

Capital moves to specialization

Brad Cherniak, Financial Post · Tuesday, Oct. 12, 2010

There are widely varying views about the state of the capital markets for private companies and how to fix them. Many fit the maxim: "where you sit drives where you stand." A broader world view and greater objectivity are critical to effectively assessing and addressing the challenges that exist.

Serial entrepreneur and angel investor Michelle Scarborough takes such a view. She is head of the Investment and Commercialization Group at Ottawa Centre for Research and Innovation (OCRI), a nonprofit tasked with advancing knowledge-based industry in the Ottawa region. She and her team are turning early-stage companies into high-growth enterprises by connecting them with capital -- the whole point of the debate.

While Scarborough agrees the venture capital industry in Canada is clearly struggling and restructuring, she also says it is being boosted and even supplanted by new developments, including the angel investor community.

Angel investors will form a critical piece of the puzzle, increasingly playing a more significant and organized role in the capitalization of early-stage companies than ever before, Scarborough says. She sees additional tax and other incentives being effective in fostering broader angel investment and dramatically increasing the total amount of capital invested.

In the VC industry, there is also a renaissance of very-early-stage funds capitalizing on small investments in Web and tech companies with more modest upside but vastly reduced capital requirements -- VC returning to its roots, as it were.

She notes that the global venture capital community "is getting a lot flatter," with several larger, later-stage funds raising capital, not just from their traditional Canadian LPs but further afield in the United States, Europe and beyond. There is a growing impetus for new funds across North America, with the borders

increasingly becoming indistinct. For example, more U.S. funds are looking to establish locally managed funds in Canada, she says.

Yet, Scarborough knows all too well that private capital markets are still in a major down cycle, and she expects a constructive, continuing role for governments to help facilitate the next up cycle in the short term. Government-initiated investment funds managed by existing VC firms should play an increasingly important role across the country, Scarborough says. Quebec is a leader in this, followed by Alberta and Ontario. However, she expects government "stimulus" to ramp down as the capital markets recover, and not be a permanent feature of the private capital markets.

That being said, the private risk capital market should see better returns over the long run, as VCs are forced to address their operational inadequacies as part of the industry's restructuring. For example, Scarborough sees the trend of VCs shifting their staffing mix toward veteran entrepreneurs with deep operational experience and away from bankers and accountants as very positive.

She also sees an emerging trend in "investors at all stages of the corporate life cycle being more prepared to play nice when building high-quality companies" -- a process that, "if done right, will create solid returns for everyone including the broader economy." The misalignment of interests between angels, traditional institutional investors and their investee companies are renowned and were not helped by the recent downturn.

Overall, capital is becoming much more specialized, to be successful in more focused target investment areas, Scarborough says. She indicates that these players are ahead of the curve and are still generating good returns and raising capital even in the challenging environment of the past few years. She also contends good companies are managing to get capital, if perhaps with more effort. Nonetheless, it could be five years or more before the whole system starts showing adequate returns on capital again and that in the transition many existing funds will disappear and new ones be formed.

In summary, Scarborough says the best ways to accelerate the positive evolution of private capital markets are: a reinvention of thinking around the structure of the industry, which is already happening organically; select government support in this period, tapering off in the long run; and continued commitment to growing strong companies driving innovation in both industry and in the capital markets.

Scarborough has been instrumental in fostering the expansion of Canada's Top 10 Competition. It was originally a life sciences initiative, but she saw the applicability of the concept to IT and cleantech, with great results.

The goal of the competition is simple: To identify the best investment opportunities in the country. A jury panel of global investors judges almost 300 competitors each year. One key qualification is an identified and specific requirement for capital within the next year. Winners get the prestige of the title and intensive support from a battery of peers, coaches and investors. There are networking and pitch sessions, road shows and introductions to key VCs, investors and strategic partners across North America, with numerous follow-on contacts and support.

In the past three years, in a depressed capital market, Scarborough estimates "Top 10" companies have raised a combined \$100-million to \$150-million in capital. This is the true test of all capital market initiatives. For more details, go to www.topcanadiancompanies.ca.

Read more:

<http://www.financialpost.com/entrepreneur/Brad+Cherniak+Capital+moves+specialization/3656052/story.html#ixzz12AbS30wr>

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