Building a Domestic Supply Chain of Capital For All Entrepreneurs in All Communities

Written Submission for the Pre-Budget Consultations
in Advance of the Upcoming Federal Budget

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(NACO)

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Measures the Federal Government Must Take to Restart the Canadian Economy

- **Recommendation 1**: That the government implement co-investment or "matching funds" to leverage angel investment and increase support to entrepreneurs

- **Recommendation 2**: That the government implement a national equity tax incentive as a risk-correction mechanism to mobilize community-based capital for entrepreneurs at scale.

- **Recommendation 3:** That the government increase support of the not-for-profit angel group network to allow all entrepreneurs, in all regions, from all backgrounds, access to capital, mentorship, and resources to scale-up their companies .

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Overview

Immediate action must be taken to create a **domestic supply chain of capital** - both public and private sector, working in tandem to support all entrepreneurs. Ensuring that founders can access the investment they need to turn their big ideas into opportunities, jobs and prosperity. Without a steady stream of capital flowing at the early stages of the innovation pipeline, we risk losing a generation of startups and their future economic and social impact.

A decrease in angel investment could create aftershocks felt for years to come. We must act now to mobilize private sector capital, stimulating angel investment to support entrepreneurs from coast to coast to coast.

With the possibility of a second wave of COVID-19 on the horizon and borders restricted, federal and provincial governments have called for the establishment of domestic supply chains and doubled down on support for Canadian innovations, opening up new procurement opportunities and funding programs. While these efforts will help mid and large size companies survive, what remains to be seen is how our early-stage startup ecosystem, once touted as first in class, will weather the storm.

Early indicators are not encouraging with Startup Genome reporting that 58% of startups in Canada say their industry has been "affected significantly" by the COVID-19 crisis, which is 7 percentage points higher than the global average. In addition, the effects of the pandemic have been intensified for companies led by traditionally underrepresented groups, many of whom did not qualify for the COVID-19 response programs, further widening existing gaps and strengthening systemic barriers.

On July 30th, NACO released the 2020 Angel Activity in Canada Report. We now have ten years of data, demonstrating the vital role that angel investors play as an early support system for entrepreneurs in communities across the country. By highlighting both the investment activity and year-on-year investment trends, this report provides unique insights into angel investing activity in Canada.

But more importantly, the data we have compiled over the past decade are helping us to create a much-needed roadmap for the future. Best practices and research will help Canada navigate the uncertainty and new challenges that have presented themselves over these past few months, ensuring that our innovation ecosystem emerges from this crisis stronger than ever.

Recommendation 1: That the government implement co-investment or “matching funds” to leverage angel investment and increase support to entrepreneurs

Co-investment initiatives are a common approach that governments in various countries have used to increase the supply of equity finance. Prominent examples include the Scottish Co-Investment Fund, the New Zealand Seed Co-investment Fund, and the European Angels Fund, which is an initiative of the European Investment Fund.

Co-investment initiatives are typically structured as a government fund that invests alongside private investors, committing one dollar for every dollar invested by private investors. Most co-investment initiatives partner with angel investors and VC funds. The co-investment fund invests under the same terms and conditions as private investors (i.e. pari passu). The government fund relies on the due diligence work by angel investors to reduce costs. The risk of moral hazard is low because angel investors have ‘skin in the game’. The purpose of co-investment funds is to improve early-stage capital available by leveraging angel investors.

The first co-investment initiative -- the Scottish Co-Investment Fund -- emerged in the aftermath of the post-2000 dotcom crash to address the liquidity constraints faced by business angels and angel syndicates due to the withdrawal of existing VC investors from the Scottish market. By relying on an angel investor to write a first cheque, business co-investment initiatives address concerns of adverse selection, government ineffectiveness, and the critique that governments should not ‘pick winners’.

The design of co-investment initiatives is critical. There are two basic models.

1. In the first model, the co-investment fund invests alongside approved investment partners – typically angel groups and early-stage funds. Approved partners bring deals to the fund that meet its investment criteria automatically triggering the co-investment. Angel investors prefer this model because of the high level of certainty of matched funding and the speed of decision making. This model also greatly lowers costs for the government.
2. In the second model, investors can bring deals where they have invested. The co-investment fund undertakes its own investment decision.

Further design issues concern: the maximum size of investment under the initiative; whether it only applies to businesses raising their first round of equity finance; and whether follow-on investments are permitted. The co-investment initiative should be designed with as few exceptions as possible and give businesses as much financial runway as possible, suggesting that the maximum matched funding should be no lower than $5m (i.e. total investment of $10m) and that follow-on investments should be permitted.

Evaluations of co-investment initiatives have generally been favourable, concluding that they are effective in leveraging investment capital from existing investors. They enable more and larger deals. And they do so in a manner that minimizes the cost to the public purse and the risk to public funds. Moreover, the limited evidence suggests that co-investment initiatives generate a positive return to the government and public over the longer term.

