

CIRANO Note, prepared by Jean-Marc Suret and Cécile Carpentier, May 2008

For the past 30 years, government policy has largely been driven by the idea that the supply of venture capital was inadequate: Substantial tax incentives were created to funnel savings into that sector. Globally, Canada's pool of venture capital, administered by venture capital funds and companies, ranks third in size. The supply of venture capital offered on the exchange, available through the TSX Venture Exchange (TSX-V), is also very significant. Despite this abundance of funds, money for financing start-ups and major new investments remains elusive. Why and how should this situation be remedied?

Canada is the only country in the world with a venture stock exchange: Companies with no earnings, or even revenues, can be listed on the TSX-V, drawing on various methods that include start-up capital firms. The cost of IPOs is lower than in the United States. On average, every year 195 Canadian firms are newly listed on the stock exchange (compared with 295 in the United States), where they typically raise less than a million dollars. Unlike in the United States, a very small proportion of these firms is supported by venture capital.

Publicly traded firms then raise funds through private placements. Between 1993 and 2003, 4,592 private placements were made by companies that did not post any earnings in 66 per cent of cases, and, 40 per cent of the time, did not even declare any revenues. Often, subsequent public offerings are issued by firms that are unprofitable (49 per cent of cases) or even that generate no revenues (23 per cent of cases). Thus, the TSX-V finances emerging companies and, between 1989 and 2006, paved the way for 809 of them to be listed on the TSX, versus a mere 156 for private venture capital.

Venture capital is abundant in Canada, a country ranked third by the OECD as third in the world in this area. Here an enormous mass of capital, estimated at approximately \$5 b, remains unused. This idle capital is concentrated in Quebec, where tax-advantaged funds accumulate approximately \$1 b annually. According to national averages computed by the OECD, Canada's yearly requirements in start-up capital should be on the order of \$400 m. Do we need to continue adding to this pot of unused funds?

IPOs of companies supported by venture capital are relatively infrequent. This method of "going public" for venture capital allows it to be recycled and yields substantial returns. The yield to venture capital is low in Canada (-3 per cent between 1995 and 2005). Thus, it has little appeal to institutional investors. This return is far below that earned on the TSX-V, while private venture capital presents significant advantages for selecting and circumscribing projects. The total value of venture capital

offerings is less in Quebec than in Ontario, British Columbia, and Alberta.

The aforementioned paradoxes are largely attributable to a policy designed entirely to increase the supply of capital. This policy ignores the notion of investment readiness, a factor extensively integrated into government policy elsewhere, notably the United Kingdom. According to this analysis, increasing the supply is pointless to the extent that we do not have an adequate number of high quality start-ups ready to absorb available venture capital. To increase this number, it is necessary to focus on the incubation, pre-start-up, and start-up phases. This is when companies with a high technology content confront considerable hurdles. Since risks are high and reliable information elusive, private investors stay away. If market failure is a factor, this is where we observe it and government intervention may be justified.

The relative size of tax-advantaged funds is another potential explanation. Given the surplus of capital, their usefulness appears limited and their low return, combined with their vast asset base, has a significant negative impact on the industry's yield. However, this last element is vital for attracting significant amounts of private funds.

The scarcity of IPOs funded by venture capital must be explained and corrected. In the absence of sufficiently diversified private funds, one of the principal problems pertains to the financing of major investments immediately after the initial offerings. This problem appears to be unique to Canada. If it is not incumbent on governments to directly address this problem, it is nonetheless important that they create conditions propitious to the market playing its role and thus that they understand the nature of the issues. It is possible that the widely held opinion, that initial public offerings raise more in the United States than in Canada, plays a role. The splintering of the Canadian industry, undue fiscal tinkering by governments (crowding out private funds), the mode of functioning of venture capital, and the quality of funded projects are other potential explanatory factors.

Analysts of government financing policy favour the notion of global strategies spanning everything from incubation to IPO. This is the path we should explore.