



INFORMATION TECHNOLOGY
ASSOCIATION OF CANADA



ASSOCIATION CANADIENNE
DE LA TECHNOLOGIE DE L'INFORMATION

The Issue:

Building a Strong Venture Capital Climate in Canada

Capital is one of the vital ingredients in the formation of robustly competitive information and communications technology companies. Canada's venture capital industry has been challenged on a number of fronts recently and in need of stimulus. In January 2013, the Federal Government announced the Venture Capital Action Plan deploying \$400 million in new capital. The plan identified the following elements.

- \$250 million to establish new large private sector-led national funds of funds in partnership with institutional and corporate investors as well as interested provinces
- Up to \$100 million to recapitalize existing large private sector-led funds
- Up to \$50 million in three to five existing high-performing venture capital funds

The Venture Capital Action Plan was developed after a national consultation process. ITAC, as a community of R&D intensive investee companies, submitted the following perspectives on the question posed in the consultation:

What are the key challenges facing high growth firms in Canada in accessing the capital they need to innovate? What are the unique challenges confronting early or late stage

companies or those in different industry sectors?

The Information and Communications (ICT) industry is the most mature of Canada's knowledge-based sectors and is the most research and development intensive industry in the economy. R&D cycles in our industry range from a few months to many years from product inception to market entry and revenue creation. This relatively long gestation period characterizes ICT ventures as high-risk with the potential of high reward deferred over what can be a long period of time. Typically ventures created to introduce a new ICT product or services are not built on loan financing. Financing in ICT generally begins with a 'friends and family' round supplemented over the innovation by rounds of funding derived from angel investors, venture capital firms or a combination of both. As a company evolves into revenue production and profit, it must continue to feed its R&D engines to maintain competitiveness while investing in operational functions such as sales and marketing. Its continual demands for capital to fuel growth will precipitate additional funding rounds and potentially even a drive to take the company public with an initial public offering. The pathway from start-up to publicly traded company is fraught with challenges that make the chances of building a large Canadian company capable of competing or leading in the

global marketplace slim indeed. Many of these challenges stem from the acute dependence on venture capital financing.

The venture capital industry in Canada is relatively small, immature in comparison to other jurisdictions and also comparatively risk-averse. Additionally the venture capital industry itself has faced serious challenges since 2000 and is only now beginning to recover from a serious decline in deal flow.

In sum, venture capital is essential for the growth and success of companies yet it is difficult for even the most seasoned ICT entrepreneurs to find the capital they need in Canada. This results in a number of conditions which inhibit growth.

Firms are chronically underfunded. The scarcity of capital leads many start-ups to reduce their targets. Underfunding means subsequent rounds follow at shorter and shorter intervals. This persistent quest for funding is a drain on executive capacity. Many entrepreneurs exhaust themselves or sacrifice other dimensions of business development in this financing 'hamster wheel'. Underfunding leaves firms more vulnerable to acquisition or, worse, failure.

Firms that cannot find Canadian financing are forced to seek financing in other jurisdictions. Generally speaking, foreign investment in Canadian companies is perceived as a positive thing. But many promising Canadian start-ups have learned that many foreign investors like to keep a close eye on their investments. Many companies have been required to relocate their ventures from Canada closer to the source of their funding. This is generally a one-way journey with the innovation and enterprise of the start-up founders frequently lost to Canada. As a result, Canada becomes a feeder system for the international hunt for talent and loses economic growth opportunities.

