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Market solutions to public policy problems

Crowding Out Private Equity: Canadian Evidence

by Douglas Cumming and Jeffrey MacIntosh, with Keith Godin

Main Conclusions

- **Labour Sponsored Venture Capital Corporations (LSVCCs) are a government initiative introduced in the 1980s to increase the amount of venture capital in Canada. LSVCCs provide generous tax credits to individuals as an incentive to invest.**
- **LSVCC tax credits have cost Canadians billions of dollars since their introduction. In 2006, their cost was about $300 million.**
- **LSVCCs are an inferior way to organize a venture capital fund due to a whole host of geographic and financial regulations. These regulations impede the ability of fund managers to operate as effectively as managers of private funds that do not have the same regulations.**
- **LSVCCs perform poorly compared with other venture capital funds. Historically, LSVCCs have recorded a large gap between the amount of funds they raise and the amount they actually invest in Canadian entrepreneurial businesses.**
- **LSVCCs have also yielded poor rates of return, consistently below those of what are considered to be risk-free investments, such as Treasury Bills.**
- **Canadians are investing in LSVCCs not because they provide a high rate of return, or because they are investing in Canadian entrepreneurs, but rather to receive generous tax credits.**
- **LSVCCs have displaced more effective venture capital funds and have even lowered the level of capital available to Canadian entrepreneurs. In fact, federal LSVCCs alone have resulted in more than 400 fewer venture capital investments per year (Canada wide), representing nearly $1 billion.**
- **If policymakers wish to improve Canada's venture capital market, characterized by more funds raised and more businesses receiving financing, they would be wise to eliminate LSVCCs, making room for more effective venture capital funds.**

Introduction

Venture capital is a type of financing provided to new, high-growth businesses by external investors. Typically, venture capital is the primary source of funding for these entrepreneurial companies as they are often deemed too risky to receive adequate funding from traditional financers such as banks. Without sufficient venture capital, the creation of high-growth firms and their associated benefits, including innovation, job creation, and enhanced economic growth, would be lower. In response to the need for more entrepreneurial firms, a number of governments in Canada created well-intended programs to encourage venture capital financing: Labour Sponsored Venture Capital Corporations (LSVCCs).

This Alert examines whether LSVCCs have successfully expanded the amount of venture capital and the number of investments in Canadian entrepreneurial companies. This publication is based on our technical study of LSVCCs recently published in the *Journal of Business Venturing*. It begins by describing LSVCCs and the cost of the LSVCC program to Canadian taxpayers. It then explores why LSVCCs are an inferior way to organize a venture capital fund and examines the performance of LSVCCs. The Alert concludes by presenting evidence showing that LSVCCs have actually decreased, rather than increased the amount of venture capital available to Canadian entrepreneurs.

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Labour Sponsored Venture Capital Corporations

Labour Sponsored Venture Capital Corporations (LSVCCs) are tax-subsidized investment funds that attract contributions from individual investors through generous tax incentives and invest the funds in entrepreneurial businesses. They are called "labour sponsored" because a union must initially create the corporation. Specifically, the sponsoring union receives a special class of shares in the LSVCC which, while not entitled to dividends or assets, can appoint a majority of directors.[1]

LSVCCs are a unique type of venture capital fund in that they rely exclusively on a large number of relatively small contributions from individuals. This is different from private venture capital funds which primarily rely on institutional investors such as pension funds and corporations. Private funds also receive money from individuals, however, individuals tend to be few in number and contribute much larger amounts of money.

To entice individuals to invest in LSVCCs, governments provide investors with tax credits for investments up to a certain amount (usually $5,000). Provincial tax credits are combined with matching federal tax credits to give investors an immediate financial benefit. For example, if a provincial and the federal government each give a 15 percent tax credit, a $5,000 investment would generate a tax credit of $750 from each government, totaling $1,500. Table 1 shows the tax credit provided to investors and the amount those credits cost governments in each Canadian jurisdiction in 2006.

