



SAUDER
School of Business

UNIVERSITY OF BRITISH COLUMBIA

**Canadian Ventures:
Barriers to Success In
Risk-Capital Markets**

Summary

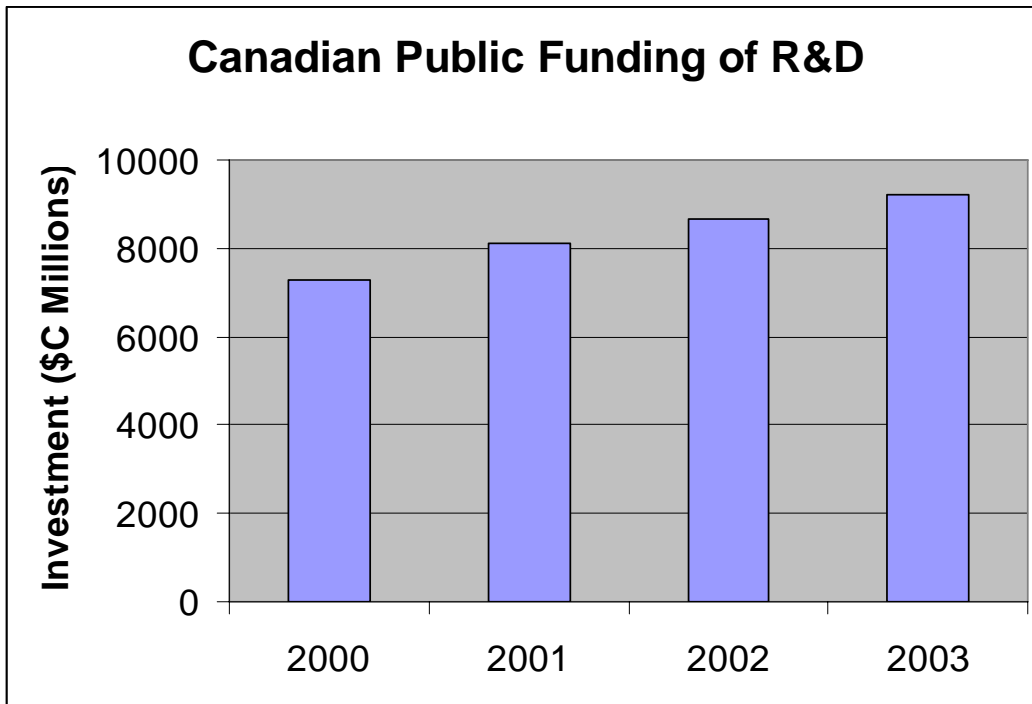
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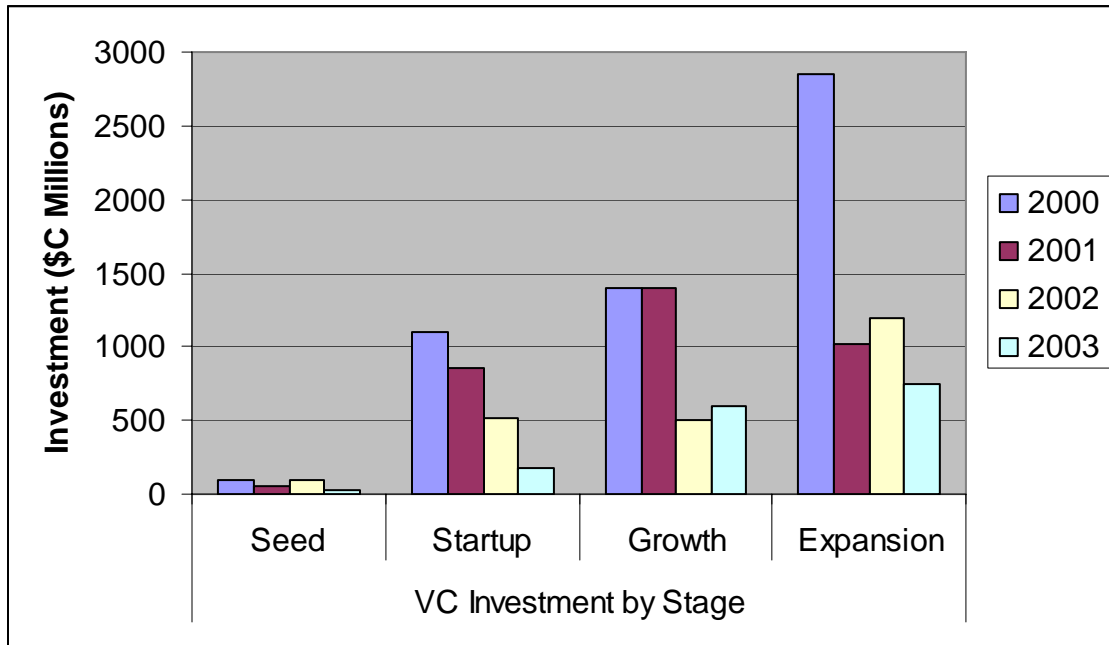
Background

