

*Without ambition, there can be no success.*

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Canada aspires to compete with the best. And, sometimes we do. It will take leadership...that much we know. But it is ambition, and courage, that will ultimately make the difference between our success and failure as a nation.

Trends are shifting faster, and business leaders and governments have less time to react than ever before. Raw leadership won't put food on the table, unfortunately, and the jobs of yesteryear are going to look nothing like the jobs of tomorrow. Canada needs aspirational leadership if we are to leverage our 19<sup>th</sup> century strengths and position our economy for the 21<sup>st</sup> century, let alone the 22<sup>nd</sup>.

Reach for that device you always carry with you on your belt, or rummage through your purse or wallet. You'll be reminded that much of what you take for granted today didn't exist a decade ago.

You couldn't just wave your Mastercard at an unmanned parking machine if you wanted to park your hybrid car in the basement of this building. If you wanted to try out a Blackberry, you had to call Research in Motion directly; our beloved Ted Rogers didn't yet have RIM on his wireless network.

If you were bored with my patter, you couldn't put your head down and update your Facebook status, Google the stats I'm quoting, check Joe Castaldo's musings on Twitter or organize the songs on your iPhone.

None of this was possible barely 10 years ago. And the impact of these innovations has been remarkable.

The market caps of Apple, Google and Facebook are almost twice the combined value of Canadian flag bearers Barrick Gold, BCE, Four Seasons Hotels, Magna, Manulife, Power Corp., Rogers, SNC Lavalin, SunLife and the big 5 Canadian banks. Wealth that took us almost 200 years to build was surpassed in a matter of months.

Where does Canada fit in this rapidly changing economic landscape? Does Canada have a start-up culture? Should governments be in the business of fostering an environment of innovation and risk-taking? Is the venture capital model "broken"? Do venture returns "suck", making the asset class too risky for supposedly conservative Canadian pension plans?

These questions have been touched upon by several mainstream media outlets over the past three years, including *Canadian Business Magazine*, *Profit* and *The Globe and Mail*.

The discussion is welcome, it is even urgent, but I'd like to establish a factual baseline for you before trying to provide some solutions to an industrial policy that appears mired in a pre-WWII mindset.

Although it has shrunk dramatically over the past 7 years, the venture capital industry has played a huge role in supporting Canada's Innovation economy in recent years:

According to a CVCA 2009 study by Dr. Gilles Duruflé, venture capital investors financed 2,175 Canadian technology companies between 1996 and 2007. 1,740 of those were still operating as of 2008.

They are a mix of small, medium and large companies. On average, these VC-backed companies had sales of \$10.5 million and employment of 47 direct jobs each.

If the 47 employee figure sounds small, work by UNB Professor Charles Davis in 2001 found that 75% of Canadian firms had fewer than five employees, and about 22% had between 5 and 50 employees. Which means the average VC-backed company was larger than 97% of all Canadian private employers.

As a group, VC-backed firms employ almost 64,000 people in Canada and 17,760 abroad. In addition, they generate ~84,000 indirect Canadian jobs for a total of 147,504 direct and indirect jobs – which represents 1.3% of all private sector employees.

That's as many direct jobs as the Canadian auto parts industry.

Sounds meaningful, doesn't it, when compared to a part of the economy that we all understand?

Despite the \$12.5 billion that Canadian governments and universities throw at R&D labs each year, there are about 100x more Americans working at VC-backed biotech companies, for example, than here at home. Canadian taxpayers invest heavily in R&D, but little appears to be done to commercialize the outcomes of this research.

Perhaps there's nothing to commercialize; which, if true, should frighten the taxpayers who are underwriting this massive investment.

When they do raise capital from a VC fund, a Canadian entrepreneur grows his/her company five times faster than the national average. This makes sense: VCs provide needed capital, but also the sales leads, governance, staffing ideas...all the things that an entrepreneur needs to hit his/her forecasts.

But we are pikers when compared to our U.S. neighbours, where venture capital-backed firms represent 11% of all U.S. private sector employment – almost 10 times the Canadian figure.

If you break that down, there are more than 5 million Americans working for VC-backed tech and biotech companies.

The germ of Canada's early stage funding crisis began when the NASDAQ bubble burst. Memories have faded, but in 2000, about the \$6.3 billion of VC capital was invested in private Canadian companies by investors from both sides of the border.

