

Nurturing Entrepreneurship: A Proposal to Improve Access to Capital

June 2010

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Introduction

During *Fullsail*[™] events sponsored by the New Brunswick Securities Commission a need was identified for the establishment of a committed source of capital that “rides” or invests with others in equity in early stage ventures, often described as a sidecar or co-investment fund.

The first co-investment fund seems to have been established in Israel (Heznek Program) in the mid-1980s as a way to stimulate investments that would protect the national interest of the state. Other countries such as New Zealand (New Zealand Venture Investment Fund) followed suit in the late 1990s. With the bursting of the tech bubble in 2001 the number of sidecar funds established as a way to stimulate investments in high-growth early-stage companies has increased significantly. Current global financial concerns have led to tightening of credit by traditional lenders and a significant decrease in venture capital funding, particularly in angel and early stage venture capital, resulting in increased interest in sidecar funds.

Since 2001 the United States have seen the launching of State funds (Maryland Venture Fund), city funds (the New York Investment Fund) and funds with no specific geographical base, the Common Angels Fund (located in Boston). The funds outlined above are funded by the State, institutions and in the case of the Common Angels, accredited individual investors only.

In Canada over the past four years provincial co-investment or venture capital funds have been launched in:

- Quebec (GO Capital Fund - \$50 million);
- Ontario (Emerging Technologies Fund - \$250 million);
- British Columbia (Renaissance Capital Fund - \$90 million); and
- Alberta (the Enterprise Corporation - \$100 million).

Ontario also has a Venture Capital Fund (OVCF) of \$205 million funded by the province and institutional investors which invests primarily in Ontario-based and Ontario-focused venture capital and growth equity funds that support innovative, high-growth companies.

The funds established in Canada have generally been funded by provincial governments, the exception being the OVCF. In addition to the Canadian Funds mentioned, the province of Quebec is in discussions with a Montreal-based Angel network to establish a \$24 million sidecar fund. As proposed, Quebec would contribute \$16 million with the remainder raised by the Angel network.

At a *Fullsail* series event held in Saint John on 31 March 2010 to discuss a model sidecar fund, participants heard from Brenda Hogan of the Ontario Capital Growth Corporation (OCGC). The principal business of the OCGC is to manage

the interest of Ontario in the OVCF, and to manage and operate the Ontario Emerging Technologies Fund (OETF).

The participants concluded that there is a need for additional funding for small and medium-sized innovative high-growth ventures not supported by the New Brunswick Innovation Foundation (NBIF). NBIF invests in energy and environmental technologies, knowledge and information and communications technologies, life sciences, value added natural resource technologies and advanced manufacturing. A sidecar fund would provide an additional source of capital not currently available in New Brunswick which could lever private sector funds and lead to substantial returns on investment.

The Fund model is based on design principles that are consistent with achieving its objectives:

- *Fund's role as a catalyst* – the Fund will be a catalyst to leverage private sector capital; it will not “go it alone”;
- *Focus on sectors key to New Brunswick* – the Fund will focus its investments on sectors of importance to the province;
- *Efficient deployment of capital* – the Fund will have the ability to make investments efficiently and directly within a short time frame;
- *Market-based investment decisions* – identification and assessment of investment opportunities will be undertaken by qualified investors that have a proven track record of success and have been pre-qualified by the Fund's Administrator;
- *Ability to make additional investments*– the Fund will be able to make initial and follow-on investments to support ongoing growth;
- *Leverage other sources of capital* - Investments should leverage or sustain lines of credit, research grants and term loans;
- *Reduced administrative costs* – Administrative costs should be minimized.

There are many variations on the structure of sidecar funds. This proposal suggests a model that the participants believe will complement funding provided by NBIF to its specific sectors and facilitate an efficient and effective flow of private equity capital to early-stage ventures with high growth potential.

Terms

Below are some of the terms used throughout this proposal.

