Government and Venture Capital:
Policy Experimentation in Search of a Solution **9/11/15**

Introduction

Collectively, Government in Canada at the federal and provincial level has become the single most important player in the venture capital industry.

This signal development has gradually occurred over the past decade and shows no signs of abating – in fact, just the reverse as venture capital policy initiatives continue to multiply.

At this juncture, and outside the confines of the venture capital industry itself and a small circle of policy makers, there is very little public, parliamentary and media awareness of what has been taking place in this vital portion of the innovation economy.

The pages below outline:

- The scope and dimensions of Government involvement in venture capital;

- How and why this situation has come about;

- What the consequences for Canada and the industry have been;

- The actions that might be taken going forward to improve the quality of public policy pertaining to venture capital.

A Snapshot of Government Activity

The following consists of an illustrative, not an exhaustive, listing of Government venture capital initiatives:

- The single largest and most active venture capital fund in the country is BDC Venture Capital;

- BDC Venture Capital has over $1 billion at its disposal and provides funding for over 40 venture capital funds in the country;

- BDC Venture Capital has direct investments into companies at all stages of their growth, from start up to expansion;

- EDC has a roughly $1 billion portfolio of venture capital and private equity assets in Canada and abroad and like BDC is both a direct investor into portfolio companies and an indirect investor into funds;

- FCC has a $150 million portfolio that is concentrated in one venture capital fund;

- The federal government in partnership with Ontario, Québec and the private sector has launched a $1.2 billion Venture Capital Action Plan (VCAP) with $400 million of government money and the balance mostly sourced from banks and pension funds. The VCAP will be deployed to funding venture capital funds that are present in Canada;

- Québec has the $715 million Teralys fund-of-funds that has been investing in venture capital funds while Ontario has the $205 million Ontario Venture Capital Growth Corporation; B.C. has the $90 million B.C. Renaissance Capital Fund that was set up to attract venture capital funds to the province and will be setting up a substantial venture capital support program in the Fall;

- Several governments across the country provide tax credits for retail investors in Labour-sponsored venture capital corporations (LSVCC's); while Ottawa and Queen's Park announced the phase-out of these LSVCC's, other governments continue to support them (Québec, B.C.) and even increase these tax credits (Nova Scotia, Newfoundland, Saskatchewan); and, LSVCC investments continue to be eligible for inclusion in RRSP's; the cumulative tax expenditure cost of the LSVCC tax credits has been considerable;

- Ottawa announced in the 2014 Budget that an Immigrant Investor venture capital fund would be established; it was expected following consultations with the venture capital industry and a report from an Expert Panel that this fund would be capitalized at $100 million and would focus on early-stage venture capital co-investments and be managed by BDC Venture Capital. Securing qualifying investments from potential foreign investors has proved to be a challenge given program design and the lack of an effective marketing strategy; the application date has been extended to December 31, 2015. Depending on uptake, this pilot program may be stillborn.

- AEC and Avac – two initiatives of the Alberta government. Both entities invest in local venture capital funds and Avac has direct investments as well.

- SDTC. This federal entity makes early stage clean tech investments, often in concert with venture capital funds.

- Offsets program of Industry Canada, whereby multinational defense and security contractors are able to 'offset' part of their purchase-in-Canada obligations by investing in venture capital funds.

- BUILD ventures in Atlantic(four provinces and BDC); Newfoundland and Labrador Venture($10 mm from province, $2 mm from BDC and a 30% refundable tax credit managed by Growthworks Atlantic – an LSVCC that froze its unit redemptions last November).

<u>How Did We Get Here?</u>

Government has largely moved into venture capital in reaction to a market failure in the industry. Just as governments around the world acted to deal with the market failure in the broader financial sector that erupted with sudden ferocity in 2008, Government in Canada has also reacted to market failure in venture capital.

The difference is that the venture capital market failure has been developing over a period of many years, almost in slow motion, and so the Government response has been equally incremental. With the result being a certain lack of awareness about what has taken place on the part of policy-makers, Parliaments and publics alike.

