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Financing Innovation in the Private Sector

*Mary Macdonald**

I could not help but notice when Bob Pavey was doing his presentation, having been the founding president of Venture Economics in Canada back in the mid-1980s, that a lot of Bob Pavey's data sources were PE here in the states. Because the venture industry is a relatively small piece of the total picture, we are disciplined on how we are supposed to account for things and report on things. Thus, you will find consistency in the sorts of trends I want to show you and what is going on in Canada, which at least helps provide some comparative perspective.

It is interesting because the Canadian situation is very different from that in the United States in a number of ways. It does not just have to do with supply of capital. Bob Pavey started his presentation looking at flows of capital into the industry and was quickly able to put it into a box, primarily involving institutional venture capital funds. The bulk of the industry in Canada is comprised of free-standing, what I call privately independent venture groups, that raise their capital from a variety of institutional sources. In Canada, despite the fact that the industry itself is significantly smaller, it is much more complex, and is made up of a more diverse group of players with respect to the funds themselves. And then, of course, that plays back into the source of funds.

I, unfortunately, was not able to actually hear Alan Nymark's comments yesterday, but I did have him send me a copy of his prepared notes. And while he talked about some of the specific and direct initiatives in which the Canadian government is involved, he did neglect to mention, in fact, that there is a lot of indirect government support. A lot of the venture capital industry in Canada today is dependent on what I have described as public/private partnerships. There are some negative aspects to it and some positive aspects to it, but a very large portion of the capital formation today is highly dependent on government policy and incentives to actually encourage that capital to flow.

Let me explain a little about what I mean by starting with a pool

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The following text was compiled from the transcript of the remarks made by Ms. Macdonald at this Conference.

of capital in Canada at present and the composition of that capital. Direct investment by institutional merchant banking type groups are just at the top end of the venture market, but I do not have the equivalent total private equity picture that Bob gave you. On the capital side, this is just a little bit bigger than the venture capital market. But at the end of 1994, we had just under five-and-a-half billion dollars of capital under management. That pool is growing quite rapidly.

Let me take a second, if I may, and just describe the different types of players and the roles they play in the market. We start with the PIs. Those are the private independent groups, the traditional venture capital funds. When I first started tracking this industry back in 1985, I can remember speaking at conferences, and the private groups at that point represented about forty-five to fifty percent of the industry. And I said very confidently we were on a track, I thought, where they would become a bigger and bigger player, and ultimately the Canadian industry and U.S. industry would look very much the same. For the first five years, I was right. And for the last five years, I have been wrong. We have turned around and gone the other direction. Those groups now account for only a third of the total capital under management.

In the corporate context, ten years ago, we had a fairly strong mix between industrial corporations. Companies like Molson's had an active venture group that did a lot of biotech-type investing related to the beverage business. Companies like Miranda had a venture capital arm. Thus, a number of industrial, well-known, large, multi-national Canadian-based corporations had venture capital activities. Additionally, a number of financial institutions like the banks also had venture capital. What we have seen happen in recent years is the industrial corporations have effectively moved out of the business, not surprisingly, in response to the economic conditions of the late 1980s and early 1990s. Some of the financial players eased up and have now come back. So those groups collectively, mostly banks, with independent venture capital account for about ten percent of that base. Government has always played a bigger role in venture capital in Canada than it has here and continues to do so both directly and indirectly.

We also have some government-owned venture capital groups that play a critical role in the market. Michael Robinson mentioned a group, Innovation Ontario, which deals only in the Ontario market. It is owned by the Ontario government, but it makes investments typically of about \$500,000.00, but only in early stage technology companies. Those deals are very difficult for a private, independent firm to justify. They are too small. The transaction costs are high. The risk is high. So the net result is that that segment of the market finds it very difficult to access funds. And in a country the size of Canada, while the angel market is important, it is clearly relatively much smaller. As a result,

those government groups and the federal business development bank, which has a very active early stage technology focus venture capital division, play a key role at the front end of the process.

Hybrid groups, groups we had to create a new name for, are funds that are formed with private sector money, but in response to some form of government incentive to draw that money in. Now, with the exception of one large fund in the Province of Alberta, a company called VanCamp Equities — which was formed with a significant commitment and injection of 200 million dollars by the Government of Alberta, and then private money was raised alongside — the bulk of that money is a rather unusual beast. And I am going to take a minute to describe it, because it really is quite unique.

We call these “labor-sponsored” venture capital companies. They started truly as labor-sponsored venture capital funds in the Province of Quebec with the Quebec Federation of Labor getting the Government to join forces with them saying, we want to raise money from individuals, and we would like a tax credit to do so. Thus, the solidarity fund was created. The fund went out and sold units to individual investors. They were offered a twenty percent federal government tax credit on their investment and a twenty percent provincial tax credit. Those investments were eligible for what we called our registered retirement savings plan. Your standard deductions depend on your income level.

