

Financing Rural Ventures: Fostering Angel Investments

Dr. Thomas Hellmann

Sauder School of Business
University of British Columbia

Dr. Veikko Thiele

Queen's School of Business
Queen's University

Entrepreneurship in Canada

- Entrepreneurship important for job creation and econ. growth
- Only **50%** of startups survive first 5 years (Fisher et al., 2010)
- **Main reasons:**
 1. Insufficient market potential for product
 2. Lack of sufficient capital
 3. Lack of management expertise
- Two common forms of **external financing:**
 - **Debt** (e.g. bank loans) – addresses #2
 - **Equity** (e.g. venture capital) – addresses #2 and #3
- Equity financing common for high growth/high risk startups
 - **Focus of research study**

Venture Capital vs. Angel Financing

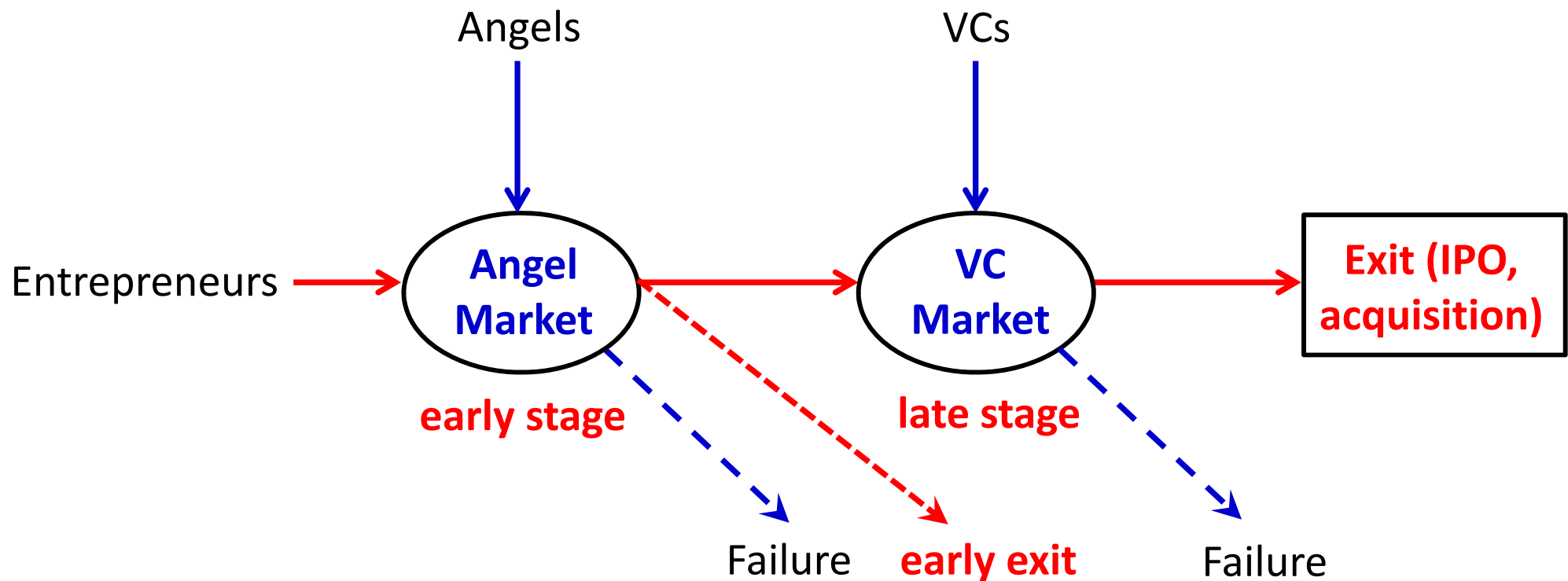
➤ **Venture capital (VC) firms:**

- Raise funds from private and institutional investors
- Invest in startups in exchange for equity stakes
- Typical investment size: **\$3 – \$5 million** (OECD, 2011)
- Startups must be sufficiently mature for VC investments
- Gap closed by **angel investors:**
 - Invest their own money in exchange for equity stakes
 - Typical investment size: **\$25,000 – \$500,000** (OECD, 2011)

➤ *How important are angel investors in Canada?*

- Est. size of angel market (2009): **\$388 million** (OECD, 2011)
- Size of VC market (2009): \$393 million

