Industry Canada Industrie Canada

Q2 2009 VENTURE CAPITAL MONITOR

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A QUARTERLY UPDATE ON THE CANADIAN VENTURE CAPITAL INDUSTRY

Canadian high growth innovative small and medium-sized enterprises (SMEs) that commercialize research depend to a large extent on the venture capital (VC) industry for funding. Therefore, a strong VC industry is important for the growth of this segment of SMEs. The goal of this series is to provide current information about the VC industry in Canada. To this end, the series will track trends in investment activity, report on topical VC-related research and look at key technology clusters where VC investment is taking place.

INTRODUCTION

This issue presents the Canadian venture capital (VC) investment and fundraising trends in Q2 2009. It also summarizes recent government initiatives related to the support of the VC industry in Canada.

VC ACTIVITY OVERVIEW

Investment and fundraising

Lowest since Q1 1996

Venture capital investment in Canada was $179M (94 deals) in Q2 2009, a drop of 42 percent compared to Q2 2008 and 34 percent compared to Q1 2009. This drop is largely due to a lower level of foreign VC investments, which dropped by $85M compared to Q2 2008 and $52M compared to Q1 2009. The low level of VC investments registered in Q2 2009 has not been seen since Q1 1996.

Fundraising was down to $260M, a 30 percent drop compared to Q2 2008 (Table 1).

Table 1
VC investment and fundraising, Q2 2008 and Q2 2009

	Q2 2008	Q2 2009	% Change
	($ millions)		
Investment	309	179	-42
Fundraising	373	260	-30

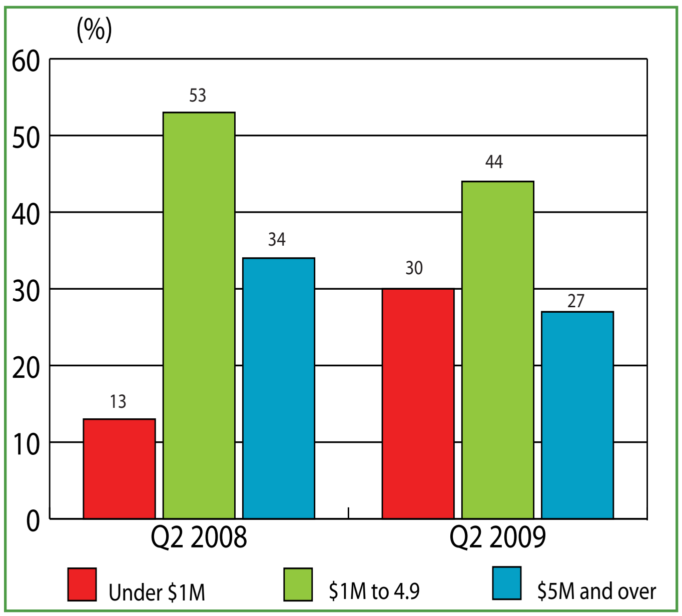
Source: Thomson Reuters Canada 2009.

Deal size

Further drop in large deals in Q2 2009

The average deal size was $1.9M in Q2 2009, compared to $2.9M in Q2 2008. This drop is consistent with the continuous drop in large deals during the last few quarters. In fact, deals worth over $5M represented 27 percent of all deals in Q2 2009, compared to 34 percent in Q2 2008. The drop in deal size might be connected to the smaller presence of foreign (primarily the United States) investors during the quarter (Figure 1).