It seems crazy now, but 45% of that \$6.3 billion capital went to "early stage" deals – primarily Telecom, Internet and computer-related firms. This wasn't smart, and the fallout has been painful.

There were dozens of Canadian VCs with money 10 years ago. Today there are 10 truly active firms. Of the 935 VC funds in the USA, more than 400 were active in 2011.

With a weak bench, and only a handful of players on the ice, it shouldn't be a surprise that we have a hard time putting the puck in the net: American VCs invested US\$29.5 billion in 2011 across 3,834 companies, while 444 different Canadian VC-backed firms brought in just \$1.5 billion.

That's less than half of our traditional 11-1 GDP ratio.

Innovation sounds sexy, and you might equate it with an app for your iPad, but firms such as CGI, Macdonald Dettwiler and Open Text are large, profitable companies providing sustainable, high-paying jobs across the country.

If we can agree that the Innovation economy is important to the overall standard of living on our shared continent, three key questions remain:

Why is Canada's innovation ecosystem in crisis?

Why is it that our political system seems so weighted towards preserving the 19<sup>th</sup> century jobs that flow from Canada's natural resource bounty?

Is there a quick fix?

As much as we all still remember the NASDAQ plummeting 70% between 2000 and 2002, Canada's own start-up crisis didn't take hold until 2005.

That was when the Ontario government announced the end to the Labour Sponsored Investment Fund tax credit: According to Finance Minister Greg Sorbara at the time: the "incentive to investors is no longer needed in [a] healthy venture capital market."

At that point, Ontario's LSIF funds had backed 600 Ontario companies with tens of thousands of employees in a variety of sectors. The LSIF structure warranted improvements, but not the guillotine.

With the loss of the Ontario tax credit, which Ottawa and many other Provinces have maintained to this day, local VC firms Covington, Growthworks, VenGrowth and VentureLink began to wind down. A billion dollars of early stage capital essentially evaporated from Canada's largest innovation market.

The reduction in VC deployments was almost immediate: Ontario dropped 35% by 2007. For the 1<sup>st</sup> time in memory, Quebec attracted more VC capital than Ontario, despite having almost half the population base.

Around the same time that Mr. McGuinty killed the Ontario LSIF program, several traditional lead supporters of the Canadian VC asset class backed away, too:

- Most Canadian banks had a VC arm 10 years ago. They are largely shut now, a far cry from representing 20% of commitments to our VC market in 2000.
- La Caisse de Depot morphed from being a lead limited partner to an important co-founder of the \$750 million Quebec-focused fund-of-fund player Teralys.
- CPP Investment Board: formerly the lead LP for Edgestone Venture Partners, Lumira and Ventures West, is now only playing on an indirect basis (and rarely at that).
- OMERS: previously lead LP for JL Albright, Ventures West, etc. They now run a unique \$180 million in-house VC fund, and sense an opportunity to make outsized returns.
- Ontario Teachers: ceased backing funds (such as Mosaic Venture Partners) and is rarely seen in Canada on the direct side.

Then the Business Development Bank of Canada pulled in its horns. BDC cut its venture deployment by 33% in 2009/10, in the wake of losing \$300 million on their own investments over the prior 5 years.

Two years ago, BDC's VC chief Jacques Simoneau told *La Presse* newspaper that he'll be applying the investing brakes "until we see attractive returns in a few companies to show that venture capital is still an attractive investment." A classic case of "blame the patient" for getting deathly ill.

Since BDC tells Parliament that its public policy role is counter-cyclical, it likely surprises you that BDC pulled back during a sectoral crisis, and even went so far as to lay off a portion of its VC team in an effort to cut expenses...all while increasing spend during the recession in its lending and management consulting areas.

The Crown Corporation responsible for the health of the Canadian start-up ecosystem became its Rasputin.

These three sea changes meant Canadian entrepreneurs had substantially less access to capital; in 2010 they raised just \$1.1 billion of VC capital, down from \$1.7 billion during 2006 – a 35% hit. U.S. deployments dropped only 15% during the same period, meaning the global economic crisis isn't all to blame for our poor showing.