Venture Capital vs. Angel Financing

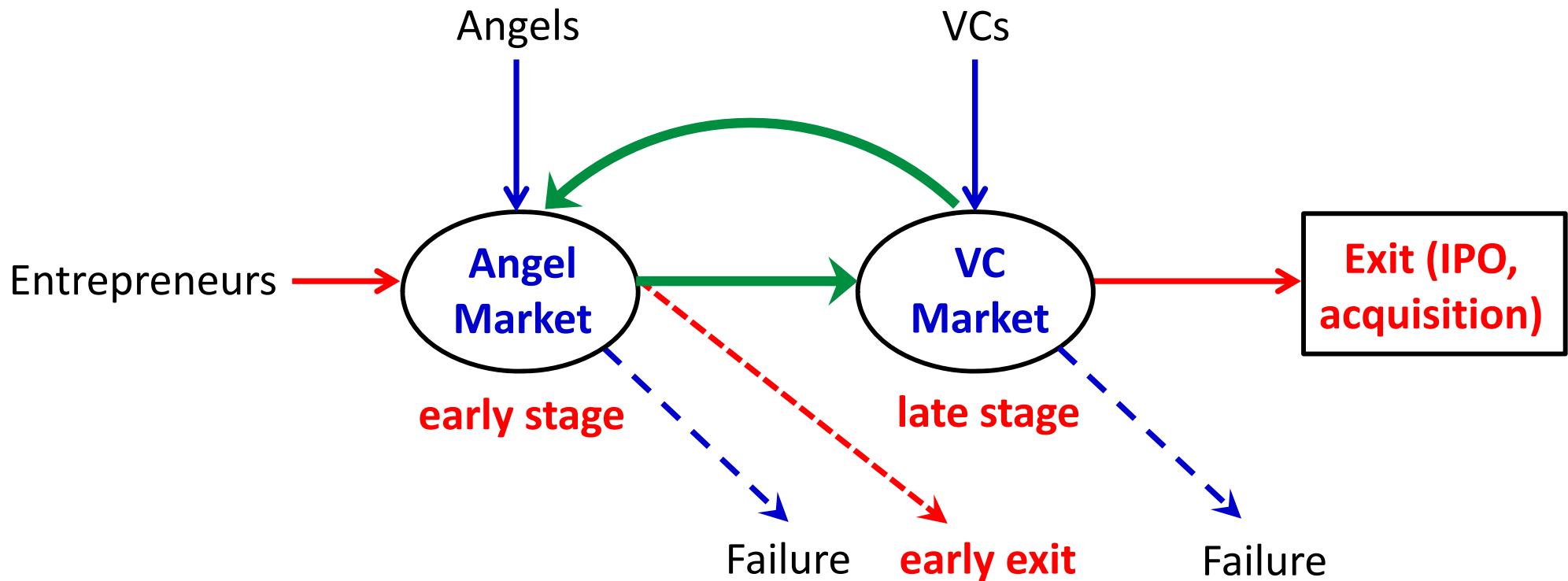


- Angel market “feeds” VC market
- Pre-screening of projects → angels face more investment risk

Angel Financing – Challenges

- Angel market is critical pre-market for VC investors
 - **Highly intransparent** → *Who are the angels?*
 - Network externalities → clustered angel market
 - Particular challenge for entrepreneurs in rural communities
- **Main challenges for angel investors:**
 - Limited wealth → **rely on follow-up investments**
 - Late stage investors (VCs) have bargaining power
 - Contractual incompleteness: dilution of equity stake in late stage financing rounds
 - **Holdup**
- Angels often reluctant to make investments
 - **Forgone opportunities**

Venture Capital vs. Angel Financing



➤ **Focus of study:** What encourages more angel investments?
How does it affect the **survival rate of startups**?

- Transparency of angel market (search frictions)
- Holdup in late stage market
- Subsidies?

Main Insights

- More (early stage) angel investments when
 - Angel market more **transparent** (less search frictions)
 - VC market more **transparent**
 - Easier to receive critical follow-up investments
 - Better **contractual protection** of angel investors
 - Mitigates potential dilution of equity stake (holdup)
 - Improves expected returns → encourages more investments
- Implications for entrepreneurs:
 - More entrepreneurs receive early stage financing
 - Improves overall **survival rate** of startups
 - **Reason:** more likely to receive external financing before idea/product outdated

Main Insights

- **Related question:** Who should receive **subsidies**?
 - Angel investors or VC firms?
- **Main objectives:**
 - Increase **number of startups** receiving external financing
 - Improve **survival rate** of startups
- **Key insight:** **Angel subsidies** more effective when angel market much less transparent than VC market
 - Likely the case
 - Angel market is 'bottleneck'
- **Implications...**



Rural Innovation Strategy In Eastern Ontario

*High Growth Potential Equity Investment
“building a business ecosystem”*

Canada's Innovation Problems

➤ **Canadian Innovation model is dysfunctional**

- The best Canadian innovators are leaving for Silicon Valley
- Low number of active Angels in Canada
- Limited Angel investor roles (Select, Finance, Flip)
- Seed funding gap between \$100K - \$1M
- Over-reliance on urban areas for current networks and entrepreneurs

