Canada's Venture Capital Landscape

May 2023

Table of contents

Message from the Executive Vice President 3
Executive summary 5
Canadian VC through the lens of economic downturns 6
The state of Canadian VC 9
- After substantial expansion, returns are under pressure 9
- Rich unicorn history; subdued exit environment in the near term 12
- Canada mirrors global trends 15
- Seed stage showed resiliency and cleantech gained steam 16

Portfolio resilience 21
- Cash crunch anticipated 21
- Marked increase in flat rounds 21

Investor ecosystem and capital availability 23
- Increasing foreign investment within the Canadian market 23
- A growing number of GPs in Canada 24
- Canada-based VC investors have an estimated $13B in dry powder 25
- VC participation from Canadian corporates is on the rise 26

A fundamental shift in mindset 27

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Message from the Executive Vice President

Jérôme Nycz
Executive Vice President,
BDC Capital

BDC Capital is pleased to present the 2023 edition of Canada's venture capital landscape report.

We've made some enhancements to provide more detailed performance data, an estimate of available dry powder and an analysis of prominent market trends.

As in previous reports, we've combined internal and external data to provide stakeholders with an examination of the Canadian venture capital (VC) ecosystem and a perspective on how the future may unfold.

In the wake of the Silicon Valley Bank (SVB) failure earlier this year, investor confidence has been notably shaken. In addition, uncertainty stemming from geopolitical risks and unfavourable macro-economic trends is already reverberating throughout the ecosystem. As a result, the growth-at-all-costs mentality is being replaced by a renewed focus on operational efficiency.

"BDC Capital will maintain its resolve to provide for a healthy venture capital ecosystem to ensure high-potential companies are not stymied on their path to becoming Canadian champions."

Businesses, small and large, will continue to come under pressure over the coming months. Management teams will have to weigh the cost and benefit of growth opportunities against the need to preserve capital should the downturn become more severe.

Message from the Executive Vice President

While recent news has been troubling, our industry has progressed significantly over the past decade and a more resilient, diversified and sophisticated ecosystem has emerged. However, we are mindful that entrepreneurs face the challenge of managing cash burn rates and the likelihood of a reduced operational runway. Tightening of credit has come at a time when companies are in greater need of capital. Amidst the headwinds, investor syndicates may be more fragile, but we must stay the course. By remaining steadfast, we can continue to collectively build upon the foundation that is necessary for enabling sustainable growth of the ecosystem over the long term.

As we look ahead to the next phase of venture investing in Canada, resiliency and grit will play a key role in separating sound businesses from the ones unlikely to thrive. Part of this resilience will stem from carefully considering environmental, social and governance (ESG) best practices. It is becoming increasingly clear to all market participants that unmanaged ESG risk could lead to financial and reputational costs.

Pressure from consumers, investors, supply chains and governments are building on businesses worldwide to improve their ESG practices. We believe that by integrating ESG into their DNA, Canadian companies will gain a significant competitive advantage—helping them identify and mitigate risks, prepare for the future, and attract both clients and capital over time.

While 2022 has confirmed a softening of our industry, BDC Capital will maintain its resolve to provide for a healthy venture capital ecosystem to ensure high potential companies are not stymied on their path to becoming Canadian champions. As an experienced organization that has invested in prior cycles, we will be there for entrepreneurs nationwide through the ups and downs of the market.

We hope you will find this report informative.

Jérôme Nycz
Executive Vice President, BDC Capital

Executive summary

Market participants entered 2022 with the sense that it would be an uneasy, unpredictable year. 2021 had been a banner year from a VC activity standpoint, breaking records across many important metrics. Many were hopeful that some of this momentum could be maintained. Yet, anxiety manifested itself following a steep climb in interest rates, which was followed by sustained public market turbulence.

Another legacy of 2021 was the large injection of capital. This was an indirect boon from the response to the COVID-19 pandemic and a result of non-traditional investors entering the VC asset class seeking higher returns in a low-interest rate environment. We believe 2021 was an outlier. Whereas 2022 reflects a return to pre-pandemic levels and, in fact, a reset. While challenging for the industry, this should lead to the continued sustainable growth of our ecosystem, restoring balance to discussions between investors and entrepreneurs.

