



## Small Business Access to Capital: Venture Capital Action Plan Addresses Only Part of the Problem

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The federal government’s announcement last week of a \$400 million Venture Capital Action Plan (VCAP) to provide high-growth companies with better access to venture capital targeted one of the most important factors that will determine Canada’s competitiveness in global markets and our prosperity: How well we identify and nurture small and mid-sized companies in the high-growth sectors of the economy. But while Ottawa has pinpointed the problem, is the VCAP the solution? The record of Canada’s venture capital industry suggests more is needed.

There is no doubt of the importance of small and mid-size companies in high-growth industries. They provide the foundation for economic growth and skilled employment. The VCAP is an attempt to bolster this sector by injecting government funds into i) a new venture capital “fund of funds” in partnership with institutions, corporate investors and interested provinces; ii) existing large funds of funds; and iii) 3-5 existing high performing venture funds.

### Risk Capital Investment<sup>1</sup>



<sup>1</sup> based on the latest survey in 2004

<sup>2</sup> includes angel investment and friends and family financing

Source: Allan Riding, Telfer School of Management; CVCA

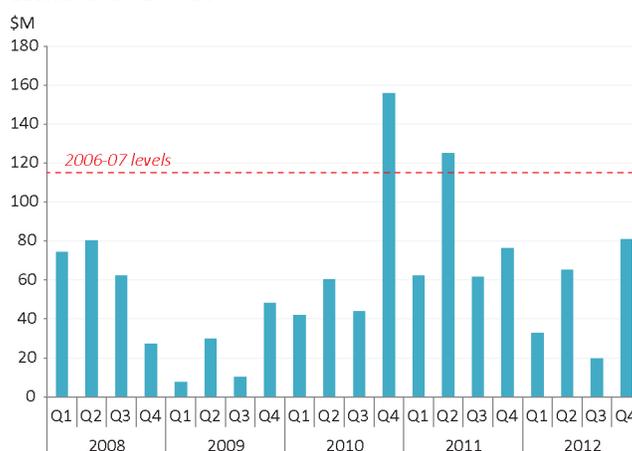
The injection of federal government funds into existing venture capital funds will certainly benefit the venture fund industry, but will it be effective enough in channeling capital to startup businesses? A background paper accompanying the funding announcement pointed out that Canada’s venture capital

industry has been challenged by “persistent low returns”, “the relatively small size of venture funds in Canada”, and a “shortage of experienced fund managers.” Given this track record, it is not surprising angel investor networks have eclipsed venture capital funds as the dominant financiers for startup businesses in corporate Canada.

How will the VCAP address these weaknesses? It is unclear exactly how injecting new capital into venture funds will strengthen the expertise of venture fund managers. And even if it does address the identified structural problems in Canadian venture capital, how long would it take?

One challenge facing venture capitalists that the VCAP will not solve is the need for an effective exit strategy from growing businesses to recycle funds back to new startup businesses. The typical exit point is the launch of an initial public offering. But public markets for small and mid-sized business have been in the doldrums since 2008 and, in the past year or so, are not at all conducive to an IPO offering for small business – effectively eliminating the crucial exit strategy and discouraging initial venture capital investment. Would this not diminish the Plan’s impact from the outset?

### Going Public Launch of Small IPOs

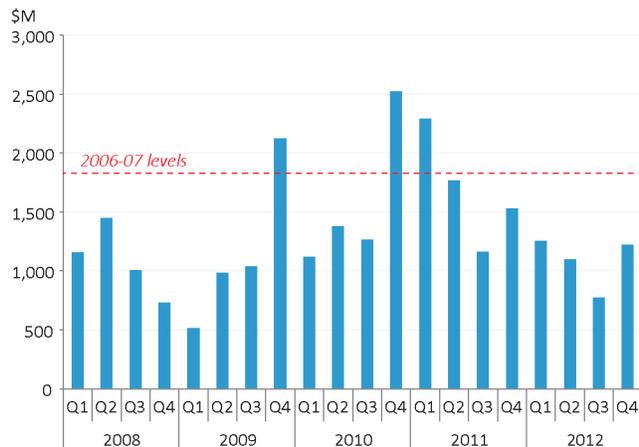


Source: IIAC

Even if the VCAP is successful, it doesn't address a serious financing problem in the Canadian small business sector, particularly in present conditions: The difficulty established small and mid-sized companies with a promising future encounter in accessing needed new capital for further expansion.

All too often, successful small and mid-sized Canadian listed and unlisted companies with market capitalization in the \$200 million to \$500 million range run into financing obstacles in public and private markets, because of the size of the financing requirement and related investment risk. For high-growth companies, building scale and improving production efficiencies are key to staying competitive. Meeting these demands is time-sensitive. Without timely access to capital, these companies are forced to seek out an acquiring partner – and that often means businesses outside Canada. Policy needs to solve this problem.

**Limited Access to Markets**  
Small Equity Financing



Source: IIAC

The second problem in our small business sector is the fact that a large number of private Canadian businesses, an estimated 300,000 firms, are on the verge of selling to outsiders in response to impending retirement of the original owner – in effect the intergenerational transfer of ownership. In normal circumstances an IPO financing would enable distribution of shares to new ownership, or alternatively, a private equity offering by the purchaser could fund the acquisition. But it is unlikely these market financings can be undertaken in present market conditions, leaving existing owners with little choice but to wind the business or sell to offshore business interests.

These are serious financing problems in the small business sector in Canada that are not addressed by the Venture Capital Action Plan. What is needed is a complementary strategy, one that provides a broadly-based tax incentive to encourage institutional and retail investors back into the marketplace to purchase new shares of small, successful and growing businesses. There are various options. The government could consider a Canadian version of the U.K. Enterprise Investment Scheme, providing an income tax break and capital gains

exemption to invest in the new shares of designated small companies. In place for more than 20 years, this incentive has become the critical instrument for financing emerging small businesses in Britain. Other potential mechanisms include a rollover exemption on capital gains taxation on the sale of financial or real assets, conditional on the reinvestment of the proceeds in common shares of small high-growth companies within six months of the sale of the disposed asset. Also, lower effective capital gains tax rates could apply for IPO shares or secondary offerings of treasury shares of small high growth companies.

In its venture capital policy, the federal government has identified a serious problem for our economy. They need, however, to target a more precise and comprehensive solution.

Yours sincerely,

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