All is not lost, however. Several Canadian VC firms have recently raised new or follow-on funds:

- BlackBerry Partners Fund II -- \$150 million
- Celtic House IV -- \$105 million
- Georgian Partners I -- \$70 million
- iNovia Capital III -- \$110 million
- Lumira Capital II -- \$105 million
- McRock Capital -- \$50 million
- Rho Canada -- \$100 million
- Tandem Expansion Fund I -- \$300 million
- Vanedge Capital I -- \$140 million
- Wellington Financial Fund IV -- \$178 million

Big name American funds continue to do deals in Canada:

Sequoia and GrandBanks are in Achievers, Highland is in Beyond The Rack, NEA recently put ~\$60M into Desire2Learn, Kleiner Perkins is in FixMo and Madison Dearborn recapped QuickPlay.

These are some of the U.S. VCs that were behind Apple, Cisco, Facebook, Google, Oracle, PayPal and YouTube, for example. They recognize that some good things are going on up here; we should have the same confidence.

There have been some nice exits, too:

- Belair (a Wellington Financial portfolio co.) was acquired by Ericsson in 2012, and Ceridian bought Dayforce.
- In 2011, Q1 Labs earned a 9x return and Radian6 generated a 22.8x return for Summerhill, Brightspark and BDC when it was acquired by Salesforce.com.
- Labour Sponsored fund Covington got a 13 bagger with Catamaran, and Protus generated a 9x return, both in 2010.

The early stage industry's not dead, although it may well be on life support. So let's tackle the premise that Canadian VCs generate poor returns:

Leo de Bever, CEO of the \$70 billion Alberta Investment Management Corp., one of Canada's largest fund managers, recently told the Globe and Mail that "the last 10 years have been just a wasteland from a return point of view". "We'd like to do more and we're being pressured to do so" by governments, he said. "But us stepping into that is a bit tricky because the failure rate is so high" in Canadian venture capital.

AIMCo isn't known to have ever had an allocation to VC, but the real question is the so-called investment "failure rate". It isn't a "wasteland" from my vantagepoint. Edgestone's last two venture funds made folks money, for example, and our own firm, Wellington Financial, has a 5 year GAAP IRR of 10% net to investors.

According to Thomson Financial's 2011 data, Canadian VC funds as a group earned 1.2% IRR over a 5 year period, compared to a negative 1% return for the Dow Jones 30. The top quartile Canadian VCs earned around 5%. Skinny returns, perhaps, but certainly better than many of the alternatives.

And what have our institutions done with our money – and it is our money, after all – while they avoided the so-called venture "wasteland"?

Canada's largest fund, CPP Investment Board, has committed more than \$29 billion to external private equity managers. Firms such as Apollo, KKR and TPG. According to one former Toronto-based pension boss, this program has likely earned us a zero return over the past decade.

Overall, CPP's broad investment strategy produced a 5 year annualized return figure of 3.3% as of 2011, well below the 5-6% of top quartile Canadian VCs.

And while AIMCo's not in the megabuyout space like the CPPIB, 24% of its pension and endowment assets are in traditional equities. If you put \$1 in the S&P 500 index five years ago, you'd have seen your capital shrink by about 6%. Not a great outcome, with a huge amount of volatility.

Although they've had many wins, CPPIB has lost hundreds of millions of dollars on several recent high profile equity investments.

EMI went bankrupt. Freescale is down 50% post IPO, and that price was below the original going-private valuation. Sino-Forest turned out to be a shell game of a fraud. Our pension plan is also underwater on a huge LBO investment in SunGard, as well as the US\$45 billion leveraged buyout of TXU, the largest LBO in history.

You got that?

In an effort to avoid the risk of early stage Canadian innovation deals, our pension managers are either down on their public market portfolios, or losing money on transactions that make the original *Bonfire of the Vanities* \$25 billion LBO of RJR Nabisco seem like chump change.

At least when you bet on a Canadian VC investment, our economy benefits from the jobs and spinoff benefits that come with every new start-up – whether it eventually succeeds or fails.

Canadian firms, such as ATI, CAE, Cognos, Constellation Software, QLT, Research In Motion and Valeant Pharmaceuticals are proof that when you put capital into local tech and biotech companies, good things can happen.

