Venture Capital in Atlantic Canada: Asking the Right Questions

by
Fred McMahon, AIMS Senior Policy Analyst
Dane Rowlands, Professor of Economics at Carlton University

Atlantic Institute for Market Studies
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1326 Barrington St., Halifax, Nova Scotia B3J 2V1
Telephone: (902) 429-1143 Fax: (902) 423-1528 E-mail: aims@fox.nstn.ns.ca

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EXECUTIVE SUMMARY

Two main impediments stand in the way of a more active venture capital market: the availability of subsidized government financing, and a fractured and difficult securities regime.

The Atlantic premiers have proposed the establishment of a regional venture capital fund. They argue that Atlantic Canadians are deprived of sufficient access to venture capital. This would be corrected by the fund, the argument goes, with the added benefit that it could spark private sector activity by increasing expertise in the region. The fund would be managed on a commercial basis and would involve the Atlantic Canada Opportunities Agency and the major banks as co-investors.

This paper argues that the proposal addresses only the symptom - a perceived shortage of venture capital - rather than the root causes underlying the problem. The key questions which should be addressed are:

> Is there actually a shortage of venture capital in Atlantic Canada?
>
> If so, why isn't the capital market providing more venture capital in the region?
>
> What can be done to remove impediments to the supply of venture capital?

Venture capital here implies investment in start-ups[1] expansions or turn-arounds. Investors aim for high returns in order to compensate for risk and losses which are inevitable in a venture capital portfolio. In exchange for their financing, investors take an ownership position in the company.

This paper, after an examination of the venture capital market in Atlantic Canada, concludes that the region does not attract much venture capital, but that there is no evidence this is due to a lack of supply. Indeed, there is a surplus of venture capital nationwide, and various funds are seeking to increase their investments in this region.

Two main impediments stand in the way of a more active venture capital market in the region, and both are related to government policy: the availability of government investment money in the region, and a fractured and difficult securities regime in Atlantic Canada.

Entrepreneurs have become accustomed to looking to government when they need financing, and not to private sector markets. Because government money is available at reduced or no cost, they are reluctant to give up the ownership share in their company required to attract venture capital.

However, government money is a poor substitute for private financing. There are a number of reasons for this.

Government money does not come with the management expertise that is often so important to small entrepreneurs and which venture capitalists usually insist on providing. Government money also changes the incentive structure for owners and workers, often requires the company

to massage its business plans to meet funding criteria, and is frequently directed to political rather than economic ends.

Governments, however, can no longer afford to give money away, and indeed their massive borrowings have been a driving force behind higher interest rates for businesses and consumers, Reform here could go a long way to removing impediments to capital formation in the region.

The fractured and difficult securities regime in the region increases the cost of capital.

As well, the fractured and difficult securities regime in the region increases the cost of capital. Each of the four provinces have their own, very different, regulatory regime, splitting up an already small market. This limits the amount of equity a company can raise by registering in any one of the provinces.

Moreover, the costs of registering are unnecessarily high for small companies, a problem acknowledged by the Nova Scotia Securities Commission though it applies in different measure to each of the provinces. Thus, with high costs and limited benefits, few companies register and the equity market in the region remains extremely thin.

The Atlantic Provinces should move quickly to create a common regulatory regime, one that opens the door to listing by the typically small companies in Atlantic Canada.

The AIMS paper recommends that the four provinces quickly move to create a common regulatory regime, one that opens the door to listing by the typically small companies in Atlantic Canada. The premiers should also continue to pressure Ottawa to introduce a national securities regime.

An improved securities regime would increase access to equity capital and remove one of the major roadblocks to the use of venture capital in Atlantic Canada -- the lack of a liquid equity market in the region.

Investors invest to make money, but if they can't get their money Out, even a successful investment becomes a money trap. Without a liquid equity market and the option of preparing a public offering down the road, investors are likely to insist taking a controlling interest in a company to ensure they can get their money out at the end of the day. This is a cost many entrepreneurs are unwilling to accept.

Lack of information also inhibits investment. Increased efforts by business organizations and others to match private investors and companies in need of capital could provide great benefits.

Proposal for a venture capital fund

The creation of a government-supported venture capital fund poses several problems: in principle, it is undesirable to risk taxpayers money in commercial ventures; the past record of government supported programs does not augur well for success; and the fund may have problems finding commercially viable investments, given that businesses in the region have not

tapped into currently available sources of venture capital. Moreover, nothing even close to a cost-benefit analysis has been undertaken to determine the merit of such a fund.

However, if the decision is made to proceed with the fund, it must at a minimum be structured and managed as a private sector fund. This is consistent with the proposal on the table and consistent with the objective of involving private sector money in the fund. If the fund does not meet these criteria, it will likely further distort the capital market, creating even greater inefficiencies. The key recommendations here are:

> The management of the fund must be independent, and a firewall should be built between it and political interference.
>
> The management must come from the private sector and be appropriately remunerated, otherwise the quality people needed for astute management won't be attracted to the fund.
>
> The fund should provide financing only on a commercial basis. Firms financed must have large growth potential, be willing to give up an appropriate equity stake in exchange for the investment, and require financing of at least $500,000.
>
> Co-investors should be required for all financing, so that only ventures in which a private investor is willing to risk money would be accepted.
>
> The fund is partially premised on the argument that it will spark private sector activity. Thus, government participation should have a sunset clause, say 10 years.

The best way and most cost effective way to provide risk financing to Atlantic Canadian entrepreneurs is to remove market impediments. No compelling case has been made for the establishment of a government financed venture capital fund.

The simple measures outline above, however, can help ensure that the fund's potential negative effects are minimized. The fund must be established in conjunction with addressing market impediments, and the fund must have an independent management which provides financing only when commercial criteria are met.

I) INTRODUCTION

i) Proposal to Create a Venture Capital Fund

The four premiers of the Atlantic Provinces and the Atlantic Canada Opportunities Agency (ACQA) have proposed the establishment of a venture capital fund in the region. This proposed 'Atlantic Investment Fund' (AIF) would combine government and private capital in a privately managed investment pool to help address a perceived deficiency in the current supply of 'patient' equity investment and, in the longer term, to spark the development of a venture capital market in this region. The proposal is to create a fund of $30 million with the four provinces, the large banks and ACQA each contributing $10 million.

It is crucial to understand the implications of such an approach before committing public resources. In particular it is important to understand that the AIF proposal focusses on the symptom rather than root cause of any shortage of venture capital in Atlantic Canada. The proposal aims simply to provide additional venture capital. Less attention has been focussed on the fundamental questions in this area:

> Is there actually a shortage of venture capital in Atlantic Canada?
>
> If so, why isn't the financing market providing more venture capital in the region?
>
> What can be done to remove impediments to market formation and spark activity?

These questions are particularly important in light of the consensus that has developed that the availability of government financing and grants has suppressed the market for venture capital in Atlantic Canada. This consensus is reflected in government-commissioned reports, private sector reports[1] and studies by research groups. (See for example, in bibliography, reports from the Science Council of Canada, the DRM Advisory Group, and the Atlantic Provinces Economic Council; also see Section III. of this paper) In this light, the venture capital fund could well become another impediment to the formation of private sector venture capital in Canada, the very thing it is supposed to encourage.

This highlights one crucial point: *The logical goal of policy initiatives in this area, including the formation of an AIF, should be the development of a functioning venture capital market in Atlantic Canada.*

This point of view has not been much reflected in the ongoing debate over the AIF proposal. But it is the central issue, and policy should focus on long-term solutions to the root problem rather than short-term solutions to symptoms of the problem.