The effectiveness of co-investment initiatives is likely to be reduced during the current pandemic because of constraints on the ability of angels and other early stage investors to invest. Hence, these initiatives need to be complemented by other support initiatives.

Recommendation 2: That the government implement a national equity tax incentive to reduce angel risk in order to expand the amount of funds invested.

Many countries offer tax incentives to business angels to shift the risk-reward balance of making high risk investments in early stage businesses. The UK's Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) is one of the most generous, giving 30% tax relief on investments in qualifying businesses as well as a range of other tax breaks (such as loss relief and capital gains tax exemption). Investors can qualify for these tax breaks either by investing directly in qualifying businesses or by investing via professionally managed investment funds.

Some governments might be uncomfortable providing tax incentives to 'wealthy people'. However, some studies suggest that entrepreneurs are the primary beneficiaries of tax incentives and that the tax revenues generate a significant return on investment for government. There is also plenty of evidence that most investments made by angel investors fail and do not generate a return on investment. Hence, tax incentives function as a risk-correction mechanism.

Another dimension to consider is the desire of angels to have a positive impact on their communities. This is the rallying cry of Northern Ontario Angels (NOA), North America's most successful angel group, which had invested over $155 million, protecting over 4,000 jobs. NOA has drawn contributions from investors across a geographically dispersed group region with a population of only 780,000. This rate of investment is the equivalent of unlocking approximately $7 billion of angel capital from the Canadian population. Sadly, the current rate of angel investment for the rest of Canada is significantly below this benchmark.

The key issue for tax incentives is how to design them. What businesses qualify and how? Most impose age limits on businesses, annual and total limits on the size of investment, and excluded activities. They may offer higher tax breaks for targeted businesses (e.g. seed stage, knowledge sectors).

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A further issue concerns whether tax incentives should be transferable across provinces. On the one hand, limiting tax initiatives to investments made by residents in businesses located in the same province discriminates against investors in small provinces and those living close to provincial boundaries. On the other hand, it is understandable that provincial governments will not want to see lost tax income supporting out-of-province businesses. The reality is that angel investing is geographically concentrated due to local networks that angels use to identify and appraise investment opportunities. Hence inter-provincial investments may always account for a small proportion of total angel investment. And any financial gains that an angel derives from an investment in an out-of-province business might be reinvested in within-province businesses.

Recommendation 3: That the government increase support of the not-for-profit angel group network to allow all entrepreneurs, in all regions, from all backgrounds, access to capital, mentorship, and resources to scale-up their companies.

Angel investment plays a critical role in supporting early stage high risk ventures. As a result, the government should consider providing ongoing, multi-year financial commitments to projects administered by angel groups, particularly not-for-profit organizations. There are significant incremental costs associated with mobilizing angel activity; however, most angel groups are operating with severely constrained financial resources. Therefore, not-for-profit organizations in particular, have to rely on volunteers who only have a limited amount of bandwidth and/or expertise to deliver needed services.

Additionally, some groups had experienced cuts in existing funding which covered as much as one-third of the operational budgets for some of the smaller member groups. And because “there was no warning that this funding would be cut off, they are scrambling now to try to replace those funds.” This is a clear risk to entrepreneurs, particularly those from diverse backgrounds, as a consolidation in the number of angel groups would reduce the number pathways to capital.

Conclusion

Angel investors are **community-based investors** that take a “leap of faith” on entrepreneurs before institutional investors, such as venture capital firms. Angel investors fuel the “scale-up” pipeline that flows into the venture capital industry by putting capital-at-risk in local communities. As the main source of capital for Canada’s entrepreneurs, angel investors are in virtually every community and play a vital role in the development of local entrepreneurial ecosystems by providing funding, mentorship, and access to client networks.

The above recommendations are a powerful and proven combination of policies that will entice new investors off the sidelines, encouraging them to invest in their communities and will support active investors. Ensuring that innovative startups have access to the capital they need will support the continued development of our innovation ecosystem. Now is the time to double down on Canadian entrepreneurs by mobilizing private capital off the sidelines at scale to create jobs in local communities that are Made-in-Canada and remain in Canada.

As our ecosystem has evolved, so has the face of the angel investor. NACO has led the formation of nonprofit angel investor groups across Canada, resulting in more inclusive pathways to capital for entrepreneurs and in a diversification of the angel investment community. Many of NACO’s members report that they are not motivated by a return on investment, pointing instead to a desire to pay-it-forward and help create social impact.

A coordinated policy and programming response to support and stimulate angel investing is essential to a robust post-pandemic economic recovery. As Canada moves into economic recovery, the evidence-based recommendations that NACO has identified for government consideration are similar to those found in previous years, **but with greater urgency**.

Yours truly,

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