Drivers of Performance in the Canadian Venture Capital Industry

Building Strong Portfolio companies & Exiting Effectively

Objectives

The objective of this work is to examine the following issues/observations:

- The Canadian technology community and VC industry seems to be creating mainly small to medium size companies, but is creating very few global sustainable corporations. This results in comparatively lower returns to VC investors, and to the Canadian economy. We undertook to examine: a) the Israel model as it appears to have been more successful at growing global sustainable corporations and b) the US model. The objective is to get a sense of what might be a better model for Canada by looking at what has worked and what has not worked various locations.
- Timing is important to VC success as GPs: a) need to enter new sectors early; b) need to recognize when the exit window is open and use it; c) need to recognize when the early sale opportunity should not be taken because a much bigger win is possible. It appears that Canadians GPs have been less effective at timing their entrance into new sectors and exiting effectively when the opportunity to do so is available.

The Work Group

This work was undertaken by a group which consisted of:
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Work undertaken

The work undertaken by this group has consisted of:

- Examining the literature on best practices in the VC industry (6 studies);
- Reviewing 3 reports that included interviews with US VC investors; and
- Interviewing two people who are familiar with VC in Israel (the reasons for focusing on Israel are described below).

The work touched on a wide range of topics which are summarized below.

The VC Best Practices Model

United States

Research on this topic has been conducted by McKinsey and others. The best practice is described as:

- Identify emerging sectors early, before others do.
- Make many small investments in these emerging sectors i.e. buy several options.
- Be effective at helping to build companies—US GPs are effective at this because of their operational experience and because of broad networks which include research institutions, corporations, investors and entrepreneurs.
- Invest additional capital in the winners and walk away from the losers.
- Exit (engineer large exits quickly). GP experience in exiting appears to be a key part of this.
- Repeat for the next sector.

This is the model in the US but it may not be applicable in other locations, in fact it is likely not applicable outside of Silicon Valley and Boston because implementing it requires: a) the network and deal flow to identify emerging sectors (several studies have noted the positive effects of industry experience and networks) and b) a large enough number of investment opportunities so that several investments can be made in the chosen sector. These conditions only exist: a) in locations with very large and mature technology communities and b) for well known VC firms.

Israel

In Israel, it seems that the model is:

- Become aware of interesting technology while in military service.
- Upon leaving the military, start a venture, usually around the core of technology which was developed in the military. In the past the entrepreneur often was a senior military person who had finished his service however recently more companies are being started by people leaving multinationals and by repeat entrepreneurs. Israel has many international companies which have located major R&D and manufacturing facilities there. For example, both Intel and Cisco have their largest non-US R&D facilities located in Israel (presumably so that these companies can access the supply of technical talent).
- The government makes technology freely available (subject only to national security interests).
- A key talent has been to take a technology developed for military use and repurpose it for commercial markets.
- The Office of the Chief Scientist provides grants to early stage companies. Originally (20 years ago) this could amount to 50% of R&D costs. The program is being reduced and contributions are now typically is less than 20%. Also, there are grants available to small companies which fund roughly 30% of R&D costs.
- It is a fundamental tenant of companies in Israel that they must work with customers from the very beginning so ensure that products are market driven, not technology driven. To do this, partnering is critical. Venture funds have corporations as strategic LPs, which allows the GPs access to the LPs (who may be potential customers for the product) as a due diligence resource. Portfolio companies try to get strategic investors early, sometimes as early as the A round, in order to get early customer validation. The objective is “to be global from day one.” This is aided by personnel who bring an international perspective and networks because they have come from multinationals to join startups or have emigrated to Israel (generally from the US).
- When the company reaches the stage where product is ready to be sold, the sales and marketing organization is located in a country that is a key market. Formerly this was usually the US but now this increasingly includes Europe, Japan and Asian countries.

- Moving the whole company away from Israel generally has not been effective.
- Hiring an experienced CEO and moving him to Israel has generally not worked. The experience has been that it is more effective to use locals or move expatriates who can reintegrate into the community quickly.
- Planning for exit starts early and some venture funds force their portfolio companies to have a detailed exit plan and to update it annually. The VCs look at this based on their expected IRR and will force sale of the company if they believe that building the company further will reduce the IRR as might be the case if the company was going to require large amounts of capital or take a long time to get to a natural (unforced) liquidity event.
- There are no tax barriers for investment by foreign investors either directly into companies or into VC funds – on the contrary there have been incentives for investment into VC funds (the Yozma program).
- Local VCs have foreign VCs (mainly US) as LPs, which provides further networking opportunity for the portfolio company.

