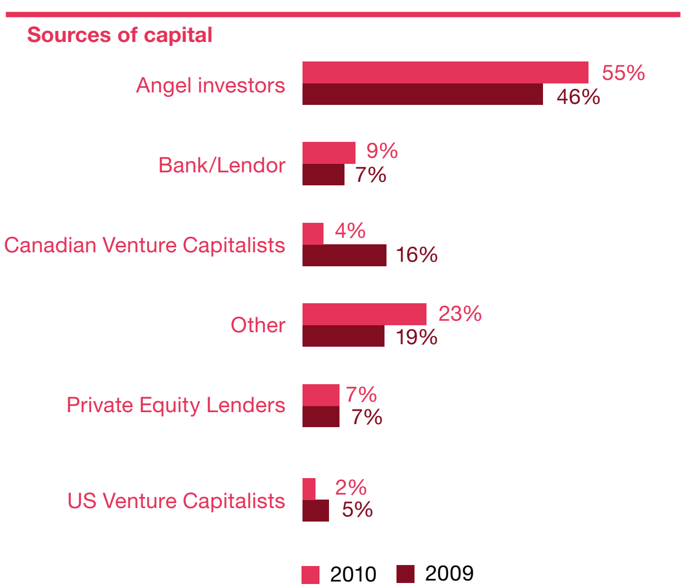
For over half of those organizations that didn't attempt to raise funds in 2010, the most frequently reported reason was sufficient funding through government grants and tax incentive R&D programs. Many also indicated a preference to continue to "bootstrap" their operations through internally-generated profits as opposed to trying to raise capital. This might be due to the fact that many companies perceive a lack of funds availability in the market or a desire to minimize dilution. Particularly in emerging sub-sectors like mobile application development, capital costs are minimal and we've observed a renewed willingness from employees to accept equity as a portion of their overall compensation. The growing number of serial entrepreneurs using cash flows from existing businesses to finance entirely new ventures is another sign of Canada's strong entrepreneurial climate.

So, why are fundraising trends an important predictor of innovation and growth? The survey results show that companies who successfully raised capital in 2010 were 3.5 times more likely to adopt an aggressive approach to business reinvestment compared to businesses that were unsuccessful.

If Canada is going to grow a vibrant technology economy, it's crucial to ask: are we giving emerging technology businesses the best chance to innovate and succeed? Unfortunately, the answer isn't so clear. Although a recent Statistics Canada report ranks Canada second among the major industrial countries for our incentive programs, there's still a significant gap between the amount US and Canadian companies receive (average dollar amount invested per company) from venture capitalists. Canadian companies receive only 39% of the dollars that go to their US competitors ($3.2 million vs. $8.2 million on average in 2010). This VC funding gap continues to present a challenge that limits Canadian technology businesses from competing in the global market.

Lisa Kendall
Managing Director
Corporate Finance, PwC

In 2010, PwC Corporate Finance was recognized as the leading advisor globally in terms of the number of deals completed in the mid-market (deals up to $50 million).



1 Based on data from Thomson Reuters

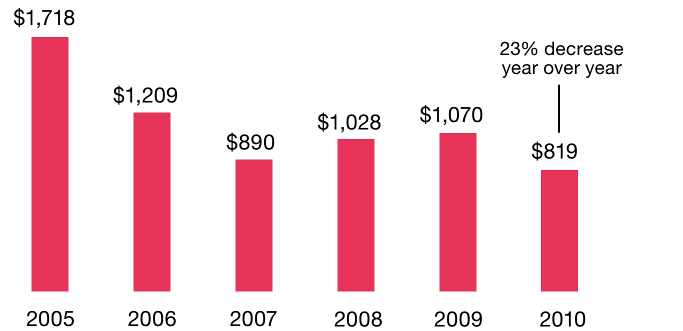
Health of the Canadian VC market

The VC market in Canada has historically been a vital component to help technology businesses grow in Canada. To strengthen Canada's technology economy, we believe that the VC industry needs to continue to play a strong role. On a positive note, the Canadian Venture Capital Association and Thomson Reuters reported that despite a slow final quarter, Canadian VC market activity grew moderately in 2010 with $1.1 billion invested, 10% year-over-year growth. In the same period, domestic VCs represented the majority of that investment, deploying $811 million, an 11% year-over-year increase. Yet despite this optimistic trend, there's still a concern for the long-term health of the Canadian VC market. In 2010, Canadian VC fundraising activity fell to a 16-year record low with new capital commitments to Canadian VC funds totalling $819 million, down 23% from the previous year. Given the continued challenges facing Canadian VCs to raise new funds, we don't expect to see any near-term improvements in this market.

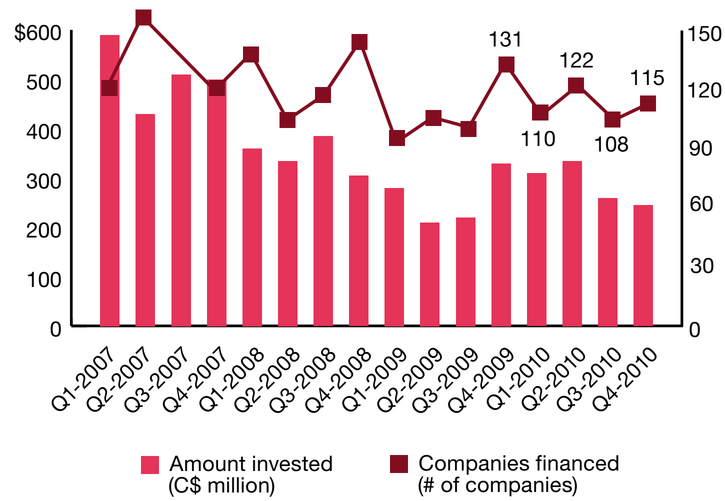
M&A and exits:
Growth through acquisitions

According to the survey, fewer respondents are actively pursuing acquisitions as an avenue for growth this year compared to 2009. One reason for the trend: the economy is improving, and businesses may think there are fewer opportunistic deals available in the market. This is also coupled with the fact that emerging software companies found it difficult to access acquisition financing. In addition, many CEOs indicated they preferred to pursue strategic partnerships or joint ventures, as opposed to outright acquisition.

Canadian VC fundraising



VC investment in Canada



In 2010, Canadian VC fundraising activity fell to a 16-year record low.

Exit strategies

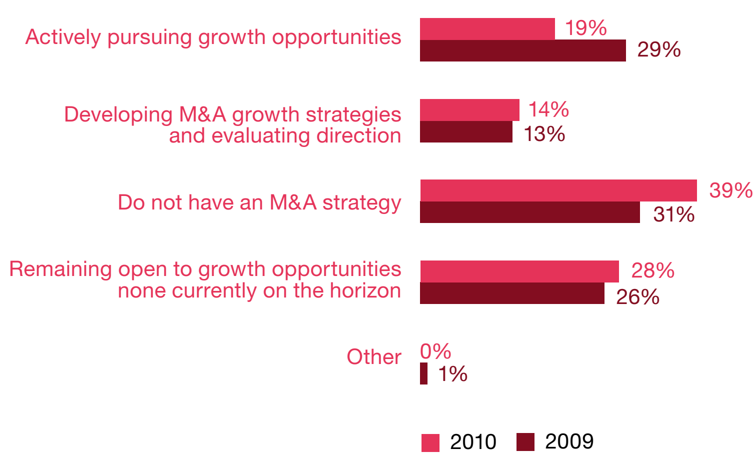
Even with news circulating about public markets gaining strength, the percentage of CEOs who saw an IPO as their most likely exit decreased from 7% to 4%. Undoubtedly, respondents were pessimistic about the prospect of an IPO in 2009—and even more pessimistic this past year. It's also no surprise that CEOs shifted their thinking further away from the IPO route to other alternatives since the IPO market was essentially closed in 2010 for many Canadian technology businesses. According to Thomson Reuters, there were 30 Canadian venture-backed M&A exits in 2010, compared to a single IPO. This mirrors the 2009 results of 24 M&A exits and another lone IPO.

This is good news for the vast majority of respondents (73%) who believe M&A will be their company's most likely exit scenario, as the strength of the technology M&A market through 2010 and into 2011 could be a positive sign of what's to come. The percentage of CEOs who expect to exit via M&A transactions was consistent across technology sub-sectors. Of those respondents who are planning an M&A exit, approximately 25% expect to do so within two years and a further 50% within four years. Interestingly, businesses that have been operating for 10 or more years have, on average, longer time horizons to exit than businesses that are less than five years old.

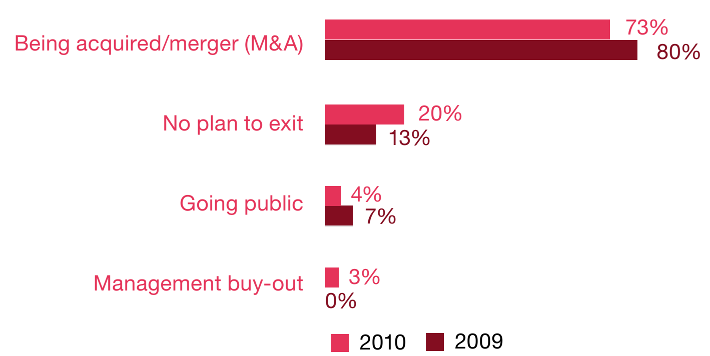
Only 4%

of CEOs see an IPO as their most likely ext strategy.