After a period of substantial growth, we expect unrealized returns will continue to be under pressure. Investment activity is also expected to slow. While Canadian-based VC investors hold an estimated $13.2 billion in dry powder, this will be deployed more slowly, and not all of this capital will be put to work in Canada. Fortunately, the renewed Venture Capital Catalyst Initiative (VCCI) is expected to accelerate approximately $2.2 billion in new capital into the Canadian VC ecosystem.[1] Participants such as corporate venture capitalists and foreign investors will undoubtedly continue contributing to the pool of available dollars. Even accounting for this, however, we still expect total capital deployment in 2023 to fall below 2022 levels.

2022 reflects a return to pre-pandemic levels and, in fact, a reset.

Refocusing on profitability

A slowdown in capital deployment will pressure general partners (GPs) and entrepreneurs to be more thoughtful. Increasing focus will be placed on identifying and supporting sustainable business models (from both a financial and environmental perspective) capable of scaling and generating future returns and profitability through multiple market cycles. Even so, investors will seek additional downside protection through a lower valuation entry point or investor-friendly terms. Within our own portfolio, up rounds starkly declined while flat equity rounds increased from 14% in 2022 to 49% in 2023.[2]

As of early 2023, several of our portfolio companies have less than 12 months of runway. We anticipate that companies in our portfolio and across the ecosystem will put a premium on cash conservation in the coming months. Founders will need to continue thinking carefully and continually assess their capital efficiency. Given the environment, founders and investors need to be disciplined and understand that the era of growth at all costs is over.

It is time to refocus on profitability.

The renewed VCCI is expected to accelerate approximately

$2.2 billion

in new capital into the Canadian VC ecosystem

[1] Expected amounts based on historical averages of previous fund of fund programs.
[2] Fiscal years - 2022: April ’21 – March ’22; 2023: April ’22 – March ’23

Canadian VC through the lens of economic downturns

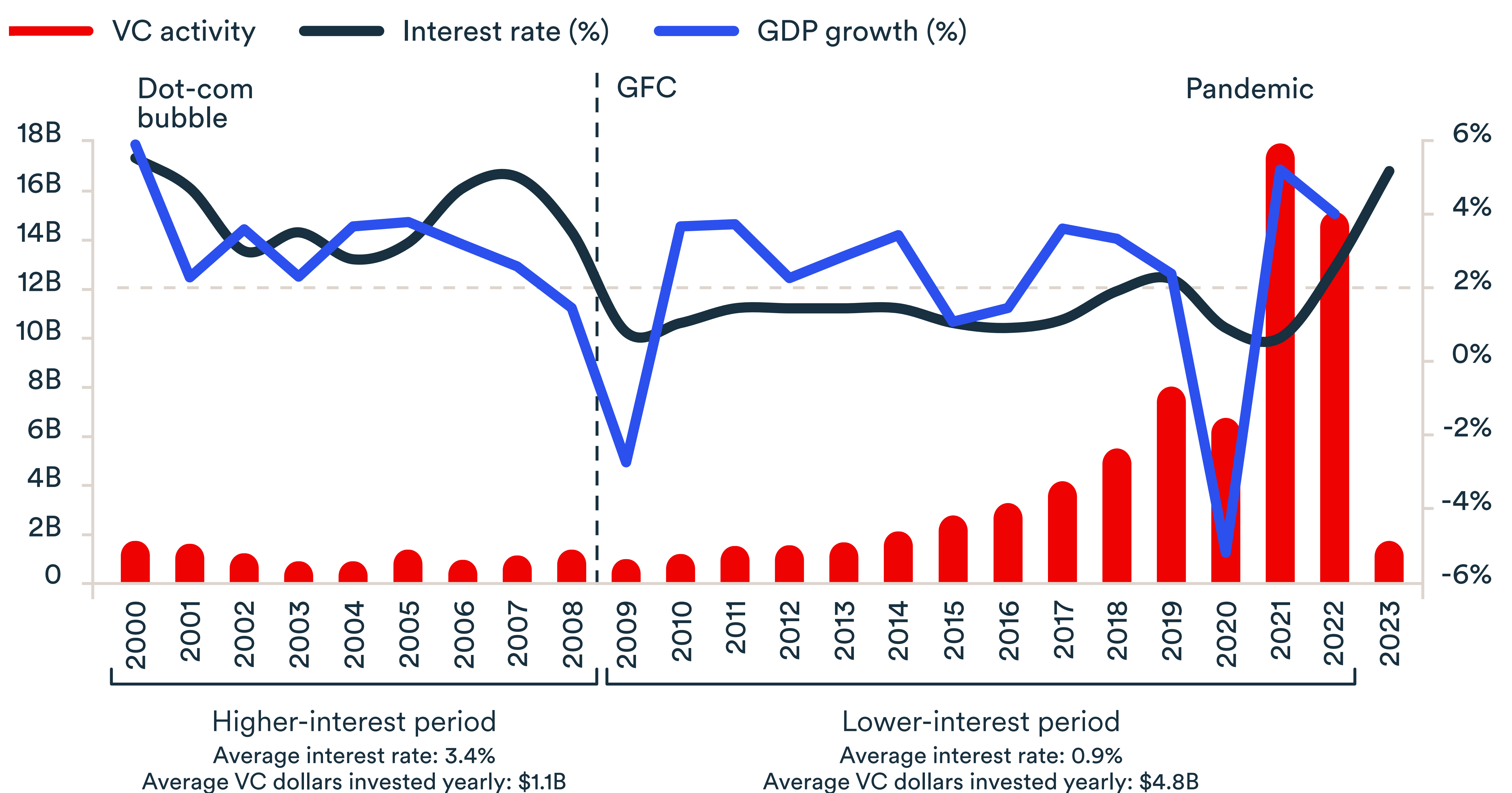
Canada has been in an extended bull market in which the VC industry has been bustling. 10-year returns have risen significantly, crossing into the mid-teen territory.

