

The trouble with venture capital

Problem is not too little money but too much

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There have been plenty of stories in the press in recent months quoting well-respected industry leaders and practitioners prescribing fixes for the undeniably parched and struggling Canadian venture capital industry.

For the most part, these prescriptions involve finding additional sources of capital to buttress dwindling investment volumes. Inevitably, one of the key sources suggested is government. To be fair, few are asking directly for a bailout, but still there are variations on the theme that are equally harmful to the long-term prospects of the industry.

In my opinion, there has been little basic economic analysis of the industry for either Canada or the United States.

First, the problem with venture capital is not the lack of capital, rather it is excessive capital. Far too much has flowed into the industry in the past decade, flooding companies with cash that

should never have been funded, skewing investment valuations and overdiluting the management talent pool.

In both countries, capital inflows, as the accompanying graphs show, have exceeded gross domestic product growth by all measures since 1990 by orders of magnitude. This was simply not sustainable, and reverting somewhat to the mean was inevitable. What is happening now is a market acting rationally, not some mysterious evaporation of capital.

This historical excess of capital has predictably pancaked returns, particularly in Canada but also in the United States, leading to the vicious circle that has brought the industry to the sorry state it is in now. This has had a far greater effect on the flow of venture capital than the global recession, which the industry is designed to react to and benefit from.

The graphs also show the U.S. market has been far more disciplined in correcting the capital excess in recent years and will rebound long before the Canadian market. Total venture capital under management in Canada has not fallen a single dime in the past three years, while in the United States it has dropped almost a third. Ah, free markets.

The worst thing that could be done would be for governments to pour funds into the industry -- this would only delay the painful reckoning and exacerbate the problem, not dissimilar to what we have seen in the auto industry or the U.S. financial sector. This will also continue to hurt the few top-performing funds that still have capital to invest. We should not forget the lessons of the well-meaning but failed, Labour-Sponsored Investment Fund tax credit experiment.

It remains to be seen whether an Obama administration, which is the most activist and expansionist in memory, can resist the temptation to become the next chapter of this lesson. Timothy Geithner, the Oracle of Delphi, or at least D.C., has already made noises to Congress about regulating the industry to prevent a "threat to financial stability" -- a ridiculous notion as it relates to the venture capital industry, but the mantra of interventionist governments everywhere today. But I wouldn't place all the blame for the industry's current plight on governments. There is plenty to go around.

My advice for private companies seeking growth capital is this:

Recalibrate expectations

Venture capital is a niche industry by nature and will remain so. It is the equivalent of the NBA for high school basketball players -- only a very, very select few fitting a specific profile will be able to obtain this form of capital, so manage your expectations and your business appropriately. Get the stars out of your eyes and back to basics.

The league may have expanded from 30 teams to 500 in the past few years, but those added franchises will fall by the wayside to stem the bloodbath they brought on themselves.

Anticipate the future

The venture capital industry is in for several years of drought as it works its way out of its capital excess. This process will be drawn out further to the extent heroic measures are undertaken by governments. There is no specific problem to be dealt with -- only the rational cycle of a free market.

For their part, governments should focus on fiscal discipline and keeping taxes as low as possible, particularly those on investment income and capital gains, and, to a lesser extent, reducing the red tape in cross-border capital inflow from the United States. Only initiatives like these will really help the venture capital industry through this extreme downcycle.

Plan and seek creative alternatives and solutions

Businesses seeking growth capital are the collateral damage and victims of timing--but this has been the case since the industrial revolution. Focus unwaveringly on your own business and don't fight a cycle you can't control.

Broaden your financial capital net, structure deals to conserve or even create capital, and always, always do the math before doing anything. Those who can properly analyze the situation will more often than not come out ahead.

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