Canada has both an opportunity and a problem.

We have made a major investment in research and development and have the potential to create a number of new enterprises which will yield both wealth and employment for Canada. The alternative is that the research and development money, invested by the government on behalf of the people of Canada largely through the University sector, will result in new ideas and technologies. Herein lay the opportunity. New businesses, which employ Canadians in high value jobs, may be created resulting in increased GDP and increased wealth for Canadian investors. The alternative, which is very real, is that these technologies simply find their way into the literature to be exploited by organizations in other countries and/or licensed out of companies around with the world with limited benefit in employment or wealth creation in Canada.

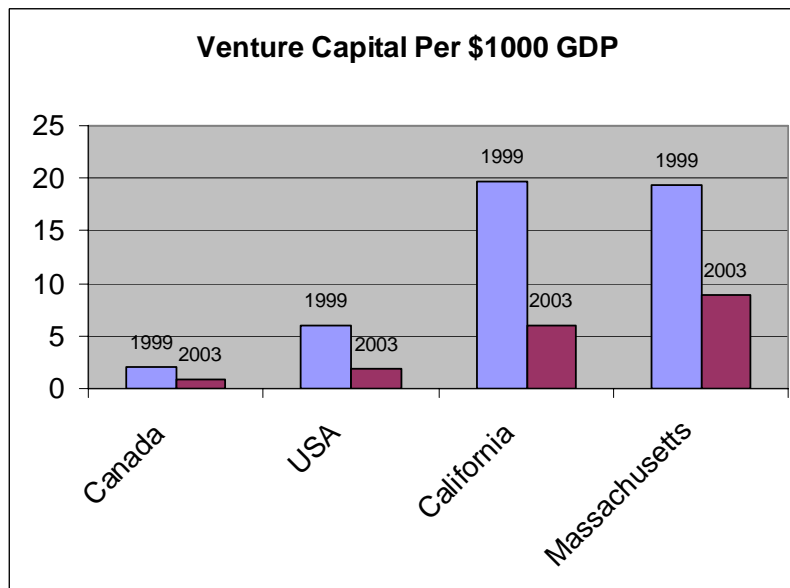


One of the key determinants of whether the technology that results from our public investment in R&D is fully nurtured here is simple: the existence of sufficient, good quality venture finance and venture financiers. However, a cursory review of the numbers, let alone the evidence regarding performance, shows that we do not have sufficient capital available. Some analyses suggest (e.g., in the biotech sector) that we do not have a sufficient number of resources, a sufficient number of qualified and experienced investors or a sufficiently large willingness to see through to full fruition the development of firms as measured by the size of venture funding rounds.



While some in Canada point out the “precipitous fall” in the formal venture capital per capita available in the U.S. by 2003, it is clear that the high technology jurisdictions in the U.S. still remain with many times the amount of formal venture capital available to them than we do despite our major aspirations to become a knowledge and innovation economy.

