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The availability of risk capital for
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review of the issues / prepared by
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The Availability of Risk Capital for Technology-based Firms in Canada

A review of the issues

prepared by:

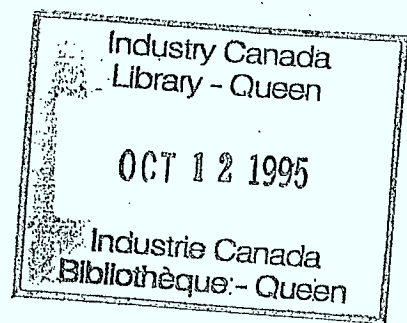
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Executive Summary

Canada's "venture capital problem" has been the subject of many studies in recent years, none of which have been acted upon. The main reason is that the problem is still not well understood and is addressed by simplistic answers like "there is no shortage of venture capital in Canada".

While the statement is technically correct, it ignores the fact that it is now virtually impossible to attract any of that pool of capital to technology-based startups and early stage investments. This is stifling innovation in Canada and making it difficult to transfer technology out of our publicly-funded R&D laboratories and universities. More patience and expertise is required on the part of the venture capital companies to operate in this end of the investment spectrum. The current trend towards domination of the industry by provincially-owned venture capital companies and the accumulation of large pools of capital (e.g. labour-sponsored pools) will not address the problem adequately. Smaller and more community-oriented pools working in cooperation with private investors who can provide mentoring and discipline to entrepreneurs represent a more viable solution.

Some changes in the tax laws are required to address the patience factor and either grants, subsidies or tax changes are required to address the expertise factor. Since it is assumed that the Department of Finance has a limited appetite for tax incentives, it is recommended that ISTC take the initiative by diverting some existing industry grant money towards such investors. In the longer term, government policy should be less focussed on assisting technology-based companies directly and more focused on building an investment industry that can start and develop such companies so they are better prepared to face global competition. In addition, procurement policies should be implemented that would assist Canadian SMEs to identify and develop market opportunities at all three levels of government in Canada.

Disclaimer

The views and ideas expressed in this report are those of the author and do not necessarily reflect the views and policies of Industry, Science and Technology Canada.

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1. Introduction

The Canadian venture capital industry has been the subject of many studies in recent years. They have been sponsored by all three levels of government, by the Prime Minister's National Advisory Board on Science and Technology (NABST), by the Prosperity Initiative and by trade associations. While they have compiled a great deal of **data**, they do not seem to have compiled very much **information**, because the debate on whether or not Canada has a "venture capital problem" is as intense and inconclusive as ever. The debate is of significant interest to Industry Science and Technology Canada (ISTC) because access to venture capital by small and medium enterprises (SMEs) is an essential ingredient in the commercialization of technology that is developed in Canada's publicly-funded laboratories and universities. It is also an essential ingredient in the restructuring of Canada's economy from a resource-based economy to a more technology-based economy. Of all types of business enterprises, those that are technology-based have the greatest need for venture (or risk) capital since they do not typically have significant assets that can serve as collateral for debt financing.

There is a need to interpret some of the data that has been produced and convert it into information that can be used by ISTC in its deliberations with Canadian industry and with other government departments. The industry debate usually involves trade associations such as the Canadian Advanced Technology Association (CATA), the Information Technology Association of Canada (ITAC), the Association of Canadian Venture Capital Companies (ACVCC) as well as firms and individuals involved in the commercialization of technology. The government debate usually involves the Department of Finance because there is a widely held belief on the part of the trade associations, the firms, and the individuals that a more strategic approach to the taxation of investment returns would solve "the problem".

Unfortunately, when pressed to define "the problem", they have difficulty in doing so with great precision because it is perceived differently by all of the players involved. ISTC officials acknowledge that there is a problem of some kind because of the many complaints they receive from entrepreneurs and because of their awareness of Canada's overall ineptness in commercializing technology that is developed within its publicly-funded laboratories and universities. There is an increasing body of evidence that this ineptness is related to the difficulty of financing technology-based firms, particularly in their startup and

early stages. While Canada has one of the most generous tax systems in the world for financing R&D, what seems to be forgotten is that it takes much more than R&D to commercialize technology. Risk capital is required to pay for marketing and selling expenses, for financing capital equipment and inventory (banks give little collateral value to these for debt financing) as well as accounts receivable and other components of working capital.

Although several meetings have been held between ISTC and Finance, Finance officials are not convinced that "the problem" (whatever it is) can be, or should be, solved by taxation policies.

The purpose of this report is to convert some of the more pertinent data that has been provided by the studies into information that will form the basis of a more meaningful dialogue between the parties involved. It will also recommend solutions that can be pursued by ISTC on its own with only minimal involvement by Finance.

2. Previous Studies

The following is a list of some of the studies that have been done on the availability of venture capital for technology-based firms in Canada:

- **Creating Threshold Companies in Canada: The Role of Venture Capital - by Mary Macdonald for The Science Council of Canada, 1991.**

It provides an overview of technology venturing in both Canada and the U.S. and provides nine specific recommendations that would improve Canada's capabilities. None of those recommendations have been implemented.

- **Under-funding the Future: Canada's Cost of Capital Problem - by the Canada Consulting Group for the National Advisory Board on Science and Technology, 1992.**

It discusses the implications of the high cost of capital (particularly of equity capital) in Canada on the country's ability to innovate and remain competitive. It makes four recommendations for improving access to capital by smaller, innovative firms. It also recommends that Canada establish financial/business institutions similar to the Kieretsus in Japan. None of these recommendations have been implemented.

- **NABST Committee on the Financing of Industrial Innovation - Final Report, 1990.**

It shows that the cost of capital is higher for Canadian firms than for their counterparts in most other industrialized countries, and that it is due mainly to the higher cost of equity capital. It states that "access to capital, whether for start-up or expansion, is the primary financing issue for new or emerging technology-intensive firms". It makes five recommendations, two of which are tax related and two of which are related to the creation of pools of investment funds. None of them have been implemented.

- **National Biotechnology Business Strategy - by William A Cochrane, Chairperson, National Biotechnology Advisory Committee, 1991.**

It identifies the lack of equity financing as the major impediment to the building of a biotechnology industry in Canada. It calls for the implementation of the recommendations of the above-referenced NABST report and includes several recommendations of its own. None of its recommendations have been implemented.

- **A Competitive Assessment of the Canadian Software Products Industry - by Coopers and Lybrand for ISTC, 1991.**

Venture Economics Canada provided data for this report that showed that the flow of venture capital was drying up for all types of investments, and for high technology investments in particular. It called for the implementation of the recommendations of the Mary Macdonald report to the Science Council. None of the finance-related recommendations have been implemented.

- **Venture Capital in Canada - by Mary Macdonald and Associates for the ACVCC with support from various government agencies, 1992.**

It shows that government owned venture capital firms are becoming a dominant force in the financing of technology-based firms, and are now almost the only sources for startup financing.

