In the constant quest to unlock the mysteries of innovation, it is inevitable that some eyes fall on Canada’s venture capital industry as a potential key to cracking the code. Canada’s venture capital industry has struggled for the last decade, delivering underwhelming returns to investors and failing to develop the kinds of new industries and world-beating companies that regularly come roaring out of Silicon Valley. So Ottawa’s decision earlier this year to inject $400 million of taxpayers’ money into the industry has been welcomed by some innovation observers. They see it as a good first step toward reversing that woeful record, a steroid shot to help Canadian start-ups join what new economy writer Chris Anderson calls the “industrializing of the do-it-yourself spirit.”

But Ottawa must take into account the evolving nature of the global venture capital industry. Its cash will be chasing Canadian entrepreneurs who have options. There are also new players and models for financing start-ups. Google has entered the venture capital game with Google Ventures, and in 2009 super-angel investors Marc Andreessen and Ben Horowitz built on their record of spotting leviathans like Facebook, Skype and Twitter to form Andreessen Horowitz, raising $2.7 billion in three years. Both these firms offer a deeper expertise in design, engineering, political connections and, in Google’s case, access to big data analytics, than the industry has been able to muster in the past.

Other investors are tapping the potential of “crowd-funding,” a Web-based fundraising practice that allows start-ups to raise up to $1 million collectively from hundreds or thousands of small-investor donations. Crowd-funding was part of the Obama administration’s American Jobs Act earlier this year, turning “donors” into legal investors, though the regulatory details remain to be worked out. (A popular movement is afoot to bring crowd-funding to Canada, but for the moment provincial regulations restrict it.) And despite a track record of carnage in some places, other countries continue to throw money at the start-up game, trying to replicate Silicon Valley.

Ottawa’s money is part of its response to the federal Expert Panel on Support to R&D, chaired by Tom Jenkins, but the Conservative government has yet to fill in details of how it will operate. The articles here tackle some of the issues that must be addressed. What should be the mix of public and private funds? Is $400 million enough to make a difference? Is public money doomed to pursue political goals, pumping up particular regions or industries the market ignores? And above all, will more and better venture capital funding truly be that ticket to innovation?
Venture capital has its virtues but it is not the magic bullet for greater innovation, argues Harvard Business School’s Josh Lerner. The limitations of venture capital include investors’ frequently short attention spans, a one- and two-year approach to picking industries that can lead to overlooking start-ups.

Le capital-risque a ses avantages mais n’a rien d’un panacee magique pour stimuler l’innovation, soutient Josh Lerner, de la Harvard Business School, qui cite parmi ses limites une approche de ciblage pouvant mener au surinvestissement des entreprises en démarrage ainsi que l’importance de la capitalisation des entreprises en démarrage et l’importance de l’investissement des partenaires de capitalisation. 

Bruce Wallace
Le mot du rédacteur
POLICY OPTIONS
NOVEMBER 2012

PHOTOGRAPHY

Josh Lerner is the Jacob H. Schiff Professor at Harvard Business School and the author of The Architecture of Innovation (2012), from which this essay is adapted.

A second critical limitation is that the venture market is extraordinarily uneven, moving from feast to famine and back again. Consider the tremen-
dous surge in funding for biotechs, peak-
ing in 2006, and again in social media companies during the last two years. During booms, unjustified exuberance rules, a common phenomenon known as “money chasing deals.” As more money is thrown into the proverbial bucket, institutional and individual investors, venture capitalists are willing to invest in ever riskier deals (and often on worse terms). The share of first-round venture dollars going to seed-stage companies — those whose prospects are least certain — has varied from a low of 24 percent in 1995 to a high of 58 percent in 2000-01. To
day that percentage has climbed again, reaching 61 percent in 2011. Moreover, this risk-taking is not rewarded: returns in boom years such as 2000 are among the lowest seen in any period.

Cycles in the venture industry stem largely from the behaviour of funds themselves. During hot markets, inexperienced groups raise capital, often pursue the same opportunity, each hoping for a share of the exuberant market. As venture groups grow, they increase the capital that each partner is responsible for and broaden the range of industries in which they invest. What starts as a trickle ends as a torrent. Ultimately the expansion proves unsustainable as investment returns fall. Then the cycle repeats itself all over again.