Table 1 shows that the generous LSVCC tax credits result in a significant cost to the federal and provincial governments in the form of foregone tax revenue. Canadian citizens ultimately bare these costs.[2] The federal government "spent" $150.0 million in 2006 on LSVCC tax credits. Quebec spent significantly more than any other province at $98.0 million, while Ontario and British Columbia both spent $20.0 million.[3] The total amount of LSVCC tax credits in Canada was about $297.9 million in 2006.[4]

LSVCCs are an inferior way to organize a venture capital fund

There are several reasons why LSVCCs are an inferior way to organize a venture capital fund. Most of the reasons relate to the way governments regulate the structure of LSVCCs and their investment activity. For example, LSVCCs can only invest in businesses in the province in which they were created, regardless of market conditions and despite the fact that businesses in other regions that may offer investors superior rates of return.

LSVCCs are also constrained as to the size and nature of their investments in any given entrepreneurial business. Furthermore, they must invest a certain percentage of the funds they raise within a period of time (usually 1 to 3 years), regardless of economic conditions. Exacerbating these problems is the fact governments usually predetermine the number of LSVCCs in each region, effectively stifling competition among such funds, and in turn, reducing the incentives to provide high rates of return.

These geographical and financial restrictions, as well as investment time limits, can lead to pressure on LSVCC managers to invest in businesses regardless of market conditions, and can result in investments in inferior firms.[5]

Another important structural aspect of LSVCCs is that they must be organized as a corporation rather than a limited partnership, which is the most common form of private venture capital funds.[6] Limited partnerships in the venture capital market are typically set up with a predetermined lifespan, whereby the fund will be closed after a certain date. The restricted lifespan of private limited partnerships tends to impose a greater degree of discipline on managers than LSVCC's corporate form, which does not have a limited lifespan. In addition, corporations are subject to more legal regulations than limited partnerships. Corporations are subject to a whole host of regulations that impede the ability of managers to easily and quickly create contracts with investors and entrepreneurs. Accordingly, managers in LSVCCs are less flexible in their operation of the fund and cannot react as quickly to changing market conditions as managers in limited partnerships.[7]

Furthermore, as mentioned above, only individuals are permitted to invest in LSVCCs. This differs from the majority of private venture capital funds that receive significant funding from institutional investors such as pension funds and corporations. Part of the LSVCCs mandate is that they accept a small investment minimum (less than or equal to $1,000). Consequently, LSVCCs tend to have many shareholders each holding a small portion of the fund. In addition, LSVCC managers typically contract out investment management services to professional managers as opposed to operating the fund themselves. The combination of a large number of small investors making small investments and the distant relationship between investors and fund managers means investors will rarely have the appropriate incentives to monitor or take action to discipline fund managers for poor performance. In

Table 1: LSVCC Tax Credits and Tax Expenditure, 2006

	Tax Credit	Tax Expenditure ($ millions, 2006)
Federal	15.0%	$150.0
British Columbia	15.0%	$20.0
Alberta	none	$—
Saskatchewan	20.0%	$7.3
Manitoba	15.0%	$1.5
Ontario	15.0%	$20.0
Quebec	15.0%	$98.0
New Brunswick	15.0%	n/a*
Nova Scotia	20.0%	$1.0
Prince Edward Island	15.0%	n/a*
Newfoundland and Labrador	15.0%	$0.1
Total		$297.9

Source: Federal and provincial budget documents. These amounts are the direct tax costs only and do not reflect indirect costs associated with displacement of private investment and/or other tax costs associated with LSVCCs such as that from RRSP allowances.

*Note: Correspondence with the New Brunswick government explained they do not disclose LSVCC tax credit data for confidentiality reasons. Request for this information from Prince Edward Island went unanswered.