In the end, we have both a problem and opportunity. Will we be willing to make major strides in improving the quantity and quality of venture financing available to firms throughout their life-cycle in order to achieve the economic results that may be realizable?



(Sources: Fall 2004 Throne Speech & Mary MacDonald Associates)

The Issue – *Generating Economic Benefit from Canada’s Investment in Research & Development*

Over the past five years the federal government has increased direct spending on research and development by \$13 billion. Several provinces have also matched this investment with expenditures of their own in partnerships with agencies such as CFI and Genome Canada. Our country can be proud of this high level of investment, but it raises a critical issue:

What economic and fiscal policies must we have in place to ensure we capture the economic benefit from this investment for years to come?

Clearly venture financing or risk capital, in its many forms, plays a vital role in the acceleration of innovation into the marketplace. But it’s not just about raising more money – there needs to be an emphasis on fiscal policy that links experienced management with innovation. Policy must be focused on establishing innovative companies destined for success through all stages of their development. It must also be focused on mobilizing all forms of risk capital, from individual “angel” investors, through formal venture capital (including labour-sponsored funds, etc.), direct venture investment by pension and other funds and mezzanine financing from banks in support of new venture initiation, growth and development.

We must look at all layers of the financing system, which we characterize as a complex “ecosystem”, when formulating risk capital policy and programs. Only by using this approach will both levels of government be able to achieve their mutual goals with sound economic and fiscal policy that is sustainable over the long term.

Although Canada enjoys a large and highly efficient capital market for large companies the same cannot be said of the capital markets for seed and early stage companies. The seed and early stage capital markets are small, inefficient, imperfect and far from transparent. We believe that government intervention is required in order to make adjustments in the “ecosystem” in order to realize the desired economic growth objectives.

There are a number of reasons why these markets are inefficient. Some of these are well known and well researched:

- The average size of deals in Canada is smaller than then in the USA and yet the costs associated with investment are almost the same in both markets.
- In Canada entrepreneurs have a substantially lower number of banks they can approach than in the USA.
- Canada also suffers from large geographic distances between investors and companies. Clusters tend to be spread out and the matching up of individual investors with companies is more difficult.

The lack of efficiency in our markets shows up also in the rates of return of our formal venture capital industry. Our venture capital industry’s performance, as compared to other national jurisdictions, is comparatively low as measured against the U.S. and Europe. Arguments could be made that the venture capital industry doesn’t have enough developed deals to choose from (caused by a lack of the very early stage seed funding

and sufficient angel investment activity), capital to invest in follow-on rounds due to insufficient capital formation (caused by comparative underinvestment in venture capital by pension funds, etc., as well as underinvestment by foreign investors turned away by Canadian tax policy), or experienced hands. Its underperformance could also be attributed to underinvestment in venture capital by foreign funds for whom there are tremendous structural complexities and substantial tax risks to investing in Canadian private companies – complexities and risks that are not present in the USA (for either domestic or international investors) or in other jurisdictions.

The “bottom line” is that despite current public funding of R&D in Canada in amounts over \$9 billion annually, we may lack adequate venture funding to make this R&D investment convert into broad-based economic returns. To ensure both the quantity and quality of risk-capital required, we need to take a multi-year, “ecosystem” approach to further developing and maturing our risk capital industry. Government can and does play a role.

Recommendations

The following recommendations have been formulated by The Canadian Task Force on Early Stage Funding, a pan-Canadian volunteer task force comprised of Venture Capitalists, Angel Investors, Entrepreneurs, Professional Advisors, representations from the Government and Academia. (See Appendix 1 for a full list of participants, and Appendix 2 for details on the origin of the task force). Our Task Force instituted processes designed to eliminate biases and to produce consensus for recommendations.

These recommendations were formulated after two meetings of our Task Force, to views on immediate measures that will benefit the entire ecosystem.