A recent report for the Science Council of Canada addresses this point in relation to venture capital and the high technology sector.
We do not believe that [impediments to the formation of venture capital] can be broken by additional direct government intervention in the Canadian venture capital and technology sectors. Direct intervention in the form of increased capital commitments (which is not a

practical option in today's environment in any event) would do little to address the structural impediments that have led to poor rates of return and the flight of capital. Government can, however, play a role in helping reduce those impediments and thereby allow both the venture capital industry and the technology sectors to move closer to achieving critical mass and a mutually supportive environment. *(Creating Threshold Technology Companies in Canada: The Role for Venture Capital,* Mary Macdonald, 1991)

ii) Venture Capital: A Definition

The type of investment proposed for the AIF is known by a number of terms, venture capital, patient capital, entrepreneurial financing, etc. This report will use the term *venture capital,* not because it is superior to the alternatives, but simply because it is now commonly to be employed in the discussion of the premiers' proposal.

Venture capital may be used to finance a start-up, expansion or turn around. The term itself implies that the investors take an ownership position in the firm, though some institutions have instituted venture loans,' relatively risky start-up, expansion or turn-around loans typically made at roughly market rates, but with the requirement that the firm also pay some percentage of revenue or profit to reflect the added risk.

Investors in venture capital projects usually aim for high returns - in the range of 25% to 35% - in exchange for the risk they accept and to make up for losses which inevitably occur in any venture capital portfolio. As well, most investors expect to be able to take out their capital and profits in five to seven years, with a 10 year time horizon usually being the outer limit.

iii) Organization of paper

Section II will examine the state of the venture capital market in Atlantic Canada. It will conclude that the region has attracted very little venture capital, but that this is not clearly a lack of supply. If supply is not a problem and current sources of supply are not fully tapped, then the motivation for the AIF is severely weakened and the fund may not be able to invest its resources on a commercial basis.

Section III will explore why the market has been weak in the region. It will conclude that the availability of government subsidies and subsidized financing has undercut normal market forces (a problem made worse by the region's isolation from large financial markets), by complicated and fragmented securities regulations which limit liquidity in the region's equity market, and by a number of secondary factors.

Section IV will examine the option of continued reliance on government-subsidized investment funding. It will argue that government funding is much less productive than private sector funding.

Section V will outline the necessary conditions for a venture capital market to develop in Atlantic Canada. Key to this is a reassessment of government's economic development strategy and reform of the region's securities regulations. More generally, government can help reduce the

cost of capital - making borrowing more affordable for both businesses and individuals - by getting its fiscal house in order.

Section VI examines the proposed AIF and the drawbacks inherent in the proposal while the following section details ways in which these dangers can be mitigated. The last section presents this study's conclusions.

II) CURRENT STATE OF THE MARKET

i)Is there a shortage of investment funds?

As tempting as may be to believe that Atlantic Canada has been locked out of the venture capital market, the facts do not support this viewpoint.

The Atlantic Provinces Economic Council (APEC) report to the Conference of Atlantic Premiers[1] *Equity Capital Investment: A key to Entrepreneurial Expansion in Atlantic Canada,* expresses concern over the "lack of access to equity (venture) capital that many Atlantic businesses, especially small and medium-size ones, have faced for years" *(Atlantic Review,* January/February 1995). Although this view has become widely accepted, it is important to ask why investment funds remain inaccessible. Is it a shortage of these funds which has restricted business investment?

Firstly, it should be noted that the ratio of investment to gross domestic product (GDP) in Atlantic Canada is not dramatically different from the national average. Government and private investment made up 18.6% of Atlantic Canada's GDP in 1992, while the comparable value for Canada is 1 9.0% (Statistics Canada, Provincial Accounts).

This simple comparison is not ideal since these percentages change somewhat from year to year and are very broad measures of investment. As well, Atlantic Canada is more dependent than Canada as a whole on government investment and thus has relatively less business investment. For Canada, business investment equals 16.6% of GDP compared to 14.9% in Atlantic Canada; government investment for Canada equals 2.4% of GDP compared to 3.7% in Atlantic Canada. The relatively weak business investment numbers contain another cautionary tale: under normal circumstances, economically depressed regions need above-average capital expenditures to catch up with prosperous regions. Thus, although the total amount of investment funds in Atlantic Canada does not lag behind the rest of Canada as much as is sometimes thought, this is not necessarily good news for the region.

In particular, Atlantic Canada has attracted relatively little venture capital. The Federal Business Development Bank (FBDB) surveyed 516 companies assisted by venture capital for its *Economic impact of Venture Capital Investments in Canada, Second Annual Survey,* 1 994. Of the 386 firms which responded only four were in Atlantic Canada. The province with the lowest number of such firms outside Atlantic Canada was Saskatchewan. Yet that province, with half the population of Atlantic Canada, had six such firms, half again as many as found in Atlantic Canada.

The view that the venture capital market is weak in Atlantic Canada is also supported by the findings of Association of Canadian Venture Capital Companies. Of the 341 venture capital investments undertaken by the 56 active venture capital funds in Canada in 1993, only two were in Atlantic Canada. *(Annual Statistical Review,* June 1994) There is a large and growing amount of venture fund capital in Canada, but it is not being attracted to the Atlantic Provinces.

As tempting as it may be to believe that these numbers indicate that Atlantic Canada has been locked out of venture capital market by venture capital groups located elsewhere in the country and little interested in the region, other facts do not support this interpretation. For example, of the roughly $60 million in venture capital the FBDB has invested, the Atlantic regional office estimates that only $500,000 is invested in this region. Yet, the FBDB has a strong mandate to serve all regions of the country fairly, and it has active offices in all four Atlantic Provinces. FBDB's portfolio of traditional business loans reflects its strong presence in the region. As of 31 March 1994,14% of its portfolio was in Atlantic Canada, considerably more than the region's share of the national population. *(1994 Annual Report,* FBDB)

Moreover, a surplus of venture capital appears to exist throughout Canada. Although funds would always leave some money uninvested, many funds appear to be significantly under invested at the moment. The FBDB has $50 million uninvested of the approximately $110 it is prepared to commit to venture capital projects throughout Canada. Working Ventures Canadian Fund Inc., sponsored by the Canadian Federation of Labour had $479.5 million of net assets as of March 1, 1 995, but its venture investments were valued only at $79.5 million. (It held $242.5 million worth of bonds and short-term investments in government and large crown corporations, and $157.5 million in other investments.) *(Working Ventures Canadian Fund Inc., Statement of Investment Portfolio,* March 31, 1995) According to the *Annual Statistical Review and Directory,* June 1 994, of the Association of Canadian Venture Capital Companies, half of the $4 billion under management by these companies was still available for investment.

Thus it would appear that much venture capital is available for investment throughout Canada, but that the demand for it, particularly in Atlantic Canada, is relatively low, at least from firms which meet the commercial requirements for venture investment and are willing to pay the price. Section III will analyze reasons why this might be so.

ii) National and international considerations

It is also worth noting that in today's era of highly-integrated, worldwide financial markets, Atlantic Canada is merely not part of the Canadian equity market but also of the international market. Thus, Atlantic Canada does not constitute a single, isolated, capital market. Even large nations do not have that status in the highly integrated markets of today.

There is no reason why the quantity of investment in the region should equal the amount of investable funds saved in the region. Investors have the ability and the desire to invest in the projects which offer the highest rates of return, regardless of which province or country those projects happen to be in. The market rates of return are established, therefore, by global - not regional - capital markets. If there are projects in Atlantic Canada which promise these returns but cannot attract local investors, then capital from outside the region will flow in. Similarly, if outside opportunities offer higher rewards than local projects, it would be harmful to prevent capital from flowing out of the region.