Canada

Generally speaking, the Canada model can be described as follows:

- The company is formed in Canada.
- Funding comes initially from Canadian venture funds. In B and later rounds companies with good pedigrees often raise money in rounds led by US investors.
- When the company starts to sell product, sales and marketing is set up in the US.
- Often the company outgrows the founder and a new CEO is brought in, usually from the US.

Close proximity to the US has often been described as an advantage for Canadian companies as travel and communication are easy and the US labor pool is quite accessible. There is however another view that the closeness of the US does not aid Canadian companies, for several reasons.

- Canadians may assume that cracking the US market is all that is required for success whereas forward looking companies in the US and Israel today go global from the start.
- The US draws talented people from Canada.
- The US executives who come north may be "dabblers" who don't have to be fully committed as they are only a 2 hour plane ride from "home." Anecdotal evidence suggests that very few CEOs transplanted from the US into small Canadian technology companies succeed.
- Good deals in Canada are "poached" by US funds thus reducing returns for Canadian funds. Because of the close proximity of Canada to the US, a US investor may feel less need to have a Canadian VC involved (to have a person on the ground, close to the company) than would be the case for a company far away, in Israel for example. This may reduce Canadian VC fund participation in good deals if the good deals are being "cherry picked" by US funds.

In summary, Israel, being far away, has been forced to build its own talent pool whereas Canada has relied more on obtaining people from the US.

The US GPs view of VC investors in Canada

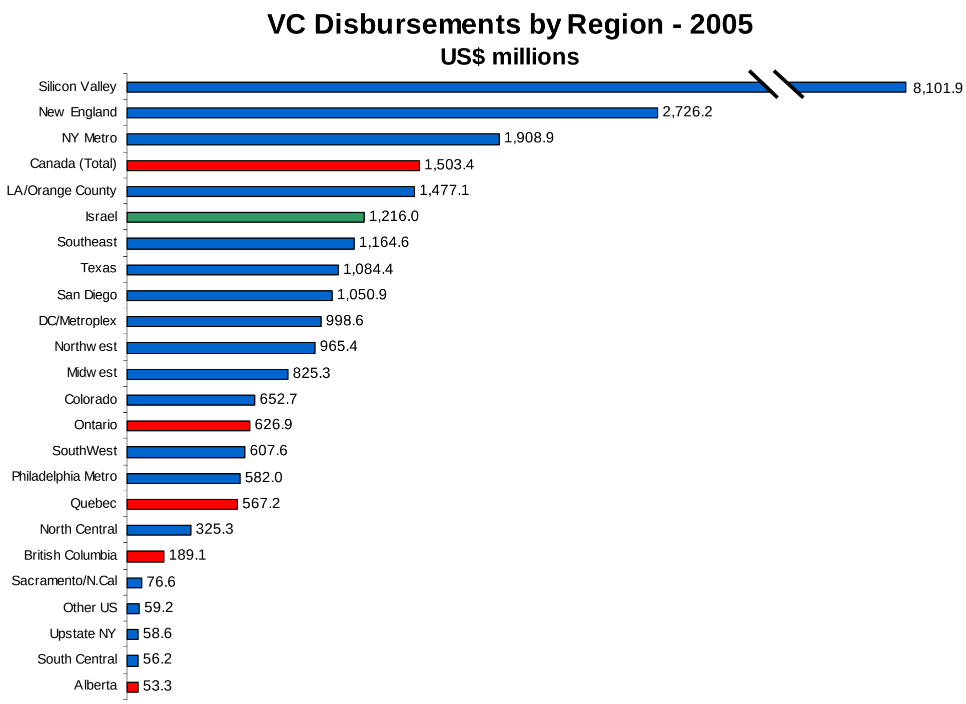
The following comments are mostly extracted from the Thompson MacDonald report "The activity of American Venture Capital Funds in the Ontario Market: Issues, Trends and Prospects", 2005.

