Start Me Up

Will Canada Ever Get Venture Capital on Track?

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?

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QUEBEC GETS AHEAD OF THE GAME

GILLES DURUFLÉ

There is a strong case for governments to support the development of a dynamic venture capital industry — provided numerous pitfalls can be avoided, argues Gilles Duruflé, a leading Quebec venture capital consultant. Duruflé says success requires not only money, but money coupled with expertise, industry and operational expertise, and deep networks. Even if governments play a critical role in financing high-growth start-up companies, they cannot create the deal-flow without relying on the know-how of entrepreneurs and business angels. In Quebec over the last decade the province's venture capital industry has made bold moves to adopt best practices and build on them with a long-term vision requiring persistence and continuity.

Les gouvernements auraient tout intérêt à favoriser l'essor d'un secteur de capital-risque dynamique, croit Gilles Duruflé, à condition d'éviter certains pièges. Car selon ce consultant québécois en capital-risque, toute réussite d'entreprise nécessite de l'argent, certes, mais elle doit être jumelée à une expertise sectorielle et opérationnelle ainsi qu'à de solides réseaux. Même si les gouvernements jouent un rôle clé dans le financement de jeunes entreprises à forte croissance, on ne peut créer de flux d'affaires sans le savoir-faire d'entrepreneurs et d'investisseurs providentiels. Tel a été le cas au Québec, où le secteur du capital-risque a pris depuis 10 ans des mesures énergiques et adopté des pratiques exemplaires selon une vision à long terme qui nécessite persévérance et continuité.

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 bad timing: Canadian venture capital was set back in its early stages because it emerged just as the tech bubble burst. But it was also hurt by insufficient local expertise, onerous geographical constraints and the prevalence of funds that were either too small or poorly integrated into the North American and global VC ecosystems.

Given these problems, Canadian institutional investors avoided the Canadian VC asset class. And without a record of good returns and strong local support, it has also been challenging to attract foreign institutional investors.

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.

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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 saluted and supported by the whole VC industry.

Switch from direct to indirect investment that supports the development of a private-sector industry: In 2004, the government, the Caisse de dépôt and the labour-sponsored funds decided to stop investing directly in technology start-ups and instead joined their efforts to fund specialized private-sector investment teams.

Support specialization and best practices: The shift from generalist managers to specialized and experienced investment teams applying North American best investment practices was not easy. There were very few experienced investment managers in Canada and Quebec. Special efforts were made to link local teams to international expertise and networks, including leveraging the Caisse de dépôt's international network.

Link Quebec firms to the rest of the global VC ecosystem: It would have been counterproductive to invest in only

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 teams that could demonstrate a fit with the Quebec deal flow.

Ensure arm's-length management: From 2004 to 2008, Investissement Québec, the Caisse de dépôt and labour-sponsored funds acted together. But in 2009, they set up an independent management team, Teralys Capital, to invest their second cycle of allocations and manage investments done during the first period. This allowed an independent, professional and stable team to manage portfolios over a longer period of time.

Focus on size, persistence and continuity: Building a critical mass of funds of a minimum size at a time when institutional investors were turning their back on venture capital required predictable public-sector support for more than a decade. Management teams need time to build a track record and to raise funds on their own from private- sector investors. Realizing the size of the effort needed, the Government of Quebec, the Caisse de dépôt and the labour-sponsored funds committed $600 million for the first period (2004-2009) and another $700 million for the 2009-2013 period. Encouraging results are beginning to be seen, though a similar commitment to a third period will be required before the Quebec VC industry can become self-sustaining.

Venture capital is only part of the innovation ecosystem. Successful companies are usually started by entrepreneurs with the financial support of "friends, family and fools" and angel investors, who bring to the table not only money but also their expertise and networks. It took time for the Quebec government to recognize this and stop relying exclusively on institutional venture capital funds. But since 2009, the government has taken a series of measures to support investment by business angels and link them to the venture capital chain.

First, it created technology seed funds, with money awarded through a process in which teams propose innovative strategies to invest at the seed stage and demonstrate they can raise a minimum amount from private-sector investors. If selected, the government matches that original investment on a 3:1 basis. In the information technology sector, this process has led to the emergence of new entrepreneurial management teams strongly linked to networks of business angels, some of which have invested directly in the fund. The impact on the dynamism of the Montreal entrepreneurial fabric has been significant.

Second, the Quebec government has provided direct support to business angels through Anges Québec, a province-wide business angels' network, and through Anges Québec Capital, a fund dedicated to co-invest in deals made by Anges Québec.

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: four 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 proven to be beneficial for Quebec, not only for investment dollars but also in terms of expertise and networks.

And the first positive performance results are being seen, leading to 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?

Many of the decisions taken in Quebec are now considered mainstream by policy-makers and industry leaders, which was not the case ten years ago. These are difficult steps for governments to take with taxpayers' money. It requires long-term commitments without any guarantee of being able to show quick returns. And they require governments to refrain from directing investment traffic toward specific groups or regions.

Creating a successful VC industry requires a long-term commitment of sufficient size, and a determination to manage the tension between local economic development objectives and the essential requirement of opening the domestic industry to external expertise and networks. The Quebec experience shows the advantage of opting for these best practices at the outset and of building on them with persistence and continuity. ■