However, this does not lessen the desirability of unblocking impediments to the formation of an active venture capital market in the region. Several firms which have received venture capital from outside the region have been required to move at least some of their operations closer to

their funding sources. As well, potential investors are most likely to be aware of and able to help in the management of nearby opportunities, one of the key benefits of venture capital investment.

iii) Market Analysis

The above thoughts can be put into a more rigorous economic analysis (see box) which raise several possibilities:

* The venture capital market in Atlantic Canada is in equilibrium Most entrepreneurs simply aren't willing or able to pay market-going rates for venture capital; policy moves, such as deficit reduction to lower interest rates or the use of the tax system to reduce the cost of capital, might help generate market activity.

* The market is not in equilibrium because of policy blockages such as:

- artificially low non-market prices, i.e., government subsidized capital, which distort underlying demand

restrictive securities regulations which limit the ability of investors to retrieve their money even from *successful* venture deals, penalizing rather than rewarding success.

* The market is in an unnecessarily low equilibrium because some costs are needlessly high and could be reduced by judicious policy moves, thus 'thickening the market.' For example, the cost of information - of finding and matching investors with entrepreneurs - may be high and, thus, deals which could struck at the market price are not consummated.

* A potential market exists, but it is too thin for spontaneous combustion; policy initiatives might help spark market activity.

Market Equilibrium and Venture Capital

Here, market equilibrium means that the market has set a price that balances demand and supply and that anyone wishing to make a transaction at this price is able to do so. When the market is clear of removable distortions, such an equilibrium is an efficient outcome since suppliers provide the good - in this case venture capital - up to the point where the capital could be used more productively elsewhere. Thus, the higher the price the greater the supply as the higher price outbids alternative uses of the capital. On the demand side of the market, only those who can meet the market price, who are productive enough to produce the expected return, are supplied.

This efficiency is dynamic and adjusts to changing conditions. If, for example, demanders become more productive, they will be able to pay an increased price for venture capital because their improved productivity enables them to meet the higher price and still make profits. More capital is enticed away from other uses and drawn into the market. Or, on the supply side, if other more productive uses of capital arise, capital will be drawn to those uses, increasing the price so that only those who have the productivity to meet or surpass these other uses will participate in the market. Whatever the case, a market in undistorted equilibrium implies that goods flow to their most productive uses.

The following sections argue that policy blockages and, to a lesser extent, high costs have inhibited market formation, making it impossible to determine at what level of activity the venture capital market in Atlantic Canada would operate at equilibrium. The key to the problem, it is argued, is public policy blockages.

It is also argued that government debts and deficits have increased the cost of capital and that better fiscal management could increase market activity by reducing the equilibrium price of capital.

III) WHY THE VENTURE CAPITAL MARKET IS WEAK IN ATLANTIC CANADA

What private investor can compete against free or subsidized government money? Why would any entrepreneur sell equity when government money 15 not only cheaper but often easier to obtain?

The formation of a venture capital market in Atlantic Canada has been hobbled by the direction in which private and public money flows in this country, by a difficult regulatory environment and by secondary effects which lock market impediments into place.

i) Capital flows

Vast amounts of public money, including investment (economic development) money flow into the region. This has had the perverse effect of suppressing the development of a private venture-capital market. What private investor can compete against free or subsidized government money? Why would any entrepreneur sell equity or pay high interest rates, reflecting a risk premium, when government money is not only cheaper but often easier to obtain? ACOA has stated it will stop giving grants and shift entirely to loans. However, these loans will still be subsidized and available at below-market rates. Were they to be offered on a purely commercial basis the uptake would be small because of the number of alternate commercial funding sources with conveniently located offices throughout the region.

A recent of study 20 innovative export-oriented firms in Nova Scotia and Prince Edward Island dramatically illustrates this point. Of these firms, *100% had accepted government money,* only 50% received significant outside, private-sector funding. *(Creating Value for Export,* DRM Advisory Group, June 1994) The DRM report goes on to note:

> The effect of all this government involvement in the financing sector is threefold:
>
> > * First entrepreneurs become accustomed to the notion of raising money without making relationships with investors.
> >
> > * Second, business people are often required to 'adapt' their business plans in order to fit into the requirements of government programs.
> > *Third, the fact that government financing is an option means that private investors tend to stand on the sidelines. Why put private money at risk if there is a government program that might cover it?
>
> The result is a situation where entrepreneurs would rather not take in investors if they can avoid it, while no investment is created on the 'supply side' either.

While government money flows into the region, suppressing the formation of a venture capital market, private capital - including the capital of investors willing to accept risk - tends to flow to the major financial institutions which are managed in Central Canada. This leaves Atlantic

Canada isolated from much financial decision-making and inhibits the development of expertise. As well, it isolates financial decision-makers from opportunities which may exist in the region.

Moreover, the availability of government subsidized investment money in Atlantic Canada discourages outside venture capital groups, which must operate at unsubsidized market rates, from seeking opportunities in the region, further isolating the region from financial decision-making.

As will be discussed directly below, the availability of government money also feeds into problems with the regulatory environment, further suppressing the development of a venture capital market in Atlantic Canada.

ii) Liquidity problems and the regulatory environment Why do investors invest? To make money.

Yet, potential venture capitalists in Atlantic Canada worry about their ability to make money, even from successful investments. This is because investors fear they may not be able to retrieve their profits or their capital from an investment even after a number of years.

The *Equity Capital Investment* report notes several exit strategies - ways in which investors redeem their capital and take their profits in successful ventures:
1) Sale of the investor's interest to another shareholder

2) Sale of the investor's interest to a third party

3) Sale of the investor's interest to the company

4) Sale of the company to a third party

5) A public offering of the company

If these exit routes are blocked, investors may own something of value, but be unable to sell it; they find their money locked into an investment from which they can't exit - a money trap.

Public share offerings of entrepreneurial companies are key to a liquid equity market. They provide an investor with an exit route and potentially leave the entrepreneur managing the company or perhaps retaining control. In jurisdictions with an active equity market for small issuers, the investor and the entrepreneur have the option of striking a deal at the time of investment which may, among other things, stipulate that the company must be taken public - or an acceptable alternative for the investor - once certain conditions are met. This ensures the investor of an exit from successful investments while at the same time taking account of the concerns of the entrepreneur.

However, for reasons to be explored later, security regulations in Atlantic Canada make public offerings extremely difficult. This sets up a potential conflict between investors and entrepreneurs and limits the number of deals struck.

In the absence of easy exit routes[1] a potential investor is likely to seek control before putting money into a venture. Without control and with public offerings difficult or impossible, the investor is unable to rely safely on any of the other exit strategies. For instance, another shareholder or a third party would be unlikely to purchase the investor's interest unless the new buyer also had a secure exit strategy, which they could only achieve by buying a controlling interest. Equally, the company itself has little motivation to use valuable capital to buy out an investor. Finally, an investor without control cannot force an outright sale.

Yet, entrepreneurs everywhere are reluctant to give up control,and in Atlantic Canada they see little need to do so because of the availability of government money which doesn't threaten control and seems to cost less. This would appear to be reflected in the number of venture loans made in the region, even by groups with an obvious interest in investing here such as the FBDB.

In any event, difficulties between entrepreneurs and investors over control further inhibit the development of a venture capital market here. This following chart shows both how few public offerings are made in Atlantic Canada and the preponderance of government capital over private money.

iii) A Thicket of Vicious Circles

The thin exit market, both for public offerings and for outright sales of entrepreneurial companies, is self-perpetuating. Little expertise is developed in generating public offerings, and potential buyers do not naturally look for offerings in the region.

