Department of Finance Canada – consultations
on increasing the availability of venture capital
for high-growth businesses in Canada

The Québec Venture Capital and Private Equity Association representations
to the Government of Canada

July 12, 2012
Table of contents

1. Réseau Capital ................................................................. 3
2. General Comments ............................................................. 3
3. The Current Canadian Landscape ........................................... 3
4. Recommendations
   Management of the $400M .................................................. 5
   Investment criteria ............................................................ 6
   Investment objectives in Canadian businesses .......................... 6
   Incentives to attract investments from the private sector .......... 7

Charts and Tables
   Chart 1: Yields according to the size of the funds (U.S. venture capital funds) 8
   Chart 2: Venture Capital Investments as a % of GDP .................... 8
   Table 3: Canadian Venture Capital Funds Closed over the 2009-2012 period 9
   Table 4: Indirect financing to support venture capital industry (2006-2009) 9
   Chart 5: Portion of amounts invested in venture capital tech. in QC by investor type 10
1. Réseau Capital

Réseau Capital, the Québec Venture Capital and Private Equity Association, is the only private equity association that brings together all stakeholders involved in the Quebec investment chain. The mission of Réseau Capital is to contribute to the development and efficient operation of the private equity industry, which plays a major role in the development and financing of businesses in Québec.

Founded in 1989, Réseau Capital has more than 425 members representing private equity, tax-advantaged and public investment companies as well as banks and insurance companies, accounting and law firms, along with many professionals working in the field.

2. General Comments

A strong and mature venture capital industry will have a considerable positive impact on innovation, employment and growth.

There is strong support for governments to support the development of a dynamic venture capital industry (positive externalities, increasing returns). However there are also numerous pitfalls to be avoided. Some of the key recommendations in this regard are to work in partnership with the private sector and to avoid the multiplication of counterproductive investment constraints.

The prerequisite for the success of venture capital is not only money ("money"), but money coupled with expertise ("smart money"): industry and operational expertise, depth of networks.

In the long term, the relationship between the size of the venture capital funds and their yield is concave: in general, large funds (over $400M) underperform, but small funds are also disadvantaged since they can have limited (i) management team resources (expertise, networks), (ii) sums available to invest in big winners and (iii) levels of holdings at exit. Depending on the sector, the optimal size for a venture capital fund is between $100/150M and $300/400M (Chart 1).

3. The Current Canadian Landscape

Measured by GDP share, the Canadian venture capital industry is under-developed in comparison with its American counterpart, and the gap between the two industries is widening (Chart 2).

The Canadian venture capital industry faces considerable problems when it comes to fundraising. Generally speaking, Canadian funds are (too) small. Despite the fact that the industry and the main limited partners are willing to close larger funds, the latter typically do not exceed $150 million, with the exception of Tandem Expansion, which received a special investment from the federal government through the BDC (Table 3).

One explanation for the industry’s fundraising problems is the industry’s own chronic under-performance. A number of historical factors explain such under-performance: when Canadian

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1 On these three comments, we can refer to:
- Paul Gompers, Anna Kovner, Josh Lerner, and David Scharfstein, “Specialization and Success: Evidence from Venture Capital”, February 18, 2006
venture capital was in the early stages of development, it suffered set-backs from the poor timing of its development due to the burst of the tech bubble, relatively 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 venture capital ecosystems².

Given this context, Canadian institutional investors avoided the Canadian venture capital asset class. Moreover, it is very challenging to attract foreign institutional investors in the absence of a good track-record and strong local support.

Nonetheless, it is worth noting that other jurisdictions also face sluggish venture capital yields and the withdrawal of institutional investors. For example, Europe and Israel are currently coping with these very problems as their governments attempt to establish support mechanisms in view of further developing the venture capital industry for the long term³.

For several years now, efforts have been made in Canada to improve the venture capital landscape and to develop a private equity industry based on best practices, such as expertise, adequate fund size and better integration into the global ecosystem.

The provinces have led these efforts, principally by forming funds of funds and co-investment funds. The federal government has been a more discrete contributor (Table 4).

The efforts undertaken in Québec since 2004 under the impetus of the Québec Government, the Caisse de dépôt et de placement du Québec, pension funds and other tax-advantaged funds are starting to bear their fruits:

- A $600M fund at the first phase (2004-2008), then a $700M fund at the current actual phase have as up until now permitted the financing of 12 Québec managers who invest in Québec, in Canada and abroad, as well as 7 managers from the rest of Canada and 7 foreign managers who had demonstrated interest in Québec’s deal-flow;

- This opening also drew an increasing number of foreign co-investors. The share of Canadian and foreign independent private funds of the amounts invested in technological venture capital in Québec went from 30% of the total in 2003 to 66% at the beginning of 2012 (Chart 5);

- The geographical constraints imposed by the governmental funds were managed so as to (i) allow the Québec-based funds to invest outside of Québec and to extend their deal-flow and their networks and (ii) attract outside funds, Canadian and foreign, interested in Québec’s deal-flow. If we take into account all co-investing, Québec’s outcome is positive in terms of capital and expertise⁴.