Government policies can amplify these cycles as well. The experience of the Canadian Labour Fund Program in the 1990s provides a good example of this danger. A number of provincial governments, seeking to encourage venture capital, established tax credits for these funds in the 1980s and 1990s. The amount of capital investors put into labour funds grew spectacularly in response to these investments; the venture market that pool climbed from $100 million in 1992 to $7.2 billion in 2001. But the funds that were estab-
lished and the capital raised were far from inspiring. Multiple analyses suggest that the bulk of the funds raised were invested by inexperienced groups in a very problematic manner. In many instances, these uninform ed investors were willing to commit capital at huge valuations. Many of these groups, not affiliated with the program, were convinced that they could not generate profitable returns in the Canadian market, and shifted (at least temporarily) to investing in the United States. Thus not only did this program lead to an unsustain-
able level of investment, but it actually drove away the most knowledgeable investors.

Whatever the precise mechanisms behind it, the boom-and-bust cycle can negatively impact the flow of innovative capital, at least in the short run. For instance, during the deep venture trough of the 1970s — no venture capi-
futal funds at all were raised in the United States in 1975 — many companies that sought to pioneer new comput-
ing languished unsung. Ultimately, these technologies surfaced with a rev-
olutionary impact in the 1980s (with the help of venture investors), but their emergence might have been accelerat-
ed if the venture market had not been in such a deep funk. It is hard not to feel that many long-term, expensive invest-
ment areas, such as clean tech, manufactur-
ing and biotech, are in exactly such a trough today. While venture capital may be part of the innovation solution, it is not a panacea.

The overfunding of startup firms during booms carries its own nega-
tives. Examples include the frenzy surrounding the Internet companies B2B and B2C in the late 1990s. The result is waste. Multiple companies pursue the same opportunity, each company often more marginal than the last. The initial market leader’s staff is poached by the me-too follow-
ers, disrupting the progress of the firm in the best chance of success. More-
over, once the overfunding subsides, the firms that still survive struggle to attract funding in an atmosphere that is now often poisonous.

So when do booms turn to busts? Venture capitalists depend critically on acquisitions and the public stock markets to help them exit their investment and return capital to their investors. But the public markets are fickle. During the past decade, soaring enthusiasm for clean tech in 2006-07 and social media in 2010-12...
CULTIVATE ENTREPRENEURS AND VENTURE CAPITAL WILL FOLLOW

Marcel Côté

Much of the discussion of how to improve venture capital in Canada focuses on the perception that the industry is underfunded. But Marcel Côté argues that Canada should be concerned with cultivating entrepreneurs, not venture capitalists. Silicon Valley succeeds, he argues, because it attracts entrepreneurs first. Where entrepreneurs congregate, venture capital naturally follows.


Venture capital is generally perceived as being critical to any growth strategy, an essential element for the development of the new economy. But to what extent is fixing the lagged Canadian venture capital industry a key to creating the new businesses in emerging sectors the wider economy so badly needs?

Take 2011, a good year for the venture capital industry. Canadian venture capital firms invested in 444 companies, only one-third of which were first-time investments. In other words, Canadian venture capital firms helped around 150 new entrepreneurs launch their businesses, with $300 to $400 million invested. For context, there are over a million businesses in Canada, and about 100,000 new ones are created every year. The 150 new businesses supported by venture capital amount to specks in the Canadian business universe.

It is true that some of these venture capital firms are those with the greatest potential. In Profit5 magazine’s annual list of Canada’s 50 fastest growing firms, venture capital firms are typically found backing about one-third of these companies. Venture capital targets these high-potential start-ups, usually in sectors connected to emerging technologies. But while roughly two-thirds of the Canadian venture capital industry investments are in information technology and life sciences, the majority of new businesses in these sectors do not receive any venture capital backing at all.

Providing more government support to the venture capital industry will not change this reality. Venture capitalists may be astute investors but they still miss many opportunities, turning down entrepreneurs that wind up being very successful. Venture capitalists like to brag that they invest only in one deal out of fifty that they’re pitched, long odds that leads to them rejecting many businesses that turn out to be winners.