Thus, few venture capital deals are struck and even fewer public offerings or outright sales of entrepreneurial companies follow from such deals. This leads to the first of a set of vicious circles inhibiting the development of a venture capital market in Atlantic Canada.

The thin exit market, both for public offerings and for outright sales of entrepreneurial companies, is self-perpetuating. Little expertise is developed in generating public offerings, and potential buyers do not naturally look for offerings in the region nor do they develop the expertise to evaluate Atlantic Canadian companies. As well, little expertise is developed in preparing a company for an outright sale or in finding potential buyers, and corporate buyers tend not to look to the region for opportunities. Thus, few downstream corporate opportunities develop.
The historical weakness feeds back on itself - action is thin when a company actually does go to market limiting the chances of a satisfactory deal, and so the circle continues. In short, exit markets are not liquid, and this simply reinforces investors' perceived need for control at the start of the investment process.

Entrepreneurs are more likely to seek out venture capital if they believe it is available; investors are more likely to be active if they believe good opportunities exist.

The thin venture capital market is also self-perpetuating. Supply and demand are clearly connected. Entrepreneurs are more likely to seek out venture capital if they believe it is

available; investors are more likely seek out, or be open to, entrepreneurs with ideas if investors believe good opportunities exist. Other aspects to this vicious circle are:

* Success stories and role models are lacking on both the venture capital and entrepreneur sides of the market.

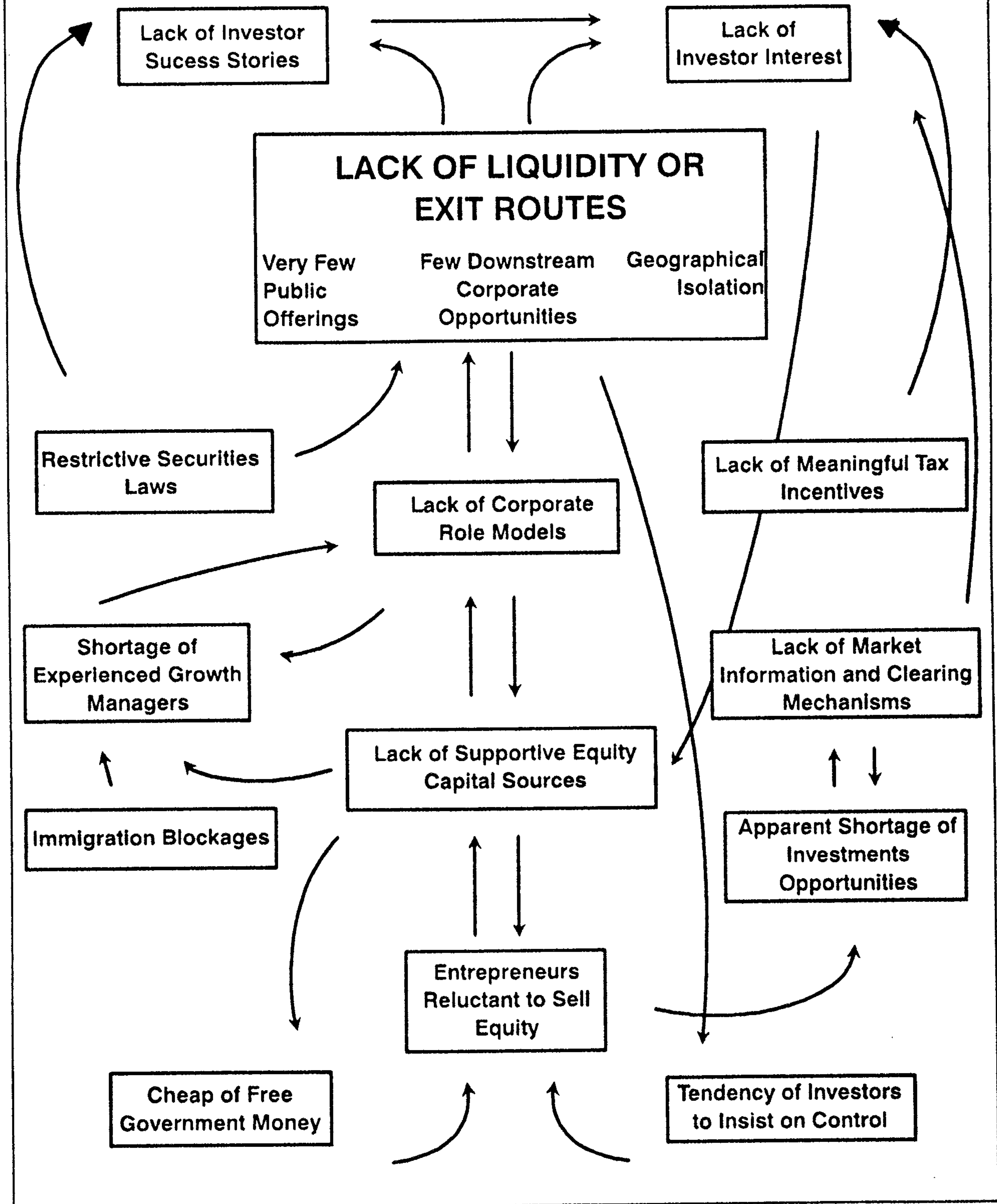
* With little history of success, investors and entrepreneurs are not drawn into the market, and expertise does not develop on either side the market neither experienced growth managers nor entrepreneurs. As noted in *Creating Value for Export,* some companies feel this is exacerbated by blockages to immigration which prevent companies from recruiting external expertise.

* Without expertise, success stories are rarer still. This is extremely important since one of the key capabilities a venture capitalist brings to a deal is management expertise which the entrepreneur often lacks.

* Because of the thin markets, information-generating networks of investors and entrepreneurs don't develop and matches are scarce. Information is expensive to gather and may not be available at any price. Thus, potential investors find few opportunities and entrepreneurs believe little venture capital is available.

* The problems with the market tend to leave the market to predatory investors, those willing to demand control and use for it for their ends, and thus reinforces the reluctance of entrepreneurs to accept venture capital.

Complicated linkages exist between these factors which may be easier to illustrate through a diagram (see next page) than attempt to describe them further.


OBSTACLES TO THE FORMATION OF PRIVATE EQUITY CAPITAL IN ATLANTIC CANADA
Lack of Investor Sucess Stories
Lack of Investor Interest
LACK OF LIQUIDITY OR EXIT ROUTES
Very Few Public Offerings
Few Downstream Corporate Opportunities
Geographical Isolation
Restrictive Securities Laws
Lack of Corporate Role Models
Lack of Meaningful Tax Incentives
Shortage of Experienced Growth Managers
Lack of Market Information and Clearing Mechanisms
Lack of Supportive Equity Capital Sources
Immigration Blockages
Apparent Shortage of Investments Opportunities
Entrepreneurs Reluctant to Sell Equity
Cheap of Free Government Money
Tendency of Investors to Insist on Control

IV) WHY NOT LEAVE IT TO GOVERNMENT?

Private investors bring with them a wealth of knowledge on the management of new enterprises - something which these enterprises often desperately need.

Despite appearances, free or subsidized money provided directly by government bodies is a poor substitute for private capital.

The key reason for this is that private investors bring with them a wealth of knowledge on the management of new enterprises -something which these enterprises often desperately need - and venture capitalists, because it is their money at stake, are strongly motivated to contribute to the success of the enterprise.

This point was emphasized in the *Equity Capital Investment* report on venture capital. The DRM Advisory Group makes the same point in its report. Easy access to government money:

> ... means that companies miss out on the benefits of receiving intelligent money - money which brings with it the support, advice and discipline demanded by a private sector view, for which no government involvement can be a proxy. The best investors work to support the success of the companies they invest in.

