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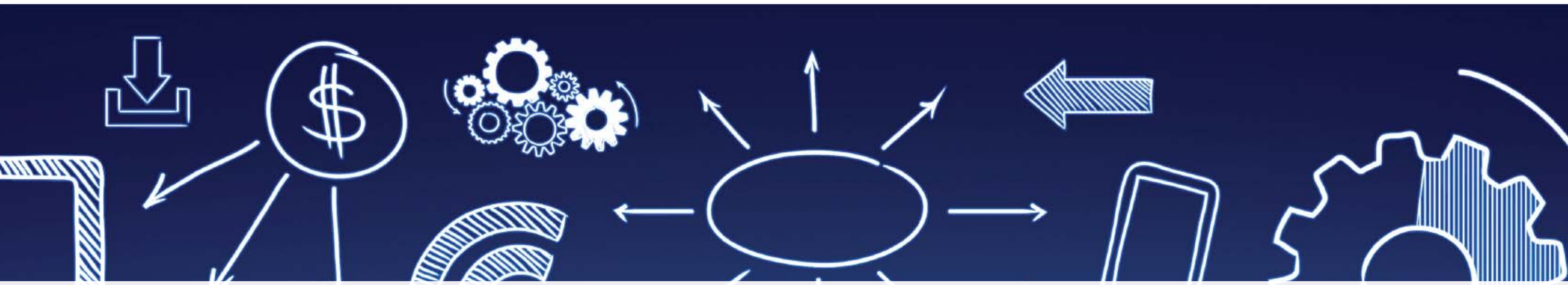
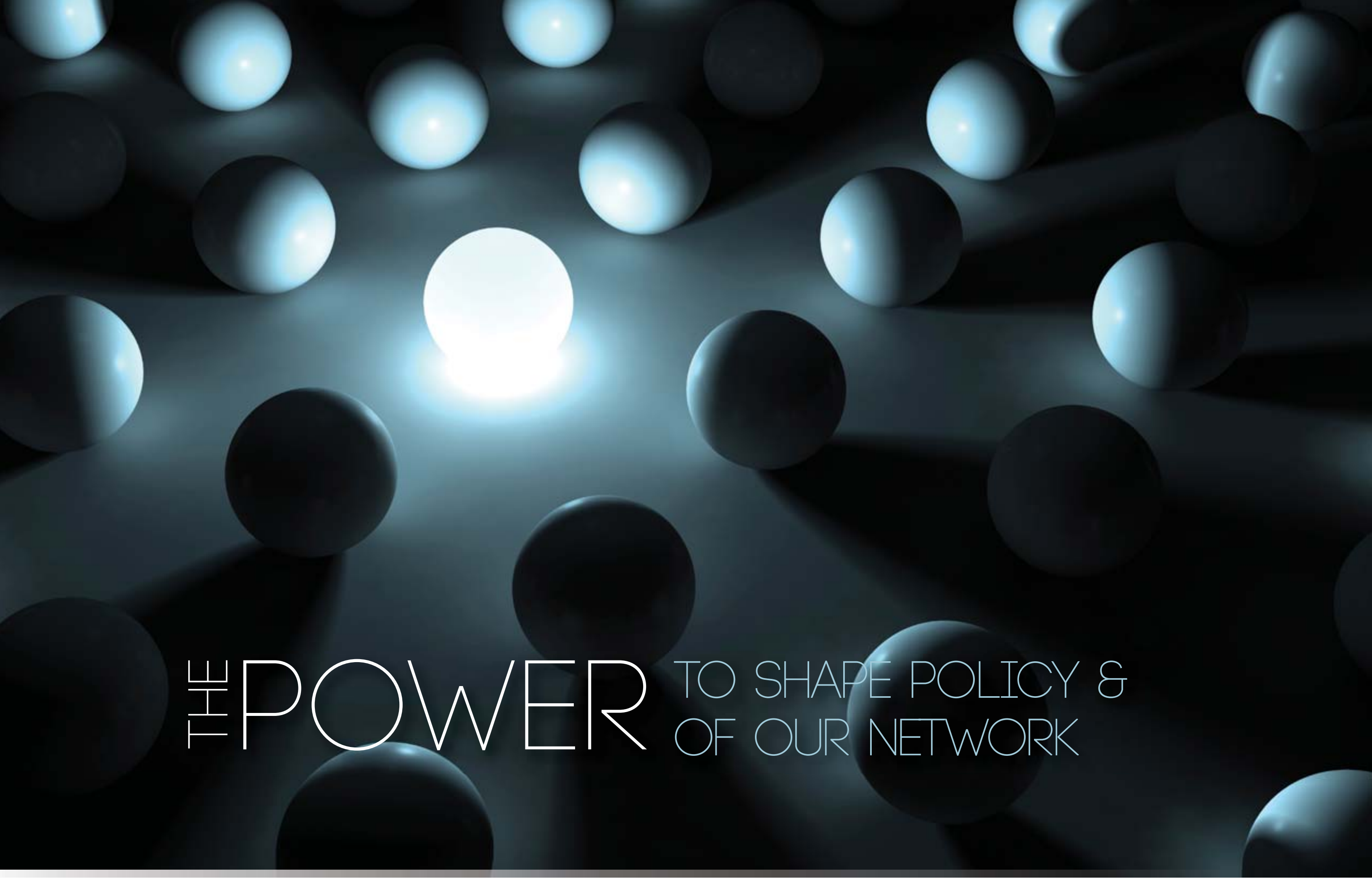