The poster child is a NASDAQ-listed company called Catamaran, which started out in Milton in the 90s and now has 3,500 employees. A company that was backed by the very same labour-sponsored funds that Premier McGuinty shuttered 7 years ago.

Canadians can succeed in the innovation landscape, as Banting and Best would remind us.

In his last budget speech, Finance Minister Jim Flaherty announced, in essence, that he was no longer satisfied with the status quo. That Canada's early stage crisis warranted his personal attention. This was welcome news.

He announced a new \$400 million allocation to help cure the ills in the start-up ecosystem, with the goal to help "high growth companies access risk capital".

This is a great start, and the industry is grateful for the focus, but many fear that it won't be enough.

The good news is the government recognizes the challenge before it. The bad news is that the 19<sup>th</sup> century economy still rules the roost in some corners of the Ottawa bureaucracy.

Our natural bounty has made Canada the resource investment capital of the world. And for as many years as one can remember, our tax system has been geared to favour resource companies over the innovation sector.

Flow-through shares are a wonderful fundraising tool. The only problem is that the gals looking for gold in the lab don't have the same tool as the guys looking for gold or copper in the Ring of Fire.

The impact is huge.

Between 2006 and 2008, almost \$1.4 billion of flow-through tax credits were paid out to retail investors by Ottawa, versus the \$365 million paid to cover the LSIF tax credit. The government also helps the innovation ecosystem via its SRED investment tax credit, but that's only available, on a practical level, after you've raised capital, hired people, and spent the money.

The SRED is a rebate, not a fundraising tool.

Flow-through shares also have a leg up over capital gain tax exemptions, since you can't write off your capital losses until you've actually earned some capital gains first. But you can take an immediate deduction of your flow-through share investment against normal income.

With so much additional capital flowing into the resource sector, rather than the innovation ecosystem, is it any wonder we excel at one and lag in the other?

And it's not just the rocks and trees that get preferential treatment.

In 2008, the Federal and Ontario governments pledged \$4 billion in aid to the auto industry. It made absolute sense at the time, and stands the test even in the rearview mirror. But can Central Canada survive on a shrinking industry?

According to the Conference Board of Canada, employment in the Canadian auto part manufacturing sector fell to 62,000 by 2010 – that's as many direct jobs as Canadian VCs have created. The CAW advises that there are 600,000 fewer auto sector jobs today than in 2002.

And that's after a \$4 billion bailout. Just think what \$4 billion could do for the early stage ecosystem.

Our traditional avenues for employment and economic growth are not going to last. We need aspirational leadership from our federal and provincial politicians. If our pension plans are going to put Chilean toll roads and Texan energy buyouts ahead of investing in the Canadian economy, which may well be their fiduciary right, it falls to Ottawa to lead the way.



Canadians have the fire in their bellies to be successful entrepreneurs. I think it falls to you, as voters and leaders in your community, to tell your elected representatives that investing in innovation is now a requirement for their future electoral success.

They need to hear from you that it's ok to take some risk. That Canada will lag in ten years if we don't put the innovation economy on an equal footing with the resource sector.

If each one of you just emailed your MP this afternoon on the importance and opportunity of Canada's innovation economy, you'd be moving the needle. Encourage the Feds to deploy the current \$400 million allocation, and tell your representatives that you want that figure doubled in the next budget.

Tell your MP to leverage the success of Communitech in Kitchener-Waterloo, and replicate 10 such incubators across Canada: in places such as Burnaby, Calgary, Toronto, Kanata, St. Laurent and St. John's.

Tell your MP to spin out the BDC's venture capital division, and free the organization of its current bureaucratic shackles.

Lastly, remind your MP that if the Quebec provincial government can lead a \$750 million fund for their local VC firms, Canada needs more money at work than the \$120 million BDC has currently spread across the nations' entire VC industry.

An \$800 million budget commitment sounds rich, but there's no reason why our cerebral resources don't deserve the same annual investment that goes into our 19<sup>th</sup> century economic engine of rocks and black sludge.

Let's aspire to build the next Amgen, Cisco, Genzyme or Google.

If a Canadian can win the Nobel Prize for mapping the visual cortex of the brain, we should be able to figure out what innovations consumers and enterprises will need 10 years from now.

We're already spending the money on R&D. The Minister of Finance is on board. It's time to get serious and take some risks.

Without ambition, there can be no success.