The growth and vitality of our VC market is partially explained by the Government of Canada's incentive programs for the industry. These include the Venture Capital Action Plan (VCAP) and the first iteration of the Venture Capital Catalyst Initiative (VCCI). Both initiatives were market-oriented approaches to developing the industry and demonstrating returns. The VCCI program, for example, successfully attracted $1.2 billion in capital from private investors, attracting 2.5 dollars of private investment for every government dollar. As a result, the Canadian market has attracted significant private capital—improving funding availability to innovative Canadian firms.

Some of the performance can also be explained by an extended period of low interest rates in which cheap capital flowed into public and private markets seeking higher returns. In 2022, the industry was impacted by the tightening of monetary policy to control inflation. Many entrepreneurs and fund managers will be operating in a downturn for the first time in this new cycle. Looking at historical data can help us draw inferences about the outlook for Canadian VC.

In seeking to understand how our ecosystem might respond to the current environment, we looked at VC activity following past economic downturns, specifically after 2000 (dot-com era) and after 2008 (the Great Financial Crisis or GFC). We noted that after the dot-com bust, VC activity slumped from 2000 to 2004, at which point it had declined 51% from the 2000 high, recovering slightly in 2005. In contrast, after the GFC, VC activity declined by only 30% and reached its floor in 2009. It recovered quickly afterward. By 2011, VC activity had surpassed the levels achieved in 2008, when interest rates had hit historic lows of 0.25%.

Figure 1: Downturns and Canadian VC activity



Sources: Pitchbook, World Bank, BDC analysis, WOWA
*Yearly interest rates reflect average of all opening monthly rates.
**2023 VC activity data as of March 15th, 2023.

During the pandemic, the Bank of Canada again eased interest rates to 0.25% to support the economy.

The record low 0.25% interest rates persisted for 24 months[3] while this low rate only lasted for 13 months post-GFC.[4] The longer period of record low interest rates accelerated investments across private asset classes without much regard for an eventual reversal in the interest rate cycle. VC valuations rose as more capital flowed in, culminating in the highs experienced in 2021.

The shift to monetary tightening in 2022 led to a higher cost of capital, similar to the dot-com era. In this higher-interest rate environment, prior valuations were no longer sustainable which led to the recent correction.