In fact, venture-backed firms grow the fastest. From 1 988-93, they increased employment at an annual rate of 42% compared to 7% for the 100 largest firms. *(Economic Impact of Venture Capital Investment in Canada,* FBDB, 1994.) Most of the venture-backed firms surveyed were financed by private sector funds, but it does include firms financed by bodies like the FBDB and private-public funds which nonetheless operate on market-based criteria.

A number of other factors limit the usefulness of money provided directly by government bodies through the type of economic development programs prevalent in the past.

* <u>Picking winners</u>
No matter how competent or well-meaning, a civil servant will very rarely have the knowledge, personal experience and motivation in picking winning ventures that a venture capitalist will have.

* <u>Commitment</u>
Even the most dedicated civil servant is unlikely to have the personal commitment and interest of venture capitalists, who risk their own money.

* <u>Political influence on investment strategy</u>
Many factors other than economic viability go into government decisions on where to invest. Politicians quite logically will worry about political payback, geographical balance and the political acceptability of various investment opportunities, and they are likely to be influenced by those with political power and connections For instance, job-intensive industries, even if they are in decline, are likely to be more highly valued than stronger wealth-creating projects which

produce less immediate employment - the number of jobs produced today may become more important than long-term prospects.

* Non-economic factors
Political and bureaucratic considerations also have an impact on the business side of the deal. Entrepreneurs will often be forced to make non-economic decisions to meet the criteria of the government program or to please the funding agency.

* Changes in incentive structure
Government money changes the incentive structure for both the entrepreneur and workers, lessening the discipline needed to succeed in the marketplace. Workers and managers may feel government will bail them out of any problems: i.e. a business that~needs subsidized money to start often needs subsidized money to continue - a story Atlantic Canadians have seen time and again.

* Unfair advantages
Government programs, by subsidizing one set of companies, often damage successful unsubsidized businesses and limit their ability to grow.

* Stow decision-making
Bureaucracies move slowly while the speed of decision-making is often crucial to the success of young businesses.

To complete the circle, government money inhibits the development of private sources of venture capital₁ a significant problem in an era of government constraint. This last point underlines the necessity of seeing the creation of any government-supported venture capital pool as merely an interim step in part of a larger strategy to create a functioning venture capital market. Otherwise, the pool becomes simply another impediment to developing a real market in the region.

V) REMOVING MARKET IMPEDIMENTS

i) Government Money and the Marketplace
ii)
The gap between Atlantic Canada's unemployment rate and the national rate has widened though development programs have typically stressed employment creation over wealth creation.

As noted earlier, a consensus has developed that the availability of government-subsidized financing has impeded the growth of private-sector financing markets in Atlantic Canada. A discussion of the complex development structures that all levels of government have put in place in the region over the past several decades is well beyond the scope of this paper. Several observations are in order, however.

Firstly, governments have experimented with many costly economic development programs in Atlantic Canada, but they do not appear to have produced the desired results. Atlantic Canada is almost as far behind the rest of Canada economically as it was 30 years ago and the gap between the region's unemployment rate and the national rate has, in fact, widened though economic development programs have typically stressed employment creation over wealth creation.

Secondly, government's fiscal position no longer permits the current level of spending. Neither accelerated debt creation nor substantially higher taxes seem to be realistic alternatives to reduce spending. All levels of government are thus cutting back.

These two factors are clearly leading to a reassessment of economic development programs and a reduction in their funding. For example, ACQA, as noted, has stated it will no longer make grants but instead offer loans. A reassessment of economic development programs may allow the private sector financing market to operate more efficiently in the future, though other market impediments must be removed for this to happen. This paper in the following sections will focus on key components in removing impediments to the formation of a venture capital market, though it should be noted that venture capital is only one aspect of a much broader financial market.

ii) Securities Regulations and Exit Strategies

Equity markets play a central role in economic development. Capital investment is a key source of growth, and securities regulations must not unduly hinder the productive alliance between investor and entrepreneur.

This paper has argued that a key impediment to the development of an active venture capital market in Atlantic Canada is the lack of exit routes for investors, reflecting in turn the lack of liquidity in the region's equity market.

It is important to bear in mind the crucial role equity markets play in economic development in a free enterprise economy. Capital investment is the key source of growth, and securities regulations, while necessarily protecting the investor, must not unduly hinder businesses' access to capital and the productive alliance between investor and entrepreneur.

An efficient, liquid equity market does not merely help venture capitalists find an exit route. By opening up new opportunities, it also encourages other investors to enter the field, perhaps simply as shareholders rather than venture capitalists. It thus expands the sources of capital available for entrepreneurs and the number of investment avenues for those seeking the best return on their money. Equally important, the market generates information on investment opportunities and on sources of investment funds.

Yet, in Atlantic Canada, already a small market, each province has its own set of securities regulations. Four separate, very different regulatory regimes make no sense. The fractured nature of the region's securities regulations is one problem which could be dealt with quickly and inexpensively

If the Atlantic premiers want to address real problems in the market for venture capital, they should immediately turn their attention to this area.

A common regulatory environment for the region should be designed to help, rather than hinder, small companies find equity investment and develop an active regional market in such equities. Few companies in the region now find it cost-effective to undertake the expense of complying with their province's securities regulations in order to raise capital through an equity issue.

In general, complying with the regulations requires companies to issue a prospectus, meet continuous disclosure regulations and sell only through registered dealers in the province (the 'registration requirement'). This is an expensive process with limited benefits, given the small size of provincial equity markets. Firms may go one step further and register on a stock exchange outside the region. But, this involves even greater costs and is a realistic option only for the largest firms in the region; it is certainly not an option for a small issuer.

The regulatory regimes do allow companies which do not comply with the regulations to make equity offerings through exemptions to filing regulations. The usefulness of these exemptions is limited by difficulties in using the exemptions and, again, by the small size of the provincial equity markets themselves and the therefore limited benefits which arise from compliance.

In mid-1994, the Nova Scotia Securities Commission circulated a discussion paper, *Small Issuer Capital Formation,* which acknowledged that current regulations place an undue burden on small companies which would like to issue equity. Nova Scotia's regulations, which are based on Ontario's security regulations, allow three types of exemptions: private issuer, seed capital and sophisticated investor. However, the discussion paper notes:

> Although there are a number of statutory exemptions that issuers can now rely on to avoid the prospectus and registration requirements, they are of limited use to smaller issuers in a small market.

The private issuer exemption, the discussion paper continues, prohibits issuers "from offering their shares to the public: a restriction that is extremely difficult to apply because of the inherent difficulty in defining who is, or is not, a member of the public."

The seed capital exemption is also difficult to use and interpret for several reasons including the requirement that:

> …each purchaser has access to substantially the same information concerning the issuer that a prospectus filed under this act would provide ... (Nova Scotia *Securities Act,* 41.1 .v.ii)

The question of what is "substantially the same information" is difficult to interpret and could lead to legal problems in failed investments. As well, the discussion paper notes: "In addition, the seed capital exemption restricts an issuer to soliciting not more than fifty prospective purchasers resulting in sales to not more than 25 purchasers."

Finally, the sophisticated investor exemption applies only to those investors willing to invest a minimum of $1 50,000 in the company. However, respondents to the discussion paper have noted, in some cases privately, that a $1 50,000 minimum is too restrictive. Those familiar with the market say many sophisticated investors willing to invest $1 50,000 or more in risk situations would prefer to spread the risk around, investing say $25,000 or $50,000 in individual companies. Thus legislating minimum amounts per investor neither protects investor interests nor helps issuers.

In conclusion, all three exemptions are of limited use, as the Nova Scotia Commission itself states.

