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Designing the Venture Capital Catalyst Initiative – Discussion Paper

Canada

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Introduction

Announced in Budget 2017 by the Government of Canada, the Innovation and Skills Plan is an ambitious effort to make Canada a world leader in innovation, with a focus on expanding growth and creating well-paying jobs in key sectors. This plan will bring together high-skilled talent, financing solutions, business advisory services and export support.

Access to capital is a vital component in growing Canada's high-potential start-ups. Venture capital (VC) is a specialized type of private equity financing that takes educated risks on great ideas and smart people, giving young, high growth-potential companies the opportunity to develop their ideas into marketable products. In addition to capital, VC investors bring operational experience, technical knowledge, networks and mentorship to the firms in which they invest. Because of the funding and expertise it provides, a strong and steady stream of VC is an essential element in the success of many of Canada's potential future technology leaders.

Firms that are supported by large amounts of VC are reaching international scale, positioning them to be Canada's next billion-dollar anchor companies. Moreover, research shows that VC-backed firms, when compared to other similar non-VC-backed firms, achieve superior growth in sales and employment. VC-backed firms also post higher wage growth, suggesting that they employ highly qualified talent. Finally, these firms tend to have higher research and development expenditure growth, suggesting that VC supports innovative firms.

As part of the Innovation and Skills Plan, Budget 2017 proposes to invest $400 million, through the Business Development Bank of Canada (BDC), in the new Venture Capital Catalyst Initiative (VCCI). This continued support for VC is a key component of the Innovation and Skills Plan. This funding will be complemented by the Global Skills Strategy, which will help Canadian companies attract the in-demand talent they need to grow; funding for superclusters, which will support the ecosystem those companies need to succeed; Economic Strategy Tables, to identify innovation opportunities; and the Government of Canada's new investments in clean technologies.

Objective of this paper

On behalf of the Ministers of Innovation, Science and Economic Development (ISED) and Small Business and Tourism, supported by the Minister of Finance and the BDC, the department of ISED is seeking advice from industry leaders to inform the development of policy on Government support for Canadian VC investment.

This Discussion Paper is designed to guide discussions and submissions on the design and implementation of VCCI, specifically:

- It seeks comments on proposed parameters that could be used to roll out VCCI using a funds-of-funds model; and
- It invites submissions of concepts and parameters for alternative fund models that could be used to meet VCCI's objectives.

Background

In recent years the federal government has generally supported Canadian VC through the BDC and the Venture Capital Action Plan (VCAP) launched in January 2013.

The federal government's investment under VCAP consisted of $340 million invested in four funds-of-funds and $50 million invested directly into four existing "high performing" VC funds. The funds-of-funds leveraged government capital, both federal and provincial, and associated incentives to raise private-sector investments that surpassed their fundraising targets. In total, the funds-of-funds raised over $1.35 billion from a variety of investors, many of which invested in Canadian VC for the first time.

The VCAP program is showing early signs of success, with the current aggregate market value of investments above cost and some return of capital to private investors through early company exits – both unusual for the early years of a VC investment.

Under VCAP, the funds-of-funds have committed $985 million overall (73% of the total program size), including $846 million in commitments to 39 funds and $138 million in co-investments to 29 companies, as of March 31, 2017. Of this total, 22 Canadian funds have received over $803 million in commitments from the program, and over 197 innovative, high potential Canadian start-up companies have received funding.

Data from the Canadian Venture Capital and Private Equity Association (CVCA), among others, have shown a recent revitalization of the VC industry in Canada. In 2016, $3.2 billion was invested in 530 deals - a 41% increase over 2015's $2.3 billion. This past year, 2016, saw the seventh straight year of growth for VC investment in Canada, and the most capital invested since 2001. According to the CVCA, these high investment numbers are a positive reflection of the impact of VCAP and the Government's support for VC. Supporting these trends is BDC's internal data, showing Canadian VC funds in their portfolio to be increasing their financial performance significantly in the past three years, with over 40% of Canadian funds now benchmarking in the first or second quartile for North America.