Interest rates during the pandemic

Record low

0.25%

persisted for 24 months compared to 13 months post-GFC.

A unique period for Canadian VC

Between 2008 and 2022, we operated in a lower interest rate environment during which rates never rose above 2%. And unlike during the dot-com era, in which higher interest rates were sustained for an extended period, BDC expects that the Bank of Canada will keep the elevated interest rate status quo until late this year, with a possible first rate cut to come in December 2023 or early 2024. As a result, we believe that beyond 2023, VC activity will return to sustainable levels of growth with corrected and defensible valuations.

Furthermore, there is greater confidence in the Canadian VC ecosystem's ability to return to more normal activity levels. The Canadian VC ecosystem is better established than it was in prior periods of economic volatility. Throughout this report, we will demonstrate the progress the Canadian VC industry has made over the last decade. We have seen an upward trend in VC as a percentage of GDP. Performance within the industry has also improved. We have more GPs and they are better established. This demonstrates the confidence and trust that LPs have in the ability of Canadian fund managers to deliver expected returns. As a result, capital will remain available for the Canadian ecosystem. Without the excess dollars that put a premium on growth over profitability, investors will focus on putting their more limited capital to work in fewer but more promising start-ups.

[3] March 2020 to March 2022
[4] April 2009 to May 2010

Resilient entrepreneurs and investors are underpinning the industry

We believe sound fundamentals are underpinning Canadian entrepreneurship, notwithstanding the recent declines in valuations and activity levels. Resilient entrepreneurs and investors will navigate the current trials and come out better for it in the long term. In the interim, prudent capital management is expected to keep valuations and VC activity in check.

The Canadian market is sound and resilient because it continues to benefit from:

- A world-class university and acceleration ecosystem
- A strong pool of technology talent underpinned by an open and welcoming immigration policy
- Access to generous non-dilutive government funding for Canadian start-ups at their earliest stages

The best fund managers understand that continuing to invest across investment cycles remains essential. Trying to time the market can lead to missed opportunities and/or haphazard returns. GPs know that while exit valuations have come down and investment horizons have lengthened, they will return to more normal levels after the market recovers in 12 to 24 months.

While the shifting economic backdrop may be unsettling, many fund managers would do well to remember that some of the most significant companies of our time were founded in downturns.

As in prior economic slumps, larger businesses reduce headcount and employees go on to create impactful businesses. These future entrepreneurs often see a critical opportunity or gap, having understood their customers' needs, and start a new company. One need only consult a list of today's largest NASDAQ companies to realize that businesses are often founded during times of economic adversity.

The state of Canadian VC

After substantial expansion, returns are under pressure

It was a challenging year for VC. 1-year global VC returns, for instance, are well below the 3-, 5- and 10-year averages. GPs gave up some of the total value paid in (TVPI)[5] earned in 2021.

Numerous start-ups that raised capital at 2021 valuations have since experienced down and flat rounds, normalizing their valuations to current market levels. Fund managers that invested dollars during the market's peak may struggle to generate returns, whereas funds raised in the current declining environment may outperform.

Figure 2: Global VC returns compared to other asset classes

Source: Pitchbook
*Yearly horizons are as of September 30, 2022.

While VC returns suffered on a short-term basis, it remains one of the more vital private asset classes over the long term—it was the most robust on a 10-year basis.

Based on BDC's portfolio of 58 Canadian-based GPs, Canada's 10-year VC return in 2022 was 14.9%—a marginal increase over 2021. The U.S. 10-year VC return in 2022 was 19.5%, a slight decrease from the prior year. The movements in different directions can be partly explained by Canada having a steeper curve to climb to catch up to U.S. returns.