Stage of M&A strategy



Anticipated exit strategy



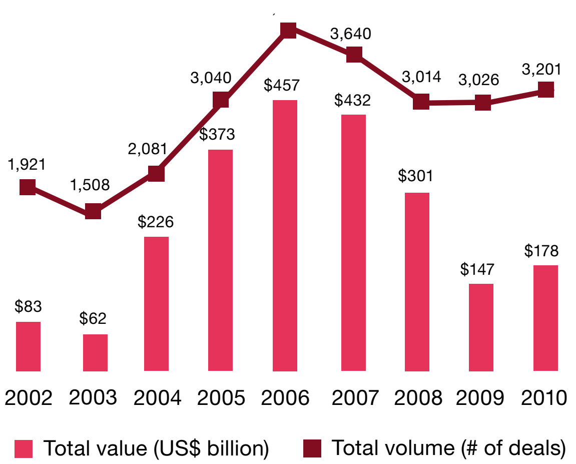
M&A deal volumes

After an uptick in M&A activity in 2010, deal volumes and valuations are persisting well into 2011 with many companies exiting at healthy multiples. The first quarter of 2011 showed a significant increase in overall deal value and transaction volume compared to the first quarter of 2010. In fact, we've already witnessed an active Canadian M&A market in 2011 with over 20 deals in the works that involved Canadian sellers. A large piece of the overall deal value figure as reported in Q1 2011, however, is skewed by AT&T's blockbuster proposed acquisition of T-Mobile ($39 billion). Prior to this transaction, the overall tech M&A markets in 2011 had continued to run at an average of just over $10 billion in deals per month.

Emerging software CEOs rejoice: if the pace of M&A in Q1 remains steady through the next three quarters, 2011 could materialize into one of the strongest M&A markets since well before the recession. Why? Consider the following predicted trends:

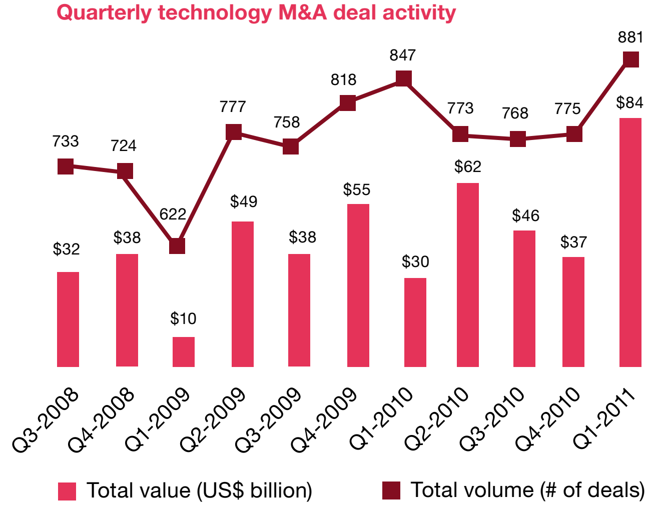
- A pick up in "cloud" related M&A during the remainder of 2011 after a cool down in the first quarter
- M&A of small and mid-sized vendors will continue to dominate when it comes to deal volume, but few mega-deal activity is anticipated
- Non-traditional buyers will make inroads into the technology market
- Venture-backed deals will increase on the back of 30 Canadian VC-backed exits in 2010 (up 24% from the 24 M&A exit events in 2009)
- While strategic buyers will continue to dominate, PEs will become more active (although we caution many have a "minimum cheque size" that prevents them for bidding on deals below $50 million).

Overall technology market M&A deal activity



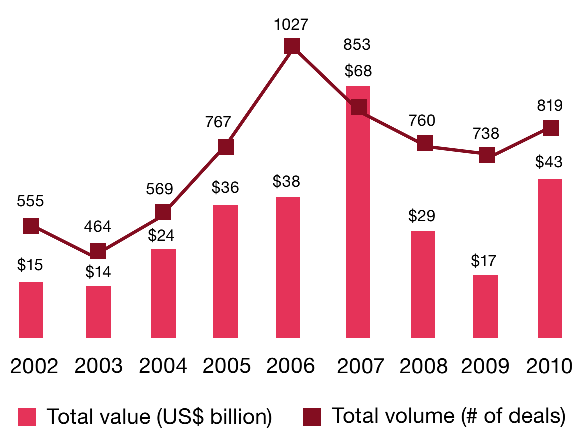
Source: the 451 Group

Quarterly technology M&A deal activity



Source: the 451 Group

Software M&A market deal activity



Source: the 451 Group

2011 could materialize into one of the strongest M&A markets since well before the recession.

M&A deal valuations

After nearly two years of exit Enterprise Value (EV)/Revenue multiples below two times, the median exit multiples throughout 2010 remained above two times. It's important for emerging software companies to be careful when applying average EV/Revenue multiples to their own businesses, as valuation multiples in technology M&A vary greatly depending on a number of factors. The impact of these factors on the deals we tracked in 2010—using the 451 M&A KnowledgeBase, Capital IQ and our own proprietary data—were very significant:

- **Sub-sector –** The technology sector is too mature and diverse to apply a "one-size-fits-all" approach to valuation.
- **Delivery model –** Deals around the emerging "cloud" paradigm showed some of the largest exit multiples, averaging over six times on 20 of the largest deals announced during 2010.
- **Size –** In 2010, the average EV/Revenue multiples on reported deals over $50 million was almost two turns higher than for deals under $50 million.
- **Capital structure –** Take-private premiums and private company liquidity discounts drove public M&A multiples higher than their private counterparts.

Average EV/Revenue multiple across a number of sub-sectors

Average EV/Revenue Multiple	Greater than 3 times	2 to 3 times	Less than 2 times
Representative Technology Sub-Sectors	• Security • Social Media • Internet • Mobile	• Healthcare • Education • Financial Services • BI • CRM • Workforce management	• Supply Chain management • Content management • Document management

The technology sector is too mature and diverse to apply a "one-size-fits-all" approach to valuation.

The average EV/Revenue multiples on reported deals over $50 million was almost two turns higher than for deals under $50 million.

Darren Speake
Senior Manager, Tax, PwC
Toronto, Ontario

Making the most of SR&ED

"Despite having one of the most lucrative R&D tax credit programs in the world, Canada currently ranks 16th among OECD countries for business expenditures on R&D as a percentage of GDP."

The Canadian government's Scientific Research and Experimental Development (SR&ED) program is the largest support program for research and development (R&D) in Canada. It ranks second among Organization for Economic Co-operation and Development (OECD) countries in the total value of tax incentives and direct support for business R&D as a percentage of gross domestic product (GDP). Over $4 billion in assistance is given to more than 19,000 claimants annually.

The SR&ED program continues to be the most popular form of government assistance used by Canadian software companies. According to the survey, about 88% of respondents felt that the SR&ED program was a somewhat or very important source of capital for their companies.

Despite having one of the most lucrative R&D tax credit programs in the world, Canada currently ranks 16th among OECD countries for business expenditures on R&D as a percentage of GDP. Canadian businesses spend less per capita on R&D, innovation and commercialization than most other industrialized countries, even though the Government of Canada invests more than $7 billion annually to encourage business R&D.

In response, the Government is undergoing a comprehensive review of federal programs that support business innovation. In October 2010, they launched a six-member expert panel, chaired by Tom Jenkins (Executive Chairman and Chief Strategy Officer of OpenText) to solicit advice from Canadians and business leaders on how they can enhance support for business R&D. The panel has been tasked to provide the Government with a plan to improve innovation support and ensure that investments are effective for Canadian businesses.

The expert panel is due to report back to the federal government this fall. The SR&ED program currently provides much needed support to emerging software companies. The specific recommendations and overall plan could go a long way to help enhance Canadian innovation and economic opportunities.

John Ruffolo

CEO, INKEF Capital/SVP,
Knowledge Based Investing,
OMERS Strategic Investments

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www.inkefcapital.com

www.omersworldwide.com

INKEF Capital

The first and only institutional angel fund in Canada.

There's a growing institutionalization of angel investing on the horizon—good news for entrepreneurs trying to become the next big software or technology company. Established in late 2008, OMERS Strategic Investments (OSI) is building long-term strategic relationships with like-minded global institutional investors to form strategic alliances that enable access to new sources of capital. Under this model, INKEF Capital was established and is funded by Stichting Pensioen fonds ABP in the Netherlands and the Ontario Municipal Employment Retirement Scheme (OMERS) in Canada. The fund intends to directly invest in start-ups—making it the first and only institutional angel fund in Canada.

INKEF Capital's mandate is to nurture investment platforms that don't logically fit under the mandates of OMERS existing investment entities. How? They're investing from a sectoral perspective and across the entire life cycle of their portfolios. According to John Ruffolo, CEO of INKEF Capital and Senior Vice President of Knowledge Based Investing at OMERS Strategic Investments, "We'll fund the life cycle of the business; but, we would also look at the life cycle of the technology. If the technology is mature, but the business is ripe for consolidation, that would be within our thesis as well—that's what we would call the opportunistic camp."

