Financing the Business LIFECYCLE

Grants, Angels and VCs

Financing innovation is crucial for the growth of a knowledge-based economy, and yet, for some of the companies who need it the most, this capital can be challenging to access. While staying competitive in domestic and international markets increasingly demands that companies invest in research, development and commercialization, sourcing financing necessary to bring ideas to the market remains a resource intensive endeavour.

Written by Ela Malkovsky, Technical Writer and Editor-in-Chief at NorthBridge Consultants

Businesses that seek financing to conduct research and development activities, and subsequently commercialize their innovations, can appeal to different sources of government and private venture capital financing, depending on the company's industry and stage of growth. From project-based, non-dilutive sources of government funding to debt and equity venture capital investments, there are multiple financing options available to meet changing business objectives.

These options can be strategically leveraged at every stage of growth, in accordance with currently available industry opportunities, to maximise the cost-effectiveness of funds that your company can receive.

Government funding: Non-dilutive, project-based financing solutions

In the high-risk stages of a company's growth, venture capital firms may be hesitant to invest since the fixed costs of appraisal, due diligence, and monitoring of the investment translate into return demands that are greater than most small and medium sized enterprises can accommodate. Financial institutions may also be reluctant to provide capital, due to lack of collateral or proven success. Government funding solutions, which are non-dilutive and often focus on specific business goals or projects, can therefore play an important role in supporting early stage research and development.

> **"Government funding solutions, which are non-dilutive and often focus on specific business goals or projects, can play an important role in supporting early stage research and development."**

Key government incentives intended to promote the development and commercialization of new technology include tax credits (indirect funding), government grants (direct funding), and the patent/trademark system. The patent and trademark system allows companies to monopolize their technologies in return for full disclosure of the technological designs. Indirect sources of government funding such as research and development tax credits are non-discriminatory, providing tax credits regardless of whether the experimental work was successful or yields a profit. Therefore, indirect funding through tax credits can provide annual support for research and development activities such as prototype development, process improvement, and experimental design, allowing companies to extend their runway while decreasing perceived risks for potential venture capital investors.

Meanwhile, direct funding through government grants and loans can offer financing for innovation, or for additional areas of focus including business growth, infrastructure, and workforce development. As such, government grants and loans are usually targeted towards a smaller group of applicants from specific industries and are aimed at funding specific priorities such as job creation, advancement of a specific sector, or development of innovative technologies (though companies often need to demonstrate at least a two year track record of sustained business success).

Direct and indirect government financing solutions can work together to provide support for early stage projects that » venture capital investors are unable, or unwilling, to fund. Refundable tax credits can help offset costs of performing research and development, while grants focused on business growth can help companies to acquire new equipment and expand their facilities. Moreover, grants focused on workforce development can help companies hire new employees and enhance the skill set of existing employees while grants focused on increasing export capabilities can help companies expand global market access. In this way, financing received from government sources can be used to extend a company's runway, acquire capital assets, and attract financing from angel investors, venture capital firms, and institutional investments.

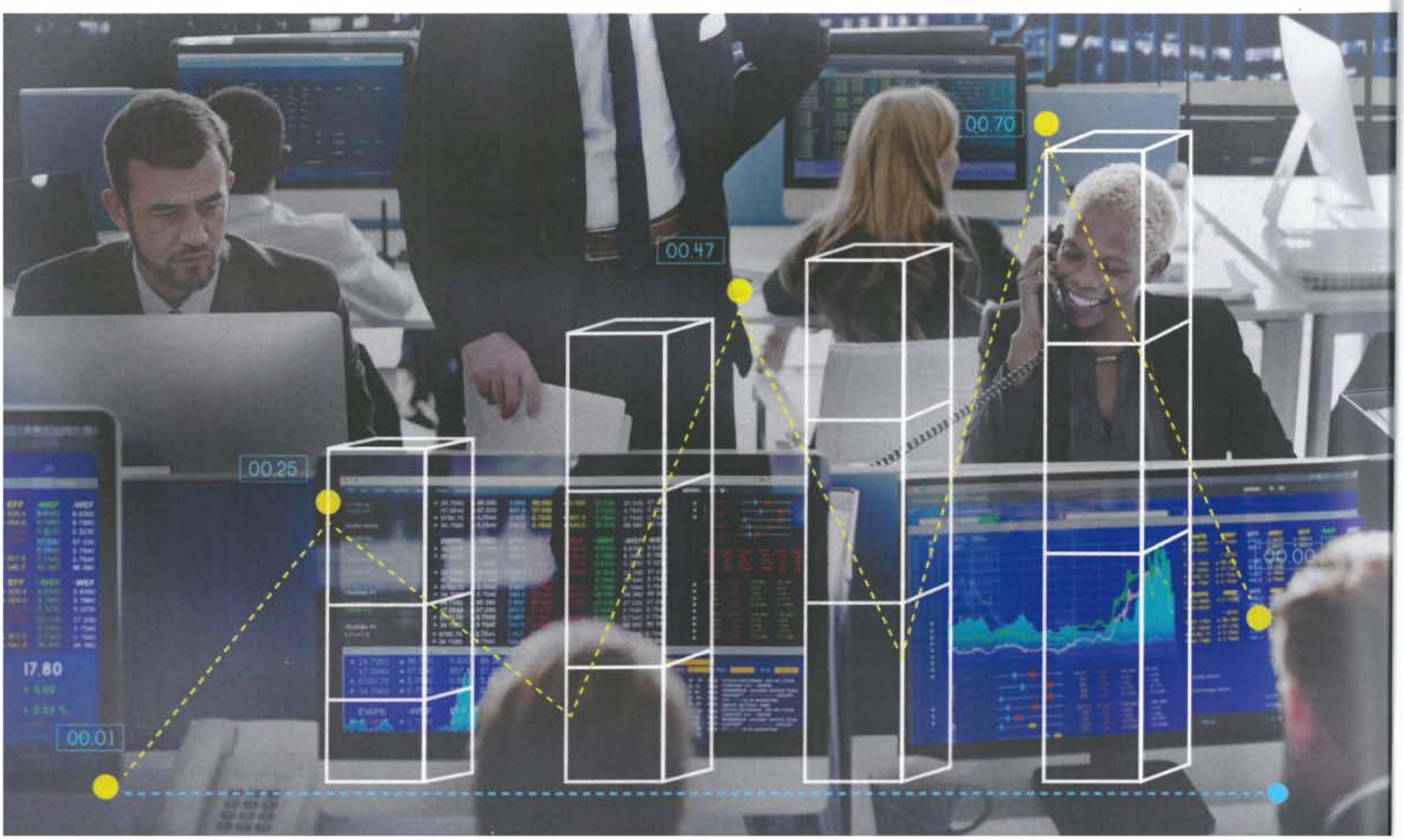
Angel investors and venture capitalists: Equity and debt financing solutions