Stimulating Canadian Innovation:

How to Boost Canada's Venture Capital Industry

September 2015



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EXECUTIVE SUMMARY

Venture Capital is a critical part of the Canadian economy because it provides the funding that enables innovative, early-stage technology companies to survive and grow.

These fast growing firms represent just 5% of the companies in Canada but they have a huge impact on our ability to innovate and on our prosperity, accounting for 45% of new job creation.[1]

Designing policies to support and stimulate entrepreneurial ventures is a challenge; there is no single sector they occupy, nor do they have common business strategies. Their challenges are as diverse as their various businesses.

But one problem is common and acute among these unusual enterprises—almost all have difficulty finding the capital they need to realize their business plans. Improving and growing the venture capital industry is one strategy government can pursue that could significantly benefit most fast-growing entrepreneurial firms. Such a strategy has the potential to transform Canada—to make it more innovative—by creating new businesses, technologies and jobs.

It is particularly timely to consider such a strategy. The Canadian economy is challenged by headwinds that will reduce the rate of GDP growth and job creation in the coming years. The natural resources and commodities that were so central to business investment could be facing many years of price weakness. The Canadian consumers who borrowed and spent throughout the global crisis must contend with record debt levels. The "nest egg" that supports consumer confidence is often housing, but the Canadian housing market is overvalued by 10% to 30% according to the Bank of Canada. If Canada's traditional sources of growth are ebbing, then it needs to increase productivity and innovation in order to expand its economy into new services and technologies.

More importantly, a study by Deloitte [2] shows that many Canadian companies are not ready for "disruptive innovation"—the huge leaps of technology that will put our traditional businesses at risk. Consider how communication has changed over the past 20 years, from basic email, web pages and desktop PCs to social media, smart apps, mobile web and powerful smartphones and tablets. Technology has profoundly transformed the way we interact with each other, the way we do business and the nature of work. Today, technological advancement is accelerating and transforming our economy by creating new products and services, increasing efficiency and cost savings, and even launching new industries. Canada must accelerate its own innovation and develop new technologies here at home to avoid getting left behind. What can government do? Canada has already invested massively in R&D. In fact, public spending on research and development, at 0.81% of GDP places Canada ahead of countries like the U.S., the U.K. and Japan (but still behind countries like Germany, Sweden and Finland.) The trouble is that Canada lags on the commercialization of products.

How do we get our great ideas developed and into markets? By helping entrepreneurs to build new innovative companies. A critical ingredient is having a vibrant, thriving venture capital industry that can provide the investment and expertise to turn ideas into

1. Industry Canada, SME Research and Statistics, Key Small Business Statistics, 2012. Can be viewed at: http://www.ic.gc.ca/eic/site/061.nsf/eng/02718.html.