"Many VCs blame the lack of entrepreneur talent in Canada and lack of opportunities in Canada when the real reason is that they had no capital," says Ruffolo. "But, based on our very short period—and even though we're still not officially open yet—deal flow is coming in fast and furious."

So, what would drive INKEF Capital to invest in a particular company? For Ruffolo, a big differentiating factor is management. "When you invest on the seed, early round the management team becomes important. It's really trying to identify if that person can really pivot."

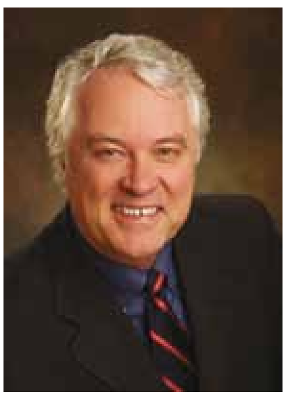
"We really want to invest in people that we know and that we've seen," says Ruffolo. "The ideal investment is when we've seen a company operate for a year to really see if they can hit their milestones. If someone's coming in completely cold and we don't know the people very well, we'll find it increasingly difficult to make investments."

It also pays off to be as forward-thinking and clear as possible. Take one company they looked at: "They really used a global hat. They thought well about the opportunities and they were more concrete on the space they believed they can hit and their revenue model. They had a far greater capture on how they were going to drive the business; so, from there it just boiled down to execution. With some other companies it can be a little unclear where they're hitting, or they're hitting too many areas, which causes us to guess. At the end of the day, if we're smarter than the management team we got a really big problem."

What further concerns Ruffolo is whether or not there are enough entrepreneurs who truly want to stay and build companies for the next 20 to 25 years—which he believes is worrisome for VCs. "Companies need to understand the pension fund model. We're trying to match our liability over the course of the next number of years."

It seems that acquiring funding is a process, and emerging software companies would benefit from developing relationships to sources of capital and having the right projections far earlier than what's generally perceived. "There is no shortage of great ideas and talent in Canada," says Ruffolo. "I'd like for us to be advisors that also happen to have a pretty significant pool of capital behind us in order to accelerate the business plan. If we're comfortable and we can see the ability to reach milestones, then "bang", we'll hit them with an investment."

...And the good news keeps on coming



Bruce Lazenby *is the Chair of the Ottawa Software Cluster (600 companies) and Regional Vice President for Canada of the Corum Group (world's largest seller of privately-held software companies).*

The Global perspective

As we predicted last year, software M&A activity has been very strong for the last four quarters and we see it staying strong for the next four quarters. Valuations are up markedly—as much as 200% in some cases with health care, social media, mobile and infrastructure sectors leading the way.

Buyers are flush with cash and doing deals. In fact it is estimated that US companies have a cumulated total of $1.9 trillion in cash on their balance sheets. This is the most since the late 1950s.

It is not just American buyers. A stronger Euro and continued globalization means that European buyers are being very active too. Even China and India are buying companies.

Now more than ever, sellers need to look globally to ensure they get the best auction environment for their company's sale. Unfortunately, we still see that most sellers are not ready for this complex process and as a result they are unable to effectively complete a transaction, or they leave considerable money on the table—which is unfortunate as this is usually the biggest financial transaction of most sellers' lives.

Market

	Q1—2010	Q1—2011	
Horizontal Applications	12.71x 2.11x	16.37x 3.47x	EV/EBITDA EV/Sales
Vertical Applications	11.15x 1.95x	13.32x 2.31x	EV/EBITDA EV/Sales
Consumer Applications	6.25x 0.77x	9.50x 2.27x	EV/EBITDA EV/Sales
Infrastructure	10.33x 2.39x	12.98x 2.78x	EV/EBITDA EV/Sales
Internet	15.89x 2.54x	13.42x 2.78x	EV/EBITDA EV/Sales
IT Services	6.97x 0.83x	8.51x 0.96x	EV/EBITDA EV/Sales

Stock price

Top buyers	Q1—2010	Q1—2011	% Change
AAPL	$235.85	$348.51	48%
EMC	$18.04	$26.56	47%
ORCL	$25.57	$33.37	31%
SAP	$47.84	$61.36	28%
IBM	$128.77	$163.07	27%
SYMC	$17.05	$18.54	9%
GOOG	$563.18	$586.76	4%
YHOO	$16.61	$16.68	0%
MSFT	$29.77	$25.39	-15%
HPQ	$53.06	$40.97	-23%
CSCO	$26.65	$17.15	-36%
		Average Change	**11%**

Canadian buyers

Buyer	Target	Value	Market
CGI Group, Inc.	Stanley, Inc.	$951,388,000	IT Services
Davis + Henderson	Mortgagebot LLC	$231,800,000	Financial Services
Research In Motion	QNX Software Systems	$200,000,000	Embedded Systems
OpenText Corporation	Metastorm, Inc.	$182,000,000	Business Process Management
HootSuite Media, Inc.	TwitterBar	undisclosed	Social Media
Research In Motion	Gist	undisclosed	Mobile Collaboration
Altus Group Ltd.	ARGUS Software, Inc.	$130,000,000	Enterprise Resource Planning
Redknee Solution	Nimbus Systems, SL	$23,725,000	Telecom Billing

Canadian sellers

Buyer	Target	Value	Market
Parametric Technology Corp.	MKS, Inc.	$302,714,000	Application Lifecycle Manamgent
j2 Global Communications, Inc.	Protus IP Solutions	$231,000,000	Collaboration Services
IBM Corporation	Clarity Systems Ltd.	Undisclosed	Performance Management
Honeywell Interna-tional	Matrikon, Inc.	$142,000,000	Performance Management
Motricity, Inc.	Adenyo	$100,000,000	Mobile Advertising
NetApp, Inc.	Bycast, Inc.	$80,000,000	Data Management
Google, Inc.	Pushlife, Inc.	Undisclosed	Mobile Content Management

The Canadian perspective

This year's survey shows that 75% of CEO's expect to sell their companies in the next four years. Based on past years reports, this percentage assumes growth targets that are usually not fully realized, as a result the 75% number will likely be too high—but—we predict that 2011 will be one of the most active years for Canadian software M&A in a long time for a number of reasons.

The seller's perspective

For a lot of complicated reasons ranging from business culture, to taxation to a lack of capital, it is difficult to grow large software companies in Canada. With incentives like IRAP and SR&ED, however, it is relatively easy to start a company so the logical Canadian scenario is to start a company, grow it to a size that the technology is proven, sell it, and repeat. Happily that model seems to be working as many of our clients who have successfully sold their companies start one, or more, new software companies (usually after a nice vacation.)

We are also seeing a number of Baby Boomers who have been running their software company for a long time finally looking at an external liquidity event when the prospect of a management buyout begins to get very complicated.

A common question is how small is too small to be sold? While the answer of course depends on the shareholders expectations on proceeds, Canadian companies are well respected for their talent and buyers will look seriously at companies with revenues well below even $5 million. Google bought a Toronto company last year—no revenues, no customers, not even a website—but one patent.

Patents continue to grow in popularity and value. Recent court rulings and successful patent suits have confirmed that software patents have more value than previously thought. While of little value to a small company, a well placed patent can make a difference when negotiating with a buyer.