Venture capital has been the subject of many other reports in recent years, particularly those prepared for ISTC on various industry sectors and for the Prosperity Initiative. It would be interesting to investigate why none of the recommendations were acted upon. One possible reason is that Finance is very cautious about anything pertaining to the high technology industry since the Scientific Research Tax Credit (SRTC) fiasco of the mid eighties. Many experts argue that the SRTC would have been a very effective investment vehicle if it had been left as an equity instrument only. The abuses occurred because investors were allowed to loan money to the companies and then sell (or "flip") the loans.

Another possible reason for the inaction is that the data supporting the recommendations is often confusing and contradictory, at least to someone who does not understand the intricacies of starting and growing technology-based firms. Another is that there is a widespread belief that whatever the problem is, it should be solved by the provinces. This belief is reinforced by attempts that have in fact been made by the provinces to flow risk capital to such firms. As will be shown later, these attempts are not a viable long term solution.

Although all of the above reports are of good quality and are based on sound data, the one that would receive the most support from both the supply side and the demand side of the industry is the one by the Canada Consulting Group. It illustrates both qualitatively and quantitatively how the lack of access to risk capital is stifling innovation in Canada. It also challenges the widely held assumption that Canadians have a natural aversion to risk. It argues that if the rewards were more finely tuned, particularly to the high technology industry, Canadians would take risks as willingly as their competitors in other countries and Canada could be a viable supplier of high technology products and services to the rest of the world.

3. What has Happened?

Although it is fair to say that virtually none of the recommendations put forward in the above reports or any of the others that have been prepared for both the government and the private sector have been acted upon, the venture capital industry is indeed undergoing some very dramatic changes at this time. There are two that are most notable and worthy of some discussion. One is a massive intervention by various provincial governments into the industry through the creation of their own government-owned (and funded) venture capital companies; another is a trend towards the creation of very large pools of capital.

Examples of provincially-owned pools are Innovation Ontario Corporation, Discovery Enterprises Inc. (British Columbia) and Alberta Opportunity Corporation. This has been motivated by the provinces' desire to diversify their economies and by pressure from firms and municipalities to address the "venture capital problem". Since the provinces' powers to influence the situation through taxation policies are limited, they have chosen to get into the business themselves with a special emphasis on helping startups and very small firms.

In fact, it is interesting to note that the Alberta Opportunity Corporation is that province's second venture capital company, the first one being Vencap Equities Alberta Ltd. which was set up in the early eighties through a combination of government and private sector funding. The second one was established because the Government of Alberta did not feel that Vencap was addressing the needs of startups and very small established firms. However, since Vencap was a publicly traded company, it had a responsibility to its private sector shareholders as well as to the Government of Alberta, and its management obviously felt that investments in more mature (and less technologically oriented) companies better served their interests. (Vencap has since seeded another fund, Rosewood Partners, to specialize in this sector).

What the Vencap/AOC situation illustrates more than anything else is the dichotomy between serving the needs of shareholders, whether they be the public at large or pension fund managers, and the financing of high risk ventures, particularly those that are in their very early stages and are not likely to provide a return (no matter how large) for several years. However, as has been argued in some of the above reports and as will be discussed later in this one, massive intervention by provincial governments (or any other level of

government) is not the answer. A fine tuning of federal tax laws (or even the introduction of some other federal incentive program) so that non-government venture capital companies can make money in all parts of the venture capital spectrum is a preferred solution.

The second major change, namely the trend towards the accumulation of very large pools of capital, is partly driven by government policies and partly by the policies of the major sources of venture capital such as the pension funds.

To deal with government policies first, both the the federal and provincial governments have provided generous incentives for the formation of labour-sponsored pools of equity capital. For example, the Canadian Federation of Labour, with assistance from ISTC, has established Working Ventures Canadian Fund Ltd. which is accumulating cash at a very rapid rate (\$50M now and expected to grow to over \$500M in 3 years) as a result of generous tax incentives for investors. It is currently under some criticism from the high technology community (Research Money, January 20, 1993) for its apparent inactivity, particularly in technology-based ventures. (As of January 1993, its only investment was in a Saskatoon printing company)

The other driving force toward the large pools is the relatively low level of management fees that the pension funds and other sources of venture capital (e.g. insurance companies) are willing to pay to the venture capital companies. Such fees are currently in the 1.5% to 2.5% range. This means that if a fund is to support any kind of a reasonable due diligence and administrative capability, it must start out with a cash position of at least \$50M (2% of \$50M would provide for annual operating expenses of \$1M).

However, large pools of capital, whether they be the labour-sponsored pools or those acquired from the pension funds or wherever, will be less attracted to small deals than to large ones, because there is little difference in the administrative costs involved. Also, the large ones are likely to be in more mature companies and are likely to provide a faster payback.

There is widespread agreement that the large pools of capital are not the solution to the financing of early stage ventures, particularly those that are technology-intensive and are likely to require a lot of attention.

The other negative aspect of large pools of capital (and it is not a trivial one) is that it allows both politicians and bureaucrats to give simplistic answers like "There's plenty of venture capital". Technically, the statement is true, but it ignores the inadequacy of the distribution of such capital across the entire spectrum from startups to mature companies.

The impact of the large pools is discussed further in section 7. Appendix I also provides insight into their impact on the industry from the perspective of a venture capitalist.

4. Non-Government Pools are Drying Up

One of the more disturbing aspects of the Canadian venture capital industry at this time is the inability of seasoned veterans with proven track records to raise new pools of capital. For example, when Noranda Enterprise Ltd. was closed down by its parent company in 1992 (because it no longer fits with its corporate mission), two of its principals attempted to raise a pool from the more traditional sources (e.g. the pension funds). They did not anticipate significant difficulty because Noranda Enterprise had returned a 38% compounded annual rate of return to its shareholders and had participated in nearly every successful high technology company that was ever formed in the Ottawa-Carleton Region. Lumonics, Mitel, Cognos, Norpak, and Simware are some of these investee companies.

They have had no success (as of February 1993) in putting together a fund, at least not one that is large enough for them to pay their expenses until they can begin generating cash again. They cite as a major reason the fact that the managers of such sources of capital are of the impression that nobody is making money in venture capital and that they are not impressed by individual track records. Ventures West in Vancouver is encountering the same problem.

Such managers are correct in their assessment of the venture capital industry generally, but they also admit that most of their traditional types of investments (e.g. real estate) are not paying off either. This would suggest that venture capital may soon be looked upon as the lesser of the two evils by such people. In fact, the Noranda principals quoted the investment managers as saying they were too busy trying to extricate themselves from their real estate investments to even revisit the venture capital option. Those who have participated in the studies behind reports such as the ones listed earlier are keenly aware of the price that Canadians are paying (and will pay even more in the future) for an investment infrastructure that denies entrepreneurs and small firms access to risk capital. Some have even recommended that pension funds (and other institutions) should be penalized if they do not place a certain percentage of their assets in venture capital. Economists such as Richard Lipsey oppose this approach and encourage a more concentrated effort to identify the obstacles in the current infrastructure and address them constructively. When it was proposed in a recent budget speech, it was met with strong objections from the pension funds and individuals

Since the provincial funds and the large pools are the predominant trends at this time, it is worth examining them in more detail to determine if they are likely to address "the problem". Before doing that it is worth defining that problem as clearly as possible.