Figure 1
Distribution of VC investment by deal size, Q2 2008 and Q2 2009



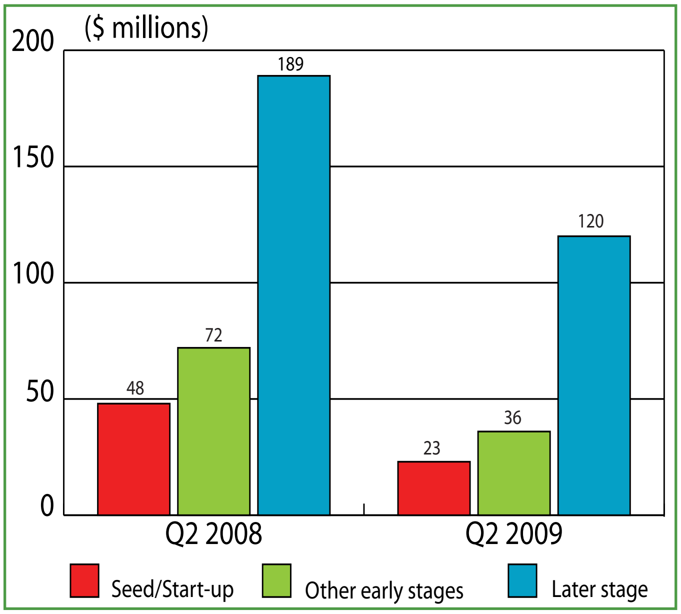
Source: Thomson Reuters Canada 2009.

Stage of development

Decreased early stage activity

Early stage investment dropped by 51 percent in Q2 2009 compared to Q2 2008. Seed and start-up companies took only $58M in investments. The share of late stage investment increased to 67 percent in Q2 2009 from 63 percent in Q2 2008 (Figure 2).

Figure 2
VC investment by stage of development, Q2 2008 and Q2 2009



Source: Thomson Reuters Canada 2009.

New versus follow-on investments

Continued drop in new companies receiving VC

Though the number of new companies receiving VC increased in Q2 2009 compared to Q2 2008, it continued the drop it started in Q1 2009. The number of new companies receiving VC represented 29 percent and companies receiving follow-on deals represented 71 percent of all companies (Table 2).

Table 2
The number of companies that received new and follow-on investment, Q2 2008 to Q2 2009

Investments		Q2	Q3	Q4	Q1	Q2
		2008			2009	
New	All	22	46	46	31	28
	Seed/ Start-up	8	14	13	9	8
	Other early stages	2	6	3	7	4
	Later stage	12	26	30	15	16
Follow-on	All	85	77	86	64	66
	Seed/ Start-up	15	10	12	10	8
	Other early stages	21	27	29	26	23
	Later stage	49	40	45	28	35

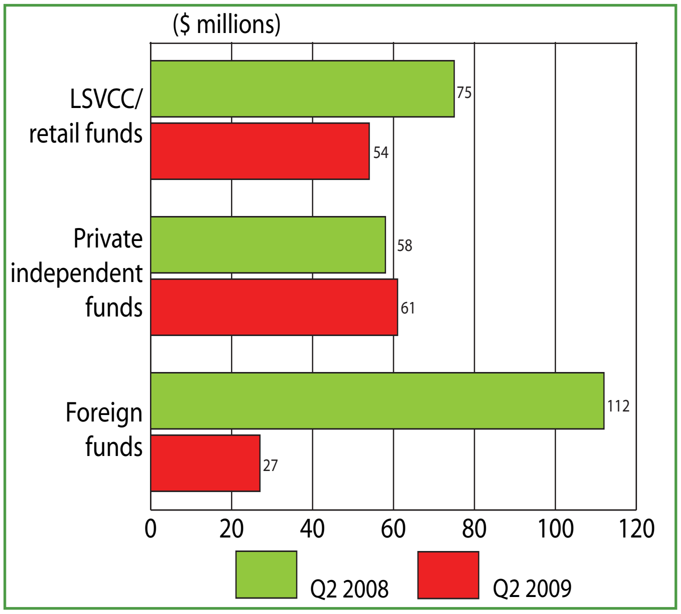
Source: Thomson Reuters Canada 2009.

Type of investor

Steep decline in foreign funds' investment activity

This quarter was characterized by a steep decline in the flow of foreign VC into Canada, which accounted for much of the overall decline in investment. This decline is part of a trend that started in early 2008. Labour-Sponsored Venture Capital Corporation (LSVCC) and Retail funds also invested less in Q2 2009 compared to Q2 2008, while Private Independent funds investment activity levels were stable at around $60M (Figure 3).