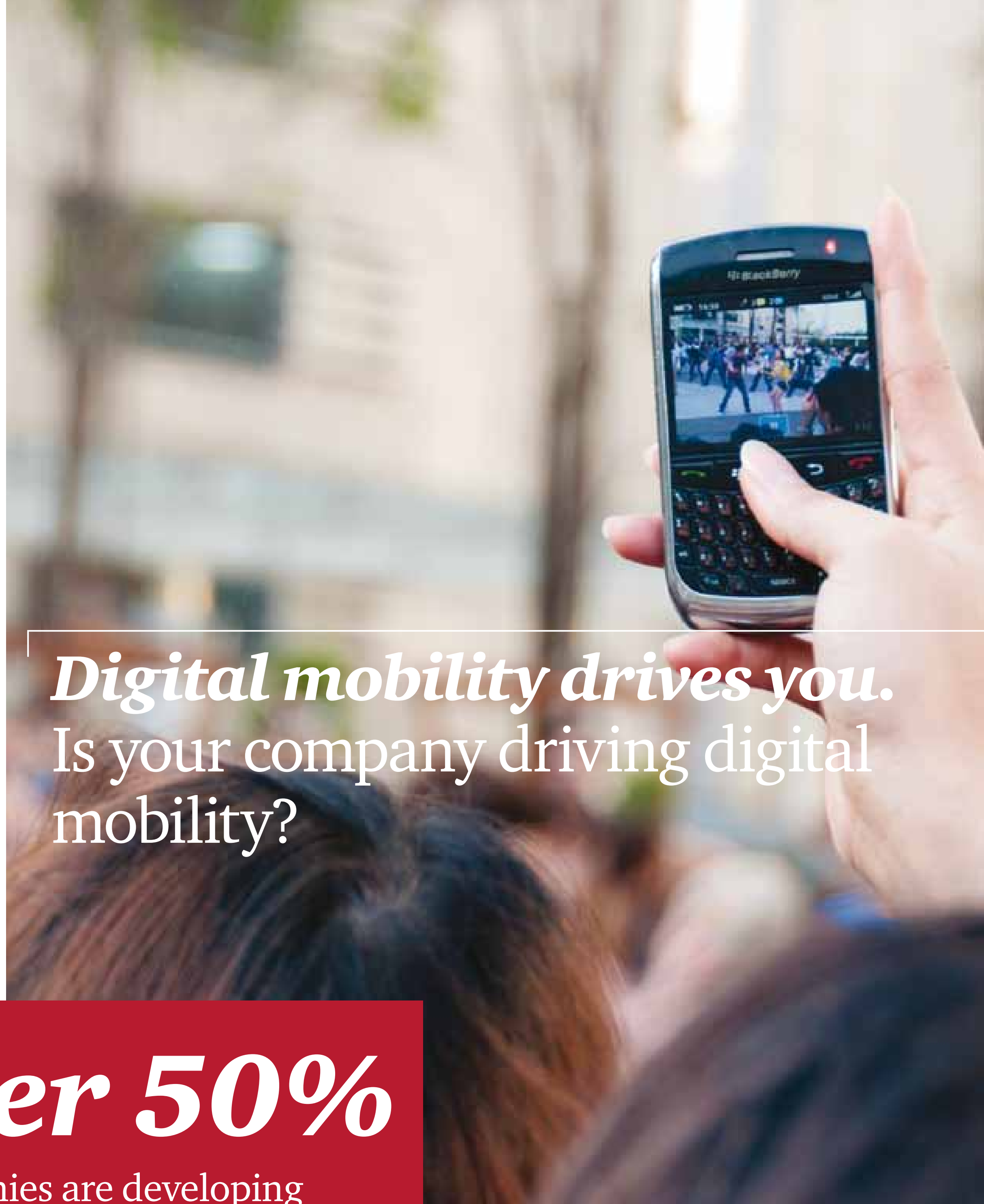
With virtually all software companies planning to be acquired at some point, sellers need to be planning for this event from day one.

The buyer's perspective

During the crash, many large companies shrank their R&D teams to reduce costs. Now that earnings are back up and they are flush with cash, most are looking to expand inorganically for a few reasons. Firstly buyers know that good teams are hard to build (especially with top talent in places like California becoming very expensive and hard to find) so companies prefer to buy a fully functioning team. A second driver is innovation. Most big companies know that innovation is hard and risky to do internally. More and more companies are turning to small innovative companies who have proven some new technology and then acquiring the asset and the team. Ever increasingly the entire team of the acquired company stays in the same location (often with the same name), but now has access to the buyer's sales and marketing engine.

While the US Dollar is losing value against almost all currencies, we do not see US buyers backing away from the negotiating table. They remain as active as ever with companies like Google doing as many as 37 deals in a single quarter. A stronger Euro has brought more European buyers to North America, however, as they flex their new found strength.

CORUM
MERGERS & ACQUISITIONS



Digital mobility drives you. Is your company driving digital mobility?

Over 50%

of companies are developing mobility applications for use by their customers and/or clients.

Digital mobility is perhaps the most important trend since web 2.0 was first mentioned. It's already touched all industries and is dramatically enhancing the ways companies conduct their business and consumers buy goods and entertain themselves. New experiential technologies and applications—like tablets, machine-to-machine communication and haptic video—continue to burst onto the scene, driving new growth opportunities and innovation, with lots to look forward to.

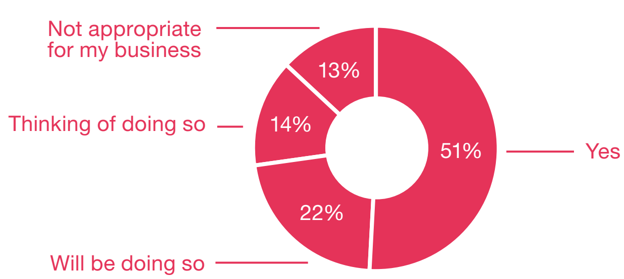
Driving the digital transformation is demand from a new type of consumer and business professional—the "Selfsumer". More and more they want devices and applications close by, which they can use 24/7 to conduct business and relax with multimedia entertainment, using location-, direction- and movement-aware capabilities and personalizing cross-linking experiences.

This "consumerization" of technology is forcing businesses to think about how they can stay relevant and be engaging to retain customers and clients. Take for example, the rise of e-books, e-news, e-reports and e-magazines. While there is still substantial demand for print, there's also significant preference among many customers to read using digital platforms, with a combined product offering of news, research and support tools. In fact, according to PwC's *Global Entertainment & Media Outlook: 2010-2014,* the electronic book market will more than triple during the next five years to $3.3 billion in 2014 from $1 billion in 2009, a 26.9% compound annual increase.

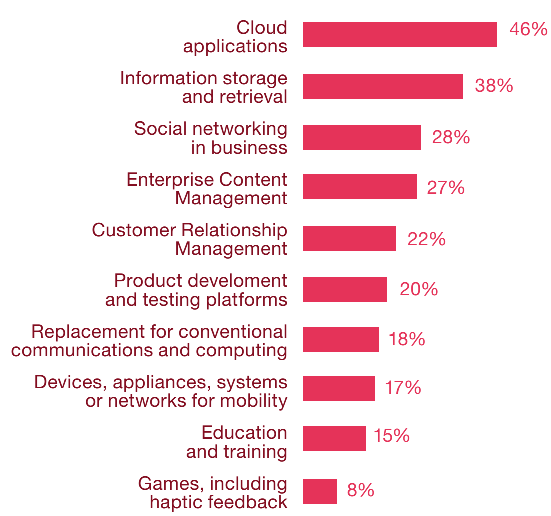
Future success lies not only in developing innovative ways to adapt to digital platforms, but ensuring that these innovations are Selfsumer-focused (both corporate and consumer) at every level. Are emerging software companies responding to this need? Yes, according to the survey. Over 50% of companies are developing mobility applications for use by their customers and/or clients. Close to 36% will be doing so, or are thinking about it. Only 13% believe it's not appropriate for their business.

The most common mobile applications that respondents are developing are cloud applications (46%). This is not surprising considering that cloud computing is no longer just being seen as a technological solution that will make IT less expensive and more agile. Many companies are now using the technology to partner with other service providers that operate in the cloud to quickly integrate business processes and reap new revenue by expanding business prospects. This trend will likely only increase, as software companies seek alliances and strategic partnerships that are complementary to their own core business.

Developing applications



Mobile applications in development



Information storage and retrieval (38%) and social networking in business (28%) are other top mobility applications developments. Enterprise content management increased significant this year from 10% in 2010 to 27%, proving more CEOs recognize the need and importance to effectively manage enterprise information. The least common development among respondents is games, including haptic feedback (8%), which is just emerging as a newer technology, but will likely be more prominent in the not so distant future.

While it's evident that emerging software companies are weaving mobility into the fabric of their business, only 42% of CEOs believe it's essential for their company's future. Close to 26% believe that it's either a nice to have or not relevant. Will mobility require IT organizations to change significantly in the next three years? Sixty-six percent of CEOs agree. Thirteen percent say "not at all".

These figures are not surprising as mobility is still in its early stages with a huge variety of tablets, smartphones, software and apps emerging only now onto the market. It's likely that in a year's time the "nice to have" will have converted to "essential" and the "not relevant" and "not at all" categories will have shrunk to near zero.

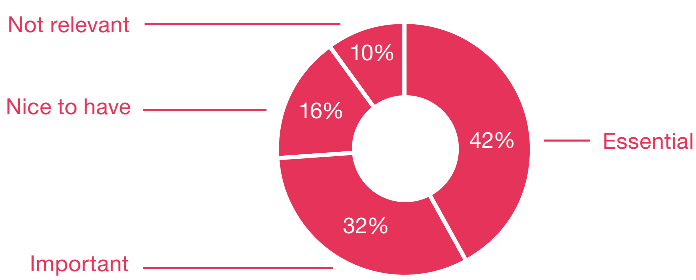
Mobile uses

PwC forecasts that by 2014, 39% of mobile Internet subscribers will connect through smartphones, compared to only 13% today. And that's only smartphones. If we consider the increase in the number of users of other mobile devices, such as enhanced phones, tablets and laptops, a major percentage of the world's population will be tapping into the mobile internet to access and contribute to information and knowledge. This doesn't just apply to consumers; digital mobility is continuing to find applications within enterprises and their networks of business partners. The "company's buyer" is also changing into a Selfsumer.