5. What is the Problem?

It should be obvious from the discussion up to this point and even from the brief descriptions of the above reports that "the problem" that the industry refers to is not that there is a **shortage** of venture capital, but that it is not making its way to the early stages of the investment spectrum. The "Venture Capital in Canada" report referenced earlier, breaks the venture capital spectrum out into the following stages:

Seed financing is normally provided to prove a concept. It may involve some product development but rarely involves any initial marketing.

Start-up financing is provided to companies for use in product development and initial marketing. Companies may be in the process of being organized or may have been in business for a short while (usually a year or less), but have not yet sold their product commercially. Generally firms looking for start-up financing would have assembled the key management and prepared a business plan.

First-stage financing is provided to companies that have expended their initial capital and started to sell their product, but require additional funds to initiate full commercial production and sales.

Second-stage financings generally support the initial expansion of companies that are making progress but may not yet be profitable.

Mezzanine financings (or third-stage expansion financings) provide capital for major growth expansion for companies whose sales are increasing and who are either breaking even or profitable. The funds are used for plant expansion, marketing, working capital or new product development. These financings often are done using subordinated debt instruments (unsecured loans) with equity kickers, or provisions which entitle the investor to some common shares if the company succeeds.

Leveraged buy out financings provide the capital to enable operating management or outside investors to acquire a product line, a division or a company. The assets of the companies involved in these transactions are normally highly leveraged to minimize the

equity required.

“The problem” that most people are referring to relates to the first three stages. It is practically impossible to attract equity capital to companies at these three stages no matter how promising the opportunities are. This in turn is related to a number of other problems, some of which are real, some of which are imaginary, but all of which can be addressed if the investors have the patience and the expertise to do so.

For example, many investors will say “We like the technology, but we do not like the management”. There are many solutions to this problem, nearly all of which are related to the patience and the expertise factors. For example, investors could be more proactive in finding the technology before it becomes “contaminated” with bad managers. They could proactively seek out technology in publicly funded laboratories (known as ferreting) and then build their own management teams around it. Such an idea seems absurd in the Canadian environment where a visit by a venture capitalist to **any** publicly-funded laboratory is a rare event, but this is done in other countries. There are at least four things preventing Canadian venture capital companies from doing it:

- a) They are receiving enough “safe deals” at the upper end of the investment spectrum for them to achieve enough “deal flow” to satisfy their investors. (Obviously their investors are **not** satisfied as is illustrated by the difficulty of seasoned veterans in assembling new pools.)
- b) They do not have a ferreting capability.
- c) It is too difficult to recruit good managers to high risk ventures. (Equity-based incentives have lost their appeal because of tax changes to stock option benefits and because of Canada’s very high capital gains tax.)
- d) The process takes too long and our tax system does not differentiate between short and long term paybacks.
- e) It is too difficult to recruit boards of directors because of increasing directors’ liabilities and the inability of many small companies to obtain liability insurance at reasonable costs.
- f) Most of the venture capital companies are located in the large financial centres (Toronto, Montreal and Vancouver) and are not in close contact with the R&D community.

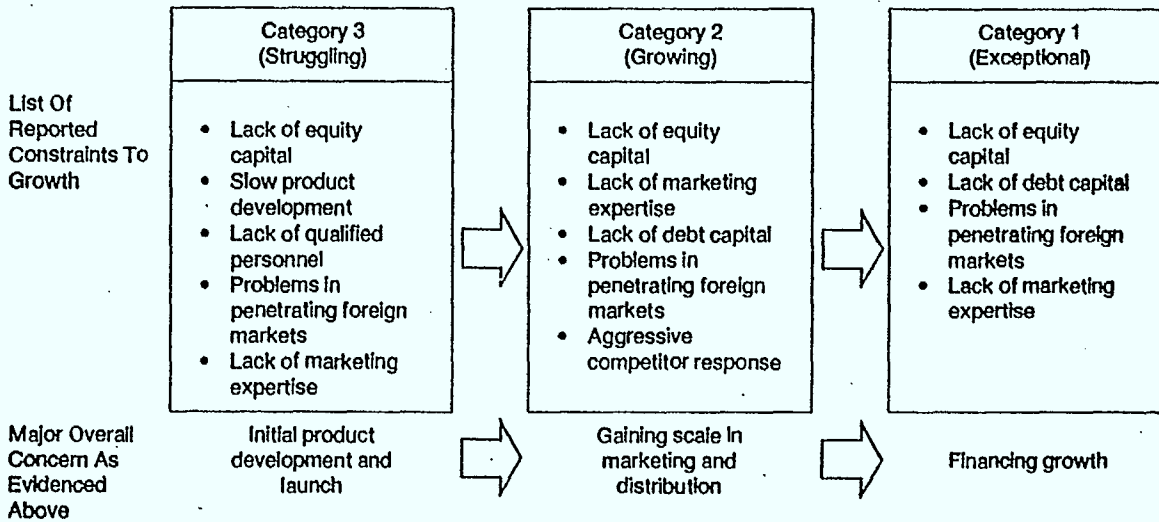
It should be noted that "lack of equity capital" is cited as the major problem facing companies at all stages of their growth. Figures 1 and 2 refer to surveys conducted by the Canada Consulting Group for the Ontario Premier's Council. However, the more mature companies at least have other financing options (e.g. debt) especially if they show an ability to generate cash. Banks will not (nor should they be expected to) lend money to firms with no assets. The financing of such firms is a specialized business that is best left to those companies and individuals who specialize in it. That is not to suggest that the banks might not eventually be the best vehicles for delivering risk capital to early stage investments in Canada. In fact, they do it very efficiently in many European countries (Germany in particular) but they do it through subsidiary companies and affiliates that have developed the necessary skills. Our banks (and in fact our venture capital companies) do not possess such skills.

Figure 1 - Percentage of Survey Companies Indicating Which Factors Most Constrain Growth

	Major Constraint %	Constraint %	Not A Constraint %	Total %
Lack of equity capital	54%	20%	26%	100%
Lack of debt capital at an affordable cost	29	30	41	100
Slow product development	14	38	48	100
Lack of marketing expertise	10	42	48	100
Lack of qualified personnel	10	32	58	100
Problems in penetrating foreign markets	9	28	63	100
Lack of technical or scientific expertise	3	18	79	100
Aggressive competitor response	2	31	67	100
Lack of new product ideas	2	15	83	100

Source: Premier's Council Survey of Ontario Start-up Companies.

Figure 2 - Constraints to Growth, by Company Category (Listed in Order of Importance)



Source: Canada Consulting and Telecel analyses.

To summarize what has been said up to this point, “the problem” is that it is too difficult to attract equity capital to early stage, high-risk ventures and this is due to a lack of patience and expertise on the part of investors. If the tax system (or some other incentive program) is going to address “the problem”, it must address the patience and expertise problems. There is also a geographic dimension to the problem as was alluded to in point f) earlier and which will be discussed in more detail later. It can be solved by most of the same techniques used for solving the patience and expertise problems. Before going into an investigation of possible solutions, it is worth examining the two trends referred to earlier (i.e. provincial venture capital companies and large pools) to see if they are ever likely to address the patience and expertise problems.