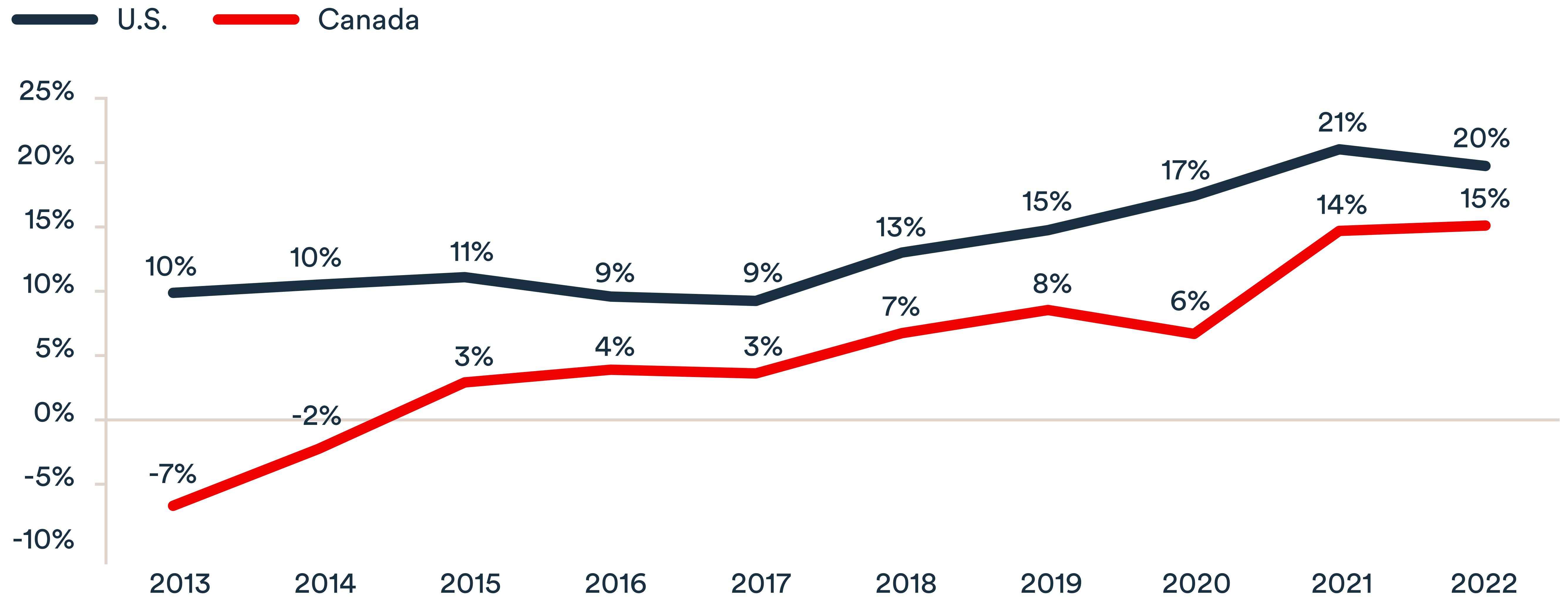
A decade ago, Canada's returns were -7% while the U.S. hovered around 10%. There is also a timing impact in 2022 due to BDC returns being based on September 30, 2022 financial statements, while Cambridge used December 31, 2022 data.

[5] TVPI includes the initial capital investment made by LPs plus the total value of all distributions to date. DPI is the ratio of money distributed to LPs relative to contributions. See the ILPA website for more details: https://ilpa.org/private-equity-glossary/.

The U.S. data contained the bulk of valuation decreases for the year. Due to our maturing VC industry, we continue to close the gap with U.S. performance, with the smallest spread on record in 2022.

Taking that same cohort of Canadian-based funds within our portfolio as a proxy for the returns generated by the ecosystem, we further categorized the returns across various vintages. Since 2011, we can see that top-quartile funds consistently deliver 15%+ net returns over time.

Figure 3: 10-year VC net returns (IRR) trend in Canada and the U.S.

