



Facing Head Winds

The Canadian VC industry in the present crisis

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- **A long term perspective: the impact of venture capital on the Canadian economy**
 - Present impact and long term potential
- **Investment and fund raising trends**
 - A crunch which could jeopardize long term cumulative efforts to build a critical mass of technology companies, managers and investors in Canada
 - Complementarities between Canadian and foreign funds
 - The fund raising equation of our industry
- **Responses to the present crisis**
 - Governments
 - The industry
 - Actions to be taken
- **Performance data**

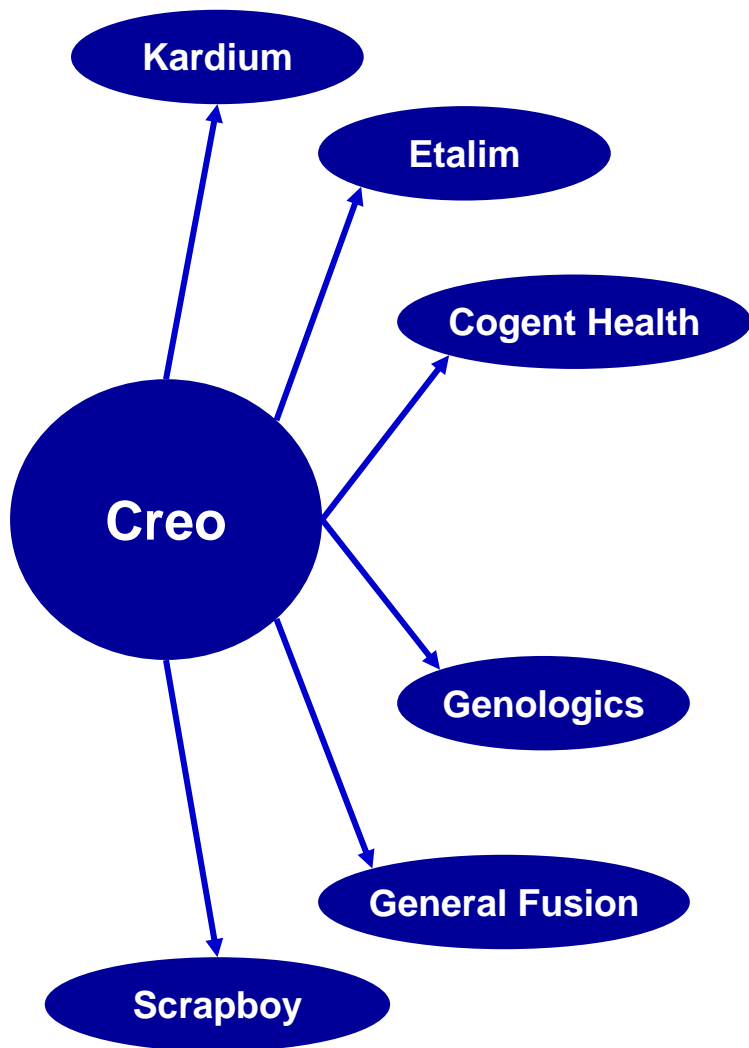
The impact of venture capital on the Canadian economy

(Main conclusions of the CVCA study)

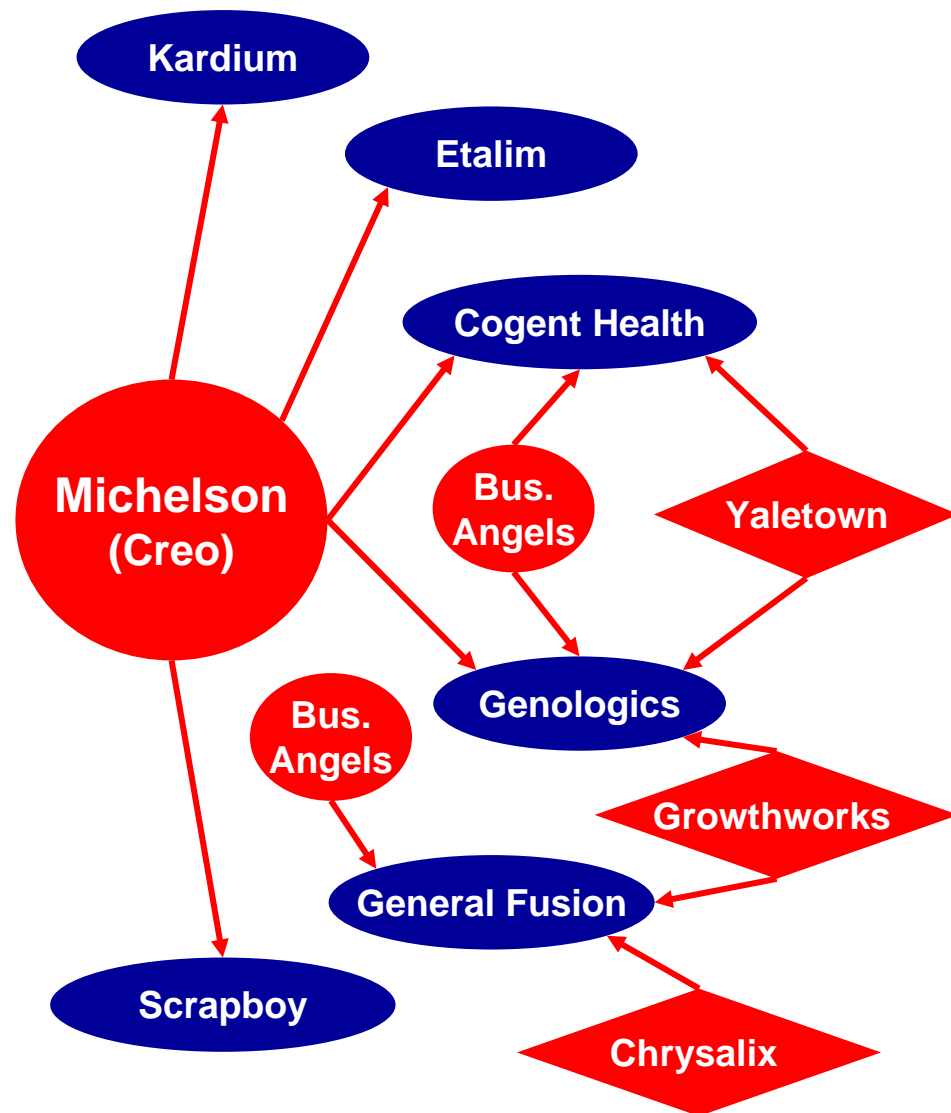
- **Venture capital backed many of Canada's largest public and private technology companies**
- **Venture capital technology companies**
 - generate close to 150 000 jobs in Canada (1.3 % of all private sector employees) and 1 % of Canadian GDP
 - have growth rates (employment and sales) which are significantly higher than the average of their sector
 - are highly R&D and innovation intensive
 - are highly export oriented
- **Snow ball effect – Successful venture capital-backed companies**
 - generate wealth and talent which are reinvested in the next generation of technology start-ups
 - create serial entrepreneurs
 - allow investments by business angels
 - 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**