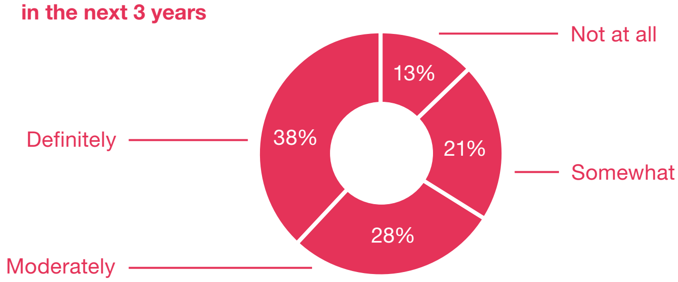
According to the survey, there isn't much difference between the ways that respondents are using mobility for their company compared to their clients. The most common use is for voice and email contact with employees (50%) and clients (59%).

Compared to last year, more software companies are incorporating social networking into their business strategy. While only 14% of CEOs saw it as a priority in 2010, 34% are using it internally and 39% with their clients. This is likely due to the fact that social networking is becoming increasingly powerful, fun and easy to use. At the same time, employees and clients expect companies to enable them to play a participatory role and interact back.

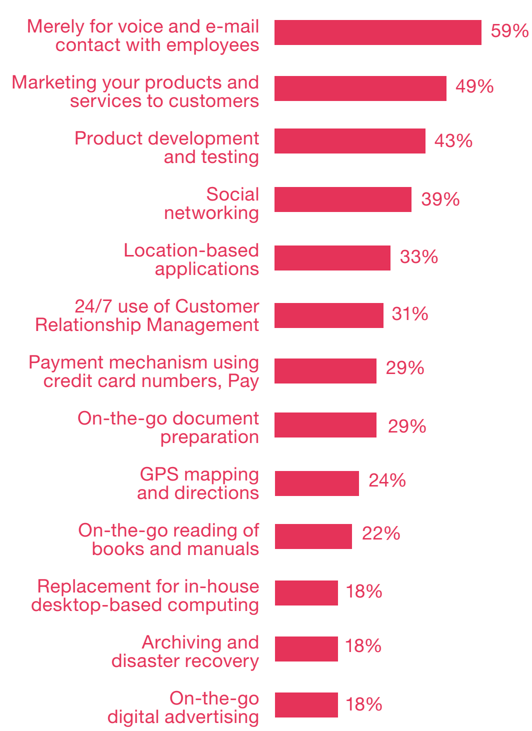
Importance of mobility



Expectation of IT organizations to change significantly in the next 3 years



Mobility use for clients



Mobile platforms are also enabling companies to more accurately market their services/products to the appropriate Selfsumers—and survey respondents believe digital mobility is useful for this purpose. Among these platforms are location-based applications, which help engage customers on-the-go over mobile means, and, through tracking features, stay current on customers' behaviours. Thirty-three percent of CEOs are using location-based applications for their clients and 24% for their company. We expect that location-based advertising, services and applications will only grow as marketing trends to enhance the e-commerce transformation, as businesses and organizations seek innovative ways to advertise. Mobile marketing is also gaining popularity for use with clients (49%).

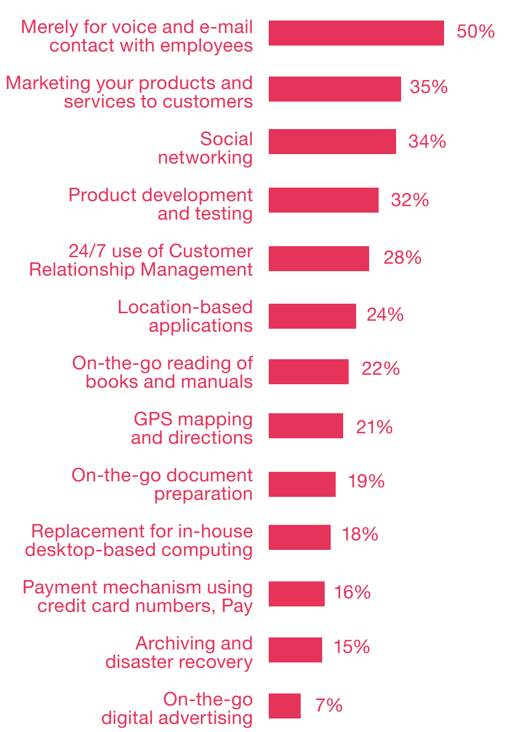
Concerns

With the movement towards digital mobility, a number of concerns are preventing emerging software CEOs from adopting mobility for their company and clients. Not surprisingly, the top issue is security, confidentiality, compliance and privacy (for clients 48%; for business 51%). As mobile devices, such as smartphones and tablets, become commonplace, IT will no doubt face the challenge of managing access, usage and security across multiple mobile devices. However, new security models continue to be established on many devices, and mobile device management software and major operating systems are evolving to embrace and extend those models.

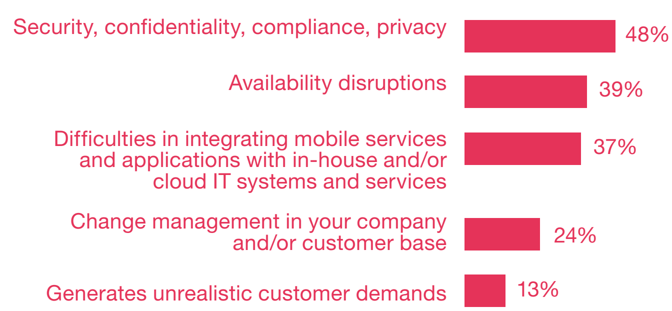
A number of CEOs foresee difficulties integrating mobile services and applications with legacy in-house and/or new cloud IT systems and services: 37% of respondents see this as a drawback for their clients and 37% for their company. The question is, will this number decrease as more companies learn—and experience—the benefits of supporting more of their business using cloud services or internal IT inspired by cloud architecture and providers. Also ranked high on the list as a concern for adopting mobility for clients is availability disruptions at 39%.

Despite these challenges, it's clear that adopting digital mobile applications is becoming a necessity for companies to compete for attention and market share from all types of users. Digital mobility is merely at its beginning, and emerging software companies should consider how it fits into their growth strategy. Experimentation and innovation will play key roles in helping technology companies meet stakeholder expectations, realize growth opportunities, and ultimately succeed.

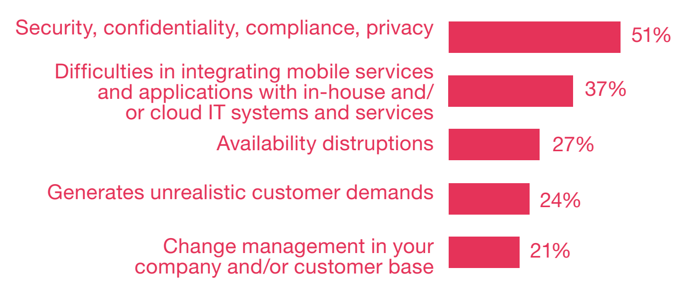
Mobility use for your company



Drawbacks of mobility for clients



Drawbacks of mobility for your company



Kunal Gupta

CEO, Polar Mobile

Toronto, Ontario

www.polarmobile.com

Polar Mobile

Understanding what their customers and consumers want—now and in the future.

Founded in 2007, Polar Mobile rapidly established itself as a global leader in mobile content solutions. Over 200 media companies around the world have turned to Polar's industry-leading platform to launch branded mobile apps across all major smartphones (iPhone, BlackBerry, Android, Windows Phone). Their secret: understanding what their customers (and consumers) want—now and in the future.

An already hot area, Gupta believes the consumer appetite for apps will only increase. "Between the major smartphone operating systems, we'll actually reach one million apps by the end of this calendar year, and this is a market that didn't exist three years ago," says Gupta. "But even more important, it will grow exponentially between all devices, including smartphones, tablets, gaming consoles, TVs, browsers and laptops. Users will have two to five devices capable of running apps."

This is good news for the industry and Polar, but Gupta recognizes that growth doesn't come without its challenges. "From a product perspective, our focus is on building out a platform to solve the three problems that we think our customers have and will continue to have: reach, engagement and monetization. How do you grow an audience on all of the connected devices? Once the audience is there, how do you actually keep them engaged? And finally, how do you make money from it?"

To tackle these challenges, Polar continues to update their platform to make sure their apps incorporate key features (e.g. Twitter, RSS feeds, photo gallery) that create an engaging, cross-device user experience, and looks for ways to help their customers get the most from their apps, such as providing ad engines and reporting capabilities.

With a heavy technology and systems reliance, Polar is using leading technology trends, like cloud computing, to help their business run more efficiently. "We were one of the first companies in Canada to embrace cloud service," says Gupta. "Today, we've got the cloud model with our hosted infrastructure, so the mobile apps on the devices don't talk to individual websites but to our infrastructure. This makes it really scalable and real-time, so we can deliver a cleaner, more reliable experience."

Looking ahead, Polar has their eye on a number of growth opportunities, including expanding their global market reach and extending their offerings to other platforms and devices. Gupta believes the myriad of Canadian government grants and incentives could play a big role in helping Polar reach their goals, but, as a small company, staying on top of developments is an issue. "From our perspective, we don't really care if it's $1 billion going into R&D or $10 billion. The question is, how much of that is accessible for small-to medium-sized and fast-growing businesses likes ours? Major companies have teams dedicated to following government updates, but we're not set-up like that. Yet, I would argue that investing in small companies is really where we're going to see the best return because this is where a lot of innovation is happening."

