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Virtues of Venture Capital

Perceptions of this vibrant market are outdated.

Canada's venture capital industry has grown dramatically over the past five years, reaching a peak of $5.3 billion in 2000. Unlike the U.S., where approximately 90 per cent of the capital is provided by institutional investors, institutions in Canada account for only 15 per cent of the market. The balance is provided by labour-sponsored funds, foreign venture capitalists, and quasi-government investors, among others.

It is accepted practice in the U.S. for plan sponsors to invest between three and five per cent of total assets in private equity. Indeed, not participating in this market is more the exception than the norm. The reasons cited for the low level of institutional commitment in Canada range from a lack of investment opportunities and venture fund management expertise, to unimpressive returns. Limited performance data and the amount of time required to manage the venture component of a portfolio are seen as other roadblocks, as are the structural impediments that sponsors say arise from the desire to invest in qualified limited partnerships.

Perception vs. reality

However, many of these perceptions do not accurately reflect the venture capital market. For example, a review of U.S. performance data as of March 31, 2002 indicates a 35 per cent internal rate of return (IRR) for all venture funds over the past five years and a 17.3 per cent IRR over the past 20 years. These are outstanding results by any measure. The Canadian industry plans to release data in the near future, but returns in both the Canadian and U.S. markets should reflect one another, particularly as our industry matures.

As well, an increasing amount of capital is being pumped into the Canadian market by U.S. venture capital funds. In fact, over the past five years, the percentage of foreign venture capital to total capital invested has grown from three per cent in 1998 to 32 per cent in 2002. This clearly indicates the increase in world-class venture opportunities available in Canada.

Rapid growth

Domestically, the number of firms and level of professional expertise have also grown dramatically. Many venture capitalists now manage second- and third-generation funds that, in turn, are investing in second- and third-generation Canadian entrepreneurs. Canada has created numerous technology leaders in information technology and life sciences and it is rapidly developing technology clusters in numerous regions across the country. This environment is paving the way for exponential growth of entrepreneurial companies. Indeed, it is similar to the rapid growth environment of Silicon Valley a decade ago.

Structurally, the market is also improving. The industry has successfully convinced the Federal government of the need to remove many barriers that have restricted the flow of capital into the sector. Finance Canada has publicly announced changes that will open up the qualified limited partnership rules, making it easier to support domestic funds. Most importantly, it will allow passive, foreign institutions to invest in Canadian managed funds without risk of taxation. Formal legislation is expected to be enacted soon. As well, several funds of funds have recently been launched at home that offer institutional investors diversified exposure to a portfolio of this country's best managed funds.

The significant decline in public markets has negatively impacted investment performance over the past two years. Now, more than ever, is the time to commit to this sector. Value and deal terms for new portfolio investments have never been more attractive. Public markets will recover and those investors who commit in these tough times will look back on this period as the most exciting time to have entered the private equity and venture capital market. ■