Creo : The Snow Ball Effect Building a Critical Mass

Management and Board of Directors



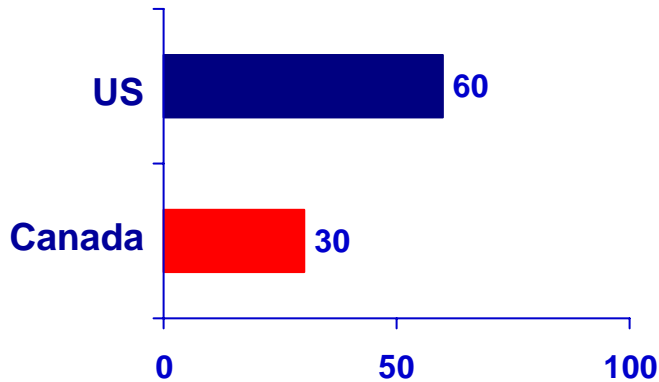
Investment



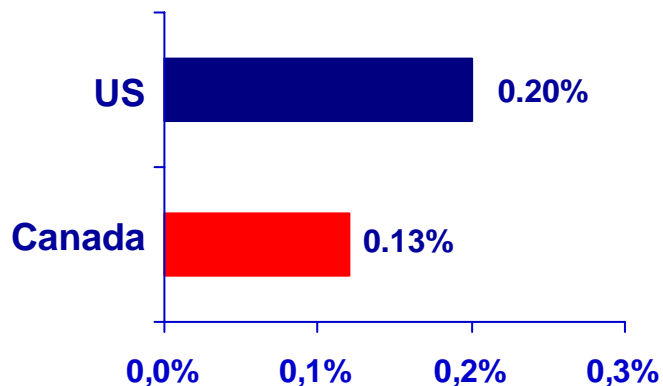
Long Term Potential Economic Impact if the Canadian VC industry is able to build a critical mass

Investment pace

Age of the industry (yrs)

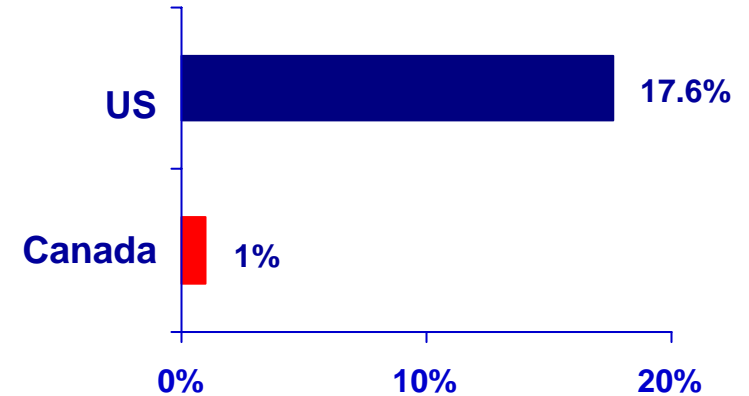


Invt/GDP (03-07)

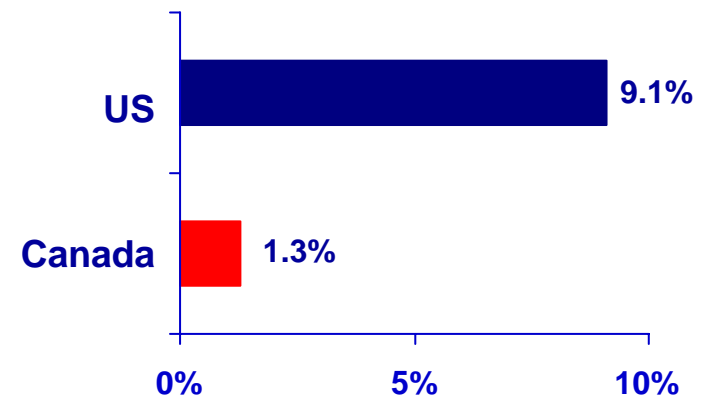


Economic impact

% GDP



% Private Sector Employment

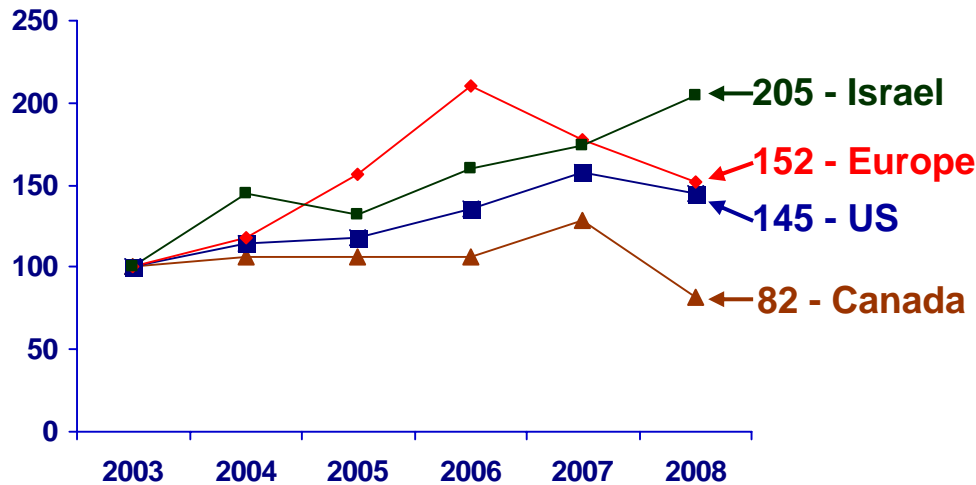


Source: CVCA – “The impact of VC on the Canadian Economy” – Data is not entirely comparable. See details in the report