- Encouraging preliminary signs are beginning to show with respect to returns, hereby enabling us to hope that certain funds will be able to build a positive performance history, thus facilitating further fundraising.

However, this effort collides with limited funds now available in Canada and with the small number of Canadian limited partnerships who invest in this asset class.

In recent years, the vast majority of Canadian venture capital funds that have succeeded in raising capital, have only been able to do so due to the coordinated efforts of major federal and provincial public or quasi-public funds. In the present circumstances, good collaboration between the various funds that receive governmental support is essential in order to stimulate and finance good Canadian

³ See QCC Public Policy Forum on Venture Capital and Innovation, Main Conclusions 2010 and 2011.
management teams and achieve a sizeable first closing, all within a reasonable time. As previously mentioned, Canadian funds remain, on the whole, too small and must rely on American funds in order to increase the portfolios of the top companies (expertise, sources of capital) and to build exits (strategic sales, IPOs). Given Canada's small economic size, it is inevitable that a considerable proportion of Canadian technological companies will be taken over by foreign companies, mainly American ones. Given the absence of Canadian anchor investors capable of taking the lead to support their investments from beginning to end, the possibility of increasing Canadian champions of technology diminishes.

In Québec, pension funds and other tax-advantaged funds play an important role as co-investor besides independent private funds. Outside of Québec, the disappearance of pension funds and other tax-advantaged funds renders the financing needs of technological companies even more blaring.

4. RECOMMENDATIONS

Réseau Capital supports the initial objective set forth by the government at the beginning of this consultation, namely, to support the development of high-growth businesses in the technological sectors by reinforcing the offer of venture capital.

Management of the $400M

The best way to reinforce the offer of venture capital and not only money (“money”), but money combined with expertise and depth of networks (“smart money”) is to attribute the management of the fund to one or two teams already actively managing a fund of funds and who have:

- A good investment history with respect to venture capital funds;
- an excellent knowledge of the pan-Canadian and foreign venture capital industry
- great aptitudes and good vision so as to reinforce current efforts to build a strong ecosystem of venture capital in Canada, based on best practices;
- the willingness take a lead role, within a pan-Canadian perspective, to strengthen the collaboration between the various federal and provincial governmental funds; and
- the proper infrastructure in place, thus allowing them to be immediately functional (the use of existing management teams would spread out the increase in costs of managing higher amounts of capital, it would also facilitate the negotiation of lower management fees).

In the situation prevailing currently in Canada, one or two competent funds appears to be the best tool to build, attract and select the best fund managers, as opposed to using an automatic “matching fund” program. Furthermore, the distribution of this allocation between a larger number of teams could have the effect of spreading the resources too thinly, thus weakening the catalytic effect that this allocation of capital could have on furthering the development of stronger and larger funds.

In light of the difficult current climate, a very important element to consider is the ability to execute rapidly. From this point of view, assigning this allocation to one or two well positioned and existing teams, who are already in line with current efforts, would have the benefit of accelerating ongoing efforts by providing additional funds to speed up the realization of the first large-size closings.
**Investment criteria**

- **Investment strategy**: the fund of funds should target funds that:
  
  i. Invest in high growth businesses in the technology sectors (IT, life sciences, Cleantechs, new materials);

  ii. have an investment strategy that is highly, but not necessarily exclusively, focused on the pan-Canadian deal-flow;

  iii. have the potential to attain a level of expertise and growth in their respective sector (this requires minimum sizes for the first closing and good perspectives for the final closing. The target growth should vary according to the sector); and

  iv. can attract private investors (financial investors, businesses and wealthy individuals). With respect to this last criteria, in a market currently in reconstruction and where it is very difficult to raise funds for venture capital, it would be counterproductive that the bar be raised too high for Canadian teams and to adhere too rigidly to these criteria. In the past few years only a minority of funded Canadian funds managed to raise substantial venture capital from private investors for their first closing, with an improvement at the final closing. Hence, the $400M contribution can be an invaluable tool to help promising Canadian teams reach their first closing.

- **Management teams**: the fund of funds should target:

  i. Established Canadian teams whose profiles show excellent expertise and competence and a good performance history;

  ii. emergent Canadian teams whose profiles show excellent expertise and competence and a good performance potential; and

  iii. foreign teams that demonstrate an excellent performance history, first-hand expertise and a true interest in Canadian deal-flow.

