CHALLENGES IN FINANCING ENTREPRENEURSHIP

CIRANO note written by Jean-Marc Suret, January 2011

The financing of growth firms is a controversial and important issue in Canada. Like most other countries, we are grappling with a variety of factors making it increasingly difficult for start-ups to raise equity. Profitability is down in the private placement and venture capital industries and institutional investors have become aware of this. Initial public offers are in sharp decline, limiting the availability of highly profitable exit opportunities for venture capital. The process of designing and implementing policies to foster venture capital is complex.

Private placement

Capital funding from private institutional investors and venture capitalists are declining precipitously, largely because of low profitability in the sector. High management fees further undermine the attractiveness of this class of asset. When institutional managers curtail their contributions, liquidities available to venture capital funds diminish. The industry favours financing businesses that have global prospects and are relatively well developed. Funds earmarked to financing the early stages of development are drying up.

Initial Public Offerings

Initial public offerings, which have allowed venture capitalists to obtain higher yields, are becoming increasingly scarce. In Canada, these IPOs appear to generate lower values than they do in the United States. The decline in IPOs negatively affects both the venture capital industry and the firms seeking to raise funds on the stock market.

Public Policy

The financing of start-ups is a complex world, and public policies implemented in many countries have failed to yield the desired results. These policies should, in essence, ensure conditions that are conducive to the good functioning of the venture capital sector and do not artificially inflate the available amounts by means of subsidies or tax breaks. Increasing the supply of venture capital requires an improvement in the profitability of the industry.

Conclusion

Venture capital is relevant to several hundred Canadian start-ups that may, in time, set their sights on the international market. Many companies that lack the ambition and potential to be active on the global stage and are in their first stages of financing cannot gain access to that source of funding. This is the type of company that government authorities should prioritize, because conventional venture capital appears to be losing interest in it.

On the surface, the Venture Exchange seems an option for these firms, but investors who are active on this exchange do not appear to obtain returns that are commensurate with the risks assumed. In this situation, there is reason to doubt the equilibrium between the financing facilities of firms and the yields offered to investors. This apparent disequilibrium to the detriment of investors cannot be sustained in the long term.

Angels are involved in the development stage of many firms that are of no interest to institutional investors and that appear to suffer from serious funding shortfalls. They boost the number of projects able to obtain venture capital while earning rates of return exceeding those earned by other categories of investors involved in financing entrepreneurs. Therefore, these investors should be front and centre in the authorities' deliberations in the matter of funding new firms.

The report is available (in French) at the following address:
http://cirano.qc.ca/pdf/publication/2011RB-01.pdf