Figure 3
Distribution of VC investment by type of investor, Q2 2008 and Q2 2009



Source: Thomson Reuters Canada 2009.

Fundraising

Fundraising rebounds compared to last quarter

Fundraising in Q2 2009 reached $260M, an increase of $81M relative to last quarter. Despite this increase, fundraising was down 60 percent compared to the $373M raised in Q2 2008. Private independent funds raised $190M while LSVCC/Retail and other funds raised the balance. As pointed out in previous issues of the Venture Capital Monitor, the continued drop in VC fundraising is an indicator of a trend towards a smaller Canadian VC industry in the future.

Regional distribution

Sharp drop in VC investments in Ontario and British Columbia

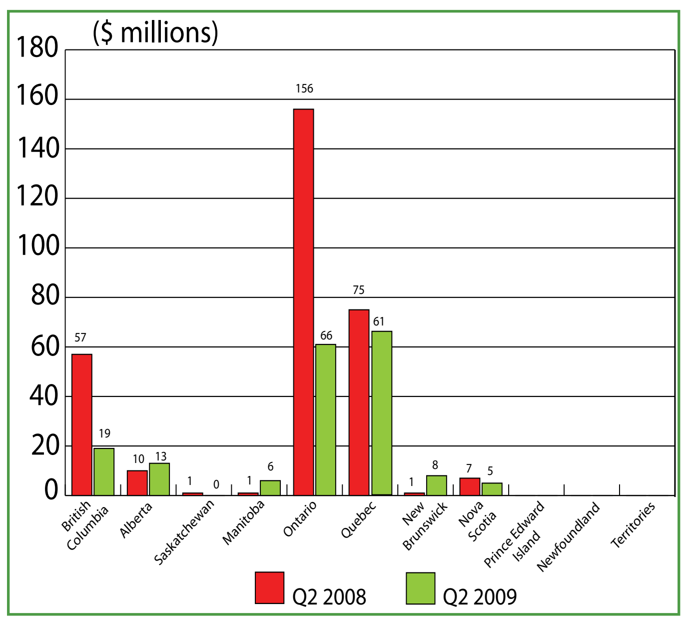
The drop in VC investments has not affected all provinces in the same way. Ontario and British Columbia's flow of VC investment dropped sharply in Q2 2009 compared to Q2 2008 (67 percent and 58 percent respectively), while Quebec experienced a smaller drop of 19 percent (Figure 4). The same trend was observed for the number of companies funded in both British Columbia and Ontario, while Quebec registered an increase in the number of companies receiving VC (Table 3).

Table 3
Number of companies receiving VC by province, Q2 2008 and Q2 2009

	Q2 2008	Q2 2009	% Change
British Columbia	17	10	-41
Alberta	4	5	25
Saskatchewan	1	1	0
Manitoba	1	4	300
Ontario	43	25	-42
Quebec	34	43	26
New Brunswick	2	4	100
Nova Scotia	5	2	-60
Prince Edward Island	0	0	0
Newfoundland	0	0	0
Territories	0	0	0

Source: Thomson Reuters Canada 2009.