A common Atlantic Canadian regime and simplified regulations to permit greater participation in investment in small issuers would create important advantages for Investors and entrepreneurs

Newfoundland's securities regulations are also based on those of Ontario. However, the sophisticated investor exemption is set at $97,000, and the seed capital exemption requires a memorandum which must meet specific requirements rather than the vaguer idea of "substantially the same information" as a prospectus. The private issuer exemption is, in broad terms, the same as in Nova Scotia.

In both provinces, secondary trading is largely restricted to trading between equity holders of the same firm, further limiting liquidity.

New Brunswick's securities legislation offers neither a private issuer nor seed capital exemption. Its sophisticated investor exemption is set at $97,000. As well, the Office of the Administrator of Securities, Department of Justice, can make individual exemptions, but the Administrator, Don Smith, in a discussion of the regulations with one of the authors of this paper, estimated that only about a dozen exemptions have been made annually in recent years. Secondary trading is permitted in New Brunswick.

Prince Edward Island has a $97,000 sophisticated investor exception and a seed capital exemption but not a private investor exemption. A firm can apply for an individual exemption,

but the Registrar of Securities, Edison Shea, in a conversation with one of the authors of this paper, says such questions seldom arise due to the typically small size of PEI firms.

Thus, in all four provinces, very few firms use equity issues, in part of course due to the small size of many companies but also in part due to difficulties with the individual regulatory regimes and the fragmentation of the market into four provincial markets.

While it is beyond the scope of this paper to make comprehensive recommendations on a new securities regime for the Atlantic Provinces, the general direction is clear.

Firstly, it should be borne in mind that the regulations cannot foresee every possible risk an investor may face. Instead, while it is appropriate to have a regime which comprehensively protects the small investor who is unwilling to take high risks, the regime should to the level of risk they are willing to accept. Thus, the regime should:

* allow individuals to declare themselves to be sophisticated investors, acknowledge their ability to understand the nature of their investments, and assume responsibility for their decisions. If some test is set to qualify as a sophisticated investor based either on the ability to take losses or on past experience - it should be a straight-forward, non-bureaucratic test, simply and quickly administered

* follow the same criteria in deciding on relevant disclosure information: i.e., that this information be provided in a simple, appropriate, and non-bureaucratic context.

Atlantic Canadian regulators should also look to the example of a number of United States jurisdictions which use a relatively simple question-and-answer disclosure format, Form U-7. This attempts to balance the small issuers' need for a simple disclosure form with the investors' need for information. The question-and-answer format often enables the issuer to complete the form with little professional assistance and can make it easier for the investor to understand.

Secondary trading between sophisticated investors should be permitted to improve liquidity, and the viability of an Atlantic Canada over-the-counter stock exchange should be examined. Stock exchange technology is already highly advanced and further developments are rapidly being made. This may make electronic, over-the-counter exchanges viable for even small markets like Atlantic Canada.

The central recommendations in this report on security regulations - a common Atlantic Canadian regime and simplified regulations to permit greater participation in investment in small issuers provide important advantages.

They would increase the depth of the market, by allowing more investors and small companies to participate, and the breadth of the market, by creating one regime covering two million people, rather than four individual regimes. This expands the possibilities for capital formation. Possibilities of increased capital formation would be reinforced by the lower costs of not being required to file with four agencies but rather with one agency under simplified regulations.

Although this paper 5 recommendations focus on Atlantic Canada, it would be clearly much more desirable for the reasons outlined above to form a common securities regime across the country, one that is as integrated as possible with international regimes. However, this proposal faces difficulties since the provinces with currently active equity markets may have little interest in nationwide reform.

iii) Information

The *Equity Capital Investment* report discusses investment 'angels' in depth. These are people who fund investment opportunities privately. Angels are highly sensitive about confidentiality for a number of reasons, not the least of which is a desire not to be constantly approached by anyone who thinks they have a good investment idea.

Angels are thus matched with opportunities only through their own private network of contacts. Given that APEC estimates that this activity is already worth $4 to $10 million annually in Atlantic Canada, it is probable it could be significantly increased if potential investors and entrepreneurs had better sources of information in matching up with each other. A large and easy to access information bank may also help draw outside investment groups into Atlantic Canada.

A number of jurisdictions, for example the Ottawa-Carleton region, have successfully implemented matching services. According to a recent Globe & Mail report the Ottawa-Carleton Economic Development Corporation has acted as matchmaker for about 50 deals in the past five years.

In St. John's, Newfoundland, the Investment Opportunities Project (IOP) made 12 matches from a list of 90 opportunities and developed a successful screening procedure before sending business plans to interested investors. A report on the program, *The Investment Opportunities Project; A performance Appraisal,* by Carleton University professor Allan L. Riding also judged IOP a success. "The findings of this analysis suggest strongly that the IOP has met or exceeded the objectives advanced in its 1989 proposal." However, the IOP was costly to maintain and depended on government funding which was cut, and the program was terminated.

Nonetheless, successful programs like this may in fact thicken the market. This process would ideally be run by a private sector entity, free of political constraints, and would put much emphasis on protecting confidentiality. The Chamber of Commerce may be able to take a lead role in this. A government run program is far less likely to be successful since it will have political as well as economic imperatives.

iv) Debts, deficits and the cost of capital

The cost of capital is unnecessarily high because of governments' great need for money to fund their deficits and service their debts.

The cost of capital is unnecessarily high in today's market. In large measure, that's because governments' great need for money to fund their deficits and service their debts means government is actively competing against the private sector for capital and thus driving up its cost. In fact, government borrowing equals 85% of all saving in Canada.

Not only does this directly drive up the cost of capital, it also forces Canadian business to rely on foreign borrowings to fund investment. This further increases the cost due to

1) transaction costs

2) currency risk: the danger the Canadian dollar may fa~l in relation to other currencies. If the loan is denominated in Canadian dollars, lenders may demand a premium to cover the risk; if denominated in the foreign currency, then the borrower bears the risk

3) the premium foreign lenders demand for sovereign risk: i.e., the danger that, due to national economic or political problems, Canadians will not be able to repay their debts.

Both currency risk and sovereign risk are aggravated by the political situation in Canada and the threat of Quebec separation.

Real interest rates, the cost of capital minus the rate of inflation, are at long-term highs. As can be seen from the chart below, rates are heavily influenced by government deficits, though the two are linked though a feedback loop. (The real rates are calculated by subtracting the inflation rate from 90-day treasury bills and from government bonds of over 10 years.)

Tax policy could also play a role in lowering interest rates by increasing the after-tax rewards of capital formation in relation to consumption. Overall tax reductions - though in the context of a fiscal strategy designed to reduce spending and deficits - would also help with capital formation. However, a discussion of Canadian tax policy is beyond the scope of this paper.

VI) PROPOSED ATLANTIC INVESTMENT FUND

I) The Proposal

None of the studies related to the A/F have presented anything like a cost benefit analysis. They do little more than state that more venture capital would be desirable, though they fail to address why the uptake is so limited on available venture capital in Atlantic

The motivation for the proposal to create an AIF appears to be twofold, to supply venture capital in the region and to spark market activity. However, none of the studies related to the AIF have presented anything like a cost benefit analysis. They do little more than state that more venture capital would be desirable, though they fail to address why the uptake on available venture capital is now so limited in Atlantic Canada.

Results from a myriad of government economic development programs gives little reason to believe that yet more government money will produce the thus far elusive results of government-driven economic growth. Moreover, in principle it is undesirable for governments to risk taxpayers' money in commercial ventures.

Such government programs have inherent flaws. They politicize the economy, making job creation/retention more highly valued than efficiency and wealth creation. Also government intervention tends to be judged on the amount of money supplied and the number of businesses helped, rather than on results. These elements drain the economy of its crucial dynamism, its ability to adjust to changing conditions, and they protect the losers - businesses that need government money to survive - over the winners.