<i>Accredited Investor</i>	An investor, as defined under securities laws as having the knowledge and financial ability to assess and make "risk" investments and thus purchase securities under specific exemption provisions.
<i>Administrator</i>	An organization or entity that manages the day-to-day operations (management) of the sidecar fund.
<i>Co-investor</i>	An individual or entity that invests with others. In this proposal a co-investor would invest with the sidecar fund.
<i>Contributor</i>	An individual, company, organization or government entity that provides money for the sidecar fund by direct contribution or by pledge which is in turn used to invest in private equity in early-stage ventures alongside external investors.
<i>Proponent</i>	An individual, government agency or entity that supports the establishment of a sidecar fund.
<i>Sidecar or Co-investment Fund</i>	A committed source of capital (Fund) that traditionally "rides" or invests with angel or venture capital investors and relies for the most part on the financial and business due diligence of the angel or venture capital investors.
<i>Stakeholder or Participant</i>	An individual or organization who participated in the development of this proposal.
Venture	A new business opportunity of a start-up or existing business that exhibits strong growth potential.

Objective

Create a sidecar or co-investment fund to provide equity capital:

- for potentially high-growth ventures;
- for the benefit of New Brunswick-based entrepreneurs and investors; and
- that levers equity investment by angels and venture capital investors.

The Proposal

The following are key components of the sidecar fund:

1. Investing for the Benefit of New Brunswick-Based Ventures

To receive an investment from the sidecar fund, the venture must:

- be privately owned;
- be incorporated [or registered to carry on business] in New Brunswick;
- have a substantial portion of its business assets and other resources located in New Brunswick; and
- demonstrate innovation and a potential for high growth.

Principal sectors where the sidecar fund will focus its matching investments include:

- Plastics/composites
- Metal fabrication
- Advanced manufacturing
- Food and beverage processing
- Resource processing
- Software development
- IT support services
- Advanced learning
- Aerospace and defence

2. Eligible Co-Investors

The sidecar fund would co-invest with others with the proven ability to undertake the financial and business due diligence appropriate for assessing the investment and who are also:

- Accredited investors who are part of an Angel network that is approved by the Administrator and that are members of an Angel network that is

associated with the National Angel Capital Organization or the Angel Capital Association (USA);

- Venture Capital firms that are members of the Canadian Venture Capital Association or the National Venture Capital Association (USA);
- Accredited investors approved by the Administrator that have the ability to fund a proposed investment.

3. *Investment Limits*

The sidecar fund would:

- invest not less than \$100,000 and not more than \$500,000 in any financing round;
- have an aggregate investment from all rounds of not more than \$1,000,000 in any single venture;
- have a matching ratio of the Fund to its co-investors that would not exceed 1:1;
- have an aggregate equity stake of the Fund and its co-investors in the venture that should provide investors with opportunities for subsequent investment rounds.

The Administrator should have the flexibility to invest in opportunities that fall outside the parameters established.

4. *Fund Size*

The Fund size would initially be \$10 million which should have an estimated fund life of 4 - 5 years. There would be an opportunity for the Fund to exceed the initial \$10 million through subsequent contributor funding.

5. *Management of the Fund*

The Fund will be "*second door*" only, meaning that it will not market itself, solicit investment opportunities, undertake full due diligence reviews or have a nominee on the board of directors of the venture. It will rely principally on the due diligence processes undertaken by its co-investors. The Administrator's review will be conducted only to determine if the investment complies with the Fund parameters. If the requirements have been met and the due diligence results are acceptable to the Administrator, the Fund will make its investment on

the terms agreed with its co-investors, and the business venture and its owners, and receive an equity stake in the venture in the same shares received by its co-investors.

The Administrator will receive periodic reports from co-investors and their nominees to the board of the venture. If one or more of the co-investors exit an investment, the Administrator will be notified and the Fund will have the opportunity to exit at the same time and on the same terms in accordance with the agreement among the Fund, its co-investors, the venture and its owners.

Unless otherwise agreed by the Administrator in agreements among the Fund, its co-investors, the venture and its owners, the Administrator will recover its costs of an investment or an exit from the venture and in addition may receive a fee from the invested company. Alternatively a reasonable portion of the Fund would be available to the Administrator to cover its administrative costs.