- Factors which encourage VC investment in Ontario include: a) good R&D innovation, b) skilled workforce, c) tax incentives (presumably the SRED program), d) efficient market which includes local funds with which to syndicate and good information available about the market, and e) close geographic proximity to the US.

- Challenges which restrict activity in the Ontario and Quebec markets include: a) cross border tax issues impose too great a cost and complexity, b) technology clusters are relatively immature in the development of entrepreneurial managers (Ottawa was seen as the most developed in this regard), c) reluctance of Canadian companies to pay the price required to attract top management, d) reluctance of Canadian companies to situate parts of a company outside of Canada, e) perceived misalignment of fund interests in some cases (the view is that LSIFs and government funds (BDC, EDC, FCC) may have objectives other than rate of return), f) professional turnover in Canadian VC managers because of inadequate compensation, g) geographic restrictions placed on some Canadian funds, h) "conservative" approach (low risk tolerance) to deals and small fund sizes leading to small financings and hence to undercapitalized companies, and i) lack of established practice in Canada to have the lead investor define the investment terms (which causes time consuming negotiation of deal terms).

Canada's place in the Venture Capital Universe

Disbursements by venture funds during 2005 are shown in the graph below. Clearly Silicon Valley is in a category of its own. It is interesting to note that one of the people interviewed thought that the first tier of venture capital locations consisted of Silicon Valley, the second tier consisted of Boston and Israel and he placed Canada in a third tier that also included the NY area, Texas and Los Angeles. In fact, venture investment in Canada is larger than Israel and has been so for some time (venture investment 2003-2005 is 40% larger in Canada than in Israel. However, Israel is one concentrated location where the technology community in Canada is geographically dispersed. The largest single technology community in Canada is Ontario and venture investment there is about half Israel.



What needs to be done to have Canada advance to the next tier?

- Some large successful companies have to be built.
- Operationally experienced GP staff have to come out of existing funds and form new ones so that the VC industry grows.
- Tax barriers to direct investment in companies and to investment in VC funds by foreign investors must be removed.

The Chicken or Egg Question

In this context, the question is as follows. Do successful companies attract venture capital and thereby create a successful VC industry or does the availability of venture capital enable the formation of good companies which then result in a healthy VC industry? The view on this from the two persons interviewed was emphatically that successful companies attract the capital. As an example, there were 30 NASDAQ listed companies in Israel before there were any venture funds active there.

Sources of money

The sources of capital in Israel are quite different from Canada, for both GPs and for companies.

- *VC Funds*—95% of the capital raised by Israel based VC funds comes from outside of Israel, 30% from strategic investors (Hitachi, Nomura, NTT, Siemens, etc.). Foreign investment banks such as Goldman Sachs have also played an important role. Data on this topic is not published for Canada but we estimate that in Canada, over 95% of the capital raised by private VC funds comes from inside the country.
- *Companies*—In Israel, half of VC equity funding comes from Israel based VC funds and the other half comes from outside the country. In the past, most of this foreign VC investment came from the US. Now it comes also from Europe, Japan and other places. In Canada, roughly 30% of capital raised by VC backed companies comes from outside of Canada, mostly from the US.
- VC co-investors— Israel VCs always look for early foreign co-investors, they:
    - Want strategic investors as early as possible—at the A round if possible;
    - Avoid Israel club deals; and
    - Get banks from the US to invest at later stages when looking to go public.

Evolution of the Israel technology community

The technology community in Israel seems to have been created based on the following.

- *Technology*—developed in the military but with potential application to commercial markets, and easily available to startup companies.
- *Universities*—with high quality academics and a positive attitude to business.
- *Incubators*—these were set up 15 years ago as a way to integrate the large number of highly educated immigrants. They were successful in achieving that integration and then these incubators were privatized and linked to VC funds.
- *Entrepreneurs*—Israel's entrepreneurial culture encourages people to start companies.
- *Outward looking perspective*—as local markets are tiny, the companies have to focus on external markets from the start.
- *Research labs of large international companies*—were attracted to Israel, initially in the 1970s, by the supply of technical talent. These labs have provided an excellent supply of people (who have international connections) to startup companies.
- *Funding*—initial funding for VC funds came from sources which were not principally interested in financial return—HNW American Jews, Alex Brown (which wanted access to Israel IPOs) and Fidelity (which was the largest buyer of IPOs and wanted an inside track). American VCs were attracted by the success of the companies in Israel. The Yosma program played a part in getting some initial finds started.
- *The GP community*—started with small funds but has been successful and so is growing. Many of the GP partners are experienced operating executives from multinational companies which have set up labs in Israel.