The net result was a significant tax advantage for investing in these funds. The solidarity fund is now a billion dollar fund. The maximum individual investment that can be made in any given year is \$5,000.00. This has clearly become a very powerful fund-raising tool.

In 1988, an equivalent national fund was created, something called Working Ventures. Slow initially in its early years of fund-raising, now it is a five hundred million dollar fund. And we have these funds across the country.

In some places, the linkage with the labor connection is strong, principally in Quebec. In the rest of the country, what is happening is that because of the change in the institutional environment, a lot of traditional venture capitalists are now creating these funds, a sort of rent-a-union joke.

Turning to the sources of capital, there was a billion dollars of new money coming into the industry in Canada in 1994. And as you saw from Bob Pavey’s data, that amount compares with just under four billion dollars in the United States. Thus, we have had a massive inflow. However, it is not quite analogous, because that billion includes all sources, including corporate and government. Whereas, Bob Pavey is really referring principally to private independents. But it is clearly a very, very strong flow with individual investors in Canada becoming the principal source. In the United States where you have pension funds contributing almost fifty percent of the 3.8 billion that is coming in; in

Canada they have effectively chosen to leave the market.

There are a number of reasons for that flight. If we take, over the last ten years, the commitments from the pension funds, and we put the Canadian on one side and United States on the other, the economies are roughly one to ten. So you would expect, in fact, for those two lines to be — if we have got comparable situations — more or less on top of each other. This started diverging significantly in 1990. The only time they have come close to converging since then is when the U.S. market really cratered. And now we have seeing a divergence again. As a result of that and because the critical mass is so much smaller in Canada, there are relatively few players. Clearly, when a couple of the leaders decided that this is not an asset class that appeals to them, they leave, and the followers tend to leave as well.

I think this has become a very important issue in the Canadian context; the lack of interest and the lack of solutions for the pension fund community to effectively participate in this segment of the capital markets. I think part of it has to do with poor performance, as Bob Pavey said; poor performance when the escalation and the growth in the industry in the mid-1980s affected a number of funds. What I find very interesting in the Canadian context is that pension funds have all certainly experienced that — in the real estate market, in the bond market, and in the public equity market.

However, since the information flow on the venture capital market is slow, you may do a deal in 1985, and you know how it turns out in maybe 1992 or 1993. It tends to leave a longer impact. Thus, as a source of capital, these groups have definitely backed up. Because of the individual flow, we have a lot of liquidity in the Canadian marketplace in terms of capital that is actually available for investment.

There is almost two billion dollars of capital still available for investment in Canada, and there is a good news/bad news story associated with this situation. The good news is that, because of this massive in-flow of capital, for the first time, the venture capital industry in Canada is in a position to really support innovative growth companies as they progress through the growth cycle. Bob Pavey suggested that venture capital is a tiny piece in the capital markets, and I could not agree more. The number of companies that get financed are small relative to the total picture. Having said that, its critical role is in financing those companies that progress through the growth spectrum and ultimately have the potential to make some of the more significant contributions to the economy.

If we were to look at a list of successful, venture-backed companies in the United States over the last twenty years, they would be the major U.S. corporations that were able to access this capital. Thus, it is really important and critical to the innovation process that those small number of companies that are going to generate the disproportionately

large share of the activity have the capital to grow on through that phase. However, it seems to me that, around in the late 1980s, Canadian technology companies that were going to the public markets were at a real disadvantage to the U.S. competitors in that the equivalent U.S. venture-backed companies going public had already accessed seven times the amount of equity from the private market than their Canadian counterpart. As the Canadian companies went public, they were starting with a much smaller capital base. By the end of a ten-year period, typically they were only 1/15th the size of U.S. competitors. This situation means that it is not unusual to see a technology company that is growing, that is doing well, and has the potential to keep growing. Now it can access the four million dollar round or the six million dollar round needed to get to the next stage before it goes public; the type of financing that has been in the United States for the last eight to ten years. On the supply side, a base is now there to provide that sort of support. The bad news is that you get a kind of concentration of capital in the hands of a relatively few number of players. I think Bob Pavey said there are 600 to 700 funds in the United States.

We actually have sixty-eight venture funds in our data base in Canada. So again, you have roughly a one to ten ratio between Canada and the United States. However, the bulk of the funds are in terms of the numbers of firms, with a very significant portion of the money being here. Twelve firms make up this group. There is a real concentration of capital, which raises some issues about the front end of the spectrum in terms of the smaller firms accessing the smaller amounts of money.

However, I think there is a lot of room for innovative ways, partnerships, and people with small amounts of money tapping into some of the groups who want to get their money out and are looking for good, solid partners to do it with. There is some real hope here. The concern is clearly that these individual are the ones who have traditionally been the technology investors. Private independent funds have been very active in this area. And it is clearly important that they continue to be able to access some of the capital. But as I indicated earlier, some of them are simply starting to switch over and say, let us turn ourselves into labor-sponsored funds and re-capitalize ourselves.