Furthermore, many entrepreneurs would rather build a new business without turning to venture capital, seeing the industry as greedy for big returns and unable to bring any significant value to the table beyond money. Indeed, not only do venture capitalists seek ambitious annual returns, but they also demand a great deal of control over the companies they invest in. And they must cash in, preferring to sell out within seven years. These are not appealing conditions to many of those with an entrepreneurial spirit.

The result is that the majority of new businesses, including those in the new economy, are still funded by the entrepreneurs themselves and by their “friends and families.” While policy-makers are right to seek ways to stimulate the venture capital industry, it is this essential personal pipeline of investment funding that they must ensure remains healthy.

Much is often made of the desire to create a Canadian version of Silicon Valley, replicating the mix of bankers, suppliers, networks and venture capital that makes the Bay Area a complete ecosystem for developing new technologies and businesses. But the core of Silicon Valley’s success is its ability to attract the best entrepreneurs — many of them Canadian, by the way. Our problem in Canada is not underinvestment in venture capital. Our problem is we do not have sufficient entrepreneurial spirit, and we lack the business and tax conditions to help people with new ideas thrive.

Entrepreneurs and their ideas are the key component of the ecosystem. Where there are good entrepreneurs, venture capital will follow.
The Canadian venture capital (VC) industry faces considerable problems in fundraising because, generally speaking, Canadian funds are too small. One explanation for these fundraising problems is the industry’s chronic underperformance. Part of that poor track record is due to geographical constraints and the prevalence of funds that were either too small or poorly integrated into the North American and global ecosystem and produced poor financial returns.

To address this situation, the Quebec government, the Caisse de dépôt et placement du Québec and labour-sponsored funds initiated a series of moves that have been successful and supported by a team to manage portfolios over a long-term vision requiring persistence and continuity.

The situation in Quebec in the early 2000s was similar to or even more severe than in the rest of Canada: there was a predominance of government or quasi-government and labour-sponsored funds, whose generalist managers did not have the right profile to invest in technology start-ups. Both public- and private-sector funds also had weak links with the North American and global ecosystem and produced poor financial returns.

Quebec-based funds that invested almost exclusively in the province. Such a strategy would have blocked managers from the cutting-edge deal flow and resulted in missed opportunities to hook up with potential co-investors. Instead, the choice was made to invest in the best local teams as well as the best external fund managers. This strategy enabled the Caisse to invest in the Quebec deal flow.

The bet on opening up to the North American ecosystem has proven to be beneficial for Quebec, not only for investment dollars but also in terms of expertise and networks.

The first results of these efforts are now being seen. During the first period (2004-2009), thirteen different investment teams with a strong Montreal footprint have been financed, ten originating from Montreal, two from Toronto and one from New York. In addition, six foreign funds have opened offices in Montreal. Two from the United States, one from Switzerland and one from Israel. During the second period, which is not yet closed, eleven new funds have been financed, most of them based in Montreal and other cities such as Ottawa, Toronto, Vancouver, New York, Munich and Paris. The share of private independent funds, Canadian and foreign, in the total VC amounts invested in tech companies in Quebec has grown from 30 percent in 2003 to 62 percent in the first half of 2012, illustrating the shift toward a private-sector industry. Despite the lack of stringent geographical constraints, the balance of capital is largely positive for Quebec. In total, each dollar disbursed by the sponsors resulted in nearly $3 invested in Quebec companies. The bet on opening up to the North American ecosystem has proved to be beneficial for Quebec, not only for investment dollars but also in terms of expertise and networks.

The first positive performance results are being seen. Expectations that some of the teams will be able to build a positive track record that will help their fundraising for subsequent funds.

So what can we learn from Quebec’s experience?

Two lessons are emerging from the experiences of Quebec: first, that governments require some form of commitment to achieve results, and second, that there is a strong case for governments to support the development of a venture capital industry that is largely beneficial for Quebec, not only for investment dollars but also in terms of expertise and networks.
Injecting more public money into the venture capital industry will not in itself ensure success, say University of British Columbia’s James Brander and Thomas Hellmann, and IRPP’s Tyler Meredith. The reason is that, as the federal government allocates $400 million in new support for venture capital, it must avoid the past pitfall of using the money to meet political goals. It must embrace a system that promotes competition and performance, and work with the provinces to transform how governments support venture capital.