➤ **Lack of Interaction between government, business, education, and entrepreneurs**

- Canadian innovation is not being commercialized
- Young educated entrepreneurs are forced to work for large corporations
- Educators can not launch their innovation, never mind 3rd party innovation
- Canadian Incubators run by educators/bureaucrats are not focused on success

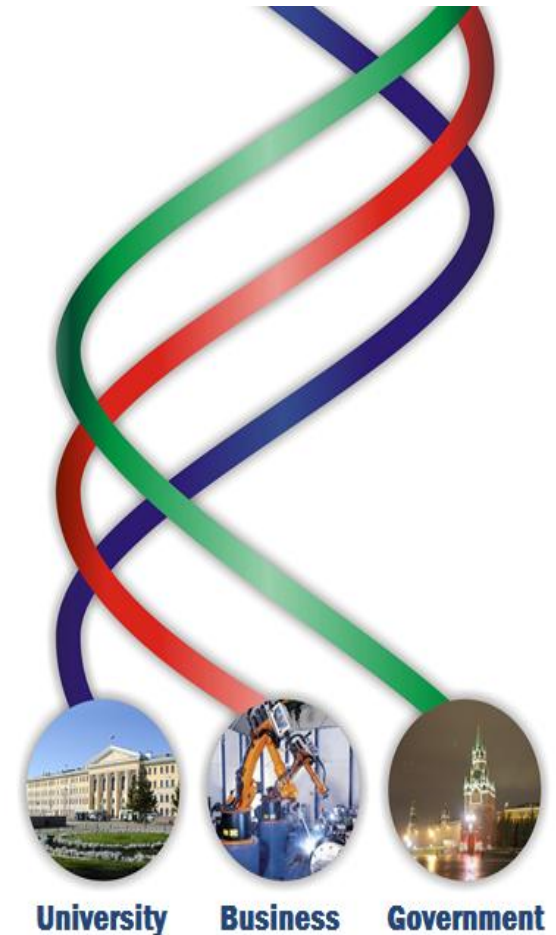
Exacerbated in Rural Canada

- Issues are magnified in rural Canada
- Rural economies lack diversity and are dominated by declining business sectors
 - Main street retail is irreversibly moving to the cloud
 - Jobs in rural Canada are low skilled, low paid, and declining
- Science, Technology, Engineering & Mathematics (STEM) grads are abandoning Canada
- Canada is lacking an early stage entrepreneur/technology ecosystem
- No comprehensive government solution for technology innovation in Canada