6. The Impact of Provincial Pools

Whether knowingly or not, the provincial governments are indeed trying to solve the patience and expertise problems by setting up their own venture capital companies. Because they are not constrained by the 2% operating fees imposed by the pension funds, they tend to have sufficient operating funds to afford both technical and financial experts on their staff (or are able to hire them on a consulting basis) and they can afford to do some technology ferreting and some management recruitment.

However, they bring with them their own unique disadvantages. For example, they are vulnerable to political influence and as they become more and more of an "only game in town", that influence will become relentless. Also, there is a limit to the expertise they can apply, particularly when the companies begin to develop and they require more management discipline. Such discipline is normally administered by a board of directors, but the people who manage these pools usually cannot serve on such boards, either because of the liabilities involved or because they are public servants. They even have difficulty in exerting any influence behind the scenes, because that usually involves the firing of key people and other personnel changes that would be difficult for public servants (and their political masters) to defend if the affected parties decide to go the political route. Issues related to the recruitment of competent directors will be discussed later.

Another problem with the provincial funds is that they have limited resources, and are often unable to go beyond even the seed financing stage. Unless the larger firms are willing to become involved well before what is referred to as the second-stage financing in the last section, the firms will either die or be taken over by larger (and usually foreign) firms.

7. The Impact of Large Pools

Some of the shortcomings of the large pools have already been referred to. They are mostly related to the patience factor, but to a lesser extent to the expertise factor as well.

Such pools tend to be impatient because they find that they have to place their funds in rather large amounts at a time. This tends to drive them to the upper end of the investment spectrum. One of the more disturbing trends is the increased focus on mezzanine financings aimed at "dressing up" companies so they can be taken public. While the number of initial public offerings (IPOs) in Canada is relatively low, they do satisfy a large pool's requirement for a quick payback on a large block of investment capital.

The competition for this type of financing is intense in Canada, and it produces two negative byproducts. The first is that many of our high technology companies are taken public at grossly inflated prices because they were able to pick the venture capital firm that was willing to "dress them up" the most. The second is that when venture capital companies concentrate on this type of activity, they tend to concentrate on developing capabilities in financial "wheeling and dealing" as opposed to ferreting and management development.

It is clear that large pools **should** be able to develop the patience and expertise but some type of intervention is obviously needed to make them move out of the upper end of the spectrum and into the lower end as well. Unfortunately, the entry of the provincial funds into this end has not encouraged them to do so, for a variety of reasons:

- a) Many of them do not want to syndicate with the provincial funds on deals for fear of getting caught up in a political tug-of-war.
- b) Many of them feel that the provincial funds are too generous in the deals they strike with entrepreneurs.
- c) While they respect the capabilities of the provincial funds to do **some** technology and marketing assessment, they would prefer to syndicate with investors who can provide help on the board of directors. In other words, there is a finite limit to the expertise that provincial funds can bring to a given investment opportunity.
- d) Many of the provincial funds have complex and onerous shareholders' agreements

which the private funds are not prepared to enter into. (The reason for such complex agreements is that the provincial funds try to implement policy and discipline through a shareholders' agreement that would normally be implemented through a board of directors.)

In entering the venture capital field, the provinces felt that they would provide an incentive for other venture capital companies and individuals to enter the high risk end of the investment spectrum. However, if an in depth study were done, it would probably show that they are driving them away from it.

8. The Entrepreneur's Perspective

The first step on the part of an entrepreneur seeking venture capital is the preparation of a business plan which outlines the business opportunity to potential investors in simple terms. Whether it is a new company or a new product line in an existing company, the investor is usually being offered very little in the way of hard assets. In fact, the entire value of the deal is usually based on some future value which in turn is based on future sales and profits.

The assessment of that future value presents a significant challenge to most potential investors because it requires an assessment of not only the technology, the products, and the markets, but of the the management team as well. It can usually best be done by creating an environment in which the entrepreneur can work closely with potential investors right from the beginning. However, such people tend to be private individuals (known as angels) and they are less interested in high risk opportunities than they were a decade or two ago. The reasons for this are varied and complex, but they are nearly all related to the tax reforms of the last decade or two. Since the imposition of a capital gains tax and a stock option tax in the seventies and the escalation of the effective capital gains tax and the surtaxes of the eighties, it has become much more difficult for even "wealthy" individuals to accumulate pools of capital. Once having accumulated them, they hang onto them more tightly. While it can be argued that tax reforms have spread out the tax burden, it has also spread out the capacity for risk taking and many would argue that it is now too low to allow entrepreneurs to find sources of seed money even among friends and acquaintances.

Most entrepreneurs go directly to the venture capital companies. Unfortunately, the business plans they write must be tailored to the companies they approach. The large companies want deals that require large amounts of capital and that will return large profits in short periods of time. It is not uncommon to see two business plans being circulated for the same opportunity, one tailored to private individuals and the provincial funds, and the other tailored to the large polls. Since the recipients of these plans tend to talk to one another, this results in a serious credibility gap for the entrepreneurs. In fact, the practice of broadcasting business plans draws criticism in itself, because most potential investors, having heard that others have received a business plan along with themselves, will tend to label such opportunities as being "street worn".

Even though the entrepreneurs have no other choice, it is doing little but “clogging up the system” with business plans and giving the venture capital companies some reason to label all such entrepreneurs as incompetent and untrustworthy.

Many of these business plans do represent good business opportunities and many of them do have good management behind them, but they are not even being taken seriously by the venture capital companies. What usually happens is the entrepreneur eventually tones down the business plan and accesses some funding from a provincial venture capital company. Of course, government grants such as IRAP are accessed as well, but these only finance R&D. The real shortfall in early stage financing is in the availability of working capital (e.g. accounts receivable, inventory, etc.).

9. Some Practical Problems in Investor-Investee Communications

It should be obvious from what has been said up to this point that early-stage investments in technology-based enterprises represent a risky business that requires close interaction between the investor(s) and the entrepreneur(s). This can only be done effectively if the two parties are in close physical proximity to each other. Large pools of capital located in Toronto, Montreal or Vancouver, (no matter how much expertise they have) will never build technology-based industries in Moncton or Kelowna. To use the expression coined by Alfin Toffler, the venture capital industry must be "demassified," at least geographically.

However, even if the geography problem is solved, there is a component of the "expertise" problem which has already been mentioned and that is the role of boards of directors and the difficulty of recruiting them. Unlike the situation in a larger established company a board of directors must take an active role in monitoring the affairs of a technology-based, early-stage company, and it must apply discipline of the type that has already been alluded to. It is beyond the scope of this paper to describe all of the activities of such boards, but the following is a partial list.

- a) It must meet at least monthly during the first year.
- b) It must insist on an annually updated long range plan and budget.
- c) It must insist on monthly sales forecasts.
- d) It must monitor performance against budget and force management to take corrective action when forecasts are out of line with budget.
- e) It must provide the president with management advice and guidance.
- f) It must be prepared to replace senior managers (including the president) if they are not performing as expected.

Unfortunately, it is becoming extremely difficult to attract directors to such companies for the following reasons:

- a) Directors' liabilities are increasing at an accelerating rate and a directorship can now cause financial ruin even to a very wealthy person.