VC investment in Canada

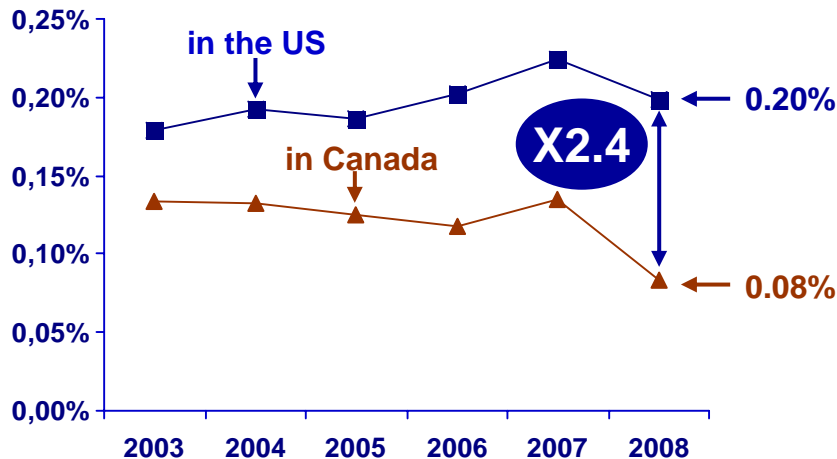
A decline with 2 components: Canadian and foreign funds

Amounts invested (2003 = 100)

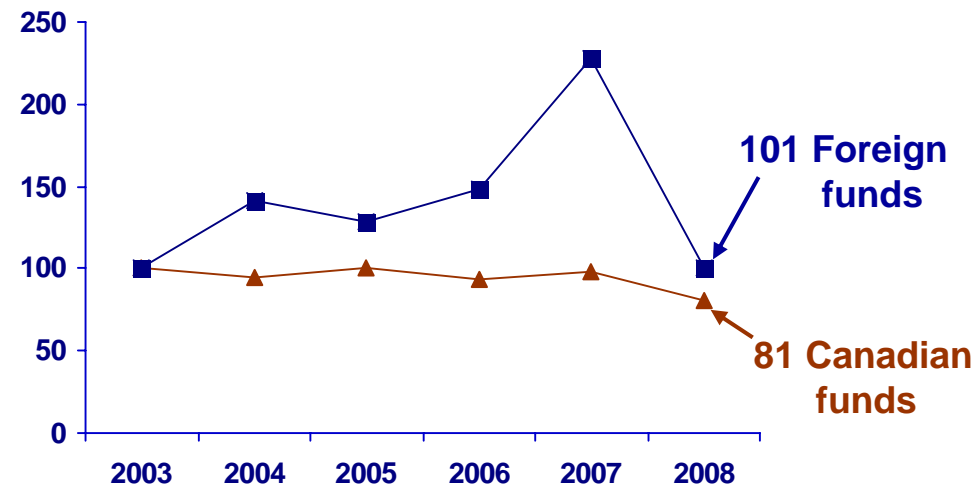


- VC investment has not bounced back in Canada after the burst of the bubble when it has in other regions
- Relative to the size of the economy, the gap with the US is now 2.4x
- The decline in investment by Canadian funds has been temporarily obscured by the increase in investment by foreign funds

VC Investment as a % of GDP

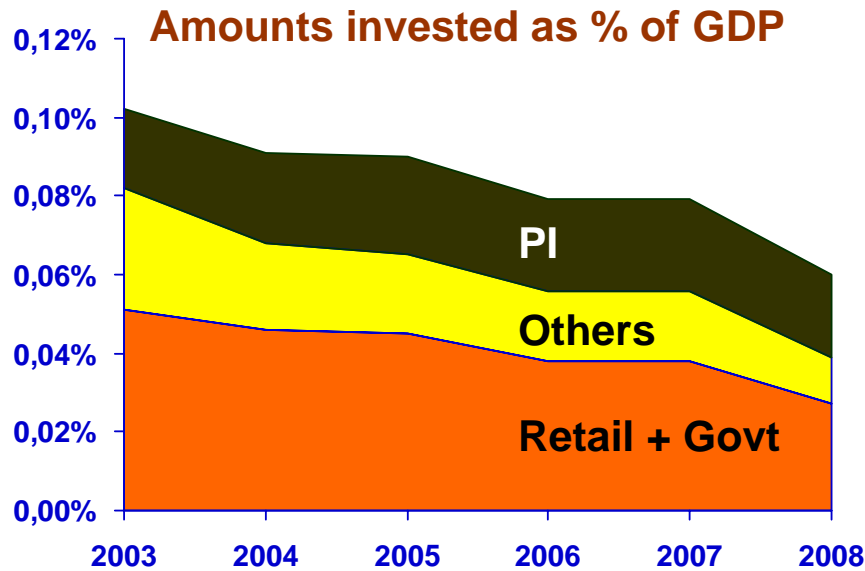


Amounts invested in Canada (2003 = 100)