These were only an initial round of recommendations designed to deal with the most pressing “first round” of actions that needed to be taken to improve the risk-capital or venture financing industry in Canada. These recommendations have also been echoed by the Conference Board in their publication concerning “Quick Hits” to improve commercialization of technology in Canada.

1. The Innovation and Productivity Tax Credit (“IPTC”)

Small businesses in their earliest stages of development face great difficulty in accessing seed or start up capital that many consider to be the “lifeblood” of commercialization. While the federal government has invested billions of dollars in R&D expenditures, start-up financing from traditional venture capital sources for the year 2003 was only \$200 million, and this gap continues to widen. The economic impact of this financing gap is significant when one considers that innovative Canadians may be unable to develop their ideas further due to lack of financing, or they may relocate to other jurisdictions with all of their taxpayer funded ideas. From a market perspective this leads to fewer investment opportunities which mainstream venture capital funds need to generate higher returns to attract institutional investors.

The IPTC seeks to address this gap by mobilizing individual, “angel” investors who can provide risk capital and market expertise that many of our innovative companies lack in their formative years. The Task Force recommends that the federal / provincial governments enact a refundable tax credit of 30% for arms-length investment in early stage companies. The United Kingdom, some American states and British Columbia already have such programs in place. This model has proven results for attracting individual investors to small businesses, where their expertise, skill and contacts improve the chances for success of the businesses. We suggest that the Federal Government’s share of this credit be 50%, and that it can be delivered to the Provinces either as sharing of a tax credit or as direct reimbursement to the Provinces.

The importance of the Individual Investor

- Only 2% of Inc. Magazine's 500 fastest growing companies received formal venture capital financing at the early seed stage.
- 3 million angels in USA invest \$50 billion annually in start-ups – 30-40x as many companies and 3-5x as much money as formal venture capitalists.

2. Harmonization of rules for Scientific Research and Experimental Development (“SRED”) Credits

There is an urgent need for a “level playing field” for small businesses claiming SRED refundable tax credits. The SRED program plays a crucial role in the development of these early stage companies. However, the arbitrary rule that a company must retain its status as a Canadian Controlled Private Corporation (“CCPC”) in order to receive refundable credits is, in our view, a serious problem. Small businesses must not be penalized when they obtain investment from foreign affiliates, foreign investors and in some cases public markets if they hope to reach entry into markets outside of Canada. Either of two outcomes has negative impact: either foreign markets are not tapped, or companies don't become publicly financed, or if, they do, they have less cash flow which curtails economic potential.

The Task Force recommends that refundable SRED credits be made available to small businesses that become publicly traded or have otherwise lost their CCPC status. We see little potential for abuse by senior public companies since the program rules surrounding taxable income and capitalization limits will restrict their eligibility for refunds.

(Note: There seems to be acceptance at the Industry Canada level and at Finance that these changes would be beneficial, and there may be work ongoing to implement this recommendation. The implementation of these changes needs to be monitored.)

3. Simplification of Qualified Limited Partnership (“QLP”) Regulations

One of the recommendations made was effectively implemented through other changes to the ITA proposed in the last budget. This recommendation, which originated with Canadian Venture Capital Association (“CVCA”), was designed to eliminate barriers to ownership of foreign investments venture pools owned by tax-exempt Canadian institutions.

(Note: We believe that the need for this recommendation has been obviated through recent legislation eliminating foreign property restrictions on pension funds.)

4. Eliminate Barriers to Foreign Capital Investment

If Canada wants to build a sustainable venture capital industry, it must foster an industry with proven market returns and remove barriers under the Income Tax Act (ITA) that deter foreign capital investment. Currently, Canadian pension funds can invest freely in US Venture Funds, and Canadian VC's can invest freely in US businesses. "Symmetry" must be our mantra, such that foreign institutions can invest as easily in Canadian VC's, and foreign VC's can invest as easily in Canadian enterprises. All without Canadian tax consequences that make our investment environment uncompetitive.