Against this backdrop, the value of government intervention in the form of the AIF is not clear, particularly in light of the assessment that demand for venture capital supplied on a commercial basis is relatively low in Atlantic Canada. This appears to clash with the proposed goal of providing funds only on a commercial basis. If the uptake for commercially available venture capital in the region is low, how will the fund, providing investment on the same basis, increase the use of venture capital in the region?

The AIF proposal, however, at least moves beyond the facile view that earned income differentials between the Atlantic provinces and Canada should be addressed by giving government money to private firms and entrepreneurs. Instead, the proposal identifies a specific perceived obstacle to business development - inadequate equity investment - and recommends an instrument aimed at overcoming that specific obstacle. Furthermore, the *Equity Capital Investment* report acknowledges that the problem isn't simply a shortage of equity investment, but the absence of experienced managers which often accompanies such investment.

APEC's focus on the equity side of business development is more appropriate than a focus on lending would be. Intervention in the equity markets is easier to justify than intervention in the credit markets, although there is a much longer tradition of the latter in Canada (eg. the Small Business Loans Act and the Federal Business Development Bank). As the Economic Council of Canada observed more than a decade ago:

> While we cannot conclude that there is a generalized credit gap in debt financing, the analysis does reveal a problem of quite a different nature: the low equity base of small and medium-sized firms.

Identifying an apparent problem and the possibility of efficient government intervention, however, is not a guarantee that such intervention is desirable. How much money will the government have to commit to such a process? How much will the 'costs' of the investment market be reduced, and after how much time? Does the prospective market size justify such investments? Why isn't the market fully absorbing available sources of venture capital? These questions need to be answered, and in some detail, before any intervention can be legitimized by cost-benefit analysis.

The proposal for an AIF in the *Equity Capital Investment* report may overcome some of the problems of the high cost of acquiring the initial expertise in supplying venture capital and providing the management help needed for successful investments. By requiring the AIF to invest the money in a particular manner (i.e. regionally, and probably focused on smaller firms), AIF personnel will probably (and eventually) learn the skills required to make intelligent investments. The government funds, in this case, can serve the function of subsidizing the poorer investment decisions made as part of the learning process.

Expertise is the key missing link. It is not clear what type of expertise the AIF will bring to entrepreneurs. Neither banks nor government are experts in small business management, some thing which venture capitalists routinely bring and insist on bringing to the table.

The deficiencies of this approach, however, are numerous. In this small market, expertise will become concentrated in the AIF, unless there is a mechanism to hasten the diffusion of this expertise to private investors. The information problems associated with picking good investments' are not really solved directly, rather they are overcome by pushing capital into the market and identifying the winners as they float to the top. Such an approach is unlikely to hone the skills of those who wish to choose good investments ex ante, as opposed to ex post.

The introduction of a government supported investment fund may similarly displace alternative sources of investment, just as other venture capital funds become interested in the region (see the interviews with Mary Macdonald and Ron Begg in *Atlantic Review,* January/February 1995). Instead of encouraging the development of private equity capital markets, the AIF may well retard their growth.

Moreover, as noted above, expertise is the key missing link. It is not clear what type of management expertise the AIF will bring to entrepreneurs. The governments and the banks who are supposed to provide the funds for the AIF may have some skills to impart to potential entrepreneurs, but will not have much by way of practical experience. For example, neither banks nor government are experts in small business management, something which venture capitalists routinely bring - and insist on bringing - to the table.

Furthermore, the proposed AIF is to operate independently of the government, so there will be a need for government to choose which members of the business community oversee AIF decisions. If there are only a few overseers, the amount of effort they will be able to give to any single investment will be minimal. If there are many overseers, the screening costs - and the possibility of making a poor choice - increase.

There are also questions of the incentives for providing management advice which the AIF will give to its 'staff'. The business 'angels' who exchange money and expertise for partial ownership in a business have clear incentives: give advice and direction up until the point where the costs of further involvement are higher than the expected return on the investment. Give only a little advice, and the investment may turn sour. What incentives will the AIF staff have if their own money is not at stake?

There is, however, the potential benefit of 'thickening' the equity market to the extent that private investments, and the concomitant management expertise, become more widely available on a voluntary basis.

If creating the AIF can be justified in this manner, what difficulties and dangers have to be avoided in its operation? Additional government intervention brings with it costs as well as potential benefits.

ii)Everything to Everyone

Since existing funds have a difficult time finding appropriate investment opportunities, it is unlikely the AIF will be able to invest fully its funds if commercial criteria are folio wed.

One danger is that the fund will be perceived as a magical cure to all the region's capital problems, and the design of the program may reflect that.

Given the fact that existing funds have a difficult time finding appropriate investment opportunities in Atlantic Canada, it is unlikely the AIF will be able to invest fully its funds if commercial criteria are followed. This and overly optimistic expectations of what the fund can accomplish will put pressure on the fund to seek investments commercial funds would shun, likely leading to losses.

Private venture capital is highly selective in what it funds: companies with high growth potential which require a relatively large amount of financing, usually at least $500,000. Transaction costs - researching the firm and the market, and providing management help - usually make smaller deals uneconomical. Yet, some of the ongoing discussions seem to indicate the premiers would like a threshold for investment much lower than the market would normally dictate.

Venture capitalists by necessity must focus on investments in firms with strong growth potential. Only by making large gains in successful investments can investors cover the inevitable losses in unsuccessful investments and make an acceptable return. Yet as noted earlier, political considerations will likely emphasize employment potential over growth potential.

Thus, there is a real danger that the discipline of the marketplace will be ignored in fundamental decisions on where to invest, both in size of investment and type of investment. If this turns out to be the case, then it must be understood that the AIF is not a venture capital fund, but simply another government funding program with little possibility of retrieving the initial investment.

It is worth noting, however, that at least one private sector initiative is having great success in providing capital to small borrowers: the peer lending project in Shelburne County by the Calmeadow Foundation in conjunction with the Royal Bank.

At least one private sector initiative is having great success in providing capital to small borrowers.

Calmeadow is a Canadian-based, non-profit foundation that provides credit to low-income, self-employed people. The foundation's funds are drawn entirely from private sector sources. It operates throughout Canada and in Africa, Bolivia and Columbia. It has been involved in lending over $200 million to 60,000 individuals, with an international loan-loss ratio of less than 1 %.

The foundation's first endeavour in Atlantic Canada, the Shelburne project, began in 1991. Since that time, it has extended over 130 loans, totalling $1 50,000. Its loan loss on this project is zero. The project works through 'peer lending:' four to 10 members of a borrowers' group guarantee each other's loans. The Nova Scotia project now plans to expand to nine additional centres throughout the province. (Calmeadow information package, October 1994)

Such private initiatives clearly show that the problems of capital supply at the low end of the market can be dealt with successfully without government money. It would be most unfortunate if this success was undermined by a poorly-directed, subsidized 'venture capital' fund.

iii) Fund proliferation

The Atlantic Premiers are not the only government body considering establishing such a fund. Funds have been established in other provinces and Prince Edward Island is moving ahead with a provincial fund. Venture capital is the economic development solution du jour.

However, as the Science Council of Canada report noted (see quote, Section I.i) flooding the market with government money is no solution to the underlying problems. In fact, a proliferation of funds, all following different market and non-market investment criteria, will further fragment the market and weaken more efficient private sector financing sources.

iv) Management of equity holdings

One of the problems which the AIF will have to deal with is how to manage its equity holdings, in particular how to exit from its investments. If the entrepreneur or private investor has the opportunity to buy out the government shares, they may have the incentive to structure the firm in such a way as to minimize the value of the shares at the time of their purchase.