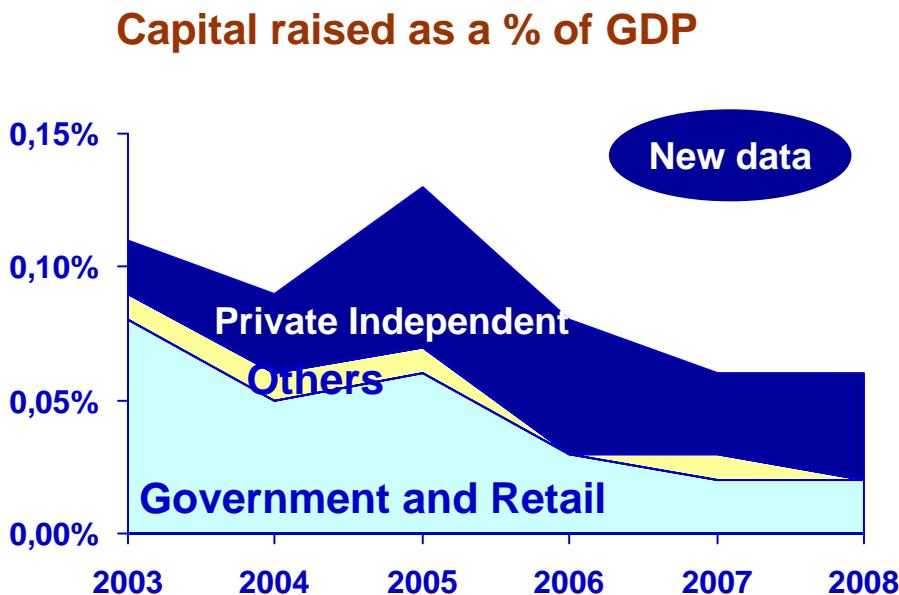


Investment by Canadian funds

PI funds do not compensate for the decline of other types of funds

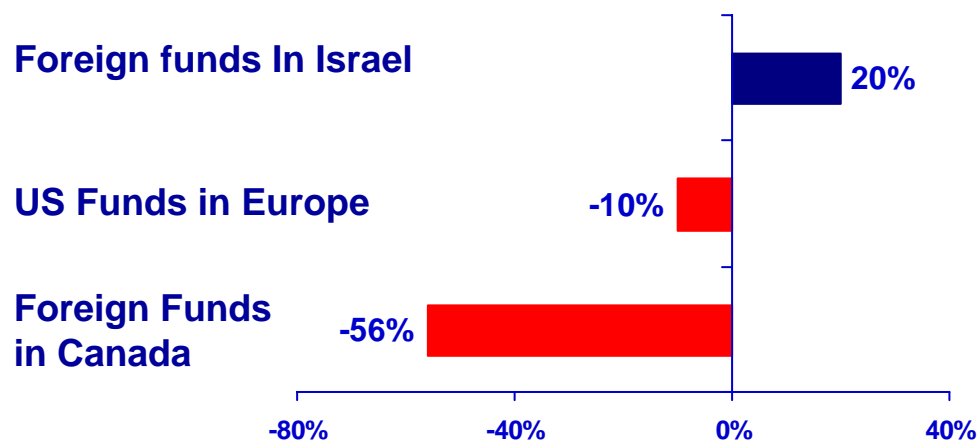


- Further to changes in government strategies to support the industry, investment by government and retail funds has declined steadily
- Investments by “Other funds”, mainly corporate and institutional (banks) funds has also declined
- This has not been compensated by a commensurate increase in investment by private independent funds
- The roots of these trends are to be found in fund raising trends
- As a consequence, the number of Canadian funds which are open for new investments and the ability of Canadian funds to support their existing portfolio companies are decreasing dramatically
- The present contraction in fund raising will lead to a further decline in investment levels down the road

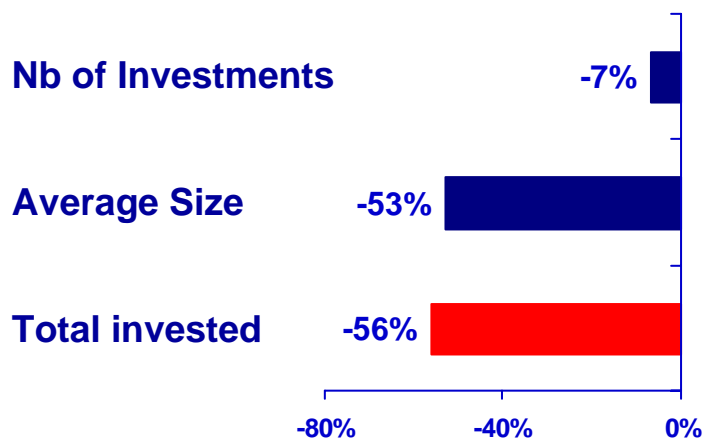


Investment by foreign funds – A drop which is partly linked to the financing constraints of Canadian funds

Amounts invested 2008 vs. 2007



Foreign funds in Canada 2008 vs. 2007



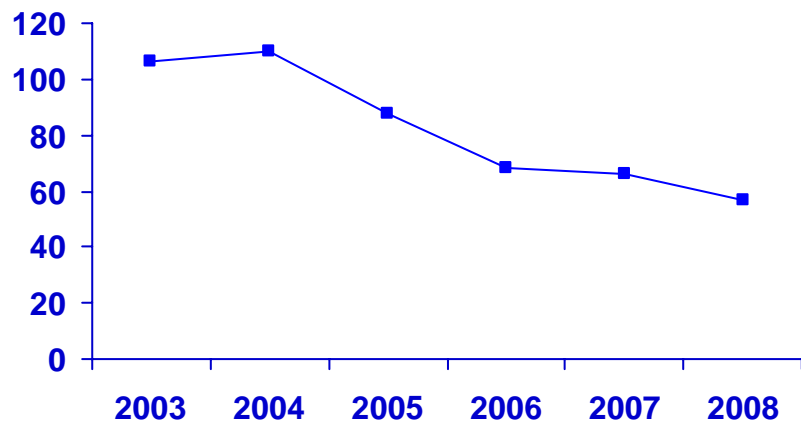
- The sharp drop in investment by US funds has not been experienced in the same way in other regions outside the US
- It is not due to a decline in the number of investments but to a drop in the size of those investments
- Beyond possible timing aleas, there are 2 main reasons for this
 - One is cyclical: in down cycles and low valuation times, early stage Canadian companies are less attractive than low valued late stage companies in the US
 - The other can be linked to the financing squeeze of the Canadian industry. In difficult times, funds will look for well capitalized coinvestors which can support their companies

Canadian companies tend to be more early stage and Canadian funds weakly capitalized