The current taxation environment forces investors to utilize a "foreign parallel investment fund" that is costly, complex and leads to marginal investment.

Currently, only 3.4% of the risk capital invested annually in Canada is sourced from foreign investors. This compares to 40% of this country's risk capital being sourced from registered Labour Sponsored Venture Capital Corporations that rely exclusively on unsophisticated retail investors. We firmly believe that this fiscal policy is unsound and unsustainable over the long term.

The Task Force recommends the following solutions to enhance the supply of foreign risk capital investment in Canada:

- i. Cross Border Mergers – as promised under earlier budgets, enact legislation under the ITA to enable technology companies to get access to strategic partnerships with foreign companies without triggering taxation.
- ii. Limited Liability Corporations – there must be formal recognition by legislation (particularly in the Canada-US Tax Treaty) of these "tax exempt" investment entities so Canada may benefit from the capital they invest in the global marketplace.
- iii. Canadian Limited Partnerships – The ITA must be amended if Canadian risk capital funds are to compete on a level playing field with their international counterparts.

Specific amendments include:

- a. Reducing uncertainty for foreign investors so they will not be viewed as carrying on a business by simply investing as a limited partner in a Canadian limited partnership.
 - b. Confirming that gains realized by a Canadian limited partnership will be treated for taxation purposes as a capital gain so long as the investments are held for at least one year, and
 - c. Enact legislation that would allow a Canadian limited partnership to transfer divested assets on a tax-free rollover basis without having to wind up the partnership.
- iv. Foreign Private Investors – eliminate the withholding tax on capital gains made by foreign investors in the equity of private Canadian companies. At a minimum, investments by "prescribed venture capital organizations", whether in the form of LLC's as referred to in (ii) above or as Limited

Partnerships must not be subject to Canadian withholding taxes. In a global market for capital, taxability of gains in Canada render Canadian companies uncompetitive as compared to their US and foreign counterparts.

- v. Section 116. Whether the necessary tax regulations are accomplished via bringing in LLC's under the treaty or dealing explicitly with foreign investors, there must be no obligation on the part of a foreign VC to provide Section 116 disclosure or income tax returns on behalf of its investors (pension funds and others). Most if not all foreign VC firms are precluded in their management contracts from subjecting their investors to filings in foreign jurisdictions, even if no taxes are payable.

We believe these recommendations will not result in revenue being lost from the Federal treasury. By and large, the barriers are so successful that no revenue is generated anyway. To the contrary, the additional economic benefit derived, such as high value jobs created from increased foreign capital investment, should far exceed any potential tax revenues lost by implementing these recommendations.

Next Steps

We must remember that these recommendations are only the first round. The task force represented an ad hoc effort to begin the process of improving the risk-capital or venture financing industry in Canada in order to improve both the quality and quantity of risk-capital. An ongoing entity is required to implement the objectives, monitor and make recommendations to the government that are:

- Unbiased,
- Informed,
- Consensual, and
- Formed with the entire ecosystem, and therefore Canada's overall interest at heart.

We propose the formation of such an entity, entitled Innovation Capital Canada. This entity will be an independent agency with stakeholders from the entire eco-system. The purpose of the agency will be to provide all stakeholders with:

- An independent forum for dialogue
- A collective analytical resource
- A national source for investment training (angels, venture capitalists and entrepreneurs)
- A representative for the system as a whole

Early work has been carried out on shaping this more durable agency to identify, harmonize, and prioritize risk capital issues on a continuous basis. Further details of the objective, principals and functions of such a group can be found in Appendix 3.

In addition, this summary has focused on one part of the puzzle. To be successful, Canada has to consider the 3-legged stool of ideas, management and money. The legs are deeply interwoven, with money forming the main thrust of this summary, along with management coming from our recommendations (such as IPTC). Ideas come from several avenues, most notably Universities, but an overall strategy cannot be formed by considering the three areas independently.