- b) Small companies, particularly those with products that are subject to strict operational and regulatory environments, have difficulty in obtaining directors' liability insurance.
- c) The financial rewards are difficult to visualize; small companies cannot pay lucrative directors fees and stock options are losing their appeal. They also have a long payback period in the case of early-stage companies.

Any serious attempt to bring investors back into early-stage investments must address the issue of directorships. If authorities at the federal and provincial levels of government insist on placing more and more personal liabilities on directors (there are now over 200, including stiff commitments for employee termination pay) then some help must be given to SMEs in obtaining the necessary directors' liability insurance.

10. An Ideal Early Stage Financing Scenario

There is plenty of evidence to suggest that a combination of angels and venture capital companies enhances the chances of success for startup and early stage investors. The angels usually bring specialized marketing and management skills while the venture capital companies bring "deep pockets" and legal, accounting and skills. (This is a simplistic view but the point is that the angels do not usually have the financial resources and the deal-making expertise and the venture capitalists do not usually have the detailed knowledge of the opportunity.)

The financing of MDI is discussed in *Venture Capital in Canada*, but several parts of the story are left untold, such as the following:

- a) The opportunity was discovered inside another company (MDA) by a Vancouver high technology entrepreneur (an angel) who brought it to the attention of Ventures West.
- b) Ventures West told him that they had not invested in high technology enterprises prior to that time and that a condition of their involvement would be a board of directors and some outside investors recruited from the industry.
- c) Such a board was assembled, it met frequently, and it kept a close eye on the company's operations.
- d) It rebuilt the management team three times with the outside angels temporarily taking over key management positions in the company, including that of the president on two occasions. (The company had three presidents before recruiting the person who finally made it succeed.)

While the company did come very close to failing, such failure would have been inevitable if either the angels or Ventures West had attempted to finance the operation on their own. Ventures West would not have had the "street smarts" and the angels would not have had the "deep pockets".

A scenario in which angels, local pools of venture capital and the national venture capital companies could work together from a very early stage would be ideal. Those who advocate that early stage investments should be left to the angels and the later stage investments to the venture capital companies are out of touch with the details of early stage financing.

11. The Future for Venture Capital Companies

To summarize what has been said up to this point in the report, "the problem" that people refer to is related to the inability of entrepreneurs and small firms to access venture capital, particularly early stage capital. Means must be found to bring angels back into this type of financing and venture capital companies must be built that have patience and expertise. The trend toward provincial pools and large private pools is not producing the desired results because of a variety of micro level factors, some of which were discussed in sections 5 and 6. Any solution to the problem must take those into account as well as the macro factors such as the sheer size of the total pool of venture capital.

While some of the frustration that is building in "the system" is directed at ISTC and Finance, much of it is also directed at the fifty or so venture capital companies that control most of the \$3.5 billion worth of assets in place at this time. Entrepreneurs and public servants alike frequently refer to them as "vulture capitalists" because they are seen as opportunists who bring little to the table and want to take as much as possible away in as short a time period as possible. While the discussion to this point has provided some of the reasons why they are influenced to act in this way by forces that are largely beyond their control, the companies themselves must eventually find ways of addressing "the problem" or other means will be found to do so. Unfortunately, those other means may be even more flawed than the two discussed already, namely the provincial pools and the large pools (specifically, the labour-sponsored pools).

Canada's inability to commercialize its publicly-funded technology does not attract much attention at this time, but it will within the next few years. For example, there is a great deal of pressure on newer programs such as the Centres of Excellence program and the Canadian Space program to deliver economic benefits through the "transfer" and "diffusion" of their technologies. What the politicians and bureaucrats do not seem to realize is that there is no "receptor" capability in Canada for such technology because there is no risk capital flowing to the early stages of the investment spectrum no matter how good such technology commercialization opportunities are.

The people who are under this pressure to deliver such economic benefits will sooner or later realize the futility of their efforts and will push back on the politicians and bureaucrats.

The result may be more "quick fixes" that will almost certainly be detrimental to the existing venture capital companies. If they are to survive, they must at least show a willingness to accommodate the technology commercialization agenda. This may require a complete rebuilding of the industry.

Canada faces a serious dilemma in rebuilding its venture capital industry. There are not enough deals to allow all fifty or so firms that make up most of the industry to have expertise in a variety of technologies (as many of their counterparts in the U.S. do) nor to have the capability to seek out deals from one end of the country to the other. A compromise must be made between geography and technology.

As mentioned earlier, most of the existing firms operate out of the large financial centres, namely Toronto, Montreal and Vancouver. This is partly due to the fact that most of them evolved out of the banking and insurance industries, but also because of their heavy involvement in upper end financing as opposed to ferreting. Mezzanine financing requires lawyers, accountants, bankers and brokers, whereas ferreting and mentoring require engineers and people who have managed such firms themselves.

Many of the companies have already begun to specialize in terms of both technology and geography, with an emphasis on geography. For example, Ventures West Management Inc. of Vancouver closed its Toronto Office two years ago and is now concentrating on opportunities in British Columbia. In fact, it has pioneered an initiative known as SPARK which orchestrates a close working relationship between B.C. investors, the academic community, the R&D community and the B.C. government. It provides an automatic ferreting capability and increases Ventures West's expertise by tapping into the technical capabilities of the R&D and academic communities. The patience factor should be increased by the availability of matching funds from the B.C. government.

The SPARK model is one that is worth pursuing in others parts of the country because it allows the venture capital company to stay closer to home and optimize local opportunities. It has another very important attribute, and that is that local investors have an opportunity to see their local venture capital company in action and a mutual trust will be built up. Over time, a complete infrastructure capable of operating over the entire investment spectrum should develop. For example, there will be people available to do technology assessment,

to provide references on the entrepreneurs, and to serve on boards of directors.

Another model worth watching is a new venture capital company (CAP-GEST-DEV Inc.) that has been established in Hull, Quebec with the pension funds of the cities of Hull and Gatineau as investors along with the Caisse de Depot et Placement du Quebec and some local businesspeople. The Outaouais Region pension fund is also an investor. It is a small fund but the company is receiving financial assistance from the Quebec government to help pay its operating expenses in its early years. This model is interesting for the following reasons:

- a) It addresses the patience problem.
- b) It addresses the expertise problem. Even though the company does not have such expertise on its own payroll, it has funds to hire consultants.
- c) It engenders local support and encourages networking which makes it easier for entrepreneurs to gain access to angels, mentors and directors.
- d) It addresses a psychological barrier that small fund investors have about paying administration fees.

12. Recommendations

Any solution to "the problem" must obviously address the patience, the expertise and the geography issues. The following is a course of action that could be pursued by ISTC with only minimal involvement by Finance. It was beyond the scope of this contract to provide operational details or costs of the various strategies and tactics which are proposed, but the recommendations will provide a framework for designing a venture capital infrastructure that would address the three problems.

- 1. Redirect some of the grants that are currently going to the operating companies as R&D and manufacturing incentives towards investment firms and individuals who would provide risk capital to early stage firms and who would do it on a more localized basis.**

The establishment of Community Venture Pools (CVPs) should be encouraged by the availability of operating funds in an amount of up to \$2 million per year from ISTC for a period of five years. This figure will vary widely from one CVP to another depending on their demonstrated capabilities to do early stage financings and other factors which will be explained later.