- Foreign funds cannot be a substitute to a solid local industry

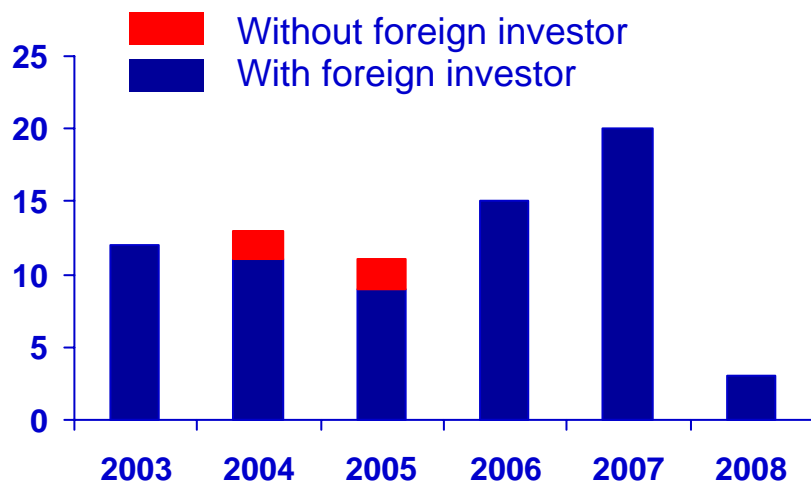
Canadian technology companies have been hit at both ends of the spectrum

Number of ES new tech. cies financed

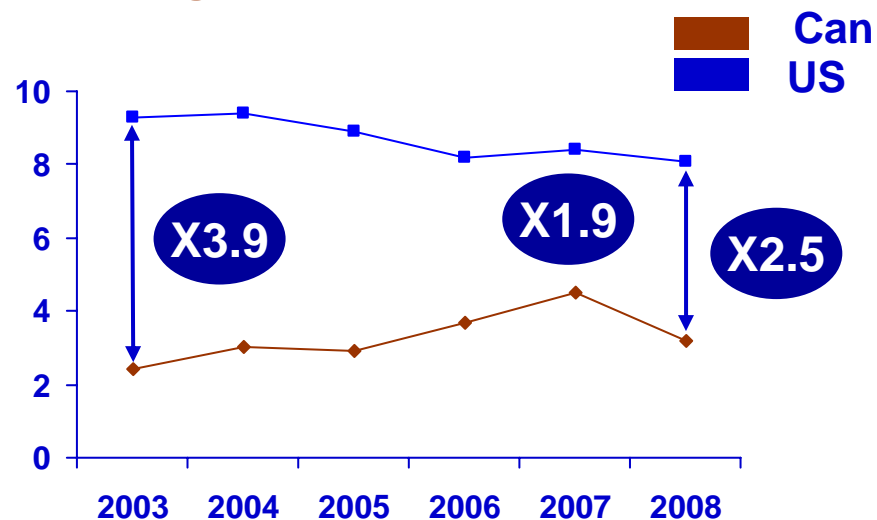


- The number of new investments in Canadian technology companies has steadily declined since 2004 as there are less and less Canadian funds open for new investments
- The number of large rounds, mostly led by foreign funds has dropped dramatically in 2008 as foreign funds have invested smaller amounts and there are very few Canadian funds able to lead large rounds
- The gap with the US in average size of rounds is widening again

Number of deals over 20 M\$



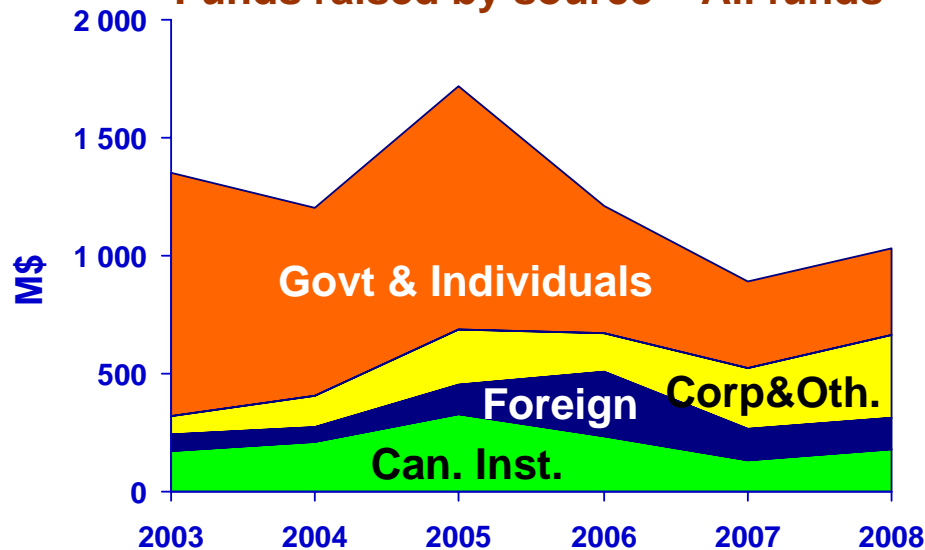
Average Size of Rounds (Can\$M)



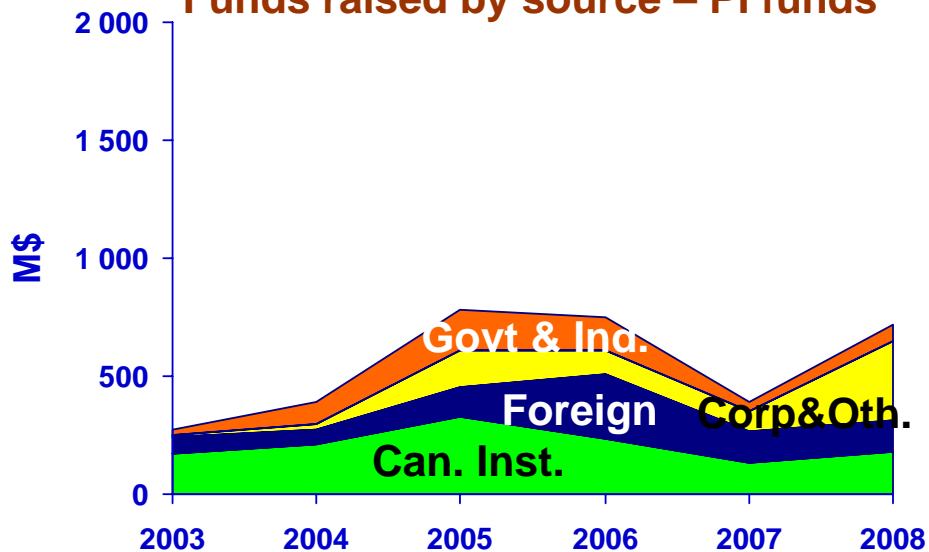
The fund raising equation of our industry