Appendix 1

Task Force Members

Daniel Muzyka	Dean, Sauder School of Business, University of British Columbia
Perry Atwal	Assistant Dean and Executive Director, Sauder School of Business
University ILO	
David Jones	Associate Director, University of British Columbia UILO
Entrepreneurs	
Glen Ballman	Founder, Onvia Systems
Ken Gordon	CEO, various Alberta start-ups
Geoffrey Hansen	Managing Partner, Rocket Builders
Greg Peet	President & CEO, ALI Technologies
Mike Brown	Chairman, Chrysalix Energy (also an “angel” & VC person)
David Demers	President & CEO, Westport Innovations
Angel Investors	
Jim Fletcher	National Angel Organization
Henry Vehovec	President, National Angel Organization
Institutions	
Stanley Hamilton	Past Chair, Faculty Pension Plan, University of British Columbia
Neil Muth	Vice President, Private Placements, BCIMC
Rosemary Zigrossi	VP, Ontario Teachers’ Pension Plan
Professional Advisors	
Keith Spencer	Partner, Fasken Martineau
John Webster	Managing Partner, PricewaterhouseCoopers (Vancouver)
Mary McDonald	McDonald and Associates
Public Markets	
Peter van der Velden	Managing Director, Fusion Capital
Harry Jaako	Director, TSX & CEO of Discovery Capital
Government	
John Connell	Acting Director General, Small Business Policy, Industry Canada
Brian Ernewein	Director of Tax Legislation Division, Department of Finance
Michael Raymont	Acting President of the National Research Council of Canada
Todd Tessier	Senior Portfolio Manager, Investment Capital Branch of BC
Andrew Wilkinson	Deputy Minister, Small Business and Economic Development, BC
Vicky Sharpe	President, Sustainable Development Technologies Canada
Venture Capitalists	
John Eckert	McLean Watson Capital Inc, Toronto
Peter Forton	President & CEO, ACF Equity Atlantic
Brent Holliday	Founder and Partner, Greenstone Venture Partners
David Levi	Founder, President and CEO of GrowthWorks, BC
Robin Louis	President, CVCA and CEO, Ventures West Capital Ltd
Claude Miron	President and Managing Partner, Invivo Ventures, Quebec
Hubert Manseau	President and CEO, Innovatech Montréal
Richard M. Rémillard	Executive Director, CVCA
Bill Tam	Partner, SpringBank TechVentures

Appendix 2

Origins of the Canadian Task Force on Early Stage Funding

The Task Force began in response to a meeting that took place in March of last year between senior federal advisors and other key members of the venture capital community including Mr. Michael J. Brown, a current director of Fuel Cells Canada, and a highly experienced venture capital and angel investor.. The goal of the meeting was to find a way to collect and consolidate issues surrounding risk capital and commercialization.

Over the past year there have been no less than 19 meetings between the federal government and various groups with their own perspective on how risk capital policy should be implemented. While each proposal may have had merit for one particular segment or group involved with risk capital, we are not aware of any submissions that took into account the entire financing ecosystem.

Presented with this opportunity, Mr. Brown approached me and Michael Rayment, Acting President of National Research Council, and together we formed this Task Force in June of last year. The Sauder School and National Research Council co-sponsored this meeting. The group is truly “pan-Canadian” with key players from across Canada representing the venture capital community - pension funds, professional venture capital managers, angel investors, entrepreneurs, university liaison officers, government and professional advisors.

The first meeting of the task force was in June 2004 in Vancouver, and was chaired by me. In this meeting, ideas were presented from all interested parties, and a follow-up meeting was held in Calgary in September. At this meeting, 15 ideas from across the whole spectrum of Task Force Members were discussed to benefit the ‘ecosystem’, and these were whittled down to 4 that all agreed would have the most impact. Of utmost importance was the consensual view taken; For a short time, all around the table were able to put aside their vested interests and agree on an ‘ecosystem’ approach.