2. Deloitte Canada, Age of Disruption: Are Canadian Firms Prepared?, 2015. Can be viewed at: http://www2.deloitte.com/ca/en/pages/insights-and-issues/articles/future-of-productivity-2015.html

products. Our objective should be nothing less than to build a dynamic, attractive venture capital industry that can provide the equity and expertise to support the most innovative, technology companies in the world.

The Canadian Chamber of Commerce offers a variety of proposals to help transform the venture capital industry in Canada:

1. Incentivize angels: make British Columbia's investment tax credit a national program

2. Provide a tax exemption on the capital gains from venture capital

3. Pull in more investors with flow-through shares for entrepreneurial companies that are financing the long development cycles for innovative technologies

4. Increase government investment in venture capital funds

5. Invest in incubators

6. Review regulations on banks, insurance companies and pension funds

WHAT IS VENTURE CAPITAL?

Venture capital is a form of equity financing for innovation-based early-stage technology firms. These types of start-ups are creating brand new products, so the growth potential is enormous, but the risk of failure is also very high. That is why traditional forms of funding, such as bank loans and asset-based lending, are not appropriate.

WHY IS THE RISK SO MUCH HIGHER FOR THESE COMPANIES?

Firstly, these companies have little, if any, of the tangible assets that are normally used as security in conventional financing. Most of their assets are intangible (software, R&D results, intellectual property and people). Lenders find it difficult to collateralize debt with products that have not yet demonstrated any market success.

There is a high level of uncertainty linked to R&D activities and the development of unproven new technologies. Many companies are seeking to create new needs and new products in markets where it is difficult to foresee what the demand might be. Particularly with technology companies, new solutions and business models emerge all the time and many of these might not work.

There is also a high level of information asymmetry between the entrepreneur and the investor for technology start-ups. It is not enough to review the financial statements and business plan. In brand new companies where there are no revenues or profits, the investor needs a detailed understanding of what is going on inside the company to judge whether it is headed for success. Again this illustrates why conventional lenders such as chartered banks, have little incentive to target these clients.

Finally, it often takes a long time, up to seven years or more, to develop, commercialize, market and start generating revenues—the stage where companies can launch an initial public offering (IPO) or are acquired. Venture capital investors do not lend money. Instead, they buy shares of a firm, which gives them an ownership stake and influence over business decisions and strategy. Established venture capital investors bring specialized teams with industry expertise, management and networks to access specialized information on technologies, markets and competition. Venture capital managers work closely with a company's management team to help build the company and, eventually, prepare an exit.

Venture capital is, by its very nature, highly illiquid and risky. Traditional financing sources are not well equipped for such an environment.

Yet, capital is the essential tool for fast-growing companies. If Canada can craft policies that increase its availability for fast-growth firms, the potential for benefits is very great.

Spotlight on Angels

Last year, the Canadian Chamber of Commerce hosted roundtables with entrepreneurs all across the country to learn more about their barriers to growth. One of the biggest challenges they identified was a lack of capital, and in particular, a need for angel investors.

The entrepreneurs the Canadian Chamber spoke with said they—and others—need more angel investors who have a longer-term mindset and less of a "make it profitable and flip it" mentality.

An angel is an individual who invests his or her own money in an entrepreneurial company. Angels provide patient capital that is committed for many years. As a comparison, angels invest small amounts early and venture capitalists invest larger amounts later. A typical angel investor is a successful entrepreneur who is willing to speculate on new ventures by providing cash and expertise to nurture their development. Some of Canada's most successful technology companies, such as Mitel, BlackBerry and Shopify, received their initial support from angel investors.[3]

3. National Angel Capital Association. Reports on Angel Activity in Canada can be viewed at: https://nacocanada.com/knowledge/research/.