*Note: These figures do not include the costs of other tax items such as RRSP deductions. While RRSP deductions are a tax deferral and not a tax credit, they nonetheless reduce the cost (and increase the rate of return) of LSVCCs to individual investors. See Cumming and MacIntosh (2006) for a more in-depth discussion.

fact, “the atomization of share ownership sacrifices most if not all of these benefits, since collective action and free rider problems ensure that few if any shareholders have the appropriate incentives to monitor or discipline fund managers” (Cumming and MacIntosh, 2006, p. 582). In other words, people who invest a small amount in an LSVCC will be less likely to effectively express dissatisfaction with fund managers than an investor in a private limited partnership who invests a relatively larger amount of money and has a more direct relationship with fund managers. As a result, LSVCC fund managers have less incentive to perform well than do managers of private funds.

LSVCCs have performed poorly

Not surprisingly, given their organizational problems, LSVCCs have performed poorly. Specifically, LSVCCs tend to maintain large amounts of uninvested capital despite their obligation to invest certain amounts each year. In addition, what capital is invested earns a poor rate of return.

Uninvested venture capital

LSVCCs tend to post a significant gap between the amount of venture capital raised and the amount they actually invest, which is often referred to as uninvested capital. This gap matters because if venture capitalists are raising funds but not investing them, then fewer businesses are being created than would be otherwise. In addition, few of the benefits associated with venture capital backed companies will come to fruition. The most recent estimate by the Canadian Venture Capital Association of LSVCCs’ uninvested capital was $1.3 billion in 2001. However, this estimate excludes the requirement that LSVCCs must hold between 20 and 40 percent of all contributions in low-risk investments (i.e., government bonds). It is more accurate to include the low-risk invesment figure with the estimate of uninvested capital. Were that done, then in 2001, total uninvested capital amounted to over $3.8 billion, representing 45 percent of all LSVCC capital under administration ($7.2 billion) that year. The amount of uninvested capital (including low-risk investments) held by LSVCCs, has been consistently significant: in 2000 it was $1.9 billion; in 1999, $1.5 billion; in 1998, $1.3 billion; in 1997, $1.1 billion; in 1996, $0.9 billion, and; in 1995, $538 million. While the data are somewhat stale, they nevertheless show that LSVCCs have been consistently responsible for billions of dollars of uninvested venture capital.

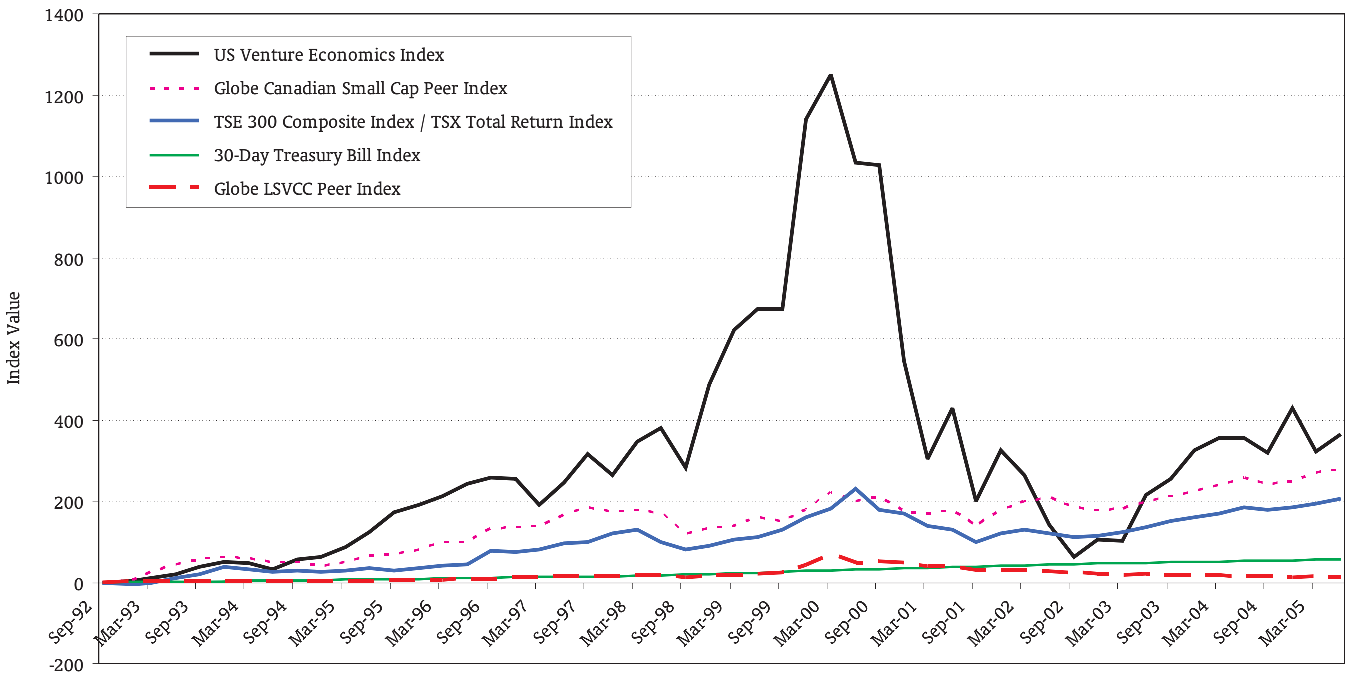
There are several reasons why we can expect LSVCCs to maintain the significant gap between funds raised and funds invested. First, as mentioned above, LSVCCs must hold 20 to 40 percent of the capital they raise in low-risk assets that can be converted easily into money. This is because LSVCCs are “open-ended” funds, meaning that investors can take their money out of them at any time. While redemption is somewhat predictable because investors must keep their money in an LSVCC for 8 years to receive the tax credits, it still means LSVCCs must keep a certain portion of their funds available for redemption (i.e., not invested). This is different from private venture capital funds, which are typically “close-ended,” meaning that investors cannot usually withdraw their funds without serious financial penalty. In addition, private funds usually require investors to keep their money in the fund for 10 years rather than 8. As a result of their close-ended structure and longer time horizon, private funds have less need to maintain liquid investments.

