Industry Canada Industrie Canada

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VENTURE CAPITAL MONITOR

A QUARTERLY UPDATE ON THE CANADIAN VENTURE CAPITAL INDUSTRY

The Canadian venture capital (VC) industry is a key contributor to the growth of innovative firms that commercialize research. For this reason, the health of this industry is an ongoing concern. The goal of this series is to provide current information about this key enabling industry. To this end, the series will track trends in investment activity, report on topical VC-related research and look at key technology clusters where VC investment is taking place.

INTRODUCTION

This year-end issue examines the venture capital (VC) activity in Canada during 2006[1] as well as the fourth quarter trends (October to December). This issue also examines the potential of institutional investors as a source of VC and the "In Focus" article discusses New Brunswick's recent initiatives to boost its capital markets.

VC ACTIVITY OVERVIEW

Investment[2] in 2006 was level compared with 2005, fundraising was down

Total VC investment in Canada in 2006 was $1.69B. As such, it was at roughly the same level in 2006 as it was in 2005,[3] ending the downward movement seen between 2004 and 2005 (Table 1). Investment in Q4 of 2006 was $489.4M, up 42 percent compared with Q3, but roughly equal to Q4 of 2005.

Canadian VC funds raised a total of $1.64B in 2006, down 26 percent from the $2.22B raised in 2005, and its lowest level in a decade.

Table 1
VC investments and fundraising, 2003 to 2006

	2003	2004	2005	2006
	($ billions)			
Investments	1.69	1.84	1.68	1.69
Fundraising	1.97	1.78	2.22	1.64

Source: Thomson Financial Canada 2007.

Larger deals with fewer companies

Investors made larger deals with fewer companies in 2006 compared with previous years. A total of 404 companies received VC in 2006, well below the average of 640 for the years 2001 to 2005. This was true for all types of domestic funds. This concentration in investment resulted in a significant increase in average deal size (Table 2). Foreign investors continued to concentrate on a small number of companies in 2006, and although the average amount they placed in each company is up significantly from 2005, it remains consistent with that of recent years. Figure 1 shows this shift toward larger deals for both domestic and foreign investors in contrast to the previous behaviour of Canadian VC funds, which saw them make a large number of small deals compared with U.S. funds.

[1] The data source for this publication is Thomson Financial Canada (2007), unless otherwise stated.

[2] **Investment** refers to the activity by which VC funds invest capital in firms on behalf of their investors.

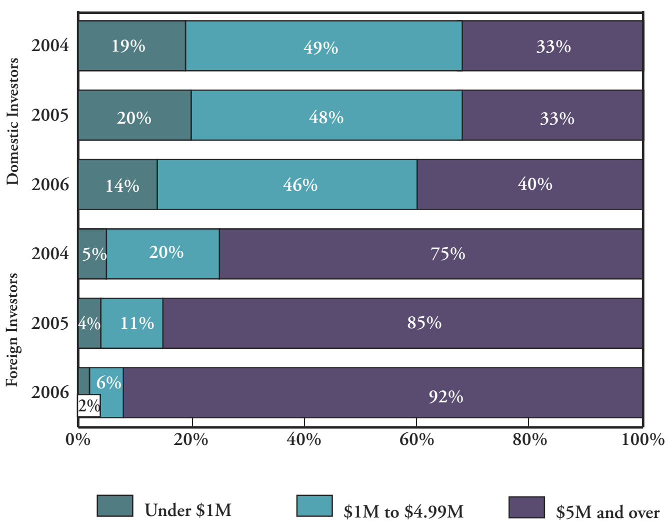
[3] Thomson Financial has adjusted the data for 2005 and 2006. As a result, the amount of VC investment for 2005 reported in this issue of the *Venture Capital Monitor* is lower than what was noted in the issue for Q3 2006.

Table 2
Average amount of VC placed in each company by location of investor, 2002–2006

	2002	2003	2004	2005	2006
	($ millions)				
Domestic	3.1	2.3	2.6	2.5	3.4
Foreign	9.0	7.0	8.1	6.3	8.1
All	3.8	2.7	3.2	3.0	4.2

Source: Thomson Financial Canada 2007.

Figure 1
Proportion of the number of VC investments by deal size, 2004–2006



Source: Thomson Financial Canada 2007; Statistics Canada 2006; Industry Canada 2003.

Shift toward later-stage investment

In 2005, 47 percent of VC was placed as later-stage investment. In 2006, this grew to 57 percent, higher than the average during 2001 to 2004 (Table 3). Early-stage investment is at its lowest level since 1998, which increases the importance of non-VC sources of early-stage capital, such as angel investment.