BIG RISKS, ENORMOUS BENEFITS FOR CANADA

Venture capital is the lifeblood of innovation—turning ideas into products that form the basis for new businesses. These innovative, early-stage technology companies create a disproportionate amount of the high-paying, highly skilled jobs for Canadians. Consider that they represent less than 5% of businesses in Canada but account for 45% of net new job creation.[4]

This innovation is also particularly critical to the Canadian economy because the development and application of advanced technologies is accelerating and has the potential to impact each and every business. According to a study by Deloitte, 60% of Canadian companies think the pace of change will increase over the next five to 10 years. As it does, the pace of technology-driven disruption will grow, and Canada's economic well-being will depend, more than ever, on its competitiveness—on how well Canadian businesses can adapt and develop new technologies.

That is why Canada needs a continuous churn of new technology firms because they are so important for developing new ideas and technologies.[5]

Large established firms are usually much slower to develop new opportunities and technologies outside their set product lines. In fact, studies show that a dollar invested in venture capital is three times more effective in creating patents than a dollar invested in corporate R&D. Though venture capital represented less than 3% of corporate R&D[6] from 1983 to 1992, it accounted for 8% of industrial patenting during the same time.[7] The companies that are backed by venture capital are also growth engines, growing more than five times faster than the overall economy.

Finally, there are enormous intangible benefits of venture capital that are impossible to quantify. Most importantly, these firms generate wealth and talent that are reinvested in the next generation of technology start-ups. These serial entrepreneurs are always looking for the next big opportunity and they provide a source of experienced management talent. Alongside business angels, venture capital funds play a critical role in linking these pools of wealth and talent to new start-up companies.

HOW IS CANADA DOING?

Canada's venture capital industry is growing impressively but is still small and hitting below its weight, particularly when compared to much larger venture capital industries in the U.S. During the course of 2014, the Canadian Chamber of Commerce spoke with dozens of entrepreneurs leading fast-growing companies who said one of the biggest hurdles they faced was securing capital to take their companies to the next level. Entrepreneurs observed the capital gap is largest when moving from R&D to commercialization.

Ominously, several mentioned the continuous pressure they are under to relocate to the United States to be closer to sources of capital.

The adjacent chart shows how Canadian jurisdictions are dwarfed by the major U.S. centres, with Ontario attracting just a twentieth of the venture capital investment of California. Overall, Canadian venture capital funds invested $2.3 billion in Canada in 2014, a solid 31% gain over 2013, however, this is still well below a peak of $4 billion in the late 1990s.

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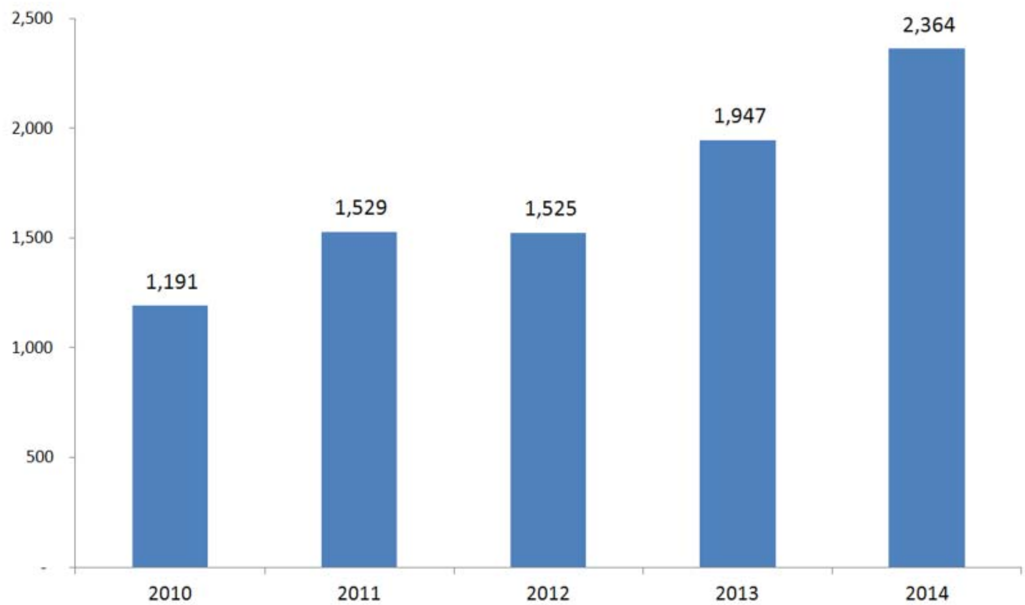
4. Industry Canada, SME Research and Statistics, Key Small Business Statistics, 2012. Can be viewed at: http://www.ic.gc.ca/eic/site/061.nsf/eng/02718.html.