The second and perhaps more important way LSVCCs contribute to uninvested capital in Canada is the comparative lack of skill of LSVCC managers compared to private fund managers (Cumming and MacIntosh, 2003a; 2003b). While there is little empirical research quantifying the skills of fund managers, anecdotal evidence suggests many LSVCC managers have little experience in venture capital investing, which may explain their inability to identify investments with potentially high rates of return (Cumming and MacIntosh, 2006, p. 579).

Poor rates of return

The primary, if not the sole purpose of venture capital, is to invest in entrepreneurial businesses with potential for high growth. While it is reasonable to expect that some of these new firms will fail, overall we should expect venture capitalists to make good decisions and generate positive rates of return for investors. Venture capital funds that do not generate a reasonable rate of return are not being successfully invested in high-growth entrepreneurial businesses.

Figure 1: Performance of Selected Indices, 1992-2005



Note:
1. These figures are not risk-adjusted rates of return.
2. Each index value was adjusted to start at "0" in September 1992.
Source: Cumming and MacIntosh, 2006.

It is not surprising, given the structural problems of LSVCCs, that they have historically generated relatively low rates of return. Figure 1 shows the average rate of return of LSVCCs along with rates of return for other widely used investment options from 1992 to 2005 (latest data available).[8] These include investments with various elements of risk, such as the index of the 300 largest companies trading on the Toronto Stock Exchange (TSE 300), an index of smaller Canadian companies (Canadian Small Cap Peer Index), and an index for US venture capital funds. Figure 1 also includes an index for short-term (30-day) Treasury Bills which provide a guaranteed rate of return and thus are considered risk-free.