Figure 4
Regional distribution of VC investment in Canada, Q2 2008 and Q2 2009



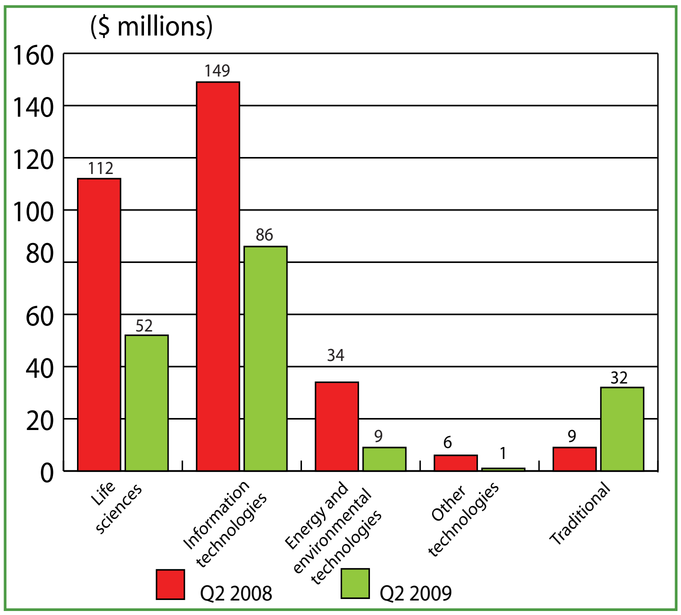
Source: Thomson Reuters Canada 2009.

Sector distribution

Sharp decline in energy and environmental technologies

Except for traditional sectors, all sectors experienced reduced VC investment levels in Q2 2009, compared to Q2 2008. Energy and environmental technologies received only 26% of what they received in Q2 2008. The information technologies sector remains the dominant recipient for VC investment, receiving close to half of all VC commitments placed in Canada (Figure 5).

Figure 5
VC investment by industry sector, Q2 2008 and Q2 2009



Source: Thomson Reuters Canada 2009.

GOVERNMENT ACTIVITIES

In Q2 2009, the Business Development Bank of Canada (BDC) made investments in 11 companies, along with other investors, worth $46 M. The BDC's share in these investments was $8.9M (Table 4).

Table 4
BDC deals in Q2 2009

	BDC	Co-investors	Total	Number of deals
	($ millions)			
Seed/ Start-up	2.8	15.2	18	3
Later stage	6.1	21.9	28	8
Total	8.9	37.1	46	11

Source: Business Development Bank of Canada 2009.

A Coherent Mosaic of Canadian Public Policies that Support Venture Capital

Like other sectors of the economy, Canada's venture capital industry has been facing challenges. The Government of Canada has recently placed new investments designed to help continue to build a self-sustaining VC industry. Provincial governments have also recently announced substantial VC policies. There is recognition that, if achieved, a mature and functional Canadian VC market will play a critical role in nurturing the high-potential firms that can transform ideas and research into new products and services, and drive Canada's future economy.

A Survey of Recently Announced Venture Capital Policies

On June 15, 2009, the Government of Canada announced plans to invest $350M over three years in the VC operations of the Business Development Bank of Canada (BDC). The first $260M will be used by the BDC to place investments in its most promising portfolio firms and new seed stage technology firms. This will also be used to support later stage technology firms not currently in BDC's portfolio, but that are having difficulty raising new rounds of funding. The BDC will also commit $90M over three years to private sector Canadian VC funds. This is in addition to the $75M investment, earmarked in the Government of Canada's Budget 2008, to establish the new private sector-led Tandem Expansion Fund.[1] This fund will place direct investments in growth-stage Canadian firms.

On September 1, 2009, the Federal Government also announced[2] that the new Federal Economic Development Agency for Southern Ontario (FedDev Ontario) would provide an additional $50 million to the BDC, including $35 million in capital to place direct investments in early-stage firms in Southern Ontario and $15 million to invest in Ontario-based venture capital funds focused on Ontario-based opportunities.

The Government of Ontario had also announced investments designed to strengthen the ability of Ontario's VC sector to support innovative, high-growth companies. The new $205M Ontario Venture Capital Fund[3] is a private sector-led fund-of-funds[4] with investments by institutional investors, the Government of Ontario, and the BDC. Ontario also launched the $250M Emerging Technologies Fund,[5] a co-investment fund that will match investments placed by qualified investors in Ontario-based start-ups operating in priority high technology sectors.

The Government of Quebec, along with institutional and private investors, created the Teralys Capital Fund,[6] the largest Canadian fund-of-funds expected to reach $825M. Quebec, in partnership with other investors, also announced that three new seed stage funds[7] will be established. Finally, the Government of Quebec announced that it will provide $60M in new funding to the Regional Economic Intervention Fund FIER-Régions Program.[8]

The Government of Alberta established the $100M Alberta Enterprise Corporation, which will invest as a limited partner in VC funds targeting investments in firms operating in priority, underserved sectors.