Entrepreneurial, outward looking, and aggressive culture
The development of technology companies in Israel seems to have been aided by the prevailing culture in the country which may be generalized as follows.

- *Aggressive*—Many entrepreneurs are former senior military officers who are accustomed to command and to aggressively pursuing their goals.
- *"Life or death"*—Israel's political situation of fighting for survival engenders a "we must win or else" approach which carries over from military service to business.
- *External looking*—As markets in Israel are very small and surrounding countries are not attractive markets either, it is essential for Israel based companies to develop strong external networks.
- *Few choices other than technology*—As Israel has few natural resources and does not have a large manufacturing sector, technology is one of the best career options. Technology accounts for 50% of Israel's exports and this is growing 15% annually.

It appears that in Israel, as in the US, a person who becomes an entrepreneur has "elevated his social status." In Canada this is not generally the case—although perhaps Canada is not as bad in this respect as a country like Germany for example. Failure of an entrepreneur in Israel or the US probably has a neutral effect on his social status (compared to before becoming an entrepreneur) whereas in Canada the person is more likely to be considered a failure.

Another issue is the level of aggressiveness. Data comparing hiring expectations of new companies in Canada, the US, Israel, the UK, Spain, Germany and other countries showed that Israel and the US led in terms of how many people they expected to have working for their companies in five years. Canadian entrepreneurs were far down the list, with quite low growth expectations.

Government support for companies
It was estimated by one person interviewed that 60% of the cost of funding a company in Israel to the "C" round comes from non-equity sources such as: a) the Office of the Chief Scientist, b) training grants, c) special programs, and d) BIRD (the Israel-United States Bilateral Industrial R&D Foundation which was founded in 1977 to encourage US/Israel joint projects). Also, when VCs cut off funding for companies which are not performing, these programs allow some of these companies to continue operating and some of them eventually succeed. This funding has been reduced and now is roughly $2 of government funding for each $7 of equity.

Government support for VC funds—Yosma program
This program was established in Israel in 1993 to foster the creation of Israel based VC funds

- The Israel government provided $8 million if foreign investors provided $12 million. The non government investors had an option during the first 6 years to purchase the government position for cost plus interest.
- The GP team had to include a name brand, experienced GP from outside Israel (from the US, Europe and Asia). The foreign investors who were attracted were good US second tier funds (Advent, Walden, Oxford) but not the first tier (KP, Sequoia, etc.).
- Investments had to be in Israel.
- This program catalyzed the creation 10 funds. Most were only about $20 million which was too small (that amount could only support 1-1.5 professionals and 3-4 professionals are required to get good synergy and mix of talents) and not many generated good rates of return. These funds collectively raised about US$250 million.
- Several of these funds are still in operation and they have now raised over $ 3 billion.

From research to product to market
Companies in Israel are proud of their ability:

- To repurpose technology developed for military purposes to commercial use.
- To get market input early in the product development process—"market driven, not technology driven."
- To use strategic partnerships to guide product development and also for market entry.
- To go "global from day 1."

Exits

As noted above, some Israeli VCs are very focused on exit planning and this is a part of the reason for creating partnerships with strategic investors, both in VC funds and in their portfolio companies. It appears that there are more strategic investors in Israel VC funds than in Canadian or US based funds. Also, there seems to be more willingness to have strategic investors in companies at an early stage than is the case in Canada.

Today, most VC exits are by sale to a strategic purchaser, not IPO. In Israel, the ratio is about 6 trade sales for each IPO. The experience for both Israel and Canada based companies is that exits in the US are significantly larger than exits to purchasers from their home country. During the 2002-2005 period, 64% of exits of VC backed companies in Israel were in the US. The corresponding number for companies in Canada is 38%.

