Montreal Economic Institute
Ideas for a More Prosperous Nation

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# Labour-Sponsored Venture Capital Funds: Time For A Reassessment

**Labour-sponsored venture capital corporations (LSVCCs)[1] programs have been around since the early 1980s and have not been significantly modified despite major changes in the financing environment for small and medium businesses which was their raison d'être. Creation of these entities was justified on the grounds that small companies had problems in obtaining financing, due in particular to an inadequate supply of capital that focused on this type of business. Many arguments can be made for re-examining this type of intervention, which has been suspended or called into question in several other provinces.[2]**

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## The financing of growing companies

The Quebec government set up a commission on capitalization[3] to study the financing situation of these companies as well as the financial environment that prevailed then. The commission noted the absence of a venture capital network that was likely to finance small companies with strong potential but that faced problems in gaining access to public equity markets. As explained below, however, the evolution of public equity markets, along with the supply of venture capital, casts doubt on the continued need for government intervention in this area.

### *Public equity markets*

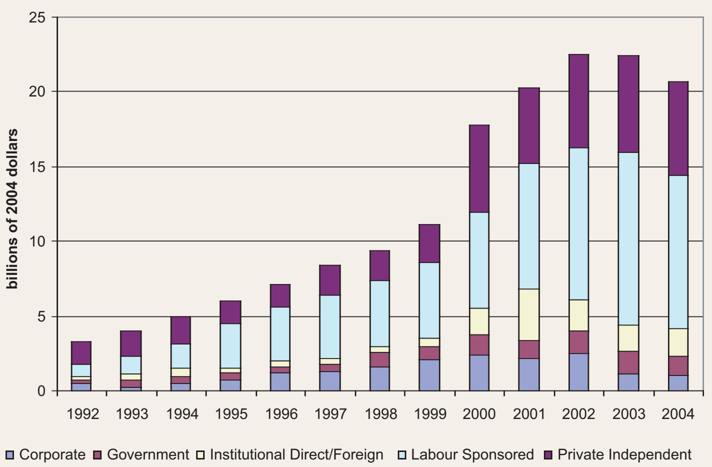
New rules and practices now enable growing companies to get financing through the stock market. The standards for a stock exchange listing are less restrictive than those prevailing on the various markets devoted to growing companies ("junior" markets); this facilitates initial public offerings. Companies can also gain access to the exchange by acquiring an already listed company (a reverse takeover) or by using a capital pool company.[4] These measures create a dual result: stock listings are very numerous, with a majority obtained by developing companies. From 1986 to 2006, nearly 5,000 companies were listed on Canadian exchanges. Each year, an average of 195 Canadian companies get listings, more than half the equivalent figure of 259 IPOs in the United States, which is a market 10 times bigger. The issuers in Canada are small, with median assets of $310,000. In half of all cases, they raise less than $1 million. Nearly 70% of these companies enter the exchange with no profits, and 40% do so with no income. The TSX Venture Exchange defines itself as a public market for venture capital.[5]

Of the 4,592 initial listings surveyed from 1993 to 2003, slightly over 74% of issuers reported no profits and 42% generated no income. Public share issues that follow initial listings, also by small-cap issuers, raise a median amount of $9 million. Of the 2,862 operations surveyed, 60% were undertaken by unprofitable companies, and 26% of the issuers had annual sales that

1. In Quebec, the Solidarity Fund of the Quebec Federation of Labour (FTQ) started in 1983 and Fondaction, launched by the Confederation of National Trade Unions (CSN) in 1996, come to mind. Quebec taxpayers who invest in these funds get a 30% tax credit (maximum refund of $1,500) and it applies in addition to the usual RRSP deductions which are used by the great majority of participants.
2. Ontario in particular plans to eliminate the associated tax credits gradually between now and 2011. See Ontario Ministry of Revenue, *Labour Sponsored Investment Funds Program*, http://www.rev.gov.on.ca/english/credit/lsif/index.html.
3. See Commission québécoise sur la capitalisation des entreprises, *La capitalisation des entreprises au Québec*, Report to the Department of Industry, Trade and Tourism, 1984.
4. A program created by the TSX Venture Exchange provides for the creation of a publicly listed shell company with no operating history, no assets other than cash and no purpose other than seeking out and acquiring assets or companies. Once this transaction is completed, the new entity may have access to the regular listing.
5. For an analysis, see Cécile Carpentier, Jean-François L'Her and Jean-Marc Suret, *Stock Exchange Markets for New Ventures*, CIRANO, April 2008.

FIGURE 1

Venture capital under management in Canada by investor type (1992-2004)




Source: Douglas J. Cumming, *Financing Entrepreneurs: Better Canadian Policy for Venture Capital*, C.D. Howe Institute, 2007, p. 5.

were nil. Subsequent financing rounds are thus accessible to developing companies.

Accordingly, the Canadian equity market provides for the financing of emerging companies that have no income and that present high risk and modest return prospects. Barriers that held back access to equity markets in the 1980s seem to no longer exist.

