

CANADA'S VENTURE-CAPITAL POOL KEEPS GETTING SMALLER

INDUSTRY PARTICIPANTS WARN THAT FAILURE TO FUND INNOVATION WILL BE CANADA'S LOSS IN THE LONG RUN

By Paul Brent

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Venture-capital investment has been on a long skid in Canada, falling by 27% in 2009 compared with the previous year. But don't blame the economy or the equities markets for that.

"The venture-capital industry had been declining even before the economic crisis," says Gregory Smith, president of **Canada's Venture Capital & Private Equity Association** (known as the CVCA) in Toronto, "which has just served to enhance the current difficulties of entrepreneurs, small businesses and growth companies in obtaining financing."

The vencap industry's statistics are grim: just \$1 billion was invested nationally in 2009 vs \$1.4 billion in 2008. And fewer companies shared in that shrinking money pot, as a total of 331 firms received financing last year, down by 15% from 388 the year prior. Among companies that did receive vencap funds in 2009, they received just \$3.1 million in financial backing on average, compared with \$3.5 million in 2008 and \$5.1 million in 2007.

Canadian companies looking for vencap financing received dramatically less than their U.S. peers, on a percentage basis, in 2009. Canadian companies received 40% less vencap financing than their U.S. counterparts. That is the largest gap in U.S./Canada vencap financing since 2005.

The epicentre of the decline in Canada is in Ontario, where vencap financing has all but disappeared. A decade ago, investors in the province pumped \$3.5 billion in vencap financing into businesses. Last year, vencap funding in Ontario accounted for a paltry \$288 million, down by almost half from the \$588 million tallied the year before.

The decline in vencap activity in Ontario and in much of the rest of the country reflects, in part, the international mobility of capital, says Smith: "We operate in a global capital market, and we see other jurisdictions compete and have very successful programs. An example is Israel."

The huge markets of the U.S., China and India are also increasingly attempting to persuade capital-hungry Canadian firms to relocate to their countries. Says Smith: "Canada, as it looks to position various industries for the new economy — such as green technology, clean technology, life sciences and agricultural technology — has to recognize that we are competing on a global stage."

A closer examination of the data by province shows the downward vencap trend could be reversed with some co-ordinated efforts. Although Ontario's tax laws have stopped supporting labour-sponsored funds, Quebec has become a major vencap player in that sector, thanks to a government-orchestrated program and both institutional and retail investors. Last year, vencap investment in Quebec grew to \$431 million, up by 10% from the previous year and accounting for 43% of all vencap disbursements in Canada last year.

"Quebec will bring in between \$600 million and \$1 billion in its retail funds this RRSP season, and Ontario will struggle to get \$50 million," says John Varghese, CEO and managing partner of **VentureLink LP**, a Toronto-based labour-sponsored fund company, and a director of the CVCA. "We are falling behind as a province, and I think we should be the leader if we are [to be the country's] economic centre. When you think of venture capital in North America, San Francisco, Boston and Toronto should all be in the same breath."

The CVCA describes the vencap fund-raising environment in 2009 as “tepid,” noting that only \$995 million in new commitments from investors went into vencap funds. That’s about even with the \$1 billion committed the year prior. Fundraising from investors, as well as the amount paid out to companies seeking vencap, did rebound in the fourth quarter of 2009, with \$388 million committed. Private funds made up 53% of new investment capital last year, or \$527 million, although this amount is a 27% decline from 2008’s tally.

Vencap financing is still a relatively young industry in Canada, Varghese says, and the lack of a long-established investment culture has hampered its growth.

To prosper, the vencap industry requires “strategic commitment” from government with regard to investing in new, rather than “old” economies; a recent example, in Varghese’s view, is the \$10-billion bailout of auto manufacturing in Ontario last year: “While I understand that we needed to do it, if we put \$1 billion into venture capital, I guarantee you that in five years, we will create more jobs and we will have a better impact on contribution to the gross domestic product in terms of how we move forward as a nation.”

VentureLink’s Brighter Future Fund, which invests in technology and clean technology, says Varghese, “is one of the only funds in the country with fresh capital available to invest in new companies.”

He worries that the lack of vencap funding has “squashed the entrepreneurial spirit” for a generation of businesses.

“If you were an entrepreneur in 1999,” he says, “you might have left your day job at Nortel Networks Corp. because you had the next greatest idea and you thought there was a way to fund it.”

One of Canada’s great technology success stories, Waterloo, Ont.- based Research in Motion Ltd., received key vencap financing in the early 1990s. RIM announced in 2008 the creation of the \$150-million BlackBerry Partners Fund, in partnership with **Royal Bank of Canada**, Thomson Reuters Corp. and several private Canadian investors. According to the fund’s backers, BlackBerry Partners has been established to finance “the best emerging mobile applications and services.”

Last year, the CVCA released a five-point plan of “practical, modest initiatives” it wants the federal and provincial governments to implement in order to support companies seeking to commercialize research and development activities. The CVCA wants governments to: establish and grow fund-of-funds structures; make improvements to the scientific research and experimental development tax credit program; improve incentives for corporations to invest in vencap funds; promote investment in Canadian vencap funds as part of the offset agreements struck with major government contractors; and improve the attractiveness of vencap investments to retail investors.

“This is a nascent industry in Canada, and it needs a good push from government,” says Doug McDonald, a **Deloitte & Touche LLP** corporate finance partner in Toronto and a CVCA director. Although there have been some vencap-supported technology success stories, he says, “The volume certainly isn’t there.

“To create volume,” he adds, “you need the people who are going to invest at the seed and early stages, pre-commercialization levels to get things moving along. If you don’t have a strong tech sector, there is a complete piece of the capital markets that is missing.”

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