New data

Funds raised by source – All funds



Funds raised by source – PI funds



- Investment by Canadian institutional investors is low: performance, allocation, diversification outside Canada
- Investment by foreign investors, which in the long term should compensate for the diversification of Canadian investors outside Canada is still low: young industry, absence of track record
- Corporations and banks have played a significant role through corporate funds and more recently in private independent funds
- Historically the Canadian VC industry has been mainly funded by governments or individuals benefiting from tax credits
- This source has been divided by 3 since 2003 (\$1027M to \$367)
- It has not been replaced by other sources

Severe cyclical factors add to structural factors to create a systemic crunch

Structural factors

- The Canadian VC industry has no proven track record, yet
- Governments have revised their support to the industry. The decrease in direct and tax credit support has not been compensated by the increase in indirect support
- Foreign funds need strong local partners, especially in hard times

Cyclical factors

- LPs face liquidity, allocation and rebalancing problems
- US funds concentrate on their portfolios and on low-valued late stage companies in the US
- Exit windows are closed. Companies need more cash

- Fund raising crunch. Fewer and fewer funds are really active in Canada
- Fewer large rounds to support existing portfolio companies
- Very few new investments
- Follow on money drying up for business angels
- Threat to the cumulative efforts to build a critical mass of technology companies, entrepreneurs, business angels and fund managers in Canada

Recent government responses

A few international examples

| | UK | France | Israel | NZ |
|---|----|--------|--------|----------|
| ■ Direct investment | | | | |
| ■ Government funds | X? | X | | |
| ■ Indirect investment | | | | |
| ■ Investment in funds | X | X | | X |
| ■ Investment in funds of funds | | X | | |
| ■ Incentives (tax credits, guaranties) | | | | |
| ■ To individuals to invest in companies (business angels) | | X | | X co-inv |
| ■ To individuals to invest in funds (retail funds) | X | X | | |
| ■ To companies to invest in companies (corporate venturing) | X | | | |
| ■ To private LPs to invest in funds | | | X? | X |

Recent government responses in Canada

Indirect investment

| | | Government Allocation | Other Anchor LPs | Private sector LPs (incented) | Total | |
|--------------|-------------------------|-----------------------|------------------|-------------------------------|-----------------|-------------------------|
| BC | Gov FoF | \$90 M | | | \$90 M | |
| AB | Gov FoF | \$100 M | | | \$100 M | |
| ON | Private FoF | \$90 M | | \$115 M | \$205 M | } \$455 M |
| | Co-inv Fund | \$250 M | | | \$250 M | |
| QC | Private FoF | \$200 M | \$500 M | \$125 M? | \$700 M | } \$800 M |
| | FoF | \$50 M | \$50 M | \$25 M? | \$100 M | |
| Fed. | Invt in late stage fund | \$75 M | | | \$75 M | |
| Total | | \$805 M | \$500 M | \$115 M | \$1520 M | /4=\$380M per yr |

- **Objectives:**
 - Build larger and stronger funds
 - Implement best practices in order to attract private sector LPs in funds of funds or as co-investors in funds
- **Will governments be able to deploy this money if private sector LPs turn their back on the asset class?**
 - What kind of incentives?
- **How long will it take to put the money to work?**

Funds raised from governments and incented individuals have declined from \$ 1.02 bn in 2003 to \$ 370 million in 2008

Recent government responses in Canada

Incentives

| | To indiv. to invest in funds | | To LPs to invest in funds or fof | To indiv. or cics to invest in cics |
|------|------------------------------|-------------------------|----------------------------------|-------------------------------------|
| | Raise tax credit | Raise max. contribution | | |
| BC | | | | X (not new) |
| AB | | | | |
| SASK | X | X | | |
| ON | | | X | |
| QC | (X) | | X | |
| NB | X | X | | |
| NS | X | X | | |
| Fed. | | | | |

- Will these incentives be sufficient to reverse the declining trend in fund raising by retail funds outside Quebec?
- Will incentives to private LPs to attract them into the asset class be effective?
- Incentives to business angels seem to have given BC an edge

Industry: Build stronger and larger funds in order to build stronger companies and deliver performance

| | <u>Action</u> | <u>Impact</u> | <u>Challenges</u> |
|--|--|--|--|
| Consolidate the industry | Consolidation of the retail fund industry | <ul style="list-style-type: none"> Stronger management teams | <ul style="list-style-type: none"> Fund raising outside Quebec |
| | Canadian LPs activism to fund fewer larger funds | <ul style="list-style-type: none"> Larger pools of capital | <ul style="list-style-type: none"> Coordination on a pan-Canadian basis |
| | Fund restructuring with secondary money | <ul style="list-style-type: none"> Better ability to support underlying portfolio companies | <ul style="list-style-type: none"> Really attracting new money? |
| Develop creative ways of fund raising | Strategies to raise funds across Canada | <ul style="list-style-type: none"> Meet Canadian LPs expectations | <ul style="list-style-type: none"> Pan-Canadian vs. specialized North-South models |
| | Work with corporations to increase corporate funding | <ul style="list-style-type: none"> Increase potential sources of funding | <ul style="list-style-type: none"> Number of Canadian large tech companies is limited |
| | Tap into industrial and regional benefits | | |

Industry: Build stronger and larger funds in order to build stronger companies and deliver performance

| | <u>Action</u> | <u>Impact</u> | <u>Challenges</u> |
|---|---|--|--|
| Improve investment practices | <p>Raise partners' profile: more operating experience and industry expertise</p> <p>Develop stronger relationship with 1st tier US funds and peer syndicates</p> <p>Larger funds will allow for better company funding</p> <p>Fund triage</p> | <ul style="list-style-type: none"> ▪ Ability to build stronger companies and deliver better performance ▪ Fewer better funds | <ul style="list-style-type: none"> ▪ Efforts deployed during the last years have not translated into better returns yet |
| Build on the present opportunity | <p>Company triage</p> <p>Grow organically</p> <p>Time to invest</p> | <ul style="list-style-type: none"> ▪ Ability to build stronger companies and deliver better performance | <ul style="list-style-type: none"> ▪ Dropping too many good companies ▪ Enough capital to take advantage of these opportunities? |