Angel investors often provide external equity for early stage companies in return for a supervisory role over the company's management practices. Typically experienced entrepreneurs and leaders in their field, angel investors contribute their technical and managerial expertise in addition to their contact network. In recent years, the North American angel investment landscape has become more visible and formalized through the formation of groups and networks or syndicates to improve connections between angels and the start-up market. Co-investments allow for risk diversification and predominantly occur with other angel investors, although angels also co-invest with public funds, venture capital firms and other types of investors. According to the *2016 OECD Scoreboard*, 67 percent of all U.S. angel investors co-invested within a group of syndicates in 2011, and by 2013 angel co-investments grew to 73 percent. Similarly, in Canada, 65 percent of angel investments in 2014 occurred within the same angel group, and 75 percent of investments were made with non-angel groups such as venture capital firms or the government.

"Typically experienced entrepreneurs and leaders in their field, angel investors contribute their technical and managerial expertise in addition to their contact network."

Unlike venture capital firms who tend to concentrate on high technology sectors, angel investors typically invest in a greater range of sectors across larger geographies. Compared to venture capital firms, angel investors can be less sensitive to market cycles and are also usually more willing to invest in pre-revenue companies and to execute an exit sooner while the company has a lower valuation.

Industry priorities and the near-term capacity of growth are the key determinants of venture capital investments. The U.S. venture capital market has largely focused on the technology sector and plays an important role in the commercialization stage of the business life cycle. Between 2007 and 2014 venture



capital investments in the seed stage declined by more than half while investments in the start-up and later growth stages grew by 25 percent, according to *OECD Scoreboard, 2016*. Often in return for equity in the company, venture capitalists provide extremely valuable expertise and business connections, as well as access to greater capital than is typically provided for companies in earlier growth stages.

American institutional investors, venture capital firms, and angel investors may be more comfortable investing in early-stage companies that are governed under the laws of a U.S. state, prompting many Canadian entrepreneurs to incorporate in the U.S. as well as in Canada. American incorporation can also provide access to U.S.-based incubators and certain funding programs. As such, leveraging cross-border opportunities to maximise financing opportunities is a growing trend for entrepreneurs. For companies conducting research and development in the Canadian market, a Canadian presence allows for simplified federal tax filings and more lucrative tax returns under the Scientific Research and Experimental Development (SR&ED) program, which allows CCPCs under the Small Business Income and Taxable Capital limits (>$500,000 and >$10,000,000 respectively) to obtain up to a 35 percent federal return on eligible research and development expenditures through refundable tax credits. Conversely, U.S.-based and other foreign-owned companies are eligible for non-refundable tax credits up to 15 percent of eligible research and development expenditures.

Strategic financing: Maximum investment with minimal equity loss

Navigating through the sea of possible financing solutions, including government funding, angel investors, and venture capital firms, requires strategic planning in order to maximize the cost-effectiveness of securing financing solutions in accordance with the changing needs of a growing company.

Initial rounds of funding from government sources, in the form of tax credits and conditional grants and loans, can be attractive options for early stage companies as they do not dilute company ownership and are often provided with lower-than-market interest rates or do not require repayment. Subsequent rounds of funding from angel investors and venture capital investors can contribute capital and provide additional business expertise, though often with some loss of autonomy. Taking advantage of these financing opportunities as appropriate at every stage of growth can preserve your company's ownership and ensure that your company can maximize the cost-effectiveness of its capital.

Ela is a Technical Writer and the Editor-In-Chief at NorthBridge Consultants. She is dedicated to helping Canadian companies innovate, compete, and grow by leveraging research- and technology-based funding solutions. ■