What's Gupta's advice for other emerging software companies? Aim high. "I'm in the US three to four times a month, and I'm not running into a lot of Canadians down there—but I really should be. More Canadian companies need to be going out to get business; look for every opportunity, even if it's outside the country. At Polar, 100% of our team is in Toronto, but 30% of our revenue is from Canada. You'll see rewards if you get out there and chase the business!"

Train more people through our universities

Financial grants made upfront from the Government rather than SR&ED recovery

Create ***networks of mentorship*** among software company CEOs and former CEOs

More support of ***IP management***

Allow ***flow-through shares*** in technology companies

Programs to support ***export marketing***

Continue to ***enhance SR&ED***

Provide incentives for ***buying Canadian products***, especially new innovative products.

Opportunities for innovation

Most technology CEOs are looking to innovation as the primary driver for growth.

According to *PwC's 14th Annual Global CEO Survey*, 90% of those surveyed believe innovation will open up new revenue streams and 34% see the development of new products or services as their biggest opportunity for growth over the next 12 months. But how should Canada cost-effectively boost innovation? Our CEO respondents provided their insights.

Taking advantage of the economic recovery: IP issues for Canadian emerging software companies in 2011

John Beardwood
Partner
Fasken Martineau

Mark D. Penner
Partner
Fasken Martineau

The portion of CEOs who consider IP to be a "top priority" has increased since last year.

We have once again examined how survey respondents view the importance, value and role of IP in their business. We have approached the survey with the view that, particularly in this period of economic recovery, emerging software companies must continue to fully understand the scope and value of their IP assets, and the extent to which such assets can serve both as the basis for increased competitiveness and as a means of revenue generation, whether that revenue is generated directly (e.g. in the form of fees or investment), or indirectly (e.g. in the form of assets securing debt financing).

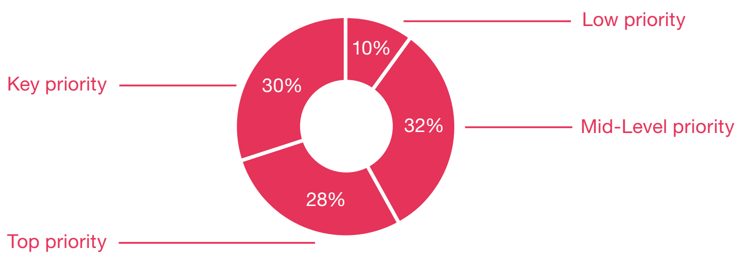
Summary

This year's survey results were generally consistent with last year's survey. While it is impossible to know the specific reasons for the differences, we speculate that optimism in the recovering economy accounts for the renewed interest in IP issues since 2010.

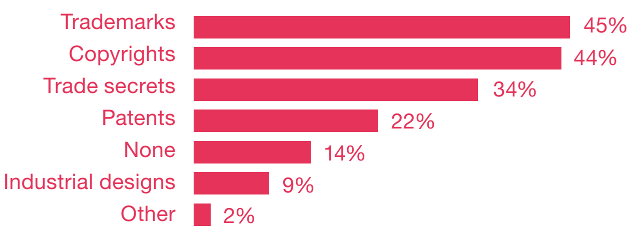
More specifically, this year's survey, when compared with last year's survey, showed the following:

1. It is encouraging that the proportion of CEOs who consider IP to be a "top priority" has increased since last year. Despite, this shift in priorities, there appears to be a continuing difficulty with implementing effective IP practices.
2. While the proportion of companies claiming to own IP rights has decreased over last year, the companies that do own IP rights are increasing and diversifying their IP holdings.
3. When considering IP protection, an increasing number of CEOs continue to look beyond Canada with the US being the jurisdiction where the largest majority of CEOs seek IP protection. Despite this, other jurisdictions such as India and China continue to grow in significance.
4. The lack of recognition of the role of third-party IP in the respondents' businesses continues to be difficult to reconcile with the typical software development model. As with previous years, there remains a lack of understanding among CEOs of how to minimize the risks associated with third-party IP.
5. The number of CEOs polled that indicated they had been involved in a legal dispute involving IP remains high. This result, and the others outlined in the report, suggests that CEOs continue to underestimate what steps could be taken to avoid or reduce the significant risk of IP litigation.

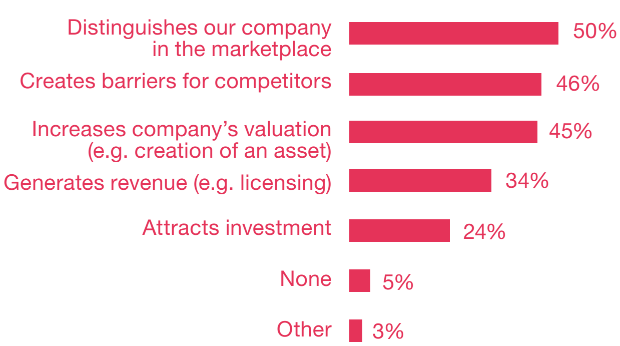
IP priority



IP ownership



Role of IP



Value and role of IP

As with the previous years of the survey, a majority of survey respondents know and understand that IP is important to their business. The percentage of respondents who indicated that IP was a top priority has rebounded (28% in 2010; 15% in 2009). An increasing majority (58%) of respondents consider IP to be either a key or top priority, whereas the percentage of respondents who consider IP to be a low priority has dropped (10% in 2010; 15% in 2009).

This year's survey results demonstrate a continued consensus among emerging companies as to the role that IP plays within their organizations. Respondents indicated that IP continued to play a role in distinguishing the company in the marketplace (50%, 50% in 2009), in creating barriers for competitors (46%, down from 50% in 2009), and increasing the company's valuation (45%, down from 56% in 2009).

Notably, the percentage of respondents who regard IP as having a role in "attracting investment" has decreased slightly (24%, down from 27% in 2009).We continue to be surprised at the downward trend in light of the fact that the respondents are emerging companies. In view of this, we would have expected respondents to view IP assets as making companies more attractive to investment. If 2011 and beyond provides stronger market conditions it would bring renewed confidence in the role of IP in attracting investment.

The results regarding the role of IP in generating revenue for their company also appear to reflect improving economic conditions. Thirty-four percent of respondents indicated that IP generates revenue for their company, up from a response of 26% in 2009. Nevertheless, the response remains somewhat puzzling, given that the business model for most software companies is a licensing model, whether directly or as part of a software-as-a-service model. It may suggest that almost half of CEOs continue to overlook opportunities to generate revenue from IP licensing more generally— opportunities that companies should be seeking to exploit in the recovering economy.

Which IP rights do emerging companies own?

By category

The percentage of respondents purporting to own specific IP rights decreased in 2010, consistent with the results we saw in 2009. However, as was reported to be the case in the 2007, 2008 and 2009 survey results, there remains a disconnect in the responses between the scope of the IP assets which the companies claim to own or not own, and the respondents' understanding of the specific nature of each particular form of intellectual property. More specifically, there continues to be a significant underestimation in the claimed ownership of copyright, trademarks and trade secrets:

- The percentage of respondents claiming not to own specific IP rights continues to increase, continuing a trend begun in 2008 (14% in 2010 compared to 13% in 2009, 10% in 2008 and 6% in 2007). It is possible that companies have not recognized the value of their IP since nearly all businesses have some form of IP whether it is a trademark, copyright or trade secret.
- When considering what specific IP rights were owned by emerging businesses, there was a significant rebound in the percentage of CEOs who indicated that they owned copyright (44% in 2010, from 23% in 2009, and 60% in 2008). Although these results demonstrate an improvement in awareness, they remain troubling as they indicate that 56% of CEOs still fail to recognize those copyright assets which they do possess. Again, copyright (a) arises from the act of creation and would therefore apply to a wide variety of material which is key to the business of an emerging software company (e.g. developed software, user documentation, websites, etc.), and (b) remains a primary means by which software in Canada is protected. As such, we expected the level of response for copyright ownership, were it properly understood, to be 100%.
- The rebound continues with regard to trademarks. The percentage of CEOs surveyed who indicated that they owned trademarks increased in 2010 to 45%. This reverses a trend from 2007 to 2009 of decreasing ownership. As with copyrights, we expect this number to increase rather than decrease as each company generally will have at least one trademark, whether or not it has registered that mark. This year's response may reflect an increase in awareness, that trademarks can arise through simply using any word, symbol, logo, slogan, etc. or combination thereof that identifies the wares and/or services of one company from those of another (referred to as "common law rights")—that is, trademarks need not arise through registration only.
- There was also an observed rebound in the response on patents. While there had been some consistency in the level of patent ownership between 2008 (35%) and 2007 (34%), there was a decrease with respect to the level reported in 2009 (20%). This year's results showed some renewal, with 22% of respondents indicating that they owned patents, although the results are still low compared to pre-2009 levels. With respect to industrial designs, nine indicated that they owned industrial designs in 2009, representing an increase from 2009 (4%) and a return to 2008 results (9%).
- There was a surprising increase in the number of respondents who indicated that they owned trade secrets. In 2010, 34% of respondents indicated that they owned trade secrets, compared to only 8% of respondents in 2009. These results are consistent with earlier results in 2008 (39%) and 2007 (45%). Trade secrets, per se, are a concept under US law, the Canadian equivalent of which is confidentiality obligations. Given that trade secrets are therefore effectively a form of confidential information that has some commercial value (e.g. customer lists, supplier information, etc.), even taking into account the improvement in the 2010 results, it appears that respondents continue to significantly underestimate the trade secrets held by each company.