- **Facing the capital shortage**
 - Speed up the deployment of government allocations
 - What role for the federal government: allocation, incentives?
 - Facilitate investments under offset agreements:
 - Aerospace and defense
 - Civilian offsets
 - Patented Medicine Prices Review Board
 - Remove obstacles to foreign investment:
 - 116 section and CCPC rules for the SR&ED tax incentive program
 - Working with private sector LPs. Need for incentives?
- **Seizing the present opportunity**
 - Do not delay triage and difficult decisions
 - Look for opportunities
- **Delivering performance**
- **Building a critical mass of technology companies, entrepreneurs, business angels and VC fund managers**

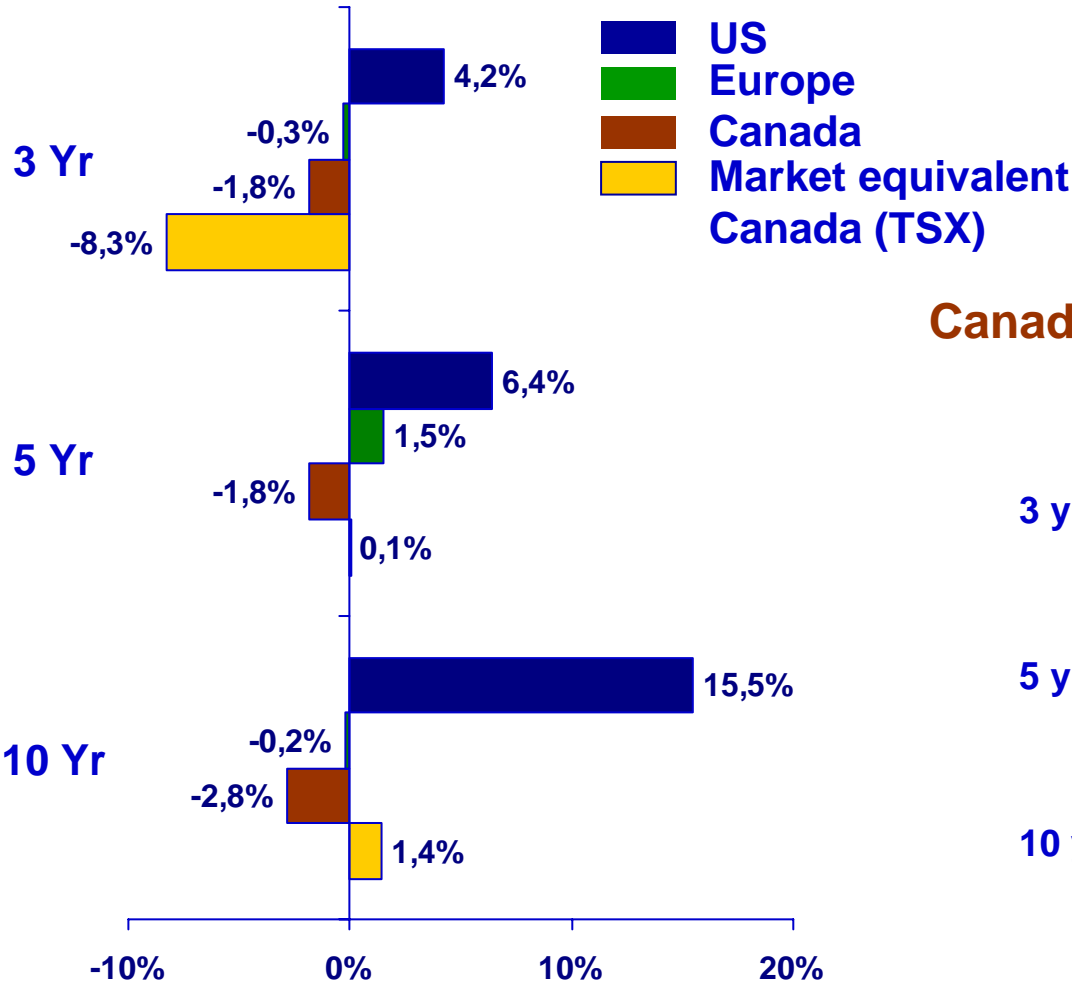
A new set of data

- **Net returns for private independent funds**
 - Net of fees and carried interest
 - Computed on cash flows between GPs and LPs
 - Comparable to international data
- **Gross returns for captive and evergreen funds**
 - Before fees and carried interest
 - Computed on cash flows between the fund and investee companies
 - Not comparable to net returns
- **Pooled average returns by quartile and market equivalents are now available**