The New Venture Capital Catalyst Initiative

As noted above, increasing the availability of VC to Canada is expected to speed the growth of Canadian companies. VCCI intends to accomplish this aim ultimately by catalyzing the most private sector capital via the highest caliber fund managers who employ the best investment strategies and who possess the greatest complement of investors who bring mentorship and well-established networks to promising Canadian firms. With this in mind, several key principles of VCCI include the following:

1. *Translating innovation into economic growth*

A key objective for VCCI is to develop Canada into a global leader that is competitive in promoting research, translating ideas into new products and services, accelerating business growth and propelling entrepreneurs from the start-up phase to international success.

2. *Increasing the availability of late-stage VC*

VCCI aims to help give innovative companies access the capital they need to scale up and compete internationally. Through the Innovation Agenda roundtables and from industry experts, the Government of Canada has heard that while the VC industry has seen growth in funding for early-stage start-ups, insufficient capital may be flowing to later-stage companies who require larger investments to fuel their growth. VCCI intends to increase the availability of late-stage VC for Canadian entrepreneurs.

3. *Improving the sustainability of the Canadian VC ecosystem and spurring private sector investment.*

VCCI is intended to continue to act as a catalyst to the creation of a robust and sustainable VC industry, eventually fully funded and managed by the private sector and without the need for government intervention.

To build toward a stable VC industry, Canada must demonstrate that VC investment in this country can generate world-class financial returns. Only when this is the case will global private sector asset managers place sufficient capital in this sector to fund Canada's promising young innovators without requiring substantial government incentives.

To encourage immediate investment, the VCAP program included incentives to attract private capital to the funds-of-funds, as timelines for realizing financial returns in VC are typically 7-10 years.

Attracting both national and international investment in Canadian VC will help put our new technologies and start-ups on the radar of global investors and help our companies to scale. To continue to attract new investment, VCCI is expected to include incentives for private sector investors. Following the early signs of success of VCAP, however, reduced incentives compared to

VCAP would be offered. To build Canada's VC ecosystem over the long term, VCCI must also be designed to maximize the financial returns of its VC investments.

In addition, VCCI will be publicized internationally and private sector international investors will be invited to participate. As part of their ongoing charter to support Canadian entrepreneurs and as part of their support of VCCI, BDC expects to facilitate introductions between international investors and funds participating in VCCI.

4. *Deepening the pool of experienced VC fund managers*

To help ensure a successful VC industry in Canada, VCCI is expected to grow the Canadian VC ecosystem by deepening the pool of experienced fund managers in Canada. This should include building Canadian talent and investment, and attracting new expertise and capital to Canada's VC market.

As well, allowing Canadian VC funds supported VCCI to invest a portion of their capital outside of Canada will lead them to increase their knowledge of international markets. This will allow them to help the Canadian companies they invest in by connecting those companies to international customers and investors.

5. *Leveraging private capital*

In taking a market-based approach, and emphasizing private sector leadership, VCCI is expected to leverage a significant amount of private sector capital. Including the $400 million in federal government investment, the VCCI program is expected to inject around $1.5 billion into Canada's innovation capital market, depending on the models selected.

While a funds-of-funds model has proven successful under VCAP, the Government remains open to other managed fund approaches, including direct matching investments into existing funds, the creation of new pools targeted at late stage companies, or other alternative value propositions that meet VCCI's objectives.

VCCI Design

This section details the competitive process VCCI would employ to seek and select proposals from the private sector. It also introduces two classes of models that will be considered in the implementation of VCCI: 1) the well-understood funds-of-funds model, and 2) an option to introduce alternative models that can satisfy VCCI objectives, and that may either complement or compete with a funds-of-funds model.

VCAP demonstrated the effectiveness of a funds-of-funds model for attracting new and returning investors into the VC space, while also supporting ecosystem development. That said, there may be other options for achieving similar objectives and we would appreciate views on what they might be and how they might be implemented in the context of VCCI and its objectives, laid out above.

Competitive Process

VCCI will use a competitive process to seek proposals from the private sector. To launch VCCI, the Government of Canada will announce a competitive call for proposals open to national and international applicants. Detailed criteria would be included in the call, and applicants would be invited to bring forward value propositions detailing their expected value-add to Canadian firms and the VC ecosystem, and laying out their track record, complement of potential investors, and investment strategy. As well, value propositions would be differentiated by certain parameters (as explained below) for which minimum or maximum thresholds could be set.