By jurisdiction

The percentage of CEOs who indicated that they sought to protect their IP rights outside of Canada increased slightly between 2009 (39%) and 2010 (45%). Not surprisingly, the US was, by far, the most common jurisdiction to be cited by respondents as the jurisdiction where they sought to protect their IP rights, with Europe constituting the second most common jurisdiction.

The survey results reveal that Canadian companies are continuing to seek IP protection in emerging countries at a similar rate to previous years. The number of Canadian companies that have sought IP protection in India has fallen slightly to 16% (3% in 2007; 9% in 2008; 20% in 2009) but has remained relatively constant (16%) for companies seeking IP protection in China (6% in 2007; 13% in 2008; 15% in 2009).

This not only continues to reflect the growing role that emerging countries are playing within an ever increasingly global software industry, but may also reflect a perception that either the IP risks in those jurisdictions continue to require a greater focus on implementing IP protections, or—more positively—that the IP protection in these jurisdictions is becoming more effective, such that it justifies companies making the effort to obtain such protection.

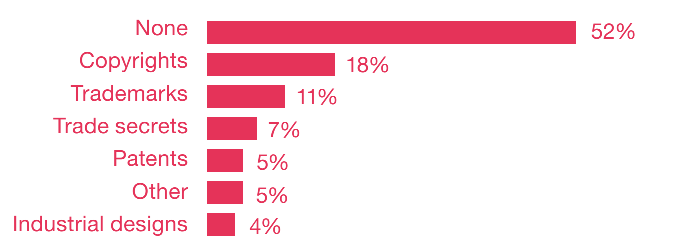
Third-party IP and in-licensing of IP rights

It appears as though the overall degree of licensing-in of IP rights has increased since last year. Copyright licensing increased from 14% in 2009 to 18% in 2010, while trademark licensing also increased in 2010 to 11%, up from 6% in 2009. Even with these improvements, it appears that this year's survey respondents, much like last year's, are not fully taking into account the licensing-in of IP. As was also indicated in the results from past surveys, the majority of companies (52%) surveyed do not license any IP rights from third parties. While the results indicate that the number of companies that do not license any IP rights from third parties has been decreasing since 2007, our expectation was that this number would be even lower. Possible explanations include:

- The respondents making the strategic decision to develop and market products which are solely proprietary and not to use any third party or open-source code in their products.
- To avoid bundling products (e.g. with third-party products to create a single solution) in such a way that the licensing-in of third party IP is required.

As noted in our summaries from past years, a statistic that approximately half of the respondents do not license-in IP is surprising in light of the increasing prevalence of open source in software development. It is a common misconception that open-source software is "free" in the sense of not being subject to license, when in fact, open source may be subject to various forms of licenses. Open source licences contain many pitfalls.

Current IP rights held by companies



For example, their terms may impose restrictions on claiming ownership in a company's software to the extent it is based on such open source. If "viral," the terms may impose the terms of such licences on the developer's proprietary software to the extent such software interacts with the open source. It is therefore important for software companies to understand how open source is used internally, and to implement an open source policy regarding such use.

IP management

Fifty-seven percent of CEOs polled indicated they have a formal policy governing IP issues (such as disclosure of inventions and employee developments). Despite the fact that the majority of smaller companies are taking the protection and ownership of IP rights very seriously, 43% have not implemented any formal IP policies. Given that software is developed either by employees or independent contractors, the absence of such policies increases the probability of there being disputes regarding IP ownership in the future. In our experience, after actual IP registrations, one of the first documents an investor will evaluate in assessing the status of a target's IP portfolio is the status of such a policy.

Of the CEOs surveyed, over half (59%) agreed that their company's IP strategy requires improvement. When the companies were asked what would compel them to define an IP strategy for their business or, further refine an existing strategy, 27% (compared to 40% in 2009) indicated the availability of more funds, while 25% (compared to 24% in 2008) indicated better knowledge of the benefits versus the costs.

While this at first appears to be a recognition of the disconnect between the CEO's acknowledgment of the value of IP and their failure to implement effective IP protection, less than one sixth (15%) indicated that an IP dispute involving the company would lead the CEO to improve their IP strategy, representing a decrease from the 18% reported in 2009. Further, this year's results indicate that only 17% of CEOs stated they would make such improvements if they became aware of a dispute involving one of their competitors. As expressed in last year's report, we remain puzzled as to what external event would actually force respondents to improve their IP strategy, if not a lawsuit?

Assessing the risk of third-party IP claims

Before launching a new business, product or service, 46% of companies indicated that they would conduct a market analysis of existing businesses, products or services. This continues the downward trend seen in previous years. Interestingly, the percentage of companies who indicated that they would search IP databases when launching a new business (19%) was virtually unchanged since 2009 (18%). These results indicate that the large majority of respondents (less than one fifth) do not conduct any IP database searches—one of the best steps that can be taken to help avoid particular IP disputes. While there are some costs associated with conducting IP searches, the relatively minor investment can pay off significantly by identifying IP risks and helping to eliminate the much more significant costs associated with IP litigation. Consequently, raising awareness of the potential benefits of these searches may be effective in increasing the percentage of companies who engage in IP database services prior to launching a new business.

The degree to which conducting IP searches can assist a company to mitigate third-party claims will vary based on many factors, including the number of competitors in the market, the nature of the product and the applicable jurisdiction. In addition, certain IP databases may not accurately reflect the state of protection for particular products. In the case of patents, for example, there is an 18-month window of confidentiality in which patent applications are not published. In other words, any search of the records of the Canadian Intellectual Property Office or the United States Patent and Trademark Office will not uncover patent applications filed less than 18 months prior to the date of the search.

Perhaps more importantly, before going to market a company should at least confirm its own internal records regarding ownership of IP directed to that business, product or service. Of utmost concern is the fact that only 3% of respondents take this step, similar to last year's results, but down significantly from 2008 and 2009. This means that nearly all survey respondents do not take the step of confirming their own internal records regarding ownership of IP. It is essential that each company complete its own internal IP due diligence, including obtaining assignments of copyright and waivers of copyright from its personnel, prior to going to market with its product. If there are key employees or independent contractors that are involved in the development of significant software, the company should confirm ownership of the software internally to avoid personnel contesting ownership, in particular where such personnel are then hired by a competitor.

What about general monitoring of the marketplace for potential IP issues? Of the companies that were polled, 65% indicated they did nothing. Of the 35% that did monitor the market, 63% of the respondents did so by reading/reviewing industry-focused publications (e.g. *Wired*) and 48% did so by reading national newspapers (e.g. *Globe and Mail, National Post*). Only 20% of respondents stated that they sought information from other sources, such as on-line search engines (e.g. Google), legal conferences or in-house counsel, relatively unchanged from last year's results. These results indicate that these companies are highly reliant on publicly available material. Companies should be cautious about an over-reliance of such materials: not only will it likely fail to provide proper definition to any such IP issues that could form a significant concern, but by the time such issues are referenced in the media it is likely too late to mitigate the risk.

Sixty-three percent of the respondents sought advice from IP counsel; this number has been on the rise since 2007.

In summary, it is difficult to overstate the importance of conducting sufficient IP due diligence prior to taking a product or service to market. Such due diligence assists respondents to avoid not only third-party infringement claims, but also claims by licensees or purchasers for breach of contract, given each licensee or purchaser will likely require that the respondent provide contractual representations and warranties regarding ownership and non-infringement. Interestingly, while the results stemming from the due diligence survey questions appear to support the conclusion that companies are not engaging in a high level of due diligence, all of the CEOs nonetheless indicate that they are either "very comfortable" or "somewhat comfortable" that their companies have completed the required level of IP due diligence to support a licensee's representations and warrantees. There seems to be a large disconnect here—specifically, how can all of the respondent CEOs be comfortable in making such representations and warranties in light of the fact that a mere 3% of these CEOs indicate that they completed an internal IP due diligence prior to taking a product or service to market, and almost 30% of CEOs replied that they engaged in absolutely no IP due diligence whatsoever?

Nearly all survey respondents do not take the step of confirming their own internal records regarding ownership of IP.

IP disputes

The adoption of an IP strategy that includes the implementation of an IP policy, the registration of IP and the conduct of IP searches prior to going to market is, of course, intended to forestall the emergence of IP disputes. The percentage of respondents who indicated that they had ever been involved in an IP related dispute decreased to 14% from 18% in 2009. While the 2010 percentage is slightly less than in prior years, this is still a relatively high percentage for a survey targeted at emerging software companies. Given this relatively significant response, we have explored in greater detail the nature of these disputes.

Surprisingly, a majority (76%) of the respondents involved in an IP dispute were involved in a dispute in Canada, while 53% were involved in an IP dispute in the US. This marks the first year in which Canadian disputes have outnumbered those in the US.