Overall performance is poor

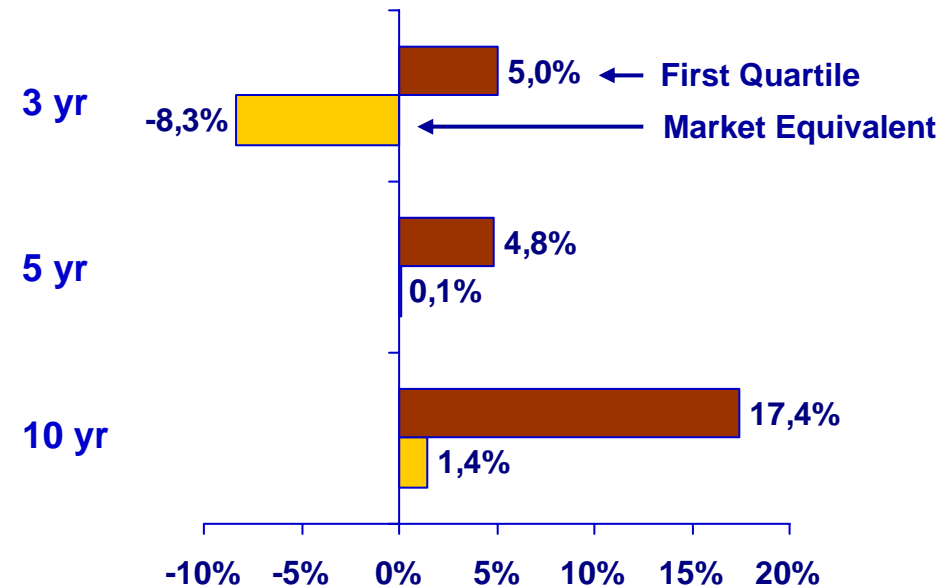
The first quartile is performing

**VC Horizon Returns
as at Dec. 31, 2008 – All funds**

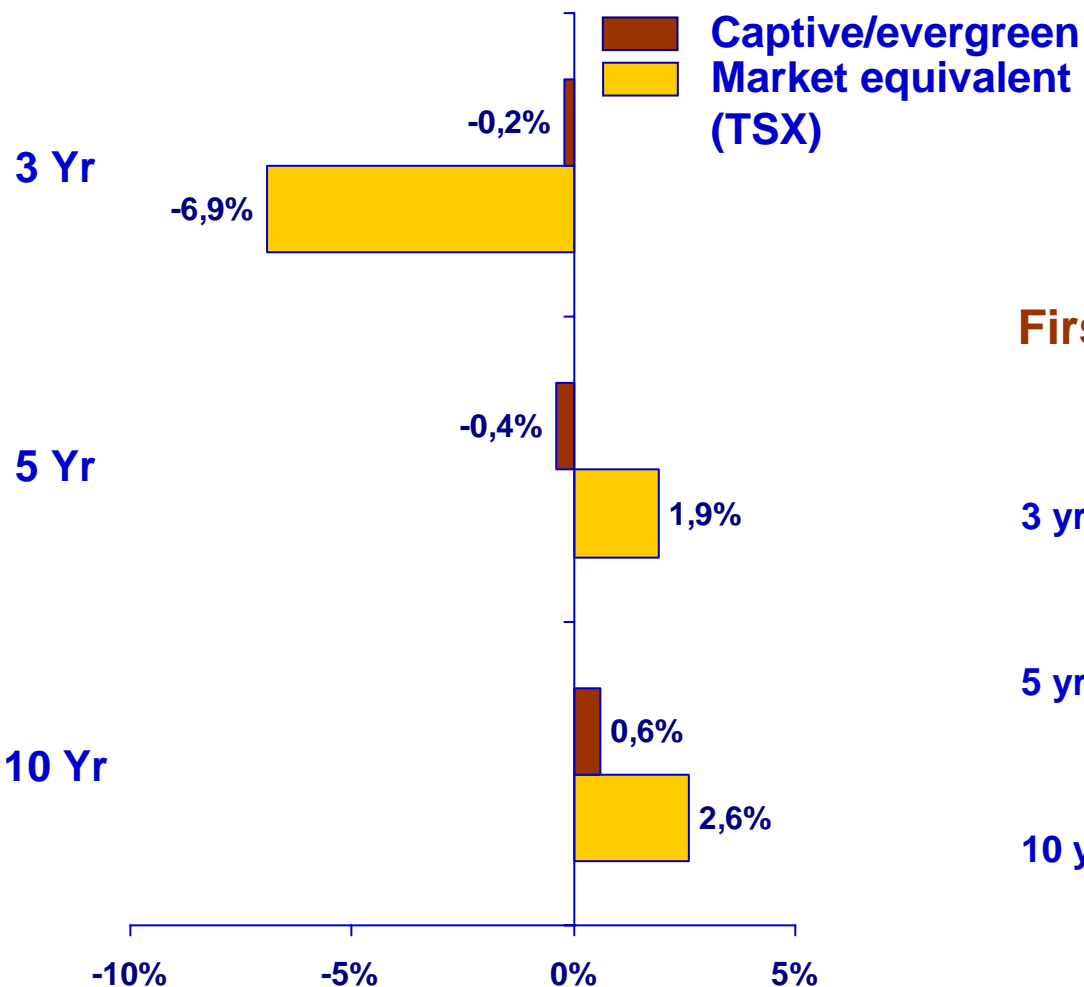


- Overall performance is poor, similar to Europe
- 3 and 5 year returns are not very strong, even in the US
- Canada first quartile pooled average outperforms the market equivalent

**Canada first quartile pooled average returns
as of Dec. 31, 2008**

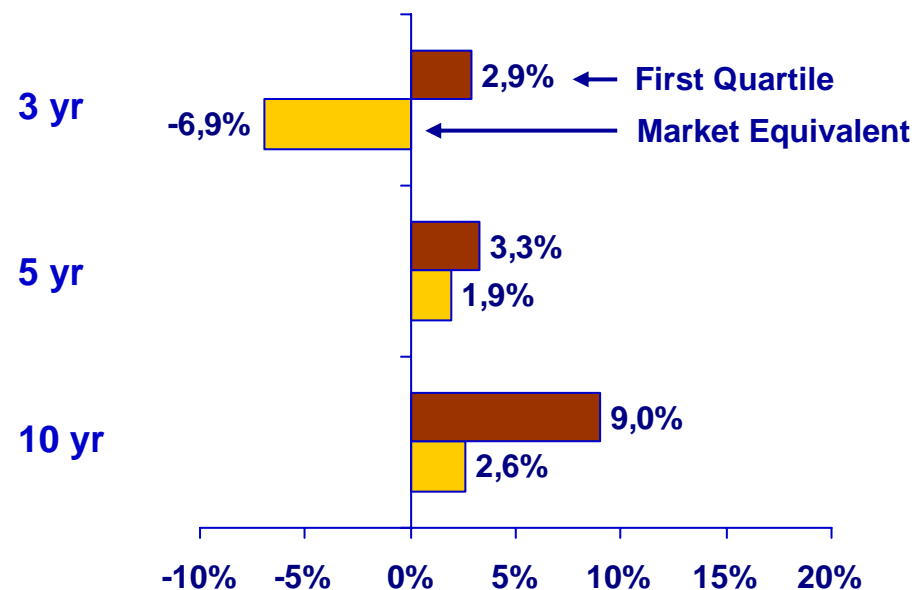


VC Horizon Returns as at Dec. 31, 2008 – All funds



- Gross returns are not directly comparable to net returns
- Overall performance is somewhat similar to PI funds
- First quartile pooled average also outperforms the market equivalent but to a lesser extent

First quartile pooled average returns as of Dec. 31, 2008





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