A CVP would apply to ISTC (actually to a regional board as will also be explained later) for such grants in the same way as operating firms apply for the existing grants and it must show that it is capable of adding value and actively seeking out early stage opportunities. Its staff must include at least a full time manager, a marketing expert and a financial analyst. It must also have access to technical experts who can assist in the assessment of investment opportunities and ferreting out such opportunities from publicly-funded laboratories. A person capable of identifying local purchasing power (to be discussed later) must also be available. It must present a business plan to regional boards (possibly five in total for all of Canada) made up of businesspeople who have had experience in funding and/or operating early-stage, technology-based firms. Such boards would be appointed by ISTC using some form of a peer review process and their members would be paid fees which are in line with those paid to directors of public companies. They would also receive bonuses based on the performance of the CVPs that they control and would be eligible for stock options in

them. They would not be public servants; in fact, they would not be full time employees, but would be adequately compensated for time spent in establishing and reviewing CVPs.

Rules pertaining to CVPs would include the following:

- a) Only one would be licensed in any given geographical area, this being defined as what is generally referred to as a regional municipality in Canada.
- b) Investors would receive the same investment tax incentives as currently apply to the labour-sponsored pools . An option might be provided for investors to receive a guarantee on the return of most of their capital (say after five years) instead of the labour-sponsored pool treatment.
- c) Each CVP would be reviewed annually by its regional board to ensure that it is maintaining the capabilities referred to above. If it falls below a minimum standard (which would be set by ISTC and the regional boards), the ISTC grant would be withdrawn, but the investor tax incentives would still apply.
- d) There would be a limit on the amount of money they would raise. Pools of \$20M or less should be adequate.
- e) Some form of disincentive against later stage financings may be necessary. One way of doing this would be to significantly reduce the annual operating fee if later stage investments exceed a certain percentage of the CVP's total portfolio.

2. Encourage angels to participate in early-stage technology-based investments

In addition to the above incentives for private individuals to invest in CVPs, they would also be given incentives to invest directly in early-stage, technology-based ventures as follows:

If an individual buys founders' shares in a firm and leaves his or her money in the firm for at least five years and if that firm spends more than 10% of sales on R&D for each of those five years, any financial returns from that investment will be free of any tax. Some time limit should probably be imposed on the **maximum** period the investment could be held on a tax-free basis, but a five year tax holiday after the five year waiting

period would seem reasonable.

3. Use government buying power at all three levels of government to assist early-stage, technology-based firms to gain a foothold in the marketplace

In addition to the marketing and financial expertise, each CVP would have a person on staff (or available on a consulting basis) to seek out product and service requirements at the three levels of government (as well as in the private sector) that might be filled by their investee companies. ISTC would implement a "first-user risk reduction program" to encourage government purchasing authorities (and their counterparts in the private sector) to buy early stage products and services from such firms. Specifically, the program would provide funds to defray up to 80% of the cost of such products and services, and such funds would be repaid to ISTC if and when the products and/or services meet the requirements of the purchaser. If they do not, the purchaser would be "out-of-pocket" for only 20% of the purchase price. Such coverage would apply to the first products or services delivered by a company and could have an upper limit (possibly \$50,000 per purchase). The purpose of this program would be to address Canadians' aversion to buying Canadian high technology products, particularly those that have not been proven in the market place. It would also provide cash flow to the investee companies and "reference sites" for marketing purposes.

Other variations on this strategy might be used, including a new type of unsolicited proposal program. However, any such program should be limited to products and services which can be exported; proposals for studies and R&D projects would not be accepted.

4. Make it easier for early-stage, technology-based firms to recruit competent boards of directors

Firms that have received significant amounts of equity capital from CVPs (at least 30% of their share capital) would receive grants from ISTC to defray the costs of directors' liability insurance that would cover all personal financial liabilities for such directors. If directors' liability insurance to cover all financial liabilities cannot be obtained at any

cost, which is often the case, then ISTC would provide such insurance itself. If this does nothing else, it will expose the folly of the existing trend in directors' liabilities.

13. Summary

The measures proposed above should produce the following results:

- a) The provincially-owned pools of venture capital would eventually be dispersed geographically and their portfolios would be taken over by the CVPs because the CVPs would have greater expertise and would be closer to where the opportunities are. They would also be farther removed from potential political interference.
- b) Syndication would occur between angels, the large pools, and the CVPs, thereby addressing both the patience and the expertise problems.
- c) The risks inherent in early stage investments would be reduced by the additional expertise in the CVPs and the government buying power.
- d) As the pension funds (and other large pools of capital) become aware of the expertise within the CVPs they would be more inclined to return to the venture capital arena because they would see them as the organizations that will do the ferreting, due diligence and mentoring that they are not currently prepared to pay for.

To fund the above initiatives, incentive programs such as the Defence Industry Productivity Program (DIPP) and the regional development programs such as the Atlantic Canada Opportunities Agency (ACOA) would be partially diverted. Programs such as IRAP should be left intact, but programs such as the Strategic Technologies Program (STP) should be directed away from firms that are in positive cash flow positions. The R&D investment tax credit (ITC) program should be left intact.

As mentioned above, it is beyond the scope of this report to develop an operational scenario that would identify the "investment" required by Canadian taxpayers to build such a network of CVPs, but it is unlikely that there would ever be more than 50 of them across Canada.

The most difficult task will be the development of (and adherence to) CVP operational procedures that will enforce good operating practice in the investee companies because every business person, entrepreneur and investor has his or her own ideas about what constitutes good operating practice. However, nearly everyone who has had any experience in a well-managed international company will cite the unwillingness of Canadian

SMEs to follow disciplined sales forecasting procedures as a major cause of failure. The rules pertaining to CVPs will have to get down to this level of detail. There will be complaints about the apparent bureaucracy but there is plenty of bureaucracy in present government programs, particularly the provincial venture capital programs.

Adherence to such rules will be the task of the regional boards. The success of the entire program will rely very heavily on the competence of the people recruited to serve on such boards. Above all, they must not be political appointees. This is why a peer review process is necessary.

The various incentives going directly to high technology operating firms currently amount to about \$1 billion per year. (The ITCs amount to about another \$1 billion per year). If necessary, at least half of the non-ITC incentives should be redirected towards this program. It makes little sense to see the majority of programs such as DIPP going to mature, foreign-owned firms when it is virtually impossible to build new Canadian firms because of the inability of entrepreneurs to access early-stage risk capital.

It should be remembered that the above strategy has been designed to be driven mostly by ISTC with minimum involvement by Finance. As such, it is more grant-oriented than might be palatable to the traditional investment community. A more tax-oriented strategy could be pursued by giving generous tax concessions for expenditures by venture capital companies on ferreting, assessing and mentoring activities in much the same way that operating companies are given concessions in the forms of investment tax credits (actually refunds) for R&D expenditures. Some differentiation would also be required between the tax treatment on returns from early and later stage investments. It is less clear how the tax system could be used to address the geography problem and the board of directors problem.