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**Investment objectives in Canadian businesses**

The government’s ultimate objective is to strengthen high growth Canadian businesses and, if possible, to help build successful and large Canadian businesses in the technology sector.

It would be counterproductive to impose strict geographic constraints as was the case in the past (investing only in Canadian funds that invest primarily in Canada) as this results in removing the Canadian fund management teams from deal-flows, as well as from international expertise. These constraints result in lowering the expected return (restriction of deal-flow) and rule out the most qualified Canadian and foreign fund management teams.

However, it is a legitimate objective for the government that a sum equivalent to $400M of public funds be invested in Canadian businesses, either by way of funds in which the fund of funds will have invested, or by way of foreign co-investors that these funds may have attracted.

The best way to ensure that this objective is achieved without imposing counterproductive investment constraints is by (i) letting it be known that we want to invest in funds that are interested in the Canadian deal-flow, and (ii) verifying that the fund management team have an interest and an in-depth knowledge of Canadian deal-flow and are seriously considering it. This verification is done during the
due diligence review: history of investing in Canadian funds, investment strategy, type of competence, knowledge of Canadian networks (scientific, industrial, co-investment), motivation to invest in Canada, etc.

Let us also mention that this method of managing the objective of investing in Canadian companies can only happen if the $400M is managed by an experienced team, capable of conducting this type of due diligence as well as capable of ensuring the “best effort” of underlying funds to invest in Canada. Including an objective of investing in Canadian companies within a program of automatic fund matching would certainly translate into rigid and counterproductive constraints. This is an additional argument to entrust the management of this $400M allocation to a competent management team instead of making it an automatic program.

**Incentives to attract investments from the private sector**

A Yozma type strategy (a call on the government’s position at a preferential rate) could be one of the solutions to consider in order to attract limited partnerships from the private sector.
CHARTS AND TABLES

Chart 1: Yields according to the size of the funds (U.S. venture capital funds)  
("pooled average IRRs" as of December 31, 2011)

Data Source: Thomson Reuters

Chart 2: Venture Capital Investments as a % of GDP  
(excluding investment in traditional sectors in Canada)

Data Source: Thomson Reuters, US Bureau of Economic Analysis, Statistics Canada
### Table 3: Canadian Venture Capital Funds Closed over the 2009-2012 period (excluding seed and accelerator funds)

<table>
<thead>
<tr>
<th>Fund</th>
<th>Size ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tandem Expansion Fund I</td>
<td>300</td>
</tr>
<tr>
<td>BlackBerry Partners Fund II</td>
<td>150</td>
</tr>
<tr>
<td>TVM Life Science</td>
<td>150</td>
</tr>
<tr>
<td>XPV Water Fund</td>
<td>150</td>
</tr>
<tr>
<td>Lumira Capital II + Merck Lumira Bioscience Fund</td>
<td>148</td>
</tr>
<tr>
<td>VanEdge Capital</td>
<td>137</td>
</tr>
<tr>
<td>Chrysalix Energy III</td>
<td>123</td>
</tr>
<tr>
<td>iNovia Investment Fund II</td>
<td>109</td>
</tr>
<tr>
<td>Celtic House IV</td>
<td>105</td>
</tr>
<tr>
<td>Rho Canada II</td>
<td>100</td>
</tr>
<tr>
<td>Cycle Capital Fund I</td>
<td>80</td>
</tr>
<tr>
<td>Georgian Partners Growth Fund I</td>
<td>67</td>
</tr>
</tbody>
</table>

### Table 4: Indirect financing to support venture capital industry (2006-2009)

<table>
<thead>
<tr>
<th>Province</th>
<th>Government Allocation</th>
<th>Other Anchor LPs</th>
<th>Private sector LPs (incented)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>BC</td>
<td>Gov FoF $90 M</td>
<td></td>
<td></td>
<td>$90 M</td>
</tr>
<tr>
<td>AB</td>
<td>Gov FoF $100 M</td>
<td></td>
<td></td>
<td>$100 M</td>
</tr>
<tr>
<td>ON</td>
<td>Private FoF $90 M</td>
<td>Co-inv Fund $250 M</td>
<td>$115 M</td>
<td>$205 M</td>
</tr>
<tr>
<td>QC</td>
<td>Private FoF $200 M</td>
<td>FoF $50 M</td>
<td>$500 M</td>
<td>$700 M</td>
</tr>
<tr>
<td>Fed.</td>
<td>Invt in late stage fund $75 M</td>
<td></td>
<td></td>
<td>$75 M</td>
</tr>
</tbody>
</table>

| Total    | $855 M                  | $550 M           | $115 M                      | $1520 M|

Chart 5: Portion of amounts invested in venture capital tech. in QC by investor type

Data source: Thomson Reuters