Panel #2
The financing landscape

Robert Finkel
President and Founder, Prism Capital
Moderator: Jennifer Brooy
Vice President of Equity, Export Development Canada
Lanis Anthony
Chief Entrepreneurial Officer, CCINC Group of Companies
Charles Lax
Managing Partner, GrandBanks Capital, Boston

Anthony introduced herself as an investor who works with companies that she deems to have high potential but remain underserved, so that her investment activities include support tools and international advancements. Lax made a similar point when explaining why his Boston-based firm makes about 20% of its investments in Canada. “We really do enjoy the elements of entrepreneurial culture up here that we can get our arms around,” he said. “But also because this is where money isn’t.” While many of his colleagues at other firms shy away from this country, his own experience has been quite positive. “We’re batting 1,000. Every single company we’ve invested in in Canada, we’ve had success with.”

That being said, he was critical of the way a great deal of financing takes place in Canada. “Continuing to fund and sponsor bad VCs with bad behaviour will get bad outcomes. One of the things that the Canadian venture capital industry is really good at is funding bad companies. When companies get funded, and they continue to get funded with bad ideas or an inability to grow big and scalable businesses, that capital is being sucked away from other opportunities, great entrepreneurial opportunities that otherwise would be getting funded.”

Finkel confirmed what Lax had indicated, describing how difficult it was for him to entice prospective investors to check out offerings in Canada. When asked by the moderator whether Canada was accessible to American investors, he referred to an outstanding roster of flights that could get him to Toronto sooner than he could reach many important American destinations. “The ease is not the issue,” he said. “There’s a perception issue. It’s not misunderstood, it’s just not thought about.” As for whether the government could do anything to change that perception (or lack of perception, more specifically), Finkel marvelled at the stark contrast between highly integrated investment communities such as Silicon Valley and the utter lack of investor interest in the equally dynamic region of Waterloo

Lax agreed that Toronto was highly accessible, especially given the competitive spur that has been provided by the success of Porter Airlines. That has not been the case in Montreal, he noted, leaving Quebec nowhere near as accessible; he also dismissed Halifax and Ottawa as parochial and not worth the effort. He suggested that the government could try to overcome these air transportation shortcomings, especially since his company has a rule that they will not go anywhere that requires a connecting flight, because their time is too important. “We want to be able to do cities in one day. I can do LA in one day, I can do San Francisco in one day; I can’t do Quebec in one day.”

Lax also celebrated the repeal of Section 116 of the federal tax regulations, which had pursued the investments made by non-residents as “taxable Canadian property.” The repeal came after 10 years of lobbying the government to reconsider this impediment to foreign capital. “The tax authorities here were under the mistaken opinion that it was their money once we made the success and they should be able to tax it,” he said, noting that upward of 10 per cent of the financing wound up in the hands of lawyers responsible for shielding each venture from Canadian law. “We had to spend $400,000 per investment to get around the Section 116 nonsense, to structure the investment so we could get our money in and get our money out. Think of how many more engineers we could hire with that.” He added that the Canadian government should widely publicize this change to the tax regime, which is still perceived by many prospective American investors as a primary reason to stay out of the country.

For her part, Anthony maintained that Canadians have much to learn from people elsewhere. “I don’t think as Canadians we’re listening to what others are in earnest giving advice about,” she said, suggesting that this stems from a simple lack of interest, which in turn originates with our lack of appreciation for entrepreneurial culture. This means we are seen — and see ourselves — as nice people living in a place packed with natural resources, but not commercially appealing. “We are not good sharers,” she complained, which accounts for why ambitious Canadian entrepreneurs are drawn to the sharing milieu of Silicon Valley. “Why? Because they can sit down with someone from Google or Facebook, or someone who wants to be Google or Facebook, and find money,

management, and mentorship that's a heck of a lot easier than we put them through the rigours here. We make it very difficult for ourselves to achieve what we want to achieve. We sneer when others have succeeded."

Anthony added that Canadian public education omits discussions of business and entrepreneurship as positive forces in our society, which leaves young people vulnerable to much of the pessimism that surrounds economic matters, rather than being inspired to take control of their careers.

When asked about the relative dearth of serial entrepreneurs in Canada, Lax explained that these individuals had more sophisticated goals than simple commercial success, namely building larger lines of business. In that light, he said, Canada presents a less attractive environment because the population base is smaller and more scattered than it is in the United States, making it more difficult to scale up a company in this country. "For us in the United States, pardon me, Canada is a 51st state," he said, describing the country only in terms of its most economically promising centres. "It's small, it's tiny, it's a fraction of the size of most of our states in the US. And if you're really going to build a scalable company, you've got to be looking at a world-wide company." If that company is going to be close to its customers, he concluded, it must come to grips with the fact that most of those customers will not be in Canada.

Finkel built on this observation, suggesting that what Canada required was less the culture of collaboration — which is widely celebrated — than an organized pattern of mentorship in the often rough-and-tumble ways of doing business globally.