Approximately half of CEOs (47%) indicated that a third party was asserting its rights against the respondent, while 41% were asserting their IP rights against third parties. What does this mean?

- A significant number of those respondents involved in an IP dispute were defendants, as opposed to plaintiffs, in Canada.
- A large number of the disputing respondents may have been sued in both the US and Canada.
- In addition, 12% of the respondents indicated that they were both defending a claim by a third party and asserting their own IP rights as plaintiffs.

When asked which IP rights were involved in the disputes, 64% identified patents and copyrights; this percentage has decreased since last year (74%). The high percentages reported for disputes involving patents and copyrights are not unexpected given that for most software products, it is these two IP rights which would be the most significant. Twelve percent identified trademarks as being the IP right involved in the dispute, with 41% identifying other IP rights such as trade secrets or industrial designs.

Interestingly, 59% of CEOs indicated that the IP dispute very significantly or significantly altered or impacted their business plan. Using that result as a proxy for the significance of the IP litigation, it is difficult to understand how, of those respondents whose business had the potential to be quite seriously affected, only 6% felt that either searching IP databases or engaging IP counsel could have avoided or reduced the impact of the IP dispute.

Again, 24% and 12% of the CEOs who have been engaged in an IP dispute indicated that patents and trademarks, respectively, were involved in the dispute. Yet, notwithstanding the fact that all issued patents and registered trademarks are publicly available for searching, even with the benefit of hindsight, none of the respondents indicated that they thought that searching IP databases could have avoided the litigation. Again, while searching is somewhat less useful for copyright, trade secrets and common law trademark rights—since there is no registration requirement for these IP rights, searching is still one of the most cost-effective means of reducing the risk of an unexpected IP dispute. Put another way, sophisticated businesses will complete a market analysis prior to developing and taking to market a new product or service—looking at the IP landscape prior to undertaking such development and marketing efforts is equally prudent.

59%

of CEOs involved in an IP dispute indicated that there were no steps that could have been taken to avoid or reduce the impact of litigation.

Further, only 6% felt that consulting with IP counsel could have assisted in avoiding the litigation. Given the key role of legal advisors in building and protecting the IP portfolio of companies, this result is similarly difficult to explain.

The most surprising result, however, was that the majority of respondents (59%) indicated that there were no steps that could have been taken to avoid or reduce the impact of litigation. When one balances the costs of defending and settling such disputes and the significant distraction they can cause for each respondent's business, against the ready availability of mechanisms to avoid this risk, this fatalism is difficult to understand. The fact that the percentage of CEOs who responded that they believed no steps could have been taken to either avoid or reduce the impact of litigation is so high compared to previous years, suggests that CEOs may be either unaware of, or unreceptive to, the numerous measures that can be effective in avoiding or reducing the impact of litigation, such as engaging IP counsel or approaching licensors/licensees.

How were these IP disputes concluded? While the majority of these disputes (71%) were settled by the parties prior to trial, none of these IP disputes were indicated to have been settled at trial. These results, particularly the former, are distinct from last year, where 16% of disputes were settled by the parties prior to trial. This year's results suggest that it became much more common for parties to settle the dispute prior to trial, and less typical for the dispute to be resolved by way of "other" methods (which constituted 37% of the 2009 results but none of the 2010 results), and by way of licensing arrangements (18% in 2010 up from 16% in 2009). The increasing number of disputes settled by licensing agreements may be related to the fact that the implementation of licensing or cross-licensing arrangements may be an increasingly common feature of IP settlements.

Conclusion

Emerging themes

Upon reviewing this year's survey results, a number of constant themes continue to emerge. First, more CEOs regard IP as a "top priority" which drives their business; more commonly, the CEOs indicate that they see IP as a "key priority" and that IP considerations are taken into account during most business decisions.

Second, the survey results continue to suggest that there is a disconnect between the CEOs' general understanding of the importance of IP and their more specific understanding as to the nature of each IP asset in their businesses and how to best leverage those assets.

Third, as with the last year's survey results, a surprising number of the CEOs of the emerging Canadian software companies polled indicated they had already been involved in a legal dispute involving IP. Finally, despite this litigation risk, CEOs have been slow in adopting the appropriate risk mitigation strategies.

Three key steps emerging companies can take to address IP concerns

The report identified a number of concerns with how CEOs of emerging software companies consider IP. To try and address some of these concerns, we have identified the following three cost effective steps that emerging companies can implement.

1. **Secure IP protection:** Between securing copyright and trademark protection, and patent protection, the latter—while more effective—is also more costly and time consuming to obtain. In light of that cost concern, it would be advisable for emerging companies to first secure copyright registrations for key software assets, and trademark registrations for those significant brands, logos, etc. in those jurisdictions that are key to their business. In the future, as the value of the asset being protected begins to warrant incurring the expense, the company should then consider obtaining patent protection. Note that each company needs to balance, depending on their stage of development, (a) the scope of protection that each IP right provides and the possibility that marketing products prior to filing applicable patent application(s) may preclude the possibility of eventually obtaining patent protection for that product, against (b) the cost of completing such step.
2. **Have effective IP policies:** One of the easiest measures that an emerging software company can adopt is the development and implementation of clear policies and procedures regarding IP ownership. First, each employee and independent contractor involved in the development of products, tools or other valuable IP should sign agreements that clearly confirm that the company is to own all IP developed during tenure with the company. The absence of such policies will significantly increase the probability of there being future disputes regarding IP ownership. Again, in our experience, after actual IP registrations, one of the first documents an investor will evaluate in assessing the status of a target company's IP portfolio is the status of such a policy.
3. **Address third-party IP issues:** It is important to make sure that each company effectively assesses and addresses the use of third-party IP in each product or service that it provides. Such due diligence assists respondents to avoid not only third-party infringement claims, but also claims by licensees or purchasers for breach of contract, given each licensee or purchaser will likely require that the respondent provide contractual representations and warranties regarding non-infringement. Two of the more cost effective means of addressing these issues are (a) conducting IP searches and (b) adopting policies which address the use of "open source" software. While there are some costs associated with conducting IP searches, the relatively minor investment can pay off significantly by identifying patent and trademark risks and helping to eliminate the much more significant costs associated with IP litigation. As for open source, it is important for software companies to understand how open source is used internally, and to implement a policy regarding such use, and to do so earlier rather than later given the potential issues surrounding "viral" software.

In aggregate, these measures should assist companies to better manage and utilize their IP assets.

Survey methodology

This is the eighth report on *Emerging Canadian Software Companies: The CEO perspective* released by PwC. Each year, we provide insights to the industry on issues being faced by emerging Canadian software companies and their CEOs.

Our goal was to continue research and provide critical information to CEOs with respect to performance and strategy currently in operation and also to explore the challenges brought by the current economic environment.

A team of Technology professionals at PwC have developed the survey over several years and have also benefited from personal discussions with CEOs to incorporate the most relevant questions of today's market place. Questions were organized into 11 sections.

- Emerging companies' profiles
- Strategic partnerships
- Mergers & acquisitions and exits
- Funding
- Key performance indicators
- Revenue
- Talent management
- Customers
- Intellectual property
- Mobility
- Current market

The results of the survey were based on the responses, either online or in person, from 160 CEOs. PwC identified a national cross-section of emerging Canadian software companies from publicly available lists, including the Branham 300, the Canadian Business Tech 100, the ROB 1000, Profit 100, Profit Hot 500 and others.

Contact with the CEOs was made via regular mail, email and telephone to direct them to the online questionnaire. Face-to-face, in depth interviews were also conducted with a number of CEOs, which involved administration of the questionnaire at the CEOs of places of business by PwC's Technology partners.

The intention of this research is not to conclude on the opinions of all CEOs across the Canadian software industry but to provide insight into the companies in the emerging segment and the CEOs who lead them. The survey results have been analyzed and the findings have been used as a basis for this report. We have responded to the findings and our views are noted within the pages of the report.

Emerging Company Services

The Emerging Company practice is a program serving companies with extraordinary potential.

You have a vision. PwC helps growth companies unlock extraordinary potential by turning your vision into reality. Whether your company is an emerging business seeking VC, or an established company seeking to expand through a merger, acquisition, joint venture or strategic alliance, you can rely on PwC for a full range of support services.

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Acknowledgements

The survey respondents

We wish to thank the respondents who participated in the interviews and online survey. Their experiences and vision were invaluable to our education and critical to our research. Their candid responses and support of this project are very much appreciated. To protect their privacy and competitive advantage, the names of the participating emerging companies and CEOs are kept confidential.

PwC partners and staff

For this study, we drew on support and experience and knowledge from around our firm. A core team worked diligently to help produce this publication. The tremendous efforts of each team member helped make this project a success. This group includes:

Gail Balfour
Amanda Barron
Eugene Bomba
Jessica Booth
Kiran Chauhan
Courtney Clark
Scott Denneney
Russell Fordham
Patrick Furlong
Nina Godard
Juliette Gonsalves
Craig Hanna
David Jacobson
Lisa Kendall
Jessica Kim
Beverly Kostela
Jai Patel
Quillan Quarrington
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