The market failure affecting venture capital has a number of features, including:

- Venture capital financial returns have been sub-par for several years. BDC Venture Capital, for instance, had not been profitable for at least five years running but is now recording a tiny paper profit, that is driven off of foreign exchange gains and unrealized net gains from portfolio revaluation;

- As a result, the venture capital industry has been unable to replenish its capital stock by itself;

- Traditional institutional investors have shied away from the venture capital asset class as have many retail investors, despite Government-provided incentives;

- Public sector pension funds have outgrown domestic venture capital funds just as they have outgrown the Canadian market as a whole;

- Deposit taking institutions are grappling with compliance with Basel 3 capital rules and international accounting regulations that together make investing in venture capital more difficult than in the past;

- Retail investors have fled riskier asset classes, including venture capital, in reaction to the public market meltdown of 2008 - 2009; other alternative asset classes such as infrastructure that can often promise a guaranteed yield have tended to occupy the space reserved for alternatives in institutional, and increasingly retail, portfolios;

- In short, the maxim of mutual fund pioneer John Templeton of 'investing at the point of maximum pessimism' has simply not been operating insofar as investing in venture capital funds is concerned;

- Venture capital investment volumes are still a fraction of what they were over fifteen years ago; despite some recent positive indications, there haven't been a sufficient number of exits, particularly via the coveted IPO route;

- Government has become mesmerized by the potential of venture capital as popularized by the string of high profile successes in Silicon Valley and as shown by its own Statistics Canada/Industry Canada research; paradoxically, this intense focus on venture capital has blinded Government to the role played by private equity in SME financing;

- Government has wanted to monetize its own huge investment in Research and Development and ensure that there is sufficient follow-on financing behind its own very early stage support mechanisms (egs., SDTC; IRAP); looked at differently, governments have provided the deal flow required by venture capital;

- Government, especially at the provincial level, is prone to State Airline Syndrome – namely, the prestige of having a homegrown venture capital industry.

Consequences

There are a number of consequences of Government involvement in venture capital, both for the industry and for Government. An illustrative list includes:

For the industry:

- Government actions have contributed to the poor returns performance of the industry as weaker funds have been propped up for longer than otherwise would be the case in a more market-centric system;

- Tax credits for investors in retail funds plus the insulation of government-owned vehicles from the fund-raising imperatives of a free market have largely been responsible for the inefficiency of the capital allocation process in the Canadian venture capital marketplace as these funds together account for a significant portion of the Canadian venture capital landscape; as returns have suffered thus cascading down to poor fundraising results, calls for yet more government assistance have multiplied while at the same time industry skepticism about the sustainability of current support measures has increased;

- Because of the perceived deficiencies of the domestic venture capital industry, Government has been increasingly turning to not merely filling perceived 'gaps' by itself but also by attracting foreign funds, particularly U.S. ones into Canada. Cross-border tax impediments have been removed (Section 116 of the Income Tax Act) and Government has supported initiatives that link high tech entrepreneurs with Canadian expatriates in Silicon Valley.

- As a result, foreign venture capital investment now stands at roughly 40% of total investment. Some concerns are now being expressed in the Canadian venture capital industry about this level of foreign investment. In addition, it appears that a two-tiered market has developed –with later-stage, larger investments tending to be made by U.S. funds and earlier-stage, smaller ones by Canadian funds. What's more, there is significant anecdotal evidence that companies tend to migrate south after receiving funding from U.S. funds;

- It has become virtually impossible to raise a venture capital fund of any size without Government money. Government funding does not guarantee success in capital raising but the lack thereof virtually guarantees failure;

- Government entities do compete with the private venture capital industry. For instance, the VCAP provides an incentive to Limited Partners (LP's) to join with the federal government but no such incentive is available to LP's seeking to invest in a particular, individual fund; the trade-off for a potential LP is the ability to select a particular GP versus the prospect of an enhanced return;

- Government sends out mixed messages. Thus, with the VCAP it has shown sensitivity to the question of increasing the supply of capital available to the venture capital funds. On the other hand, by progressively eliminating the federal portion of the LSVCC tax credit, it has cut off access to the capital that was provided by Québec LSVCC's which has dwindled to a trickle from previous years;

For Government:

- This situation has resulted in the creation of vested interests and an absence of critical scrutiny. The venture capital industry has been unwilling to critique Government venture capital policy. With the industry quiescent, out of understandable self-interest, it has become very challenging for public, opposition party and media scrutiny to take hold;

- There has been a fair amount of policy experimentation and policy stickiness in venture capital; the reasons behind the wide variety of policy vehicles have to do with the lack of policy certainty about what makes for the most effective approach. This is largely a function of the very nature of venture capital which is an asset class that typically has ten year and more life spans. Success tends to be back-end loaded and well past the time-horizon of even majority governments. In terms of policy stickiness, in which programs tend to get piled on top of one another, the LSVCC program is a prime example having been introduced federally in 1989-90 and which is not scheduled to be fully-phased out until 2017; Finance officials have been known to refer to the LSVCC program as a British Empire program – 'because the sun never sets on it';

