

FINANCIAL POST

FP ENTREPRENEUR

*2011: The Year
of the Entrepreneur*

The lesson for VCs is simple: show returns



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Is the Canadian venture capital industry in crisis, and more importantly, are Canadian startups and small growth companies being starved of capital?

It may surprise you to hear that the answer to the first part of that question is no: "In crisis" suggests that an exogenous or external solution is required, which is clearly not the case. Canadian and global risk-capital markets are functional and liquid – and yes, cyclical.

Long-term returns on venture capital in Canada and the United States are in the low single digits, even negative after the spike in returns around the bubble of 2000 worked its way out of the long-term averages. These post-bubble returns are anemic in absolute terms, worse after allowing for the high risk of the asset class.

This is the reason capital is flowing away from the VC sector, especially in Canada. There is a huge amount of liquidity in global risk capital markets. Somewhere between \$500-billion and \$1-trillion of committed risk capital sloshes around searching for a home in investments uncorrelated to public markets.

This capital is drawn quickly to returns. Consider that the once-reviled hedge fund sector is again bursting with capital because it showed returns after a few lean years: Not great returns, just sufficient returns. Total hedge fund assets have rebounded to exceed pre-2008 crash levels.

The private equity sector in Canada is also robust, just look at the solid returns, transaction volumes, exit activity and fundraising. So it is not a fundamental "Canadian" thing to avoid risk. There also is no need to do such unproductive things as setting quotas for Canadian pension funds to invest a minimum percentage of their assets in venture capital, as has been recommended.

The lesson for the VC world is simple: Show returns. No crisis, no fundamental structural challenges and no government rescues required.

The problem should self-correct. If there is indeed a lack of supply of capital, it should create the opportunity for outsized returns for existing VC funds. They can cherry-pick without fear of losing the best deals to competitors. Even if we are to believe the industry practitioners – who have been saying the Canadian market is in "crisis," with venture capital in short supply for several years now – with the average gestation for a VC investment typically three to five years, those outsized returns should be showing up soon.

That's not to say the industry isn't affected by such things as the nature of the Canadian market, which is small and difficult to build economies of scale. Additional capital won't fix this problem, but web-based technology is alleviating it as a major issue for small companies. It can also be affected by the quality of fund managers, which in recent years has seen a shakeout. Marginal players, unable to raise new funds, are slowly exiting the business. This is healthy.

But the bottom line is, Canadian VCs must show outsized returns, then market their achievements and draw in additional capital. In the United States, the capital that has flowed back into the sector in the past year has been largely concentrated in the hands of funds with the best returns and highest profile exits.

Government or taxpayer capital, though well-intentioned, interrupts this market mechanism and can keep poor performers in the business. If political connections are more important than performance, the industry is as screwed as the European Union in the long-run.

Governments of all stripes must resist the temptation to create “innovation photo ops” and limit their focus to those things that will help the venture capital industry, such as broadly based, sector-agnostic investment tax credits, lower taxes on investment returns, and lower income taxes to facilitate wealth creation. Aggregate private sector wealth and the growth rate of this wealth are the most important drivers of innovation, not blue-ribbon panel reports or high-minded industrial strategies.

Meantime, Canadian businesses are getting by with second mortgages, friends and family money, and money from angels and “super angels” (essentially VCs without baggage). Foreign VCs are also helping fill the void, as are large technology firms mainly from the United States, which are loaded with cash and actively looking for technologies to fold into their offerings.

It is also important to mention that Canadian small businesses are scrappier and more creative than they are given credit for. The strong ones survive – and it is these battle-hardened survivors who will ultimately drive improved returns on venture capital investment.

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