### *The abundance of venture capital*

Venture capital is abundant in Canada. The OECD ranked the country third in the world in the amount invested per capita. Funds under management in 2004 were about $20 billion, with half in LSVCCs (see Figure 1), including at least $5 billion available for investment. On average, in developed countries, start-up venture capital investment was 0.0338% of GDP, which would come to $400 million per year in Canada, with $100 million of this in Quebec. The amount raised each year by labour funds, about $1 billion in Quebec, thus amounts to about 10 times the province's total needs for start-up capital. This large venture capital surplus may explain the industry's low returns (-3% from 1995 to 2005).[6] The average project it finances has low returns, as the law requires the amounts collected to be invested quickly. The capital supply situation in 2008 thus differs totally from what prevailed in the 1980s.

## Observations on LSVCC returns

### *A substantial fiscal cost*

With the tax advantages provided to LSVCCs, the federal government lost $1.8 billion in foregone revenues from 1991 to 2003.[7] With the provinces included, the total cost was about $3.6 billion. Estimating the additional fiscal cost resulting from the simultaneous use of registered retirement savings plans (RRSPs) is complicated. It depends on contributions that would have been made to RRSPs in the absence of LSVCCs and is reduced by the tax paid when withdrawals are made from RRSPs. Based on the realistic hypothesis that the additional fiscal spending caused by LSVCC shareholders' use of RRSPs represents 50% of direct fiscal spending, the total cost of LSVCC programs exceeded $5.4 billion in 2003, with half of it originating in Quebec.

### *Only a small proportion of the funds is invested*

According to Industry Canada, LSVCCs invested only 50% of the funds they gathered,[8] and this proportion has been below 40% since 2001. Funds available in all LSVCCs[9] were evaluated in 2001 at $3.8 billion. Moreover, LSVCCs in Quebec invest smaller proportions, and a significant portion of the investments they report consists of amounts "committed but not disbursed" and of liquidity awaiting in secondary funds. LSVCCs also invest in public companies, in real estate and in entities outside Canada. The proportion of funds collected and actually invested in small, unlisted local companies was about 21% for the two Quebec LSVCCs in 2004.

### *Funds don't reach their targets*

Programs to aid financing must have precise targets, in areas where there are substantial market gaps. However, eligible investments in Quebec include categories for which government

*The Canadian equity market provides for the financing of emerging companies that have no income and that present high risk and modest return prospects.*

6. Gilles Duruflé, *Les facteurs déterminants de la performance du capital de risque canadien*, Speech to the Canadian Venture Capital and Private Equity Association, September 2006.
7. Industry Canada, *Labour Sponsored Venture Capital Corporations: An Overview of Their Role and Activities (1991-2003)*, 2005.
8. Funds not invested in companies covered by the program are invested instead in the shares of large companies, in bonds or on money markets.
9. Douglas J. Cumming and Jeffrey G. MacIntosh, "Crowding out Private Equity: Canadian Evidence", *Journal of Business Venturing*, Vol. 21 (2006), No. 5, pp. 569-609.

assistance cannot readily be justified: investments in real estate, in public or foreign companies, or in companies with assets of up to $350 million.

This situation has three consequences: 1) the scope of eligible investments becomes very broad and can serve as a basis for collecting even larger amounts, thereby increasing fiscal spending; 2) the share of capital allocated to sectors that truly lack financing is reduced and funds are directed instead to more remunerative and less risky investments; and 3) by going outside their particular area, tax-advantaged funds compete with and displace unsubsidized capital.

### *Crowding out*

The crowding-out effect describes a situation in which tax-advantaged LSVCCs merely displace private capital rather than expanding it. Growth in the amounts held by LSVCCs coincides with a reduction in all other forms of venture capital. The crowding-out effect is especially great at the start-up and expansion stages: the reduction in private funds may be greater than the contribution from subsidized funds. LSVCCs thus have caused a reduction in Canada's venture capital supply that may amount to 400 investments (representing $1 billion) in each of the five years studied.[10]

*The total cost of labour-sponsored venture capital funds programs exceeded $5.4 billion in 2003.*

### *LSVCCs provide low returns*

LSVCCs' returns are abnormally low. One study estimates average returns in the 10 years to 2002 at 2.5% per year.[11] LSVCCs' returns fall below all reference indices, small-cap funds (by a sizable amount[12]) and even Treasury bills. And LSVCCs' results do not get better with experience, contrary to a hypothesis suggesting that venture capital funds take several years to hit cruising speed.[13] This situation may be explained in part by the fact that companies financed by these funds are less efficient overall in creating value and innovation.[14]

### *High operating costs*

Moreover, LSVCCs' management costs are abnormally high. Estimates[15] point to management ratios of 4.24% to 4.58%, compared to 2.6% for small-cap funds. The fixed amounts paid to administrators represent 3.17% of assets.[16] This indicates that most management costs are fixed rather than indexed to returns, as is the general rule in the industry. LSVCCs manage more than $10 billion, suggesting annual management fees of about $400 million to $500 million. This amount roughly matches the total estimated annual financing needs of companies at the start-up stage in Canada.