Table 3
Percentage of VC deals by the firm's stage of development

	2001–2004	2005	2006
	(percent)		
Seed and start-up	24	13	15
Other early-stage*	32	40	28
Later-stages	44	47	57

Source: Thomson Financial Canada 2007.

*Other early-stage refers to investment in firms that have begun initial marketing and related development and need financing to achieve full commercial production and sales.

New and follow-on investments

Investments in new portfolio companies[4] accounted for 30 percent of the total investment in the fourth quarter of 2006, a significant increase from the 18 percent that it held in the first three quarters of the year. A very large single investment made in Q4[5] brought the proportion of new investments in 2006 to a level similar to what was observed since 2002, although lower than the average of roughly 40 percent observed before 2002.

In 2006, follow-on investment became more focused on later-stage companies as those companies accounted for a greater share of deals worth over $5M. In a similar fashion, VC financing to new portfolio companies was concentrated on early-stage companies. Table 4 shows that this tendency existed in the past, but the spread between early-stage and later-stage investment has become much more pronounced in the last two years.

Table 4
New versus follow-on investment distribution between early-stage and later-stage companies, 2002–2006

		2002–2004	2005	2006
		(percent)		
New	Early stages	55	62	61
	Later stages	45	38	39
Follow-on	Early stages	46	51	38
	Later stages	54	49	62

Source: Thomson Financial Canada 2007.

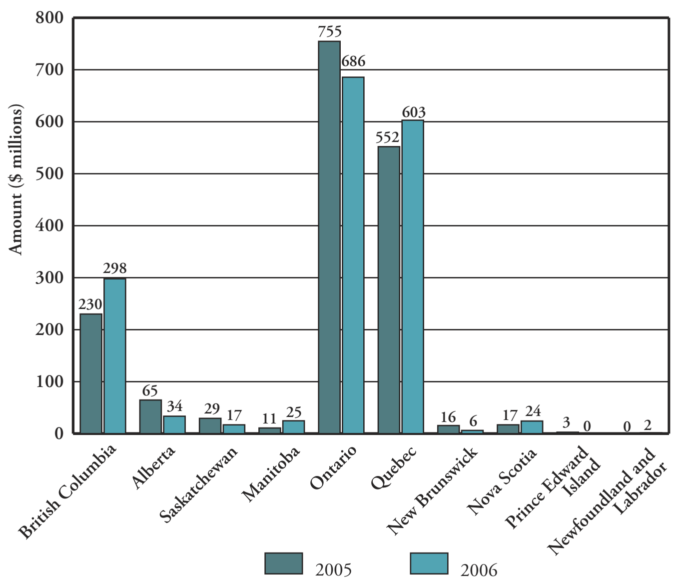
[4] **New portfolio companies** refers to firms that have not received prior VC financing.

[5] A $41M new investment was made to a Quebec-based drug discovery company in December 2006.

VC investment for 2006 increases in British Columbia and Quebec, drops in Ontario

British Columbia and Quebec experienced the largest increase in VC investment of any of the provinces between 2005 and 2006 (Figure 2); in each case, this was mostly due to an increase in foreign investment. VC investment in British Columbia reached $297.9M in 2006, up 30 percent from $230.0M in 2005, including approximately $50.0M in foreign VC placed in a Vancouver-based drug discovery company. Investment in Quebec spiked in Q4 of 2006, bringing the annual total to $602.9M, up 9 percent from $552.0M in 2005. In contrast, the largest decrease in VC investment was felt in Ontario, where investment in 2006 fell to $685.6M, down 9 percent from $754.6M in 2005, and its lowest level since 1998.

Figure 2
Regional distribution of VC investment in Canada, 2005 and 2006



Source: Thomson Financial Canada 2007.

In Manitoba, $24.7M was invested in 2006, more than twice the $10.8M invested in 2005. Private independent funds invested $10.7M, more than in any year since 1997, including a $7M investment in a Winnipeg-based film production company.

According to available data, VC activity in Alberta was down by 48 percent in 2006, and for the first time in the last decade no foreign VC was placed in that province during the year. Given the strong economic activity in Alberta in 2006, it is unlikely that these data are telling the whole story. The federal government and the Government of Alberta are looking at ways to better capture data on VC activity in that province.

As reflected in earlier comments on the number of deals made overall, the number of companies receiving VC dropped during 2006 in every province compared with 2005, except for Nova Scotia and Newfoundland and Labrador (Table 5).

Table 5
Number of companies receiving VC, by province, 2005 and 2006

	2005	2006
British Columbia	57	52
Alberta	25	16
Saskatchewan	17	8
Manitoba	17	15
Ontario	156	118
Quebec	263	179
New Brunswick	14	5
Nova Scotia	7	9
Prince Edward Island	2	0
Newfoundland and Labrador	1	2

Source: Thomson Financial Canada 2007.