With so few VC options in Canada, it is particularly difficult for Canadian companies to find investors who align with the company's objectives for growth and can set objectives beyond the typical 3-7 year investment timeline and an artificial ROI requirement which may not reflect the economic realities of the time. Most VCs in Canada have little or no operational experience with knowledge-based firms. As a result, few are in a position to help young companies grow their businesses. Investees in the ICT community discern the difference between money and 'smart money'. Smart money is venture capital that comes with other assets that facilitate company growth. These include executive and governance expertise and access to key customers and markets. 'Smart money' also comes with a willingness to align with the long range growth plans of the founders. Not all entrepreneurs create technology ventures with a view toward early liquidity. Many, particularly those more seasoned, aspire to create a large global venture or to develop a truly transformative technology. In a tight VC market, entrepreneurs on that path find it particularly challenging to find 'smart money'. If we are to build robust knowledge-based sectors in Canada, we need to increase our supply of VCs prepared to invest for long-term growth.

Canadian firms frequently pay too high a price for capital. In an environment where capital is scarce, firms frequently are forced to make less than optimal decisions about the terms of their funding, ceding more control for the money than comparable firms in other jurisdictions. This leads to more rapid dilution and contributes to earlier exits than might be possible in a healthier capital environment. ITAC believes that this is one of the factors that has led to the accelerating rate of mergers and acquisitions in ICT.

The challenges that companies face are further exacerbated the further away they are from the locus of venture capital which is primarily Bay Street, Toronto. Growing a technology venture

is not for the faint of heart. Those who do so in Atlantic Canada or the West are particularly brave.

Working capital to fuel transformative technologies or technologies with a hardware component is in particularly short supply. Firms in the ICT space have found that venture capital firms are averse to providing working capital for hardware inventories and also companies with longer than usual development cycles.

What barriers do Canadian and international investors face in participating in venture capital markets?

As the voice of the ICT industry, ITAC is better qualified to comment on challenges faced by investee firms than by investors. However, our community contains many entrepreneur investors who have channeled personal wealth into promising technology ventures. While this activity is an important part of the investment ecosystem, there is virtually no encouragement or support for it. This has prompted ITAC to advocate measures such as angel tax credits or flow through shares which we believe would increase the volume of this vital activity.

Emerging markets particularly in Asia, Latin America and the Middle East will increasingly play important parts in the growth and success of Canadian companies. Typically, Canadian VC firms are not well connected in these markets. Venture Capitalists who do function internationally are affected by the strength of the Canadian brand. Canada has many exciting technology ventures and can punch above its weight in terms of global ICT. But more needs to be done to promote and showcase Canadian ventures internationally and to strengthen our national brand.

In delivering the \$400 million announced in the Economic Action Plan 2012, what models of venture capital support should the government consider in order to encourage private sector participating and investment?

Should a priority be placed on attracting corporate strategic investors, foreign venture capital participation, or some other form of private sector investment?

Two basic principles must guide the development of a support model. First, the model must be designed for maximum leverage. By the estimate of many industry observers, the \$400 million identified for this purpose represents about one-eighth of what is required to restore the Canadian venture capital climate to health. Clearly a focus on return and leveragability must be paramount. A one-time only investment of \$400 million will have very little impact on Canada's ability to grow 21st century businesses, especially knowledge-based ventures. So the model must be sound enough to attract private sector partners in sufficient numbers to maximize the impact of this investment.

But at the same time, we must resist the temptation to create an instrument that looks and functions like every other fund or financial institution in the marketplace. The infusion of \$400 million of public money is an artificial device in the free venture capital market. It must therefore be designed to fulfill other objectives than those that guide private sector fund creation or we risk replicating, with significant public funding, market inefficiencies that currently exist. To avoid this, the model must have explicitly expressed objectives beyond simple return on investment.

For example, there is a well-recognized shortage of what we have described as smart capital – capital that comes with alignment on the growth strategy, augmentation of executive capacity and access to markets and supply chains. These characteristics must be built into the model.

Currently there is also an aversion to investment in long term transformative technology – exactly the kinds of technologies that have built global leaders in Canadian

technology in all sectors including ICT. The current bias in ICT funding is toward the shorter development cycles in software particularly in the fast paced application software. A fund of the nature currently under consideration must be prepared to go where market-oriented funds do not.

