Financing Disappearing for Tech Entrepreneurs

By Tony Wanless

Even though Dan Matlow, CEO of Toronto's Medworxx, Toronto, is a veteran technology entrepreneur with a string of successful businesses behind him, it wasn't easy to find money to expand his latest venture.

That's because there isn't much available to technology businesses these days.

Three years ago, Mr. Matlow co-founded Medworxx, which provides knowledge management software to the health care industry in Canada and the U.S. It was financed by his own money, and some angel – high net worth individuals who invest privately in a company's earliest stage -- investment backers.

Over the past three years, he's followed a predictable fundraising pattern to raise about $2.4 million to grow his company from seven to 35 people and gain about 150 client hospitals throughout North America. After bringing in the angels, he received seed capital from the venture capital company, Growthworks, which manages several labour sponsored investment funds (LSIFs), also known as Labour Sponsoured Venture Capital Corporations (LSVCC).

Usually, seed funding leads to follow-up rounds of larger financing by syndicates of venture capital companies, but when Matlow began looking last year for more than $2 million to further expansion, he ran into a brick wall.

"You're in a particular spot that's between seed funders and investment banks," Matlow explains. "At this level, the LSIF's often anchor syndicates of other investors for larger financings. This time we had an anchor in Growthworks, but couldn't find the syndicate."

After weeks of fruitlessly scouring Toronto for investment, a search he describes as "scratching and clawing", Mr. Matlow was able to put together his funding. But he had to be creative to do it. He brought his original angel investors into a syndicate that also included a couple of boutique private investment companies.

"I had no choice really," Matlow says now. "The VC pool is drying up out there. You can take a lot of meetings, but you won't get many deal offerings. Most VC's are just servicing the companies they already have."

Mr. Matlow's quest illustrates a unique situation that's currently affecting entrepreneurial companies in Ontario, and threatens to stall economic growth in the province's industries of tomorrow – technology and other knowledge-based businesses. The private investment vertical has been hollowed out, almost stopped dead between the start-up and seed stage, and the higher publicly-listing stages served by the investment banks.

This is partly because many investors shied away from technology after the crash of 2001, and never came back especially after traditional resource play investments began to boom again. Investors usually go where the returns are, and recently that's been in energy and mining.

But last year, the Ontario government added to the problem when it knocked out a strong underpinning to private investment by killing its participation in Labour Sponsored Investment Fund tax credits. The system funnelled funds from ordinary investors to LSIFs by providing 15% federal tax credits and matching 15% provincial tax credits.

When the Ontario government announced in 2005 it was going to phase out its tax credit beginning in 2008, funding immediately dried up for most Ontario-based LSIFs, which meant they had a shrinking pool of capital to invest in companies that needed it. And, because Ontario accounts for about 40% of venture capital financing in Ontario, this has affected entrepreneurs across Canada.

The fallout from the Ontario decision was palpably shown recently when the Canadian Venture Capital and Private Investment Association (CVCA) released its 2006 year end results. LSVCCs raised $907 million in 2006, down 25 per cent from the previous year. And Quebec, which still has a tax credit system intact, accounted for 85% of LSVCC fundraising.

That LSVCC fundraising problem appears to have had ripple effects that are reverberating throughout the venture capital industry. This is especially acute at the early stage of the financing chain that grows companies from startup to maturity. For example, in 2000 283 new Ontario companies received $1.6 billion in early stage (called A round) financing. But last year that had dropped drastically. In 2006, only 60 new companies received a mere $120 million, less than 10 per cent of the 2000 total.

And this is starting to show up at follow-on financing levels. For example, in Ontario, 118 companies received investment of about $686 million from all venture capital companies, a decline of 9% from the previous year. No doubt this decline will grow considerably in future as the problem works its way through the system.

According to Les Lyall, head of the Association of Labour Sponsored Investment Funds, this means that commercialization of promising technology has slowed, and tech companies are unable to grow. Already, he said, many young and educated people in the technology field are fleeing to the U.S. where they're receiving more encouragement to innovate.

"In Ontario, $500-600 million is spent every year by federal and provincial governments on research and development, but it's up to venture capital to commercialize R&D," said Mr. Lyall "But the train has been derailed. In Ontario the whole effort and initiative to commercialize has stopped because of financing problems. We're in a crisis."