Figure 1 shows that the rate of return of LSVCCs (dashed red line) have historically trailed the returns of other investment options.[9] That is, LSVCCs—an investment option designed to invest in potentially high-growth entrepreneurial businesses—have systemically failed to generate a rate of return close to other investment options. In fact, LSVCCs have trailed broad indices such as the TSE 300 and fallen far behind US venture capital funds. Perhaps most importantly, though, and indicative of the structural problems with LSVCCs, they trail the rate of return of risk-free Treasury Bills.[10] This means that without the tax credits they provide to investors, LSVCCs would have produced a higher rate of return if they had just invested in Treasury Bills rather than attempted to invest in Canadian businesses.[11]

The fact that investors continue to contribute funds to LSVCCs despite their poor rates of return means that something else must be driving contributions. Perhaps the incentive to invest is primarily tax-driven. Canadians could be investing in LSVCCs not because they provide a high rate of return or because they are investing in Canadian entrepreneurs, but rather to get generous tax credits. In other words, presumably LSVCCs are not attracting investors who have the desire and risk-tolerance to invest in typical venture capital backed businesses but instead are attracting average Canadians who are seeking a tax benefit. Ultimately, the poor rate of return of LSVCCs indicates they have not fulfilled their objective of helping to finance a number of Canadian entrepreneurial businesses.[12]

LSVCCs displace more effective venture capital funds

In addition to their poor investment performance, LSVCCs crowd out, or displace more effective venture capital funds. Our technical study upon which this Alert is based included a series of statistical analyses of factors that explain changes in the level of venture capital activity in Canada.[13] The technical study examined the impact of LSVCC legislation, interest rates, returns of other investments (such as the TSE index), economic growth, and the number of new incorporations on Canada's venture capital market from 1977 to 2001. The study also considered the boom in venture capital activity in the late 1990s (the "tech bubble"). The study examined how all these factors affected the number and dollar value of venture capital investments in Canada.

The results of these analyses reveal that many of these factors help explain changes in the level of venture capital activity in Canada. As one might intuitively expect, economic growth and returns to other investments were positively associated with venture capital investments, meaning venture capital activity tended to increase as the economy grew and other investment options provided increasing rates of return. Interest rates tended to be negatively associated with venture capital investment, meaning that as interest rates increased, investors found investment options that yielded interest payments more attractive than venture capital. The analyses showed that one of the most important factors explaining increases in venture capital over time was the trend of growth in Canada's venture capital industry, confirming the growing importance of venture capital financing in Canada over the time studied.[14]

Interestingly, the introduction of provincial LSVCCs between 1983 and 1994 had little to no impact on venture capital investment. That is, while overall levels of venture capital were low in the 1970s, the market already seemed to be growing. However, the introduction of federal LSVCC legislation during the same period was found to be negatively associated with venture capital investment, suggesting federal LSVCCs actually decreased the amount of venture capital and ultimately decreased the number of businesses receiving financing. In fact, the results of the statistical analyses indicate that federal LSVCCs alone have resulted in more than 400 fewer venture capital investments per year (Canada wide), representing nearly $1 billion in value. This is a particularly significant result, given that one of the primary objectives of LSVCC legislation is to finance more Canadian entrepreneurial businesses with high-growth potential.

The finding that the introduction of LSVCCs is actually negatively associated with venture capital investment means that the amount of venture capital would have been higher had LSVCCs not been introduced. In other words, LSVCCs displaced other venture capital funds that would have created as much, and likely a greater amount, of venture capital.

The reason LSVCCs displace other venture capital funds is rooted in how the tax credits distort rates of return and how LSVCCs finance entrepreneurial businesses compared to other sources of funding. Since LSVCCs provide generous tax credits that are not available to non-LSVCC investors, the required rate of return on LSVCC funds will be lower than the comparable rate for private funds. Accordingly, LSVCC managers can pay more for an investment than non-LSVCCs while still meeting the LSVCC required rate of return.[15] Another way to think about this is that LSVCC tax credits partially substitute for a rate of return. With part of their rate of return provided by tax credits LSVCC managers can pay more for an investment than non-LSVCCs while still meeting the LSVCC required rate of return. Accordingly, LSVCCs can secure financing deals (i.e., invest in an entrepreneurial business) they would perhaps otherwise not be able to acquire while simultaneously placing upward pressure on the prices of those deals. The fact that LSVCCs can pay more for a financing deal means LSVCCs can acquire projects that could have been financed by private funds. As a result, returns to private funds may be lower, which discourages non-LSVCC investors from contributing funds.