It is also recommended that an annual performance review be conducted of the sidecar fund and Administrator by the contributors to facilitate adjustments in the operations of the Administrator that would improve efficiencies. Also at this time the focus of the Fund may be changed to better reflect changes or new trends in the investment market.

Administration

Full-time administration of the Fund should not be required. The Fund's administration should be assigned to an organization that is able to provide the resources required when an investment opportunity is brought forward.

The ideal Administrator would be:

- New Brunswick-based;
- considered provincial in scope;
- independent of government or its agencies;
- compliant with applicable laws;
- have good governance practices;
- have a Board of Directors that reflects New Brunswick's cultural diversity and geography with experience in the areas of accounting, law, starting and growing businesses, marketing and equity investing;
- required to segregate the Fund;
- able to communicate effectively in both official languages;
- required to prepare an annual report on the Fund's investments; and
- held in high regard and trust within the province.

propel ICT is recommended as the Administrator. Representatives from propel ICT have expressed support and agreed to take the proposal to their board.

Fund Contributors

Contributors to the Fund would include the federal and provincial governments, and their agencies, as well as private sector businesses or institutions that share a vision of growth for New Brunswick. Individual “accredited investors” may also be potential contributors. Contributors could “pledge” or promise to invest over a period of time. Contributions from the public sector will be required initially to leverage private sector involvement. A public/private funding ratio of 60/40 would be the goal.

If the New Brunswick small business investment tax credit was available to contributors with respect to their contributions to the Fund and the contributors were otherwise eligible for the credit, the Fund may well be able to attract investment from “accredited investors”.

Exit Strategies for Private Sector Contributors

Exit strategies for private sector contributors would be established in the documents establishing the Fund. Public sector contributors would be entitled to the return of their contributions and earned returns only upon liquidation or windup of the Fund.

A private sector contributor could have an option to exit from the Fund for a portion of their contribution when the Fund exited an investment, but only with respect to the contributor’s portion of the investment’s exit proceeds. For clarity a contributor would be entitled to receive their portion of the exit proceeds received by the Fund in proportion to their investment in the Fund at the time of the exit from the investment. Contributors could also leave their portion of any exit proceeds with their initial investment available for future investment opportunities for the Fund.

Appendix A

References to Sidecar Fund Websites

The following table provides a list of the sidecar funds that were researched as part of the New Brunswick sidecar development process.

Fund	Country	Web Link
Ontario Emerging Technologies Fund	CAN	http://www.ocgc.gov.on.ca/site/en/funds/ontario-emerging-technologies-fund
Heznek Program	Israel	http://www.tamas.gov.il/NR/exeres/2F9931BD-7695-4FAD-9A54-950A1E99B3F8.htm
Seed Co-Investment Fund	NZ	www.beehive.govt.nz/node/23716
Advantage Early Growth Fund	UK	www.aegf.co.uk
East of England Co-Investment Fund	UK	www.exemplas.com
GEIF Ventures Early Growth Fund	UK	www.geifventures.co.uk
London Seed Capital	UK	www.gle.co.uk
OION Co-Investment Fund	UK	www.oion.co.uk
Scottish Enterprise	UK	www.scottish-enterprise.com
Viking Fund	UK	www.vikingfund.co.uk
Maryland Venture Fund	US	http://www.choosemaryland.org/businessresources/Pages/MarylandVentureFund.aspx
Michigan Pre-Seed Capital Fund	US	http://www.annarborusa.org/business-accelerator/funding-incentives/pre-seed-fund
Michigan University Challenge Fund	US	www.muci.org
New York City Investment Fund	US	www.nycif.org
Oregon Investment Fund	US	www.oregoninvestmentfund.com

Appendix B

List of Participants

The following is a list of those participating in developing the proposal.