- Lack of clarity about 'ownership'; of venture capital from a machinery of government perspective. Responsibility tends to be diffuse and shared between Finance, Industry and other departments and agencies. In B.C., it's even the International Trade department. Government venture capital programs tend to resemble industrial promotion vehicles with preferences for buying local and staying local;

Improving Public Policy Outcomes

Extensive Government involvement in venture capital will likely continue out to the foreseeable future. Consequently, attention should be focused on the steps that could be taken to bring a measure of order, consistency, focus and oversight into Government forays into venture capital so that policy successes can be reinforced and looming policy failure(s) can be more speedily identified and eliminated. In a sense, governments may need to transition venture capital from its current unregulated, almost shadow financial institution status, to an environment that is more congruent with the treatment accorded the other parts of the financial services industry including banks, insurers, pension funds and mutual funds. In a nutshell, venture capital receives a lot from government and public policy needs to right the imbalance that has developed.

Specific measures could include:

- Improved public reporting and transparency. The current state of reporting on Government involvement in venture capital is woefully inadequate and is having a dampening effect on public debate; for example, the B.C. Renaissance Capital Fund has four identified objectives, including the generation of superior, risk-adjusted returns from the capital committed – however, there is no indication of how the Fund has performed vis-à-vis these stated objectives over the past six years; EDC provides no meaningful breakdown of its investment portfolio characteristics, including its longer-term performance overall and by domestic versus international venture capital fund and by returns from fund investments versus direct venture investments into companies;

- Mandated ten–year public review of all the venture capital support initiatives of Government – along the lines of the regular review of the Bank Act and that would mirror the life cycle of venture capital;

- The absolute single figure, dollar magnitude of the public commitment to venture capital needs to be tallied up to match the disclosure level for federal LSVCC tax expenditures;

- There should be a formal federal-provincial venture capital coordination mechanism for comparing notes, sharing best practices and minimizing the competitive bidding that goes on to attract venture capital to local jurisdictions; the two tiers of Government should meet at least annually to review industry developments and share knowledge with a view to developing greater consensus than is currently the case;

- Improved data, statistics and an enhanced research effort, particularly regarding: the demand side of the supply and demand equation; the drivers of venture capital fund performance and venture capital business cycles; the impacts of foreign venture capital investment in Canada; and, the role of private equity in providing follow on financing for firms that graduate from venture capital fund portfolios; above all, there should be a central statistics repository of all the various government programs pertaining to venture capital; the latest industry statistics gathering efforts are increasing the risk of policy error and need to be addressed – both Thomson Reuters and CVCA are putting out data on industry fundraising and investing that conflict with one another; what's more, generally-available, up-to-date data on industry financial performance is lacking – the most recent being up to December 31, 2012.

- A strengthened Social Contract with the venture capital industry via: improved and more fulsome reporting from funds accessing public monies; providing incentives for such funds to sign on to the United Nations Principles for Responsible Investing (UNPRI); developing higher professional standards for industry practitioners alongside post-secondary institutions and others such as the Kauffman Foundation leading to the establishment of a Venture Capital Learning Institute (modeled in part on the Institute of Canadian Bankers);

- Consolidation of Government venture capital entities. Three structural questions emerging from the status quo at the federal level are:

  ---What public purpose is served by having venture capital operations split between BDC, EDC and FCC? It could be argued that overlap and duplication could be minimized by amalgamating the three.

  ---What is the public purpose behind housing the state's venture capital activities inside organizations whose main activities are lending and export credit insurance? It could be argued that venture capital is sufficiently distinct in terms of staff skills sets, remuneration, hold periods and target potential clientele as to warrant being separate – much as the leading foreign, notably U.S., venture capital operations are distinct entities.

  ---Does it make sense to keep the direct investing activities (into portfolio companies) in the same organization as indirect investing activities (investing into funds)? Again, somewhat different skills sets may be called for and separation would minimize the risk of potential conflicts of interest and of private sector funds 'gaming' the system (by co-investing with the direct operations and using that as a lever to secure capital for themselves).

- Clarity around objectives and success/failure metrics. For instance, is it the federal government's intention to have a permanent window onto venture capital? There may be instances of 'mandate drift' in venture capital programs that would need to be identified and handled. Managers of the VCAP program should at a minimum provide a 'milestones' annual report to Parliament based on identified program goals and targets.

- And, finally what to make of the two competing paradigms for LSVCC's? Ottawa should make public the relevant documentation on which it based its plan to phase out the federal LSVCC's, including projected impacts on investing and fundraising by the industry as a whole. And, the seven provinces that still provide LSVCC tax credits should provide the relevant analyses to justify their continued support of the LSVCC program. Clearly, one side has it right and one side has it wrong. To start with, there needs to be an objective analysis of the impact of Ontario's decision seven years ago to similarly phase out LSVCC tax credits and the impact(s) of that decision.