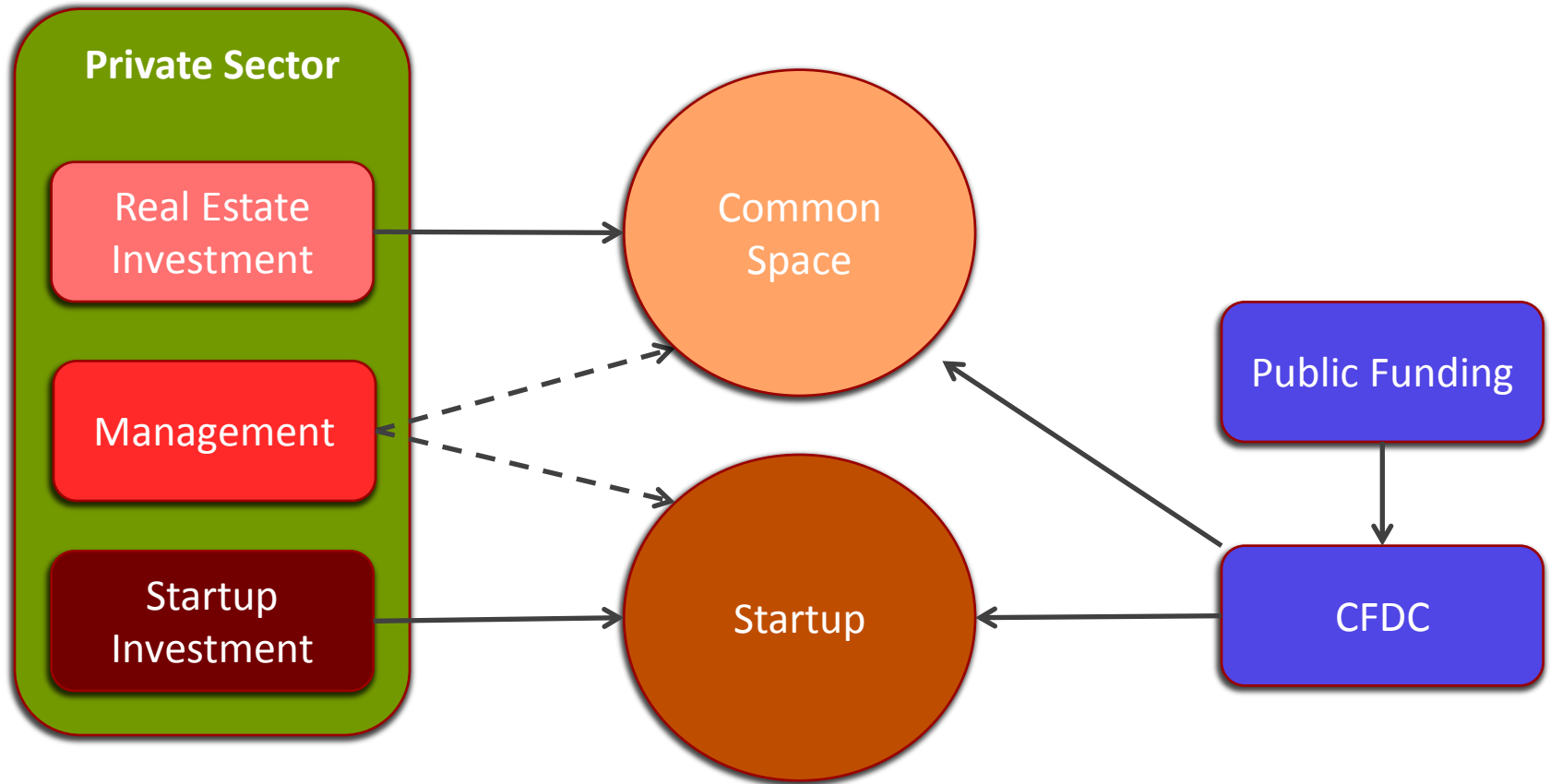
First Stone Eco-Business Model

First Stone Ventures in association with **PELA CFDC** builds small firms in Eastern Ontario through our partnerships with Private Investors, Government and Educational Institutions:

- **FIND** technology inventors and business ideas
- **PROVIDE** seed capital to small promising businesses
- **STRUCTURE** companies for dividends, accountability and good governance
- **ENABLE** interaction with a common facility
- **LEVERAGE** experience, knowledge, contacts and failures to mentor entrepreneurs into business leaders
- **PRODUCTIZE** and **COMMERCIALIZE** businesses into dividend-focused community enterprises



Structure Overview



Funding

Governance

Outcomes

- **Creation** of entrepreneurial **Ecosystem** for all Canadians
- **Diversification** of local rural **Economies** into technology sector
- **Creation** of high value **Jobs** in Canada
- **Capitalize** on market opportunities in the **Virtualization** of businesses
- **Initiate** a mechanism for public-private **Partnership** in the commercialization of innovation
- **Connect** urban and rural economies/communities

Track Record

The screenshot shows the Financial Post website. At the top, the 'FINANCIAL POST' logo is visible. Below it, there are navigation links for Home, News, Opinion, Markets, Investing, Personal Finance, Tech Desk, Legal Post, Executive, and Entrepreneur. A 'WHAT'S HOT' section lists various news items. A market data section shows indices like CAD (USD), S&P 500, and NASDAQ. The main content area features the 'FP ENTREPRENEUR' logo and a headline: 'Doing the tuango: Group buying comes to groceries'. Below the headline is a photo of two men in a grocery store. To the right, there is a search bar and a 'CFIB NEWS' section with a link to 'Small-business confidence improves: CFIB'.

- ➔ **FoodScrooge-grocery group buying: \$150k investment, recent graduate from Queen's University. \$7M revenue, sold for \$1.5M.**
- ➔ **DealerPlus-cloud-based productivity tool for auto sector: Grown from 2 to 12 employees, \$1.25M revenue, entering US market in 2013. Business valuation in the millions.**
- ➔ **3 others on the path to providing a dividend**
- ➔ **9 Initial investments in 2011-12**

First Stone /PELA Success

- Created an eco-business centre in Eastern Ontario, which supported 9 new ventures
- Brought several new businesses to market, creating year round high paying technology jobs in Eastern Ontario
- Graduated 3 millionaire tax paying entrepreneurs and created over \$10 million in net worth in 18 months
- Created a public-private co-investment vehicle PELA-CFDC/First Stone
- Developed partnerships between post secondary education, government and private sector
- Finalizing \$5 million 2nd round investment for 10-15 new ventures in the next 18 months

Summary

The First Stone Ventures builds business ecosystems for rural Canada

- First Stone/PELA CFDC will continue to develop Eastern Ontario ECO-System for Innovation and entrepreneurs
- Invest in emerging technology firms that operate in Eastern Ontario
- Invest in 10-15 ventures over an 18 month period, creating an estimated 100+ new technology based jobs.