Atlantic Canada Opportunities Agency	Glenn Fraser
Business New Brunswick	Bernie Fontaine
Conseil économique du Nouveau-Brunswick	Anne Hébert
First Angel Network	Ross Finlay
Innovatia Inc.	Roxanne Fairweather
National Research Council Canada	Bradley Goodyear
New Brunswick Investment Management Corp.	George Long
New Brunswick Innovation Foundation	Nicole Leblanc
New Brunswick Securities Commission (Organizer)	Michael Arbow David Barry Wendy Connors-Beckett Rick Hancox Andrew Nicholson
Ontario Capital Growth Corporation	Brenda Hogan
PlazaCorp Retail Properties Ltd.	Kim Sharpe
propel ICT	Richard Jones Jeff Roach
University of New Brunswick	Chris Mathis
Wallace McCain Institute at UNB	Nancy Mathis

Appendix C

List of Proponents

The following is a list of those that support the establishment of a Sidecar or Co-Investment Fund.

Individuals

Roxanne Fairweather - Innovatia

Richard Jones – SHIFT Energy Inc.

Peter M. Klohn – Partner of the firm Stewart McKelvey

Nancy Matis - Wallace McCain Institute at UNB

Gerry Pond – Mariner Partners

Kim Sharpe – Plazacorp Retail Properties Inc.

Paul Smith – Partner of the firm Stewart McKelvey

Companies, Organizations, and Government Departments

Business New Brunswick

Conseil économique du Nouveau-Brunswick inc.

First Angel Network

New Brunswick Innovation Foundation

New Brunswick Securities Commission

propel ICT

Appendix D

Letter from the University of New Brunswick

UNIVERSITY OF NEW BRUNSWICK	PO Box 4400 FREDERICTON, NB CANADA E3B 5A3	TEL 506 453-5189 FAX 506 453-3522 WWW.UNB.CA/RESEARCH	OFFICE OF THE PROVOST & VICE-PRESIDENT (RESEARCH)
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June 30, 2010

Andrew Nicholson
Director, Education and Market Development
New Brunswick Securities Commission
85 rue Charlotte St, Suite / Bureau 300
Saint John, NB E2L 2J2

RECEIVED / REQU

JUL 19 2010

NBSC / CVMNS

Dear Andrew,

The University of New Brunswick (UNB) is pleased to offer encouragement for the development of a Sidecar fund. The effort reflects an important opportunity for the Province's economic growth, and represents an excellent opportunity for UNB to support industry and academia alike in new venture creation and technology development.

UNB is comprised of over 11,000 undergraduate and graduate students, 2,000 faculty and staff, and more than 63,000 alumni. We have an excellent reputation for research and commercialization, as well as international recognition for many of the technologies developed here. Annual research income has risen from \$22 M in 1999-2000 to over \$57 M in 2009-10. Since the start up of the intellectual property and technology transfer program in 1999, UNB has had 156 invention disclosures; filed 123 patents (for 37 technologies); completed 53 tech transfer deals; and realized over \$1,260,677 in licensing and patent revenues. As well, since 2000, over \$60 M in venture capital investments have been made in companies that have commercialized technology from UNB. AUTM, the Association of University Technology Managers, has recognized 3 technologies from UNB to date in their Better World program.

We understand the fund will provide matching dollars for certain approved venture investments through applicable programs offered by the NBIF and the First Angel Network. We are also aware that Propel is the most likely group to provide the management of this fund.

As an academic institution, UNB can access programs that support commercialization and research initiatives. Depending on the funding program and timing by industry, UNB's benefits can extend to match cash investments, up to 50% of project-related expenses, from institutionally directed programs including NSERC, NBIF as examples. Current technology advancements, as well as the entrepreneurial culture that is growing at UNB and in NB overall, represent an excellent basis for demonstrating the need for such funding methods as a Sidecar fund.

As demonstrated in this letter, UNB is uniquely positioned to support the activity presented in this project. We look forward to seeing this fund established.

Sincerely,

A handwritten signature in black ink that reads "G S Kealey".

Gregory S. Kealey, PhD, FRSC, FRHistS
Provost and Vice President (Research)
University of New Brunswick

Cc: C. Mathis, UNB