Appendix 3

Innovation Capital Canada (ICC) Key Principles and Functions

(Note, there are detailed notes and presentations available that discuss the ICC concept in further detail – available on request).

Objective:

“To build more successful Canadian technology companies by improving the quantity and quality of early stage funding mechanisms, and to position companies for success in the later stages.”

Overview:

ICC will be structured to ensure:

1. Governance - Installing a governance method by which all critical members of the risk capital spectrum know they will be involved. A board will be nominated to represent all areas of the early stage funding ‘ecosystem’.
2. Support - Government supporting and financing its establishment, so ICC becomes the contact point for those with vested interests.
3. Reporting - Reporting to stakeholders, to government (e.g. to NRC &/or Industry Canada / Provinces) and to the public.

Principles:

1. The effectiveness of all participants in the early stage funding ecosystem should be maximized and optimized.
2. Knowledge of all aspects of the ecosystem will be shared, communicated, and continuously enhanced.
3. All ecosystem parties have a voice, are encouraged to provide input, and are respected.
4. The group will develop and share best practices in: ecosystem development, funding mechanism evolution, education, and training.
5. Policy proposals will be developed from broad ecosystem consultation and consensus.
6. The ecosystem works together to increase the level of competition for domestic and foreign investors.
7. The ecosystem will seek to work and produce results guided by the highest business and ethical standards.

Key Functions:

1. A meeting place where differences can be resolved (extends to-date role of CTFESF)
2. Collects via contracts data from across the commercialization spectrum
3. Conducts via contracts & disseminates research into (early-stage) ecosystem
4. Coordinates training programs for angels, VCs and entrepreneurs
5. Using data & research, proposes policies to government across a spectrum of issues
6. Co-sponsors market intelligence schemes

Appendix 4

Other Considered Suggestions

For completeness, the full list of 15 suggestions that were initially suggested as possible areas of focus is given below. A roundtable discussion between members from the entire ecosystem whittled this list down to the four recommendations made in this report.

LSF

1. Increase annual investor contribution level from \$5,000 to increase retail venture investment.
2. Expand Ontario's early stage Research Oriented Investment Fund (ROIF) program nationally, increase Fed./Prov. Tax credit to 17.5% each, and adjust the SR&ED-based investment eligibility criteria to encourage investment into a broader range of very early stage technology companies.
3. Encourage earlier stage LSF investing by restricting later stage investment to follow-on funding only (i.e. no more LSF's for purely later stage investment).

TSX Venture

4. Harmonize SR&ED rules for early stage CCPC and public technology companies.
5. Harmonize employee stock option taxation rules for option-holders of public and CCPC companies.
6. Allow flow-through investment tax treatment to make early stage technology investing competitive with early stage resource investing.

Private LP/GP

7. Create fund-of-funds.
8. Change LP ownership and tax rules to facilitate foreigners becoming LPs of Canadian venture capital partnerships.
9. Simplify QLP rules.

Angels

10. Create national angel tax credit program, modeled on BC's S.B.V.C.A., with Fed/Prov. Tax credit of 15% each.

11. Provide additional regional/heartland early stage investment incentives by increasing Fed./Prov. Tax Credit to 17.5% each for designated regions outside major urban technology centres.

VCC Funds

12. Expand the B.C./Quebec VCC program nationally, with Fed./Prov. Tax Credits of 15% each, providing the retail investor with the choice of; a) labour-sponsored and non-labour-sponsored venture funds, and, b) more powerful financial planning products to encourage more high net worth Canadians to invest in early stage venture financing (up to \$200,000 annually).

University/ILO

13. Allocate 5% of University research funding to initiatives in Canadian universities to incubate pre-commercial research into early stage venture opportunities.

General

14. Eliminate withholding taxes on gains from US ownership of private Canadian equities.
15. Allow the tax-free rollover, including capital gains, of investments in Canadian securities into securities of eligible early stage companies (e.g. U.S. home ownership rules).