The lacklustre performance of venture capital in Canada and elsewhere over the last decade should focus our attention on how we can improve public policy in this important area. In Canada, the federal government plays a central role in providing venture capital, through the labour-sponsored venture capital (LSVC) tax credit and direct investments by government-backed funds such as the Business Development Bank of Canada. As Ottawa now considers how to spend an additional $400 million in the industry, it is essential to examine whether government support to venture capital is a stimulant or hindrance to greater private-sector investment, if it can fuel the desired expansion in innovation and entrepreneurship and how it can be made more effective. As with any government intervention, the most critical test is whether public money acts as a complement to, or substitute for, existing behaviour. If government sponsorship simply replaces private venture capital that would have been invested anyway, then nothing has been achieved.

The fact that tax credits are linked to the limited number of exclusive licences has created a polarized VC market, where private and government-sponsored funds — well. Entreprenuers with a combination of majority private venture capital and minority government sponsored venture capital (VC) participation perform particularly well.

Research suggests that while there is a discernible role for government policies to facilitate access to financing, the design of these programs remains very important. Injecting more public capital alone won’t necessarily solve the underlying problems.

Canada’s LSVC programs are the primary building blocks of government support for venture capital. Under this model, investments made through a fund formally sponsored by a union or an organization affiliated with organized labour are eligible for a federal refundable tax credit of 15 percent on investments up to $5,000, in addition to parallel tax credits available in certain provinces (Ontario began phase out its own program in 2005). For many reasons, this structure is unwieldy and ineffective. In particular, there is no overriding policy interest we can see as to why government-sponsored venture capital should be tied to organized labour. Although this may have little or no practical edification, the tax rebate appears awkward and cumbersome.

Of even greater concern is the requirement that investors in government-sponsored funds are limited to small, passive retail investors, primarily among the general public. Handling such investments is costly, and they rarely have the expertise necessary to become well informed.

Furthermore, the LSVC program is based on special licences that do not seem to be allocated or reallocated on the basis of market performance. Poor performing funds can survive and retain their licences, while high-quality funds are often prevented from benefiting from government support because they cannot obtain a licence. In British Columbia, for example, a 2010 analysis of the province’s own VC support program, which includes tax-credits for both labour- and non-labour-sponsored funds, found that funds supported by the program posted five-year losses of between 31 and 57 percent when the tax rebate was excluded.

The second, we believe that instead of relying primarily on tax credits as a policy lever, the federal government could benefit from making greater use of matching funds. Consider the difference between a 50 percent tax credit and a 1-to-1 matching fund. In both cases, the government pays for half of the funds raised by an enterprise. However, with a tax credit the investor gets all of the shares of the company that are purchased. With matching funding, the investor gets half and the government the other half. With a tax credit the investor is subsidized and the government receives no direct return (other than the indirect effect of collecting higher tax revenues if the company performs well).

A system of matching funds does not mean that governments should be involved as the investment manager, however. As shown by notable international examples such as the Small Business Investment Company models in the United States or the Innovation Investment Fund in Australia, governments can successfully enable co-investment. Indeed, the final portion of any government-sponsored funds should be made available to private sector. This is an area where pilot initiatives could be particularly useful.

The third element of reform focuses on the relationship between federal and provincial governments. This is particularly important in Canada, which is in many regards a federation of provinces that have different cultures and industries. It is important to develop a federal system of tax credits and other incentives that are attractive enough to draw private capital away from direct investing and toward this kind of more nimble, competitive, and compact system that we need to think bigger than just the $400 million.
Canadian start-ups can emerge from venture capitalism’s lost decade by adopting an ethos aimed at building billion-dollar companies. Chris Albinson argues that Canadian entrepreneurs seeking investors should take advantage of the high number of Canadian expatriate investors in Canada. En vogue for the last 20 years, Canada has lagged behind in private-sector research and innovation for over a decade. Since 2001, the Canadian venture capital industry has been in a downward spiral. Too much capital was invested too quickly at the top of the tech bubble, resulting in poor performance. The result was an end to the conditions needed to seed and nurture start-ups, igniting a series of capital mistakes that may lead to an “own the podium” approach to building a world-class innovation cluster in Canada.