Share of foreign investment rises and domestic fundraising declines

Foreign sources invested $549M in 2006, up nearly 20 percent from $460.5M in 2005. Foreign investors have become increasingly active in Canadian VC investment over the last ten years. The importance of this source of funds is growing as domestic fundraising has fallen, largely due to a reduction in fundraising by retail funds.[6] Retail funds raised only $907M (of which only about $150M were raised outside Quebec), down 25 percent from $1.20B in 2005. Fundraising by retail funds will likely continue to decrease as the Labour Sponsored Investment Fund (LSIF) program in Ontario is phased out.

[6] **Retail funds** receive funds from individuals who in turn receive an income tax credit for their investment. Most of these are Labour Sponsored Venture Capital Corporations (LSVCCs); the oldest and largest is the *Fonds de Solidarité* in Quebec, with $6.8B in assets.

Government activities

In the fourth quarter of 2006, the Business Development Bank of Canada (BDC) authorized $36.9M of VC investment in 26 companies. The total value of those deals, including contributions from co-investors, was $212.3M. The BDC is much more active in early-stage investments than the rest of the VC industry in Canada (Table 6).

Table 6
BDC authorizations by stage of development, 2006

	BDC		Entire VC industry in Canada	
	Amount authorized	Distribution of amount authorized	Amount invested	Distribution of investment
	($ millions)	(percent)	($ millions)	(percent)
Seed	9.5	8	51.4	3
Start-up	49.2	43	197.3	12
Other early stage	37.1	32	472.9	28
Later stage	19.3	17	971.9	57
Total	115.0	100	1693.5	100

Source: Business Development Bank of Canada 2007; Thomson Financial Canada 2007.

Note: The percentages shown do not correspond with those in Table 4, where the investment by stage is separated by new and follow-on investment.

In the fourth quarter of 2006, Farm Credit Canada leveraged its success with FCC Ventures and became the lead limited partner in a new venture capital fund called Avrio Ventures Limited Partnership with a commitment of $50M. Avrio Ventures supports the development of Canadian commercialization and growth stage industrial bioproducts, nutraceutical ingredients and food technology companies.

Provincial government funds were behind five deals in the fourth quarter of 2006. Investment Saskatchewan was the most active provincial fund in Q4. It was the sole investor in two $3M deals with Canadian companies that were opening offices in Saskatchewan. One investment was in a geosciences company and the other was in a medical software company.

INSTITUTIONAL INVESTORS

Institutional investors provide a source of private equity capital (which includes buyout,[7] mezzanine[8] and venture capital) as they invest large pools of capital over long time horizons. Institutional investors include pension funds, endowment funds and insurance companies. An increase in Canadian institutional investor allocations to VC has the potential to provide more capital to private independent funds and to help reverse the trend of decreasing VC fundraising.

In the United States, institutional investors contribute a significant amount of capital to private independent funds, which allows these funds to dominate VC investing in that country. American institutional investors invest across the entire spectrum of private equity and many different types and sizes of institutional investors participate in the market. These investors are supported by the infrastructure of specialty advisors and funds-of-funds[9] that exists in the United States.[10]

In Canada, institutional investors make much lower private equity allocations than their U.S. counterparts, especially smaller institutional investors. This has been attributed to the lack of supporting infrastructure in Canada and the negative experiences in the 1980s when many pension funds first made capital commitments to private equity funds. Additionally, many institutional investors are subject to restrictions based on the current market value of their investments, which limit the amount that they can allocate to private equity.

[7] **Buyout** refers to a specialized form of private equity, characterized chiefly by risk investment in established firms that are undergoing a fundamental change in operations or strategy (Thomson Financial Canada 2006).

[8] **Mezzanine** refers to a hybrid of debt and equity financing that is typically used to finance the expansion of existing companies (**Investopedia.com** 2007).

[9] A **fund-of-funds** receives capital from investors and then places that capital into more specialized funds. The fund-of-funds managers have experience in fund selection that some institutional investors lack. This is a mechanism used by small institutional investors to pool their assets so as to be able to invest in some of the most successful VC funds.

[10] Macdonald and Associates Ltd., 2004.

In 2006, Industry Canada commissioned a study[11] in collaboration with Canada's Venture Capital and Private Equity Association to learn how to further engage Canadian institutional investors with respect to private equity. A key finding was that, although smaller Canadian institutional investors were typically not active in private equity, they were interested in learning more about the asset class. The study identified a need for concerted efforts by industry, government and other stakeholders to engage such investors in this priority, as well as for new market mechanisms to spur investments.