14. The Next Steps

In order to test the viability of the above proposals, the following steps would be required:

- a) Estimate the cost of such a program under various scenarios. The most likely one would be 20 CVPs within 5 years with an average annual operating budget of \$1 million per year and three regional boards each with a similar budget. (This includes directors' fees, travel, compensation for hands-on work with CVPs etc.)
- b) Draw up a terms of reference for both the CVPs and the regional boards and obtain consensus from potential participants in the program.
- c) Implement a pilot project - possibly in the Ottawa area where a venture capital void exists as a result of the Noranda Enterprise closure.

**Appendix I
Venture Capital in Canada:
Redesigning the Pipeline**

Venture Capital in Canada: Redesigning the Pipeline

James M. Fletcher

Financing Small Business: An Economic Imperative

Time and again, the rallying cry goes up that there is no equity available for small, private companies. Sometimes it is the Canadian Federation of Independent Business. More frequently, it is entrepreneurs themselves who have experienced the frustration of trying to raise private equity and have ultimately taken their stories to the media. Last summer, the National Advisory Board on Science and Technology, in an effort to address this perceived shortage of equity for emerging companies and the resulting drag on Canada's economic potential, suggested that Canadian pension funds be mandated to invest 1% of their capital in small business. The federal government has also identified this issue in its small business pension investment legislation of 1986-1987 and in its more recent support of labour-sponsored venture funds. The government of Ontario is the most recent entrant in this field with its April 1992 discussion paper.

The value of small business to the economy is unchallenged. Companies with fewer than 50 employees accounted for 75% of the jobs created in Canada in 1991. South of the border, Fortune 500 companies lost 3.9 million jobs during the 1980s. The jobs were replaced by smaller businesses. In British Columbia, employment in the coastal solid wood products industry

has dropped from 31,000 in the late 1970s to 13,000 today, while some 1,500 companies in the technology sector have grown to the point that they now employ over 38,000 people.

The raw data strongly support the case that there is very little equity available for these small business 'engines of growth'. Revenue Canada reports that there are now over 57,000 companies in Canada with revenues over \$2 million a year. Only 1,132 (less than 2%) of these have access to the public markets through current listings on the Toronto Stock Exchange. And behind these 57,000 companies with sales above \$2 million are another 1.7 million smaller businesses, many of which are undoubtedly looking for equity capital to

Why Have the Investment Results Been So Poor?

Meanwhile, the Canadian pool of institutional capital – pension funds, mutual funds and life insurance companies – of around \$250 billion is almost entirely restricted to publicly traded securities, and often only 'large cap' companies at that. Thus, we have a situation where virtually all of the country's institutional equity crowds into the small proportion of businesses that are publicly traded, while the 98% of businesses with revenues over \$2 million a year and countless more

Canada has a 'pipeline' problem in getting equity capital to its dynamic small business sector. Impatient politicians have been proposing government solutions to the problem. This article shows at least part of the problem has been a venture capital industry that has attempted to fulfill impossible mandates in the 1980s. Fortunately, steps can be taken to make Canada's venture capital industry viable. They relate to redefining business strategies, to setting more realistic return targets, to developing funding strategies that are in sync with investment requirements and to changing how fund managers are compensated.

Jim Fletcher is President, Northwest Venture Developments in Vancouver, British Columbia [1].

'start-ups' are effectively denied access to the primary institutional sources of equity capital.

Normally, one would expect this kind of market inefficiency to result in outstanding returns for investors willing to finance private companies, particularly given the characterization of venture capitalists by many entrepreneurs as 'vulture capitalists'. In fact, however, the average experience of the venture capital industry over the past decade has been poor. As a result, the Ontario Municipal Employees Retirement System has recently sold off much of its venture capital portfolio, and other institutions have ceased making new private equity investments, whether through venture capital funds or directly. In other words, at the same time that small business has been flourishing and becoming ever more important to the economy, and many of Canada's largest traditional companies have come under enormous market and financial pressure, the supply of venture capital from traditional institutional sources has been dwindling due to the poor returns experience.

Given the gap that apparently exists between the large number of private companies requiring equity and the limited availability of private equity funds, why have the real capital rates of return not been higher? Understanding the answer to this question is critical if the issue of small and private business financing is to be addressed effectively.

The High Cost of Funds

Venture capital funds are essentially a distribution channel between large, mainly institutional sources of capital and small businesses. Unfortunately, as structured and managed over the past decade, they have been a very high-cost distribution channel. With no change in final investment pricing, this translates into reduced net returns to the venture fund sponsors. More often,

and worse, the venture funds try to deliver high net returns to their sponsors in spite of the channel costs. This puts heavy upward pressure on the price the funds must charge their investments, with the result that the best and most experienced entrepreneurs bypass the venture funds in favour of lower cost channels or direct suppliers of capital, such as wealthy individuals, the occasional institution, public markets, corporate partners, and government funding programs. Left with only the lower tier opportunities, the venture funds have predictably suffered.

The high cost of funds from the venture capital industry stems from four factors:

1. The cost of capital to the venture funds is itself high. Normally, one expects a distribution channel to have purchasing economies which customers, acting individually, cannot access. However, in the case of venture capital funds, institutions demand a significant premium to what they expect over the long term from public equities, even though the equity analysis is being 'contracted out' and the volatility of a venture fund is low. (Black Mondays tend not to have much effect on the value of private equities.) Frequently, an institution will have higher return expectations of its venture capital funds than of direct private placements, even though it may have significant monitoring costs associated with the private placements. These high expectations get passed along to the private companies as incremental costs of funds.
2. Venture capital funds usually draw down at least part of their funding commitments in advance, and invest the funds in Treasury bills pending corporate investment opportunities. To deliver a given rate of return to the fund sponsors then requires a commensurately greater return from the actual fund investments, once those investments are made.

3. The typical venture capital fee structure includes a bonus arrangement equal to 20% of all gains. Even if the fund delivers only 10% compounded to the fund sponsors, this 20% can amount to \$5 to \$10 million over the life of an average \$25 to \$50 million fund. Again, to deliver a given minimum return to the sponsors, the actual investment returns must be commensurately higher.
4. The typical venture capital management style is high in cost and low in efficiency. Hundreds of hours of expensive professional time go into due diligence for very modest-size investments. Yet there is little or no evidence that this extensive due diligence produces better performance than the well-honed sense of gut-feel and experience that a private businessman applies over lunch with an entrepreneur seeking capital from that businessman. The average venture capitalist will then spend hundreds of hours annually monitoring and 'coaching' that same small investment without actually being in a productive capacity within the business, again with little evidence that this expenditure of time has a commensurate effect on the ultimate outcome of the businesses being financed. These administrative costs, which are very large on a per-dollar-invested basis, put further pressure on the level of returns required from the actual fund investments [2].

The 'Adverse Selection' Phenomenon

Some venture capital industry analysts, such as University of British Columbia's Professor Raphael Amit, have coined the term Adverse Selection to describe the process that results from these high costs of venture capital. Essentially, the most financeable managers with the best projects simply bypass the venture capital industry with its high cost structure and expensive cost of funds in

favour of lower cost options. This becomes a vicious circle, because the ultimate investment returns of the venture fund are then lower than might otherwise be expected, and the loss ratio higher, which in turn puts still more upward pressure on the effective price the venture funds must charge their remaining and new investments in order to try to deliver the same net returns to the institutional sponsors. The logical end of the cycle is the Catch 22 where all investments of sufficient quality manage to bypass the venture funds, and none of the remaining investment opportunities meet the venture funds' minimum quality standards, such that the funds end up making no investments, even when they have available resources.