5. Deloitte Canada. "Age of Disruption – Are Canadian Firms Prepared?" Deloitte Future of Canada Series, Can be viewed at http://www2.deloitte.com/ca/en/pages/insights-and-issues/articles/future-of-productivity-2015.html

6. Canadian Venture Capital Association and Industry Canada, The Performance of Canadian Firms that Received Venture Capital Financing, 2013. Can be viewed at: http://www.cvca.ca/wp-content/uploads/2014/07/VC_Study_Final_English_September_4_2013.pdf.

7. Ibid.

Canadian Venture Capital Invested (millions of C$)



While early-stage venture capital is growing, later-stage start-up financing is actually in decline at the important IPO stage. The past three years have seen a sharp reduction in capital raised by TSX-Venture-listed companies and a steep decline in new listings. In fact, the amount of capital raised for TSX-Venture companies has tumbled from $10.1 billion in 2011 to $6 billion in 2012 and to $3.8 billion in 2013 before recovering to just over $5 billion last year. The new listings show a similar decline, falling from 334 in 2011 to 240 in 2012 and to just 158 in 2013.

Numerous experts cited the low rates of return for venture capital funds in Canada as a barrier to attracting more funding. This is not unusual in such a high-risk industry. For example, the pooled average annual internal rate of return (IRR) of U.S. venture capital funds for the 10 years ending December 2000 was a staggering 25.7%, only to be followed by a miserable -0.8% average over the next decade. Yet, if one chose the 10 years ended June 2012, performance perked up to a more respectable 3.5%.[8] The point is that the high risk and variability of returns provides an opportunity for government to play a valuable, but limited role.

North American VC Rankings

State/Province	2014 VC Invested (C$ millions)	2014 North American Market Share (%)
California	30, 699	54.3
Massachusetts	5, 182	9.2
New York	4, 726	8.4
Texas	1, 664	2.9
Washington	1, 384	2.4
Illinois	1, 194	2.1
Florida	961	1.7
Ontario	906	1.6
Colorado	882	1.6
Utah	881	1.6
Pennsylvania	858	1.5
Quebec	604	1.1
Connecticut	572	1
Georgia	559	1
Virginia	526	0.9
British Columbia	506	0.9

8. Josh Lerner, Ann Leamon and Susana Garcia-Robles, 2013, Best Practices in Creating a Venture Capital Ecosystem, IDB Group. Can be viewed at: http://lavca.org/wp-content/uploads/2013/12/Best-Practices-in-Creating-a-VC-Ecosystem.pdf.

THE SOLUTIONS: TO MAKE CANADA A VENTURE CAPITAL POWERHOUSE

The objective is to build the most attractive venture capital industry that can provide the equity and expertise to build world-leading technology companies. The Canadian Chamber of Commerce has a plan to transform the venture capital industry in Canada:

1. Incentivize angels: make British Columbia's investment tax credit a national program

We need more angels, and British Columbia has a spectacularly successful, tested program that the federal government could emulate at the national level. The province gives investors a 30% refundable tax credit for investments of up to $200,000 in eligible businesses, a maximum tax credit of $60,000 per investor. The investors must hold the principal amount for at least five years or pay back part of the tax credit.

A study at UBC[9] showed that for every $1 in provincial tax credits issued, the companies ended up paying $2.92 in Canadian taxes (sales taxes, income taxes and corporate taxes).

The federal government should establish a 15% refundable tax credit on eligible start-ups that would be matched by the provinces. A country-wide 30% tax credit would incentivize angel investors to do more and to hopefully grow the angel community.

