

WHERE IS GOVERNMENT FALLING SHORT?

THERE IS STILL MUCH WORK TO BE DONE BY OTTAWA TO FIX THE SNAGS HOLDING BACK VC GROWTH IN CANADA

By John Varghese

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The Canadian venture capital industry is at a crisis point and help is needed NOW to fix it. Venture capital is an important contributor to the economy and should be a part of each government's policies and initiatives. Whether they like it or not, the federal government needs to play a more active role to become a part of the solution.

The facts and figures are in and have been reported in numerous studies, and it is an irrefutable fact that Canada faces a severe VC shortage.

The amount of money invested in or available to be invested in VC firms has been declining. In fact, 2009 was the lowest year on record in the past 13 years for VC money invested in Canada, with 27 per cent less invested than in 2008. The lack of funds available to VC firms means that there will be less and less money available to fund innovations and innovative companies. Without innovation, we will fall behind as a nation on a global basis. How will Canada compete?

In Canada, the two ways to raise a VC fund are through institutional limited partner investors and from individual investors through retail venture capital programs known as labour sponsored investment funds (LSIFs). My company VentureLink has commenced raising an institutional fund. In our tour across the country, we have learned there are currently just four potential LP investors. That's right, four.

That leaves retail as the only viable source of capital. Presently, retail investors get a 15-per-cent federal tax credit for a maximum contribution of \$5,000 annually plus the relevant provincial tax credit, which varies province by province. This investment

is RSP eligible, thus the investor, depending on their personal tax rate, can get credits (RSP and LSIF combined) that total over 70 per cent of their cost base when they file their annual tax return.

Recommendations only

The House of Commons Standing Committee on Finance, in its prebudget report this year, had the following recommendation: "The federal government works with the venture capital industry to identify new sources of financing and examine the effectiveness of existing tax incentives related to financing. Moreover, the government should review the feasibility of increases to the labour-sponsored tax credit to 20 per cent of eligible investments, to a maximum eligible investment of \$20,000."

Proposals similar to this have been included in the past two federal pre-budget consultation reports. Yet for unexplained reasons, the recommendations have not made their way into the final budget. The federal contribution limit and the federal tax credit have not kept pace with the increases in RSP contribution limits nor with enhancements made at the provincial level.

With the dramatic exception of Ontario (time to rethink Premier McGuinty!), the provincial governments have made positive changes to their respective LSIF programs. Quebec has increased the provincial tax credit from 15 to 25 per cent. Down east, the contribution limit has moved to \$10,000 and the credit to 20 per cent. Saskatchewan increased the tax credit to 20 per cent, and in British Columbia the contribution limit is \$13,333. In Manitoba it is \$12,000.

Federal and provincial governments do a good job in creating some early stage programs. VC firms help

take early stage companies to commercial viability with a combination of money and expertise through an active investment process. This is a long and capital-intensive process that averages anywhere from three to eight years, or longer in the case of bio-tech companies.

Funding gap

Without a vibrant VC industry, it could be argued that the large amount of money being spent on early stage programs by the government is for naught. The funding gap at the VC stage means that next stage of funding is limited and the majority of companies that receive assistance will fail to get their concepts to the market.

The CVCA has five recommendations as it pertains to venture capital. To be fair to the federal government, it addressed one matter in the 2010 Budget. Section 116 has been removed and thus an obstacle for foreign investment has been eliminated. It has taken most of a decade for this easiest of problems to be fixed. We don't have the same luxury of time for the remaining proposals to be accepted.

Our large institutions no longer support investing in the venture capital sector as LP investors. If institutions are not going to fund these programs, then it's time to encourage the federal government to follow through on the recommendation in the pre-budget consultation report.

The federal cost of the LSIF program, as recommended, means that it costs \$20 for every \$100 raised. Each \$20 creates \$100 of available investment dollars. The cost is only incurred if and when the money is raised. That means the leverage is five to one in terms of benefit to cost. Very few programs that are run by the government provide such returns. The money raised is used to invest in innovative Canadian companies that help create jobs and boost the economy. Payroll taxes alone help recover most, if not all, of the expense.

Improving the LSIF program federally by enhancing the tax treatment as recommended by the Standing Committee on Finance, while not a complete solution, is a near-term, present-day solution that can be implemented to dramatically improve the prospects of an industry in crisis.

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