Concluding Comments: What is next on the horizon?

Federally, both the Liberals and the NDP have committed (in French, in Montreal, prior to the election call) to re-introducing the LSVCC tax credits. The LSVCC funds in Québec are lobbying hard to hold both Messrs. Trudeau and Mulcair to those commitments and have them repeated in the TV debates. That being said, both parties have quietly let it be known that should they get into power on the 19th, then there will be (unspecified) changes to the pre-existing LSVCC program.

There are indications that the Office of the Auditor-General (OAG) has been inquiring about the VCAP. It is not known whether the OAG will be proceeding to review the VCAP or what the timing of the release of an audit report on the VCAP may be.

Pressures are already building for what is being referred to as VCAP 2. It is likely that the VCAP funds of funds will have exhausted their available capital by the end of 2016 or beginning of 2017. At that point, the solid returns that are expected will not have materialized and the traditional venture capital funds that will be out fundraising may be facing a capital cliff of some magnitude. So, venture capital funds themselves, the funds of funds that are managing the program and the LP's that are benefiting from a preferential position relative to government will likely all be actively promoting a VCAP 2.

BC is about to launch its own nine-figure venture capital support program that will not be harmonized with the VCAP. As for Alberta, there have been discussions, pre-the arrival of the NDP government, about there being an increase in public commitments of dollars to AEC and the possible involvement of AIMCo. The venture capital industry in Alberta is banking on the NDP's commitments to diversify the Alberta economy and improve the oil and gas industry's environmental footprint.

As for the industry itself, there are indications that the nuclear winter that began in March 2000 may finally be coming to a close and that the venture capital business cycle may be entering a new, more positive phase – formerly absent investors are edging in to the asset class, net unrealized gains are improving, cash distributions to LP's are increasing and, in a sense, it appears that strong demand is finally beginning to generate a supply response.

At the same time, traditional venture capital funds are increasingly at risk from a variety of non-traditional players that are taking larger bites of the venture capital pie. Thus, revenue-based financing entities, angel syndicates, Family Offices, angel networks, peer to peer lenders and crowdfunding entities are among the new organizations that are actually supplying capital to potential high growth, earlier-stage firms.

It is also likely that as private placements markets begin to take off, aided and abetted by securities commissions easing the rules for accredited investors and Offering Memoranda, the threats to the early-stage venture capital fund business model will also appear for later-stage company financings. In the U.S., private equity funds are playing an increasing role in venture capital and the same development is starting to take hold in Canada.

The competitive threat to the franchise of the leading wealth management firms(banks, insurers, asset managers) posed by Google and Facebook amongst a whole host of other, smaller, start ups is leading to an explosion of fintech financings. BMO has invested in the VCAP but also in OMERS Ventures II while Power Financial and Dundee have made direct investments into various fintech companies.

Big pharma (eg. Merck) has been active in the venture sphere and there are indications that the oil and gas majors will similarly come to the conclusion that they need to become active earlier-stage investors in cutting-edge technologies. Then there are the media/telecommunications companies (Rogers, TELUS, Torstar) that are also becoming a presence.

In a word, as disruptive technology threatens a wide range of industries, one competitive reaction is to begin funding those particular firms, which in turn is leading to increases in the amount of risk capital available to earlier-stage high tech firms. After all, as leading U.S. venture capitalist and technology pioneer Marc Andreessen said, “In short, software is eating the world.”

Finally, the real disruption would occur when more of the leading pension funds go direct with substantial funds of their own, just as OMERS (which now has $440 million in capital under management, in two separate funds – rivaling in size the direct investing operations of BDC) and the Caisse de Dépôt have, and begin to outbid existing players – just as has happened in the private equity space. In this regard, the direct involvement of the pension funds will be assisted by a trend towards larger venture capital investment rounds that is starting to become noticeable, particularly in the U.S.

Consequently, there is a significant risk that domestic venture capital funds will be squeezed from above by entities with greater financial resources(banks, pension funds, U.S. and corporate venture capital funds) while also getting compressed from below by angels, accelerators and incubators, crowdfunders and the like.

On the one hand, this could pose a novel challenge for public policy as the pool of potential providers of risk capital expands to include widely diverse entities with their own priorities and objectives. A one size fits all policy approach may become increasingly less relevant. On the other hand, and apart from traditional venture capital funds which are likely to remain in need of public support for the foreseeable future, there may be less need for overt public policy mechanisms as supply begins to ramp up from a range of non-traditional providers and as the industry enters a new, more vibrant phase of the business cycle.