An analogy could be made to full-service department stores which suddenly find a new Costco warehouse club next door skimming the 80% of the sales volume accounted for by 10% of the department stores' merchandise. One department store reacts by carrying ever more novel and faddish merchandise. Another responds by noticing that Costco only accepts cash and so offers generous credit terms to virtually all comers. A third does nothing, watching its volume of business drop precipitously.

The first two strategies lead to higher inventory or credit losses, which push the required margins up rather than down, exactly the wrong response to a new, efficient competitor. The third (do nothing) strategy leads to the same high fixed costs being spread over an ever smaller base of business. In the venture capital industry, a 2% annual management fee quickly becomes 10% if only 20% of the available funds are deployed.

Fixing the Pipeline

Is the venture capital industry doomed? As a distribution channel, are its costs too high structurally ever to permit access to quality opportunities? Are the ad hoc financing sources which

have accounted for the recent disintermediation of the venture capital industry destined to become the only available sources of equity capital for small businesses?

Strategic solutions do exist which can make the venture capital industry viable, albeit on a different basis. There are at least four:

1. The initial and biggest step is for venture fund managers to become more cost-effective and efficient. This can happen one of two ways. Either the fund manager can decide it is not going to be an active part of the management teams of its investments, in which case the investment decision process and the monitoring process must be made at least 10 times faster and more efficient in order to amortize the fund's high administrative and staff costs across many more investments and more invested dollars. Alternatively, the fund manager can take on business opportunities that are not established to the point where they are financeable elsewhere, and become an active hands-on developer in building those businesses. The fund's overheads can then be defrayed, at least in part, through a proper cost allocation of the fund's professionals to the businesses being developed [3].
2. Funding institutions must be more realistic in their expectations of venture capital funds, and in communicating those expectations to the venture fund managers. It is of little value for the funding institution to expect and be satisfied with 15% compounded if the fund manager thinks that it is supposed to deliver 25%, and prices its investments accordingly.
3. Funds should only be drawn down as required for investment purposes, so as to avoid the performance drag which results from carrying cash on hand. Alternatively, returns from cash and from investments should be measured separately, with only the net investment returns being

"...strategic solutions do exist which can make the venture capital industry viable..."

used to evaluate the fund manager's performance.

4. In order to eliminate the performance drag of the traditional 80:20 sharing formula on investment income and gains, the fee structure should be changed in favour of one that only rewards performance above the minimum established rates of return.

These structural changes can break the vicious cycle of high distribution costs leading to expensive deal terms leading to adverse selection. In fact, the same cycle works in reverse. As the venture fund's minimum required rate of return drops from 40% to 20-25%, the higher quality opportunities come back, reducing loss rates and taking more pressure off the hurdle.

A very important side benefit also develops. By virtue of the lower hurdle rates, many more businesses become eligible investment prospects. Currently, only the jazziest of companies have the opportunity to double revenues every year and generate 40% rates of return. There are many more businesses that are stable, well-managed, low-risk and capable of solid, though not spectacular, growth. For these companies, a 20-25% return is often achievable. Thus, the universe of opportunities available to the venture funds expands dramatically, and the number of companies that have realistic access to venture capital expands dramatically.

A New Player: The Labour-Sponsored Venture Funds

It will be very interesting to see what strategies the labour-sponsored venture funds adopt. These funds have received heavy subsidization of their start-up costs; fund units are RRSP eligible; and generous tax credits accrue to the purchaser of the units, without reducing the adjusted cost base of the units. Even if one ignores the front-end subsidization and the RRSP eligibility, the tax credits alone mean that these

funds are working with only 60-cent dollars.

If the fund managers see the tax credits only in the narrow sense of having motivated individuals to part with their money, and then go on to run the funds in a traditional way, as if they were working with 100-cent dollars, they will run into many of the structural and other difficulties described above, as well as some new ones.

But if the fund managers view the tax credits for what they really are, which is a subsidized cost of funds, and lever aggressively off that low-cost funding base by offering attractive financing terms to entrepreneurs, they will be in a position to attract the very top tier of opportunities. Realistically, there is no segment of the capital markets – retail, public or institutional – in a position to offer funding as inexpensively. The Costco's of venture capital!

So, will the labour-sponsored venture funds use their subsidized funding to price aggressively and go after quality market share? Or will they overlook their strategic advantage, attempt to pass the economic benefits along to the investors rather than the clients and simply blend in with other private equity participants?

The key related issue then becomes how the other, non-subsidized private equity participants respond to the tax-assisted fund strategies. If the tax-assisted funds adopt the Costco strategy (as they probably should), and if the major institutions are unable to obtain similar government subsidization for their private investments, the institutions and their funds of choice will have no alternative but to gravitate ever more toward the full-service developer role, where the returns are earned through active development, turn-around execution, acquisitions and so on, rather than simply accrued via the investment security.

Venture Funds Must Decide Which Strategy to Pursue

As usual, there's no free lunch. In today's capital markets, the venture capital fund that adheres to the requirement of finding zero-defect, zero-risk deals at a price that will generate a 40% compound rate of return will find itself with no investments. High returns can be generated if the fund takes on 'raw land' – basic opportunities without all of the pieces in place – and develops those opportunities.

Alternatively, the venture capital distribution channel must be streamlined as described above in order to bring the distribution costs down to a level where passive venture capital funds can compete in the capital markets. Once the costs have been brought into line, the field of opportunity expands dramatically as many more businesses have the potential to meet the lower hurdle rates.

A big unknown is the labour-sponsored funds. If they elect to price aggressively, the passive option may not be viable, even with reduced distribution channel costs. It's tough to compete if your cost of funds is 67% higher than the competition's. The only viable option may therefore be for the distribution channels to become active developers rather than passive investors.

Notes

- [1] Jim Fletcher has spent the past decade in the Canadian venture capital industry. His current focus is on developing complete management teams and financing programs around new product/market opportunities. His last article in Canadian Investment Review appeared in the Spring 1990 issue.
- [2] As an aside, it is worth noting that unduly protracted due diligence and decision processes can often be not only expensive and unproductive, but actually counterproductive. For every hundred hours invested by a venture fund manager in researching and analyzing an opportunity, the target company's management probably spends several hundred hours. In a world with ever shortening product life cycles, this inordinate distraction from building the business can seriously undermine the overall chances of success.
- [3] But there is no longer room for the traditional 'mixed' function, which involves high levels of 'professional consultation', but does not produce results that can easily be accepted by the investments as legitimate costs of doing business. An excellent recent example of both of these strategic thrusts was the investment by Helix Investments in Geac. The due diligence process and decision time were short; the funds deployed were substantial; and Helix assumed the role of controlling shareholder in developing new strategies and recruiting new management, including installing Helix staff on a full-time interim basis. Geac is today performing very well indeed.

"...it will be interesting to see what strategies the labour-sponsored venture funds adopt ... these funds are working with 60-cent dollars..."

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