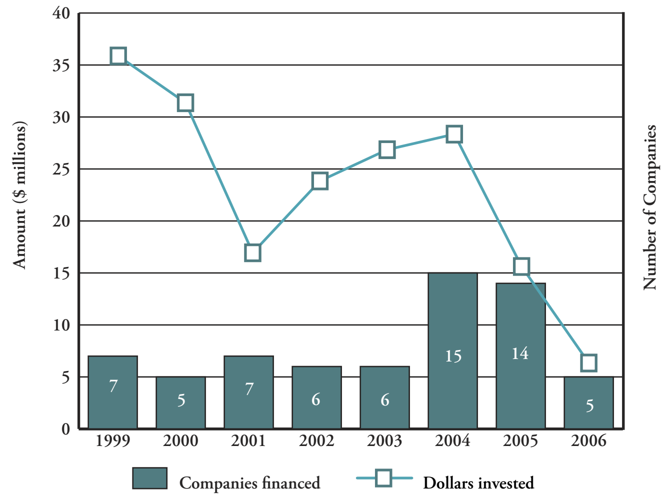
"IN FOCUS" — NEW BRUNSWICK

The New Brunswick Securities Commission[12] has launched an initiative to increase investment in New Brunswick companies. The commission's strategy regarding VC is to get more firms VC-ready and to promote the investment opportunities in the province. Historically, New Brunswick and the other three Atlantic Provinces have had low levels of VC investment compared with the rest of Canada (Figure 2), with significant year-over-year variation (Figure 3). The province accounts for less than one percent of overall VC investment in Canada. Government and retail VC funds have financed a large number of companies in New Brunswick, but the majority of VC money has been invested by private independent, corporate and foreign funds that have concentrated their investments only on a small number of companies (Table 7).

Successful New Brunswick companies that have grown through VC investment include a software solution provider with 200 employees and over 1000 customers and a global supplier to the gaming industry, both of which raised over $7M in VC and continue to be headquartered in Moncton. However, 60 percent of VC money invested in New Brunswick since 1999 has gone to three companies that are no longer headquartered in New Brunswick, although they likely generated significant returns for investors.

The loss of these companies has added to the concern about the environment for capital markets in New Brunswick, a province that is home to only six of Canada's more than 3000 publicly traded companies.

Figure 3
VC investment in New Brunswick by number of companies financed and by amount invested (1999–2006)



Source: Thomson Financial Canada 2007.

Note 1: Companies financed each year may have also been financed in previous years, so the sum of "companies financed" in Figure 3 is larger than the total number of companies financed in Table 7.

Note 2: After only two months, VC investment in 2007 has exceeded the amount invested during 2006.

Table 7
VC investment in New Brunswick by source of funding, 1999–2006

	Number of companies financed	Investment ($ millions)
Government and retail	26	49.7
Private independent, corporate and foreign	9	82.1
Institutional	4	28.5
Other	8	25.0
Total	34*	185.3

Source: Thomson Financial Canada 2007.

*The total for companies financed is not the sum of the rows above as some companies are financed by more than one type of investor. The number of companies financed may be slightly understated as some transactions are not disclosed.

[11] International Financial Consulting, 2006.

[12] The New Brunswick Securities Commission was established in 2004 with the traditional mandate of maintaining investor confidence and also responsibility for actively promoting capital markets.

The New Brunswick Securities Commission is working with the business community to improve this environment. The commission brought together entrepreneurs, investors and delegates from federal, provincial and municipal governments, and industry organizations for its Fullsail Summit in January 2007. The delegates developed and committed to action plans to address recommendations developed following consultations led by the commission in 2006. Champions and supporters from private, academic and government sectors committed to put in place 24 initiatives that will build an entrepreneurial culture, develop networks to support entrepreneurs and angel investors, and promote the province as a wise place to invest by demonstrating success.

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NOTES

This publication is part of a series prepared by the Small Business Policy Branch. The branch analyses the financial marketplace and how trends in this market impact small businesses' access to financing. Current research is focused on high-growth firms, the aspects of both Canada's VC and general business environment that affect the success of these firms, and the key players in the risk-capital market (for example, VC firms and angels).

The Small Business Policy Branch is also responsible for the Small and Medium-Sized Enterprise Financing Data Initiative (SME FDI). The SME FDI is a comprehensive data-collection program on SME financing in Canada. In partnership with Statistics Canada and Finance Canada, Industry Canada reports on the supply of and demand for financing by small and medium-sized businesses. Further information and statistical findings and reports are available at **www.sme-fdi.gc.ca**.

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