To advise on the evaluation of proposals, the Government will establish a private sector selection committee. Once provisionally selected, applicants would be required to do their own fundraising to meet predetermined targets. It is proposed that a pre-determined fundraising target would be met within a period of nine months following provisional selection. If a selected applicant does not meet this target, the Government would reserve the right to re-allocate some or all of the capital.

A funds-of-funds model

We are seeking advice on the following proposed elements that could be included in a call for proposals for funds-of-funds. For example, we invite views on whether the targets specified are appropriate given the current Canadian VC market. Additionally, we invite comments on which of the following elements should make up the fixed structure applicable to all applicants, and which elements should be open to competitive proposals and used as criteria on which applications would be evaluated.

Size and number of funds-of-funds

Through VCCI, the Government of Canada could support a number of private sector-led funds-of-funds, with potential commitments also coming from provincial governments.

The Government would target funds-of-funds at a minimum size of $350 million. The federal government contribution to each fund-of-funds would depend on the amount of private sector capital raised, the number of funds-of-funds selected, and any commitments from provincial governments. As was the case under VCAP, provincial capital would invest on the same terms as federal capital.

After being awarded a provisional federal and possibly provincial government commitment under VCCI, each fund-of-funds would have a limited period of nine months during which to complete fundraising from private sources to reach a pre-determined target size.

Amount of private sector capital leveraged

Under VCAP, funds-of-funds leveraged government capital to raise a multiple of 2x from private sector investors. After the successful close of four funds-of-funds under VCAP, VCCI is targeting a higher leverage ratio. It is proposed that the amount of private sector capital leveraged as a multiple of provincial and federal government capital would be at least 2.25x.

Co-investments

Funds-of-funds would be required to allocate at least 75% of committed capital to investments in VC funds, with discretion to allocate the remainder toward direct or co-investments. VCAP, by comparison, required at least 80% of committed capital be allocated to VC funds.

Co-investments generally support later-stage companies. While increased co-investment reduces investments in the VC funds, increasing the level of co-investments permitted under the program can increase the amount of later stage capital directly available to Canada's fastest growing companies.

Incentives to attract private sector investors

Under VCAP, government investors provided incentives to attract private sector investors. These incentives included equal preferred returns to both private and government investors. Additionally, government investment flowed into the funds-of-funds at a faster rate than that of the private sector investors.

A key objective of VCCI is to demonstrate the sustainability of Canadian VC, while still attracting new investors. To do this, the VCCI funds-of-funds model could offer reduced incentives compared to VCAP.

As an example, asymmetrical capital flowing in at a ratio of 75/25, government to private sector, with private sector capital flowing in at 100% after all government capital is paid in. As capital is returned to investors (capital distributions), the model could also include asymmetrical distributions, flowing to the private sector investors at a ratio of 25/75, until set levels of preferred returns are satisfied. Under VCCI, the preferred return could be set in the range of 5 to 7%.

Investment strategy, capabilities, network and experience of fund-of-funds managers

Similar to VCAP, managers would be expected to demonstrate experience and performance in raising and managing funds-of-funds, funds or other investment entities, as well as an in-depth knowledge of Canadian VC, entrepreneurial experience and a strong network of business and financial contacts. Fund-of-funds managers would be expected to apply this knowledge and network in advising and supporting the Canadian funds in which they invest. Fund managers would be evaluated on the degree to which their proposed investment strategy is aligned with their demonstrated capabilities.

The amount of private sector capital already secured

Fund managers would be evaluated on their demonstrated ability to raise funds from private investors. They would also be evaluated on the degree to which they have been able to secure letters of intent to support their proposal from potential investors before applying.

Expected benefits for Canadian companies

Proposals would be evaluated on their overall impact to the Canadian economy, in particular, the fund managers' expected value-add to Canadian firms.

Under VCAP, certain restrictions on international investments were included for funds-of-funds and funds. These included that recipients maintain a Canadian presence by having or establishing at least one Canadian-based senior investor and at least one full-time Canadian office.