In fact it may be extremely difficult to determine an appropriate share price in the absence of widely held and widely traded shares. Even if an equity market develops in Atlantic Canada, it is likely to be too small to easily absorb the sale of shares by the AIF, because of its large relative size ($30 million is proposed), without distorting prices.

One obvious solution to the disposal problem is to have the AIF hold onto its investments for an extended period of time. Indeed, the explicit identification of the need for 'patient' capital investment in smaller Atlantic firms suggests that AIF holdings should be long term.

The difficulty with this approach is that government funds become tied up in a single set of investments, rather than becoming available for new investments on a continual basis. Presumably the AIF will want to roll over its funds - especially if fiscally strapped governments are to maintain their level of participation - by eventually selling off some of its acquired shares. The alternative would be to provide new financing for the AIF on a regular basis, which obviously has important implications for government finances and could perpetuate government-induced distortions in the financing market.

v) Political interference

The AIF may be faced with political pressure to prop up bad investments. The successful venture capitalist must be able to walk away from investments gone sour.

The potential for political interference in the AIF is dangerous, as the equity capital report recognizes. In the report's recommendations, government money is supposed to be used as leverage for additional private funds, but the project as a whole is to be "subject to private investment criteria" *(Atlantic Review,* January/February 1995). As John Dick, vice-president Atlantic region for Roynat, points out in the interview, "government and venture capital are not a natural blend. It must be structured correctly". The problem is knowing what that correct structure is.

Government intervention in the past has often been accompanied by political interference. This is particularly true of regional and economic development, where there is a strong need for politicians to be seen as actively promoting economic growth. Sod-turnings and ribbon-cuttings are important opportunities for politicians to be seen by their constituents.

Since politicians are elected on the basis of geographically defined constituencies, there will be a temptation to have the AIF allocate its funds according to geographic criteria. Forcing investment into the Atlantic region through the AIF already introduces one capital market imperfection. Artificially truncating the investment market further through geographic quotas will lead to larger distortions, leaving some relatively worthwhile investments unfunded because of the need to divert funds into another province or community.

The premiers argue that no geographic quotas will be put in place, though it is difficult to imagine that any provincial government would participate if the government felt it was being 'shortchanged.' Pressures will also arise within provinces for geographic diversity if funds flow predominately to one area of the province.

In addition to the divergent rates of return that would result from geographic quotas, there would also be unfavourable implications for risk diversification. For high risk venture capital investments, risk diversification is essential.

Any limitation on investments on the basis of geography would severely restrict the AIF's capacity to diversify risk sufficiently to meet the high rate of return requirements of private investors. This risk is raised even further by the fact that businesses in the region will frequently be affected in the same way by economic shocks. It is entirely possible that the entire AIF portfolio would be devastated by a region-specific shock such as a fisheries crisis or changes in the system of federal transfer payments. With a geographically restricted mandate, the primary means of diversifying risk for the AIF will be cross-sectorally.

The difficulty with this approach is that AIF officials will have to build up expertise in a wide range of sectors and industries. It is arguable that learning about a single industry or sector in an international context is easier and more efficient than learning about several industries within a region. The size of the Atlantic market is unlikely to justify the extensive investment in expertise required to run a balanced venture capital fund.

Finally, if the AIF is faced with political pressure, it may be asked to continually prop up bad investments. The successful venture capitalist must be able to walk away from investments gone sour, but politicians are likely to be more open to pleas for further help.

VII) RECOMMENDATIONS ON GOVERNING STRUCTURE

i) Independent management

The fund's independence from political interference should be guaranteed by legislation. Contact between AIF management and politicians on a particular case should be proscribed to the same extent that contact between, for example, a justice minister and a judge is proscribed.

If the AIF is to proceed, at a minimum its independence from political interference should be guaranteed by legislation. That legislation would not just require the appointment of a fully private sector board, which in turn would have sole responsibility for management including the appointment of a CEO. The legislation should go further and set Out precisely what the measurable objectives of the fund will be. Contact between management and politicians on a particular case should be proscribed to the same extent that contact between, for example, a justice minister and a judge is proscribed.

First among the objectives of such a fund should be a commercial return on capital using some objective benchmark like the average return of some agreed group of like organizations. Similarly a benchmark should be established for the share of non-performing and otherwise failed investments within the fund. Such benchmarks would force fund managers to invest only in commercially viable projects - investments of adequate size and growth potential - and not bow to political imperatives to make the fund a be-all agency for investment needs.

Second, it should be made clear that, if the fund has the power to borrow money, it cannot do so on the credit of the provinces or another government body. Otherwise$_1$ it increases taxpayers exposure and raises money on a non-commercial basis, creating further distortions in the market place.

Finally, the fund must have a sunset clause requiring government to back out of the venture in some reasonably short time, say seven to 10 years. If the intention is to create a stimulus to private sector activity which might not otherwise occur, then there is no reason to make governments' participation open-ended.

As well, the board and management should have some personal stake in the fund. This will strengthen resistance to political interference. And, remuneration should be comparable with remuneration in the private sector, including the sometimes-rich incentive packages available to managers in this industry. This will help attract qualified people and boost their stake in success.

Accountability would come through regular management reports, an annual report, and private sector auditing based on standard commercial accounting practices.

ii) Developing expertise

The AIF should insist on placing a designate, with appropriate management expertise, on the board of each firm it finances. The board member would not have to have connections with the AIF, but could come from any private sector company so long as the board member has appropriate expertise.

This has two important advantages. It provides the entrepreneur with important expertise and it increases the number of people involved in the venture capital market - in particular it increases the number outside the AIF structure. This could help with market formation. Board members would be paid standard board fees by the company.

This still leaves open the question of the strength of incentive for fund managers or the board member to provide the management help so crucial to successful venture capital deals. Clearly, the incentive is less if personal money is not at stake.

All AIF investments should be contingent on finding a private angel' to act as a co-investor. In other words, the AIF could not become involved unless a private investor also agreed to put up money someone who will then have a strong incentive get fully involved in helping the firm expand and grow. As well, a private investor is more likely to have the expertise to provide this help than would the fund managers.

This structure heightens the odds of picking winners. Private investors usually only put money into companies if they are familiar with the marketplace and believe the company has a strong chance of success. The cost of failure is much greater and more personal for a private investor than for a fund manager. This structure also broadens the market by getting more investors involved. Depending on the case, either the private investor could sit on the firm's board or the fund in conjunction with the private investor could appoint someone else.

VIII) CONCLUSION

* The AIF proposal is designed to address a perceived market failure - a shortage of venture capital - with little or no consideration of why the market is not providing more venture capital and no attempt to address any underlying problems.

* Little evidence suggests that a 'shortage' of venture capital actually exists in the region. Instead, a number of market impediments appear to inhibit both the supply of and demand for venture capital.

* Given the fact that existing funds have a difficult time finding appropriate investment opportunities in Atlantic Canada, it is unlikely the AIF will be able fully to invest its funds if commercial criteria are followed.

* This will put pressure on the fund to seek investments that commercial funds would shun, likely leading to losses. In this case it is inappropriate to use taxpayers' money and demand the use of private sector money supposedly to create a commercially viable fund, when the fund is unlikely to operate as such in practical terms.

Recommendations:

* Impediments to the formation of a functioning venture capital market in Atlantic Canada should be immediately addressed. The key reforms needed are a rethinking of economic development programs and restructuring of security regulations to integrate the Atlantic Canadian market and open it up to small issuers.

* If a venture capital fund is established, it must operate as a private sector entity, using market-based investment criteria and managed independently of political considerations.

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