The Province of British Columbia established, in 2008, the $90M Renaissance Capital Fund, which is a fund-of-funds.

Some Canadian governments support labour-sponsored funds with tax credits for private investors. The provinces of New Brunswick, Newfoundland and Labrador, Quebec and Saskatchewan recently increased the size of those credits. Some of these provinces have also increased the individual annual claimable investment credit amount.[9]

[1] The Tandem Expansion Fund's first close is expected to be over $275M and reach over $400M in a subsequent round of financing.

[2] Industry Canada news release of September 1, 2009.

[3] Ministry of Research and Innovation news release of June 11, 2008.

[4] A fund-of-funds invests primarily in private venture capital funds, which in turn invests in technology firms.

[5] Ministry of Research and Innovation news release of March 18, 2009.

[6] Quebec government news release of April 27, 2009.

[7] Quebec government 2009 budget, page F88.

[8] Quebec government 2009 budget, page F26.

[9] *Venture Capital Monitor* Q1 2009, page 5.

Venture Capital Public Policy Goals

The recent federal and provincial public investments in VC, outlined above and summarized in Table 5, provide a spectrum of new support for VCs in Canada. Apart from the policies summarized in Table 5, the Government of Canada also provides an estimated $125M in tax credits each year for investors who invest in labour-sponsored funds,[10] and this in addition to the related tax credits provided by provincial governments. As well, some provinces provide other forms of tax credits for investments in eligible private firms. All of these policies amount to a substantial level of public support for VC in Canada.

In general, the overall objectives for public policies directed at venture capital markets are to create a self-sustaining VC industry, attract foreign investment, and attract a critical mass of institutional investors to this asset class. Industry observers believe that to achieve this objective, some conditions are required. These conditions include:

- VC returns must match or exceed international norms;[11]
- The industry requires a critical mass of experienced and internationally connected VC managers with in-depth knowledge of VC and product markets;
- VC funds must be large enough to provide the companies they invest in with the financing levels they require to achieve successful exits;
- The nation must have a critical mass of experienced entrepreneurs; and
- An appropriate flow of investment-ready opportunities must exist.

Table 5
Recent Government Commitments* to VC Initiatives

	Federal	British Columbia	Alberta	Ontario	Quebec	Total Government Support	Estimated Support by All Limited Partners
Start-up Stage	$60M			$250M	$50M	$360M	$435M
Follow-on	$275M					$275M	$500M
Support for Private VC Funds	$90M	$90M	$100M	$90M	$260M**	$690M**	$1 430M**

* Excludes government investments in investment tax credit programs and labour-sponsored funds.
** Includes a $60M investment by the Government of Quebec in the FIER-Régions program.

[10] Finance Canada. Tax Expenditures and Evaluations 2008. Available at http://www.fin.gc.ca/taxexp-depfisc/2008/taxexp08-eng.asp.

[11] Duruflé, Gilles. Presentation at the annual conference of Canada's Venture Capital and Private Equity Association. May 28, 2009.

NOTES

This publication is part of a series prepared by the Small Business and Tourism Branch. The branch analyses the financial marketplace and how trends in this market impact small businesses' access to financing. Current research is focused on high-growth firms, the aspects of both Canada's VC and general business environment that affect the success of these firms, and the key players in the risk-capital market (for example, VC firms and angels).

The Small Business and Tourism Branch is also responsible for the Small and Medium-Sized Enterprise Financing Data Initiative (SME FDI). The SME FDI is a comprehensive data-collection program on SME financing in Canada. In partnership with Statistics Canada and Finance Canada, Industry Canada reports on the supply of and demand for financing by small and medium-sized businesses. Further information and statistical findings and reports are available at www.sme-fdi.gc.ca.

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