On a different matter, the role and perceived responsibility of government as the prospective first customer for many goods and services, Anthony conceded that this function could be fairly compared with that of a nurturing parent. On that basis, she criticized the Canadian government for failing to engage directly with most businesses, and for choosing instead to sit on the sidelines changing the rules for those businesses in a downright passive-aggressive way that any good parent would want to avoid. She remained optimistic that many people in government are starting to grasp this idea and address it, offering the example of the Canadian Innovation Commercialization Program launched by Public Works and Government Services Canada. "Our nation needs to understand fully, from a government perspective and an investor perspective, that there's a time, a place, and a need for every piece in that concept-to-commercialization navigation path," she said, insisting that such an understanding will help firms through the notorious valley of death.

Lax maintained that government serving as first customer represents the very best way of directing financial support to early stage firms. Entrepreneurs and universities in the United States excel at shepherding themselves from government-funded R&D projects into commercial products or services based on the results of those projects. That being said, he was highly critical of the crowd-funding initiatives emerging from one of the American government's most recent forays into this sphere, namely the Jumpstart Our Business Startups (JOBS) Act. "There's going to be a rampant number of charlatans out there taking money from people who can ill afford to lose that capital," he said. He cautioned that apparent government endorsement of this behaviour could leave many burned investors highly cynical about the process; in contrast to the large amounts of money that led the justice system to move against a major swindler such as Bernie Madoff, the amounts being lost through crowd-funding will be much lower and much less likely to prompt this kind of intervention.

On the question of whether venture capitalists should look more to high growth markets in the developing world, Finkel insisted that the virtues of being close to an established customer base should trump the lure of exotic destinations. Lax agreed in principle, but did not rule out looking further afield. "There's a time and a place for an export market," he said. "The question is which export markets are approachable and which ones can we get to." Anthony agreed, arguing that the challenge was not one of finding the best place to invest, but rather of finding the best investment, wherever it might be. "We keep talking about what it's going to take to be

successful," she says. "Know the customer and be ready to serve, wherever they are, whatever they're doing."

When asked how the government should spend the announced $400 million injection of venture capital funding in Canada, Finkel responded that any input would be a good input for an industry that has been starved of capital. However, he qualified that optimism with a call for a more holistic strategy, which would offset the uninspiring investment approach that led to starvation in the first place. Lax expressed his concern that this new money would end up in the hands of people who do not know how to scale up an enterprise. As for a preferable alternative, he pointed to Israel's Yozma Group, which serves that country as an evergreen fund for start-ups that returned as much as six times the original investment. What could make this happen in Canada is an aggressive search for new talent, and having that talent pass along its skills to people in this country. "Historically, the venture capital industry up here in Canada got what it deserved," he said. "They're lousy investors, they're lousy support stewards, and they're generating poor returns." Anthony referred to this country's VCs as spoiled children who have wound up throwing good money after bad, which is disappointing in light of the genuinely promising investments that could be made. "I have not yet seen a VC in this nation that announced the kind of returns that it set out, which says a lot," she concluded.

Ron Freedman challenged a general assumption that often surrounds the growth of companies, which is the idea that enterprises grow organically from start-up to some level of maturity. Given how aggressively the VC industry works to flip companies in order to maximize return on investment, he asked the panel if it would be worth modelling the growth of companies as an ongoing process of acquisition.

Lax responded that this vision of growth reflected much of what he had seen, whereby companies acquire the funding that they need through a merger of one sort or another. Particularly in places like Europe, it makes much more sense to acquire an existing firm and its customer base so that you will be enjoying returns in a matter of months, when you would otherwise still be setting up a new enterprise with your own people. This is a typical strategy, he noted, and it has worked well in Canada, where they have acquired businesses that provide an established American customer base. Finkel related a similar success story, with the caveat that in buying an existing firm, you had to be ready to deal with all aspects of that firm's culture.

An audience question wondered why Canadian SMEs might be of interest to American investors, when most of these enterprises consist of just a handful of people. Finkel insisted that the talent to be found in Canada is considerable, very real, and all too often undervalued relative to any comparable American asset. Above all, such circumstances make it much easier to add value to an enterprise. "It's not really SME so much as just a growth stage," he observed. Lax built on this idea, suggesting that such investments are intended to be scalable. "It's not about the Canadian market," he said, portraying that market as too small to be of interest in itself. "It's about the opportunities around the engineering idea or the product idea. It's about scaling that on a worldwide basis. This whole room has got to stop thinking parochially. The fact is that you've got natural resources here in abundance — both physical natural resources and people, from our perspective engineering talent. Because very few of my brethren are up here, I can get that talent at a discount and make the investment at a discount, then bring our expertise to help them scale on a worldwide basis and grow."

NDP MP Laurin Liu asked about the budget cutback in the SR&ED program and the prospective appeal of a better targeted tax credit for commercialization. Anthony responded that such programs generally eat into the vital time that start-up companies need to establish themselves; a better approach is the concierge service first proposed in the Jenkins report, which would help these firms quickly identify what will be of the most help to them. "Government needs to stop looking at band-aiding the economy and the people driving the economy," she said. "They need to work with those people, roll up their sleeves and ask them, in earnest, what is it that we can do to help?"

Finkel disagreed, describing it as a good program that does take some time to execute, but is far less challenging than working with large VCs. “I really would encourage people to understand what a gift SR&ED was,” he said. “It was cash, and cash as thoughtfully put in a government program as I’ve ever heard of or seen.”