### *Governance*

LSVCCs have organizational structures that generate high agency costs.[17] The unions, without investing any capital, appoint most members of the boards of directors. The management mandate of administrators is thus not subject to a negotiating process between shareholders' representatives and the administrators themselves. The unions administer LSVCCs without putting in any funds and cannot be controlled by shareholders, who are widely dispersed. This contrasts with other venture capital companies, in which providers of capital hold a major stake, oversee the managers and can halt activities after 10 years (the period commonly defined for simple limited partnerships in this sector). The weak governance of LSVCCs is exacerbated by the fact that shareholders in Quebec cannot withdraw their funds if they are unhappy.[18] LSVCC managers thus do not have to submit to evaluation of their results.

## Calling the model into question

LSVCCs involve a model of government intervention that most countries have cast aside. Problems in financing emerging companies are no longer seen as related to the supply of capital.

10. *Id.*
11. Daniel Sandler, *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States*, Canadian Tax Foundation, 2004, p. 284.
12. Douglas J. Cumming, *Financing Entrepreneurs: Better Canadian Policy for Venture Capital*, C.D. Howe Institute, 2007.
13. Douglas J. Cumming and Jeffrey G. MacIntosh, "Mutual Funds that Invest in Private Equity? An Analysis of Labour Sponsored Investment Funds", *Cambridge Journal of Economics*, Vol. 31 (2007), pp. 445-487.
14. James A. Brander, Edward J. Egan and Thomas F. Hellmann, *Government Sponsored Venture Capital in Canada: Effects on Value Creation, Competition and Innovation* [preliminary version], NBER Conference on International Differences in Entrepreneurship, January 2008.
15. Douglas J. Cumming and Jeffrey G. MacIntosh, *op. cit.*, note 13; Scott Anderson and Yisong S. Tian, "Incentive Fees, Valuation and Performance of Labour Sponsored Investment Funds", *Canadian Investment Review*, Vol. 16 (2003), No. 3, pp. 20-27.
16. Douglas J. Cumming and Jeffrey G. MacIntosh. *op. cit.*, note 9.
17. Douglas J. Cumming and Jeffrey G. MacIntosh, "Comparative Venture Capital Governance: Private versus Labour Sponsored Venture Capital Funds", *Venture Capital, Entrepreneurship and Public Policy*, 2003, pp. 69-94.
18. Shareholders generally cannot withdraw their funds except in case of retirement or disability.

Interest should be directed instead to the deficit in demand for capital: too few companies are able and willing to get financing through venture capital. Moreover, the tax advantage at entry causes serious distortions in the behaviour of individuals, who invest "to get the tax credit". The government loses all control over the use of funds, and the tax advantages not only fail to encourage investors to control managers effectively but also disrupt markets by giving tax advantages to some players and not to others. For a tax-advantaged entity, the optimal strategy consists of using subsidized funds for the least risky and most profitable projects within the range set by the law.[19]

Most countries use measures such as hybrid or leveraged funds, with the government providing support in the form of low-cost financing.[20] When tax measures are used, they come at the exit, and investors get tax advantages only if they choose the best investments and take part in sound governance of the companies they finance. This is the principle on which the United Kingdom stimulated development of the Alternative Investment Market.

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Interventions are mostly targeted only on a market segment for which there may be true gaps in the market. They involve early stages in sectors with high technological content. Venture capital companies rarely invest in this area because these financing stages are extremely risky, involve relatively small amounts and demand levels of oversight and supervision that are too high for private players to be interested. At this stage of development, the asymmetry of information between developer and investor is enormous, and reducing this asymmetry is costly. Government intervention may thus be justified, because development of companies in this sector may provide a return in social terms without the shareholders benefiting. This would be the case, for instance, if an emerging company developed techniques or products that could raise the productivity of other companies. In this context, programs must be incorporated into a general innovation policy encompassing actions to support the demand for funds. Government intervention must be temporary and must be limited to sectors where there exist significant gaps in the market.[21]

## Conclusion

"Poorly designed, narrowly conceived or conflicting government programs that lead to a government-dependent venture capital market will not serve the long-term interests of high-growth-potential firms."[22] The expert group mandated by the European Commission emphasizes that public assistance must be linked directly to correcting market gaps (which are obvious only for start-ups). It also suggests that the aims of intervention must be clear and that programs must be designed to encompass strong incentives for money to be allocated efficiently and quickly. Thus, strict control must be established, and programs must be protected from political pressure.[23] In the opinion of most specialists who have analyzed the program, LSVCCs are less effective than other forms of intervention in this area: they involve large-scale fiscal spending and negative indirect effects. A serious, independent reassessment of this program appears to be required.

19. Despite this behaviour, the high operating costs and the restrictions imposed by the law explain their low returns.
20. For example, the government may agree to a loan at the government bond rate, whereas the risk level of the activity would justify a sizable risk premium.
21. OECD, *Venture Capital: Trends and Policy Recommendations*, 2004.
22. Industry Canada, *Canadian Venture Capital Activity: An Analysis of Trends and Gaps 1996-2002*, 2002, p. 199.
23. European Commission, *Best Practices of Public Support for Early-Stage Equity Finance*, Final Report of the Expert Group, 2005, p. 17.

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