Displacing one form of venture capital fund for another is not necessarily detrimental to Canada's venture capital market if the fund doing the displacing is superior. However, as discussed above, LSVCCs are structured in such a way they cannot allocate capital as efficiently as private funds, and have experienced very poor rates of return.

Conclusions and recommendations

Our technical analysis shows that LSVCCs are an inferior way to organize a venture capital fund. As a result, LSVCCs have contributed significantly to the amount of venture capital in Canada that remains uninvested. Furthermore, that portion that is invested has posted very low rates of return. Also important is that LSVCCs have displaced more effective venture capital funds and have even lowered the level of capital available to Canadian entrepreneurs. These poor outcomes in and of themselves are certainly reason for alarm, yet looking at the costs together with the billions of dollars LSVCC tax credits have cost Canadians turns the alarm into a need for reform. If policymakers wish to turn the venture capital market from one characterized by large tax expenditures and poor outcomes to one with more investment, better rates of return, and ultimately more entrepreneurial activity, they would be wise to eliminate LSVCCs, making room for more effective venture capital funds.

Notes

1 That said, most sponsoring unions have delegated their power to appoint directors to professional fund managers who operate the LSVCC.

2 These figures do not include the costs of other tax items such as RRSP deductions. While RRSP deductions are a tax deferral and not a tax credit, they nonetheless reduce the cost (and increase the rate of return) of LSVCCs to individual investors. See Cumming and MacIntosh (2006) for a more in-depth discussion.

3 Unfortunately, the governments of New Brunswick and Prince Edward Island did not disclose the amount they spent on LSVCC tax credits. However, because of their relatively small venture capital pools, the tax expenditure on these credits is likely small.

4 This calculation does not include tax expenditure data from New Brunswick and Prince Edward Island. Total expenditures equaled $3.3 billion over the period 1992 to 2002 (Cumming and MacIntosh, 2004).

5 Another reason to expect that LSVCCs might perform poorly is that some of them have multiple objectives including regional development, increasing investment in small firms, creating jobs, improving worker education, and in some cases advancing the union movement. Many of the LSVCC funds, however, specifically state that their principal or even sole objective is the pursuit of profits.

6 A limited partnership is a business structure with two types of people involved. The first are general partners who manage the business and are financially responsible for the firm's performance. The second are limited partners, (investors in the case of a venture capital fund), who contribute money but have no management function and are only financially responsible for the money they contribute.

7 A study by American economists Paul Gompers and Josh Lerner (1996) found that this flexibility, which is not present in LSVCCs, is a major factor in the success of the US venture capital industry.

8 These figures are not risk-adjusted rates of return.

9 Cumming and MacIntosh (2004, 2007) show that there is little variance in the performance of different LSVCCs.

10 Evidence of inferior LSVCC performance is buttressed by several other studies. See Cumming and MacIntosh, 2006; 2007.

11 In technical terms, this means that LSVCCs have actually lost money on a risk-adjusted basis.

12 As mentioned above, some LSVCCs do have multiple objectives. However, the large majority have as their primary, if not sole objective, the pursuit of profits through investments in Canadian entrepreneurial companies with the potential for high growth.

13 See Cumming and MacIntosh (2006) on which this study is based. The authors complete a number of regression analyses on the supply and demand for venture capital in Canada.

14 The trend variable in the statistical analysis attempts to capture changes in contractual technology, enhanced entrepreneur education and skills, greater entrepreneur awareness of venture capital financing, and/or other factors that have contributed to a growth in the demand for venture capital over time.

15 Non-LSVCC investors include those that are taxable, such as corporations and wealthy individuals, as well as non-taxable entities such as pension funds. See Cumming and MacIntosh (2006) for a full discussion of how each of these investors is affected by LSVCCs.

16 In technical terms, since LSVCC investors receive a partial return on their investment from tax credits, their required rate of return from an LSVCC investment is lower than for a private fund, which must generate its rate of return entirely through sound investment

decisions. This allows an LSVCC to out-bid non-LSVCCs for a financing deal, while still meeting the LSVCC's required rate of return.

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