2. Sweeten the deal: provide a tax exemption on the capital gains from venture capital

The capital gains in tax-free savings accounts (TFSAs) are exempt from taxation, a helpful boost to retirement savings. By providing a similar treatment for venture capital, the government would make Canada a very attractive destination for investors. Because so many venture capital investments fail to make any profits, it is critical that the successful ones have the large returns that can justify investing in venture capital funds.

3. Pull in more investors with flow-through shares for technology companies

For 25 years, flow-through shares, a uniquely Canadian tax innovation, have generated billions of dollars for mining exploration and enabled the development of some of Canada's largest mines. Just in the past five years, Canadian mining firms have raised $2.5 billion using flow-through shares.

The way it works: the tax deductions for exploration and development expenditures are of no use to companies that will not have taxable income for years. Flow-through shares enable them to renounce qualifying expenditures and transfer them to their

9. Thomas Hellmann and Paul Schure, 2010, An Evaluation of the Venture Capital Program in British Columbia, Report prepared for the B.C. Ministry of Small Business, Technology and Economic Development. Can be viewed at: http://strategy.sauder.ubc.ca/hellmann/pdfs/Hellmann%20Schure%202010%20Venture%20Capital%20Report.pdf.

investors. Someone who purchases shares in a mineral exploration company gets the potential return along with a nice tax deduction.

This would work for innovative technology companies that will not have any income for the years it takes to develop a new product. In fact, a study by PricewaterhouseCoopers LLP in 2010 analyzed the potential economic impacts of allowing the biotechnology sector to use flow-through share financing. The study predicted an increase of R&D spending by $411 million, a total gross output impact of $967 million, and the creation of 7,945 full-time equivalent jobs. That same study also points to an increase in government taxes collected, totaling over $80 million.

The government should make flow-through shares available to all types of technology companies, not just mining companies.

4. **Increase government investment in venture capital**

The federal government's Venture Capital Action Plan (VCAP) was announced in 2013 to provide $400 million in funding over a decade to attract $1 billion in private capital to various venture capital funds of funds. The program has been very successful because government investment must be matched by private sector funding—that is the fund managers must go out and raise money from the private investors. The government should double the size of the VCAP to $800 million and consider placing a 3% cap on the return on government investment in order to boost the returns received by private sector venture capital investors. This improves the return of private sector investments while leveraging up the funding for entrepreneurs.

5. Invest in incubators

Business incubators are organizations that support start-ups and new companies by providing resources and services, such as mentorship, funding, networking, training and office space, to accelerate their development. Incubators often vary widely in services provided and in costs to be accepted, but most entrepreneurs find them very valuable. However, the application process is often very difficult, with hundreds of companies applying for a small number of spaces. They are also far more easily available in the biggest cities.

Governments must invest in incubators as a key part of bringing together start-ups, mature companies and post-secondary institutions. These can help foster “business clusters”: organizations and spaces where start-ups, mature businesses, post-secondary institutions and governments can collaborate to accelerate learning and innovation. Examples include Montreal’s Notman House, the Waterloo Region’s Communitech, Toronto’s OneEleven and Vancouver’s Launch Academy.[10]

For this reason, the government should spend money to support incubators in partnership with universities in order to grow their size so they can serve more companies and build new ones in communities across Canada. There is an amazing array of Canadian incubators and accelerators[11] that could be expanded.

6. Review regulations on banks, insurance companies and pension funds

The government should consider changes to guidelines and regulations to encourage financial institutions and pension funds to invest a small portion of assets in venture capital funds.

10. Deloitte Canada. “Age of Disruption – Are Canadian Firms Prepared?” Deloitte Future of Canada Series, Can be viewed at http://www2.deloitte.com/ca/en/pages/insights-and-issues/articles/future-of-productivity-2015.html

11. Rob Lewis, “The Comprehensive List of Canadian Incubators and Accelerators,” TechVibes, April 13, 2011. Can be viewed at: http://www.techvibes.com/blog/the-comprehensive-list-of-canadian-incubators-and-accelerators-2011-04-13.

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