The government is to be commended for its foresight in wanting to ensure that Canadian innovation policy doesn’t repeat the mistakes of the past. There are many entrepreneurs who would like more money, and many financial intermediaries (like LSVCs) who would like additional government support. That is not surprising. But there is no strong evidence to indicate that, without transformation of the current system, higher government funding levels will improve our performance. Instead, the investments announced in the 2012 federal budget should be viewed as an opportunity to reset and refresh the policy framework on venture capital in Canada. Doing so will require active engagement with the provinces so reforms are effectively coordinated and harmonized, particularly within the integrated tax-credit system. But to get to the right end point — a system that is more nimble, competitive and compact — we need to think bigger than just the $400 million.

Chris Albinson is managing director of Founders Circle Capital in Vancouver, British Columbia. He is a six-time entrepreneur based in Silicon Valley who has invested in 52 companies, 22 of them Canadian.
Venture capital is part of that innovation mix, which is understood by Ottawa and the provinces. Currently, the domestic venture capital industry is heavily dependent on taxpayer contributions. This capital helps, but it also comes with numerous political constraints that, while they may be well-intentioned politically, have a different effect than would a relentless focus on producing winners. These political constraints drive an investment policy prone to focusing on the wrong factors, such as favouring a geographic region or picking the wrong managers, sectors and companies.

Venture capital is a very risky business, even when it is unencumbered by these adverse selection requirements. The US venture industry has had some spectacular successes, but as a whole it has not inspired the return of private capital. Improving political conditions on investment will only increase the probability of it being a business to lose money or win small winners. The returns from the taxpayer-backed investments of this decade, given the adverse selection bias, are unlikely to inspire the return of private capital.

So should Canada give up hope for domestic innovation in new industries and focus instead on our traditional dependencies of natural resources and automotive manufacturing? We don’t believe so.

The telecom industry of the 1990s created a world-class innovation ecosystem in Canada that was the foundation for over 100,000 high-tech jobs located in Halifax, St. John, Quebec City, Montreal, Ottawa, Toronto, Waterloo, Calgary and Vancouver. This innovation cluster formed the innovation mix, which is understood by Ottawa and the provinces. Currently, the domestic venture capital industry is heavily dependent on taxpayer contributions. This capital helps, but it also comes with numerous political constraints that, while they may be well-intentioned politically, have a different effect than would a relentless focus on producing winners. These political constraints drive an investment policy prone to focusing on the wrong factors, such as favouring a geographic region or picking the wrong managers, sectors and companies.

Venture capital is part of that innovation mix, which is understood by Ottawa and the provinces. Currently, the domestic venture capital industry is heavily dependent on taxpayer contributions. This capital helps, but it also comes with numerous political constraints that, while they may be well-intentioned politically, have a different effect than would a relentless focus on producing winners. These political constraints drive an investment policy prone to focusing on the wrong factors, such as favouring a geographic region or picking the wrong managers, sectors and companies.

Venture capital is part of that innovation mix, which is understood by Ottawa and the provinces. Currently, the domestic venture capital industry is heavily dependent on taxpayer contributions. This capital helps, but it also comes with numerous political constraints that, while they may be well-intentioned politically, have a different effect than would a relentless focus on producing winners. These political constraints drive an investment policy prone to focusing on the wrong factors, such as favouring a geographic region or picking the wrong managers, sectors and companies.

Venture capital is part of that innovation mix, which is understood by Ottawa and the provinces. Currently, the domestic venture capital industry is heavily dependent on taxpayer contributions. This capital helps, but it also comes with numerous political constraints that, while they may be well-intentioned politically, have a different effect than would a relentless focus on producing winners. These political constraints drive an investment policy prone to focusing on the wrong factors, such as favouring a geographic region or picking the wrong managers, sectors and companies.

Venture capital is part of that innovation mix, which is understood by Ottawa and the provinces. Currently, the domestic venture capital industry is heavily dependent on taxpayer contributions. This capital helps, but it also comes with numerous political constraints that, while they may be well-intentioned politically, have a different effect than would a relentless focus on producing winners. These political constraints drive an investment policy prone to focusing on the wrong factors, such as favouring a geographic region or picking the wrong managers, sectors and companies.