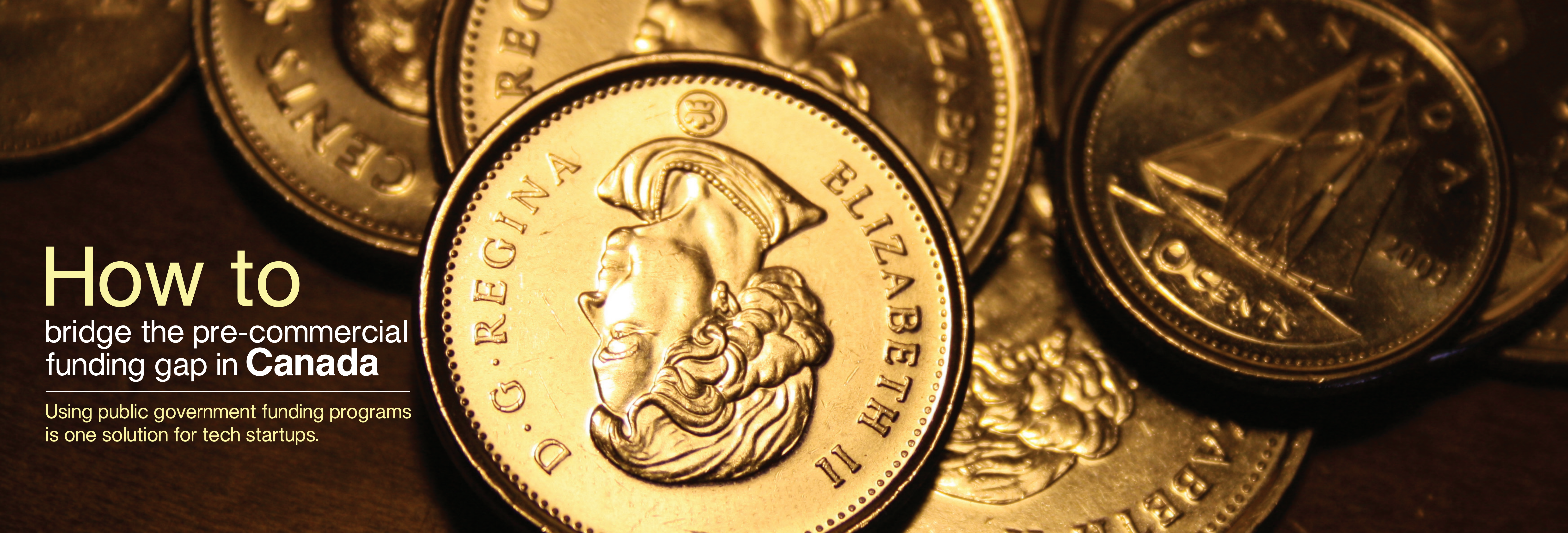

How to bridge the pre-commercial funding gap in **Canada**

Using public government funding programs is one solution for tech startups.

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Mahrie connects digital media companies with tailored and innovative funding options. Read Mahrie's take on digital media and industry news on the NorthBridge Canadian Business Blog.

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Startups are based on ideas and faith. Going from an idea to commercialization is a roller coaster ride, from conceptualization to development beta testing and, hopefully, into commercialization and market development. The primary challenge for Canadian tech startups hoping to "hit it big" is the funding gap across the stages prior to commercialization, where capital becomes scarce and companies find themselves without the cash or cash flow to ramp up.

Sustainable Development Technology Canada (SDTC) attributes this pre-commercial funding gap to "the lack of maturity of new technologies, the risk aversion of the financial sector, and a profound 'disconnectedness' around the key players in Canada." Our ability to foster startups in Canada is consistently compared to that of the U.S., hailed a superior locale for aspiring entrepreneurs.

While venture capitalism is back on the rise in Canada, growing 34 percent from 2010 to 2011, invested dollars today are still only approximately 70 percent of what VC investments were five years ago. Also, startups in the U.S. are getting about 20 percent more VC support than in Canada. So what is Canada offering in terms of public support measures to champion the indigenous startup?

The highest levels of public support for the digital media industry in Canada in terms of tax credits, loan guarantees and venture capital is seen in four provinces: British Columbia, Manitoba, Ontario and Quebec. The up and coming province is Manitoba, which grew 850 percent in funding contributions between 2007 and 2010 through tax credits and financing contributions from their Interactive Digital Media Fund.

Canada's flagship Scientific Research and Experimental Development (SR&ED) program hit mainstream media last year and has been the topic of public debate with changes recommended in the 2012 federal budget. The SR&ED program exists to promote innovation and ultimately growth in Canadian companies. While the removal of capital costs from the expenditure base will affect some machine-heavy sectors, labour-heavy software development will be negatively impacted to a much lesser extent.

Tech companies can also look toward grant programs including National Research Council Canada's Industrial Research Assistance Program (NRC-IRAP), a program the 2012 budget has committed to expand. A number of provinces are also offering tax credits to encourage angel investor activity.

One program that has been consistently growing since launch is the Ontario Interactive Digital Media Tax Credit (OIDMTC). Amendments to the program's legislation in 2008 and 2009 doubled the tax credit value from 20 to 40 percent, and grew eligible sub-contracting costs 50 to 100 percent. The OIDMTC can be very lucrative because there is no cap on labour and companies can claim 40 percent of marketing and distribution costs up to $100,000 a year.

Essentially, the program recoups almost half of early development, production, and distribution costs for eligible digital media products including mobile apps, web sites, video games or other interactive products. Similar interactive digital media tax credit programs support the industry in the other tech hubs across Canada.

While programs like SR&ED and OIDMTC can recoup significant costs, the benefit comes after initial expenditures and most early stage companies cannot afford to wait to receive their tax credit refunds 6 to 12 months after the fact. Without access to capital, startups are forced to look at dilutive equity financing options or delaying their growth plans because banks are not willing to provide them with cheap debt financing unless they are cash flow positive.

There is, however, an option outside of the traditional institutions, a form of bridge financing based on expected SR&ED refunds. Specialty financing firms like North Innovation Fund provides SR&ED accrual financing (i.e., the beginning of the fiscal year) to bridge that funding gap, which provides entrepreneurs with a non-dilutive option.

Using public government funding programs is one solution for tech startups. But the Federal government needs to consider the gaps in funding in order to foster a complete and cultivating eco-system for the IT business community in Canada.

Source: IT Business. July 30, 2012. www.itbusiness.ca

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