Similarly, a fund of this nature should be unapologetic about non-financial objectives. It must not exist exclusively to make entrepreneurs and investors rich though that is a critical sustainability factor. But a fund of this nature should have a clear and explicitly expressed capacity building objective. It should aim to fund and build enterprises and sectoral growth.

Additionally a fund of this nature should aim to address and equalize other disparities in the Canadian landscape. Companies in Atlantic and Western Canada face higher hurdles in their search for capital than those in central Canada. Companies led by women are similarly disadvantaged.

The model should also aim for operational differentiation from other funds. It should be positioned and staffed for swift decision making. It should have a growth strategy carefully gated by the achievement of specific key performance indicators. The fund should also be equipped with a strong communications arm. Canadian companies in our sector are significantly undervalued in comparison to U.S. competitors. Powerful communications about exciting Canadian investment opportunities can propel investment interest in Canadian technology ventures in the institutional and retail as well as the VC space. Proceeds from financing exits should be reinvested in the fund to ensure sustainability.

In terms of prioritizing potential partners, we note that many leading technology companies in ICT have recognized the virtues of investing in Canadian ventures. We believe that this activity could be expanded with appropriate

encouragement and incentives. These should also include broader communication and promotion of Canada's highly competitive corporate tax rate. Foreign venture capital is a rich vein of funding to tap but, as mentioned before, foreign investment at the enterprise level frequently leads to dislocation and loss of the innovation, the talent and the growth opportunities. Participation of the Canadian Government in a fund with foreign investors should explicitly mitigate against this.

Consideration might also be given to new ways to attract domestic retail investors. The most rapid growth in our sector occurred when retail instruments played a much bigger role than they do today. Our experiments with those instruments are not viewed as successful. However, that should not preclude the examination of alternative measures to encourage retail investment.

Does Canada have the right mix of large-scale and small-scale funds? Should a portion of public support target any particular stage of company development?

These are highly disputed questions. Emerging companies believe there is a shortage of early stage capital. Established companies insist that late stage financing is in short supply. Logic dictates, however, that without sufficient early stage funding, there won't be enough established companies to require later stage funding. Empirically establishing the gaps in the Canadian venture capital environment is a critical first step in the creation of this fund.

Once the gaps are identified, this new initiative must be ready to operate in areas of the marketplace where current private sector funds do not.

What criteria should the Government consider in allocating the new resources to support venture capital in order to meet the objectives outlined above?

ITAC believes the criteria should be as follows:

- Investees must have HQ in Canada with key roles and risks retained in Canada and providing employment in Canada.
- Partners and investees should manifest a clear and committed strategy for long term growth.
- A tolerance for investment in “transformative” technology should be part of the blueprint.
- Resources should include executive expertise, supply chain and market access as well as capital.
- Resources should be allocated to redress geographic and other disparities.
- Governance of the fund must take a multi-stakeholder approach including investors and investees in order to ensure that the charter objectives of the fund are met.

Submission was to “accelerate the pace of the Venture Capital Action Plan”. We note “the VC industry to hold its breath waiting for the action plan to unfold ... this has created a very difficult environment for companies seeking funding.”

ITAC will continue to press for action from the Action Plan and continue to represent a strong voice for the investee community in all matters relating to venture capital.

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The Venture Capital Action Plan is doing a number of things right. For example, it clearly seeks to maximize the leverage possible from its \$400 million investment through relationships with the private sector. And the public profile of the Action Plan and the resources deployed to execute it create vital opportunities for communication with institutional investors about the risks and rewards in venture capital activity. The Government is providing important leadership in this area. And we were also pleased to see that \$25 million of the funding for existing high-performance venture capital funds went to ICT-focused funds Summerhill Ventures and Real Ventures Fund III.

There is no question that the Venture Capital Action Plan will be good for all emerging technology firms. ITAC’s chief concern is not with its design but its pace. The number 1 recommendation in our 2014 Pre-Budget