Looking at the disbursement side and just following up on the point that I made about the increase in capital being able to now support larger transactions, it used to be that the average-sized deal in Canada tended to be very small, a million or 1.1 million, and it was difficult to get much above that. However, we are seeing a real increase in the amount of activity that is going on in the one to five million dollar range, which ultimately, is very important to the whole innovative process in that the companies are able to attract the kind of capital that they need.

Putting it in terms of new deal, old deal, the real advantage is that for the first time the transaction side shows you the number of first-time financings versus follow-ons. A lot of the small deal activity is accounted for by follow-on investments that often will be less than a million dollars, especially when the company has a particular need or specific reason. At that point, a subsequent round will go in. There has also been a lot of first-time deals done across the spectrum in terms of activity. I think that is something that will continue, because we now, or at least for the time being, are in a process where we have these flows of funds coming in on an annual basis.

There are some down sides to this activity. I am not convinced that this is the most effective or appropriate way to be capitalizing a venture capital industry. However, at least in the interim and while we have this institutional attitude, we are seeing investment activity in the range of 500 million dollars a year and a reasonably vibrant level of activity.

We are also seeing a shift regarding people's backgrounds in the venture capital market, which combines technical and scientific education with long experience. In my view, this is incredibly important for the whole financing process for innovative companies. We are starting to see more of this in Canada.

Our industry grew out of the banks. As a result, in the mid-1980s, twenty-five percent of all the money invested went to technology companies. That figure is now sixty percent. Traditional businesses still attract a chunk. Part of that amount is the role of the Solidarity Fund in Quebec. Quebec does a lot of traditional company investments. There is also a lot of technology activity, particularly activity in the computer sector with software investing.

I think the Canadian companies have started to come into their own and have started to demonstrate that they are able to compete on a world stage. I am sure everyone has heard of the big successes like Newbring and Corell. But we are seeing smaller software companies and telecom companies that are increasingly being successful. That clearly drives the innovative process in terms of drawing capital into the industry.

A couple of quick side points here. The environmental-related investing is still relatively small, but it is not insignificant. Stuart Smith, who is speaking here tonight, is involved in a new environmental technology fund in Canada. It is an interesting equation where you have a corporation with some expertise in a sector, sponsoring experienced venture capitalists. The corporation put in a chunk of money, allocated the responsibility to the venture capitalists, and then went out to institutions to put money around them. Once the traditional models start breaking down, I think people look for creative ways of trying to figure out how to use their expertise to access the market.

Similarly, on the medical side, we have a company called MDS in Canada, which is a medical and health services company. It has been very innovative. It formed an alliance with the Medical Research Council, the leading research group in the medical and health field, and established a labor-sponsored fund. To accomplish this task, it has put a commercial peer review system in place alongside the scientific peer review system so that it can identify research projects that appear to have commercial potential early and fast track those R&D activities into commercial entities more quickly. So again, I think people are coming up with some creative approaches.

We are starting to see more U.S. venture capitalists having an interest in Canadian companies. There are some reasonably well-known names involved. One of the reasons that I think we are getting a little more attention and hopefully a little more success along the way is because performance is starting to be delivered now. The single biggest challenge, in my view, facing the venture capital industry in Canada is that we really have not really had an IPO market that has been very supportive of young technology companies.

Regarding the kinds of premiums in Canada, we tend to be a little self-basing. So the investors cannot get the kind of uptake they need on those deals to offset all the inevitably mediocre investments they have.

There are signs that it is, in fact, starting to turn around. In 1991, there were just over 100 exits, dispositions that actually took place. Twenty percent were done through IPO's or the subsequent sale post-escrow on the IPO's. The investors received over four times the money back on those, which was attractive. It suggests that the markets are now there to give them the support.

There are several venture-backed companies that have gone public since early 1993. The market caps on them remain small, but they are big enough to have some substance and to have some market in them. Over a period, the strong over 300 index has increased by eight percent, these technologies now being increased with the exception of one that was thirty percent. They are all somewhere between forty and 100 or 150 percent. Again, the message is finally starting to come out that, in fact, these companies have been building, have built a capital base, and are able to perform.

All of these companies have to be export-oriented within the first twelve months of existence. Typically, the average share of sales derived from exports would be at least seventy-five percent in most instances. They have to be more sophisticated from the beginning if they are going to be successful. And they are being successful.

And the other question we asked ourselves is, if venture capital is important, how do these venture-backed companies do against the rest? We considered the TSE 300 index from the beginning of 1992. We considered all IPO price performance, price changes since the begin-

ning of 1992, and all the venture-backed IPO's. The companies that have venture capital backing at the front end, at this point in time at least, have managed to increase market performance all the way along. I think this is a positive statement that, although this segment of the capital market is very small, it is absolutely critical to the growth and development of those companies that have the greatest growth potential and ultimately, I would suspect, are going to be part of our TSE 300 somewhere within the next five to ten year period.