Barriers to investment in Canada

"We need to get to a situation where US investors can look at investing in Canada like investing in a 51st state." Without going into all the details of the tax issues which the CVCA has been pursuing for some time, suffice it to say that, based on the small sample in this study, there is a perception from the US that there are barriers which make investing in Canada, either investing in a fund as an LP or making a direct investment in a company, problematical.

Recommendations

The focus of this work is to examine how venture capital investors in Canada might contribute to the creation of more Canadian companies which become global leaders and thereby increase Canadian VC fund returns and make a greater contribution to the development of the Canadian economy. Creation of successful companies is a prerequisite to a healthy VC industry. If there are successful companies, there will be healthy VC funds. The industry must be built in that order—successful companies will enable a successful industry. Forcing the availability of more VC funding is not seen as an effective approach. To create more successful companies, we recommend the following:

1. Realistic recognition of the current state of the Canadian VC Industry

- In terms of VC investment in 2005, Canada ranks 4th in the world, behind Silicon Valley, Boston and the NY metro area, and ahead of Los Angeles and Israel. However, because of the geographic dispersion of VC investment in Canada, it is more meaningful to look at the position Canada's major technology clusters. By this measure, Ontario ranks 14th, Quebec ranks 17th and BC ranks 19th. Canadian VC investors and companies must recognize that their environment is small and they must ensure that they are building companies that truly have the people, perspective, networks and product to be globally competitive.

2. Recommendations for VC firms

- Canadian VC investors must become more cognizant of swings in sectoral emphasis of VC investment, and corresponding opportunities for achieving profitable exits. While it may not be possible to "follow the hot sectors" to the extent that this can be done in the US because of less deal flow in Canada, investors in Canada must: a) at least be cognizant of the "hot sectors" so that they can examine investment opportunities in the context of these trends, b) focus more on opportunities which combine a good technology position with receptive markets for products and receptive capital markets for exits.

- Canadian VC investors must become more networked—more connected to markets, potential strategic partners (as sources of market intelligence, as investors and as potential acquirers), capital markets and sources of talent outside of Canada. These connections must be global, not just to the US and must be an objective from the start i.e. "go global from day 1." These connections need to be made by VC funds as well as by portfolio companies.
- Canadian GPs must become more effective at building world class management teams. Anecdotal evidence suggests that the track record of building strong teams in Canada has been very mixed. The bar should be high and Canadian funds should be flexible with respect to location, but not with respect to management quality. Part or all of the team should be built outside of Canada if that is what is required to build a high quality team.
- Canadian VC funds have historically raised most of their money in Canada. More diverse funding sources including the US and, Europe and Asia are required to provide: a) expanded networks, b) a broader perspective and c) increased sources of capital.
- As a general statement, it appears that Canadian venture investors may be less aggressive and less risk tolerant than their counterparts in successful VCs in the US and Israel. Real success derives from being the best in the world and achieving that requires aggressiveness, extreme hard work, and real risk taking. It appears that Canadian VC investors often have not measured up in these three factors in the past.

3. Recommendations for venture backed companies

- Canadian companies must look at global markets from the start, not just the US.
- Canadian companies must use their networks to obtain early product validation; they must work with customers from the beginning to ensure that products are market driven and not technology driven.
- As a general statement, it appears that Canadian entrepreneurs may be less aggressive and less risk tolerant than their counterparts in successful companies in the US and Israel. Real success derives from being the best in the world and achieving that requires aggressiveness, extreme hard work, and real risk taking. It appears that Canadian entrepreneurs often have not measured up in these three factors in the past.

4. Recommendations for building the Canadian VC industry

- Canadians exits appear to have been less than optimal in the past. It appears that this could be improved by: a) addressing the under-funding of companies which appears, in the past to have derived from small, timid VC funds, b) being more cognizant of product/market trends, strategic purchaser opportunities and capital markets, and c) additional focus on, and planning of, the exit.
- The Canadian federal government must address the tax issues which impair foreign investment in Canadian VC funds and in Canadian companies. The principal issues are: a) Section 116 certificates and b) the LLC issue.
- Canadian governments should consider contributing to the formation of additional, and larger, private VC funds by implementing programs which would facilitate the creation of new funds and cause all funds which are formed, to be larger. Any such program should have the government providing "top up" capital, after the fund has satisfied the market test of having professional institutional investors commit to the fund.