For VCCI, to ensure a continued focus on Canadian investment and building the Canadian VC ecosystem, Canadian presence rules would be the same for fund-of-funds applicants as those under VCAP, requiring recipients to have or establish at least one Canadian-based senior investor and at least one full-time Canadian office.

Building a sustainable Canadian VC ecosystem, however, requires encouraging international investment and building globally-connected companies. For this reason, Canadian content requirements under VCCI could require a substantial majority of fund commitments to be made to Canadian-headquartered funds, with a majority of their partners resident in Canada, and a maximum 30% of direct co-investments being placed in non-Canadian resident companies.

Compensation for fund-of-funds managers

Compensation for fund-of-funds managers generally consists of two components: management fees and carried interest. *Management fees* are paid to cover the operating costs of the fund manager in order to operate the business of investment selection and management. *Carried interest* is paid as a portion of realized profits, in order to provide incentive to generate profits for the investors. Management fees are paid regardless of the financial performance of the fund-of-funds, while carried interest is *only* paid after all investors' capital is returned, *and* all management fees are refunded to investors.

All investors in the program – government and private – would pay the same fees for management and carried interest.

Alternative fund models

Through this discussion paper, we also invite the submission of alternative fund models that would address the VCCI objectives noted above (apart from a fund-of-funds model). Any concept for such a model under VCCI should have a value proposition that includes:

- Leveraging private sector investment;
- Deepening the pool of experienced VC fund managers;
- Increasing late stage VC financing;
- Reducing the incentives provided to private investors, as compared to VCAP
- Having a major presence in Canada; and
- Allowing for selection through a fair and transparent competitive process that could evaluate proposals on:
  - the amount of private sector capital already secured;
  - expected benefits for Canadian companies;
  - the proposed approach for risk sharing between government and private sector investors; and
  - the investment strategy, among other considerations.

For example, some of the other models that have been suggested for consideration include:

- *Direct matching investments by VCCI into existing VC funds.* Here, government capital would be placed into selected funds alongside private sector investors. In order to ensure the leverage effect desired with VCCI, fund managers would need to demonstrate that they had secured net new investment in the desired ratio in order to receive a VCCI investment, which could then fund a set of incentives for all investors in the fund.
- *Chartering of new pools of managed capital.* These third party-managed funds could include novel investment strategies or support strategically-important investment foci by, for example, targeting a specific sector or stage. Consistent with Government's goals for VCCI, specialized funds could be established and managed by specialized, selected applicants.

We invite submissions detailing these or other approaches to models and how these models would address the key objectives of VCCI.

Summary and Discussion Questions

The paper outlines objectives and presents two broad areas for discussion. The paper proposes parameters that may be used for a funds-of-funds model, and seeks input on alternative models that may complement or compete with a funds-of-funds model.

Discussion topics are as follows:

First, with respect to a fund-of-funds model, we are seeking your views on the elements summarized below. For example, are the specified targets appropriate in the current Canadian VC marketplace? Additionally, which of the following elements should make up the fixed structure applicable to all applicants, and which elements should be open to competitive proposals and used as criteria on which competing applications would be evaluated?

Private capital leveraged	*Minimum of 2.25 times government investment*
Size of funds-of-funds	*Minimum size of $350 million*
Co-investment allowance	*Up to 25% of capital*
Incentives to attract private investment	*Initial 75-to-25 inflow for government-to-private investment* *Initial 25-to-75 outflow for government-to-private investment* *Preferred returns in the range of 5 to 7%*
Strategy and capabilities	*The degree to which proposed investment strategy and demonstrated capabilities will maximize impact to the Canadian economy, in particular, the expected value-add to Canadian firms*
Capital already secured	*Letters of intent*
Canadian presence pledged	*Pledged presence of at least one Canadian office*
Canadian investment pledged	*Pledged commitment to Canadian funds of a substantial majority of all fund commitments*
Compensation proposed	*Competitive market rates*

Second, with respect to alternative fund models, we invite concepts describing how models would be structured, how the models satisfy the stated VCCI objectives, and how a selection process could be implemented.

Contact

You can reach the Government of Canada's VCCI secretariat at capital@canada.ca. We are seeking input until July 17, 2017.