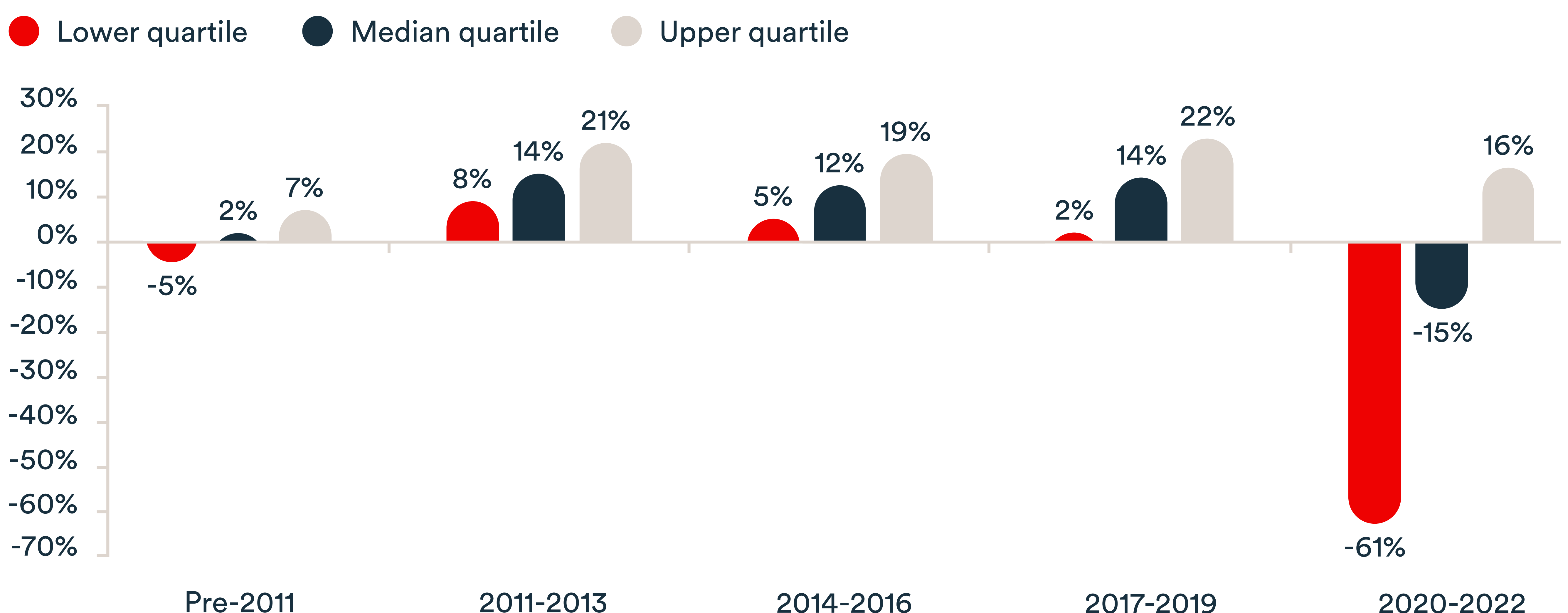


Sources: Cambridge Associates, U.S. VC benchmark data as of December 2022; BDC Capital fund investment data for VC funds headquartered in Canada (excluding any foreign-based funds active in Canada).

Due to our maturing VC industry, we continue to close the gap with U.S. performance, with the smallest spread on record in 2022.

Canadian managers with median performance lag top quartile managers by an average of 8 percentage points within the second most robust vintage (2017-2019), albeit they have been able to provide double-digit net returns across most vintages.

Figure 4: Net IRRs across vintages



Source: BDC Capital fund investment data for VC funds headquartered in Canada.
*Excludes any foreign-based funds active in Canada.
**Returns are net to BDC Capital.

The most recent vintage (2020-2022) represents the most sizable number of funds (34) and the group with the largest pool of capital. While this cohort is deep in the J-curve[6], top-quartile managers have generated some early wins from an IRR perspective, though with a marginal increase in TVPI. Whether this group of funds can maintain its performance into and out of the downturn remains to be seen.

Remaining active during a downturn can provide for some of the best investment opportunities

Interestingly, managers that raised in the 2011-2013 vintage, as the ecosystem emerged from the global financial crisis, delivered the best net returns over the last ten years, with particularly strong TVPI, and distributed to paid-in capital (DPI). This demonstrates that remaining active during a downturn can provide for some of the best investment opportunities.

The robust performance of the 2011-2013 vintage can also be attributed to that cohort of funds completing an entire 10-year cycle benefitting from both a great entry point, at potentially subdued valuations post-GFC, and fortunate exit timing during the most recent period of higher valuations.

Figure 5: TVPI across vintages

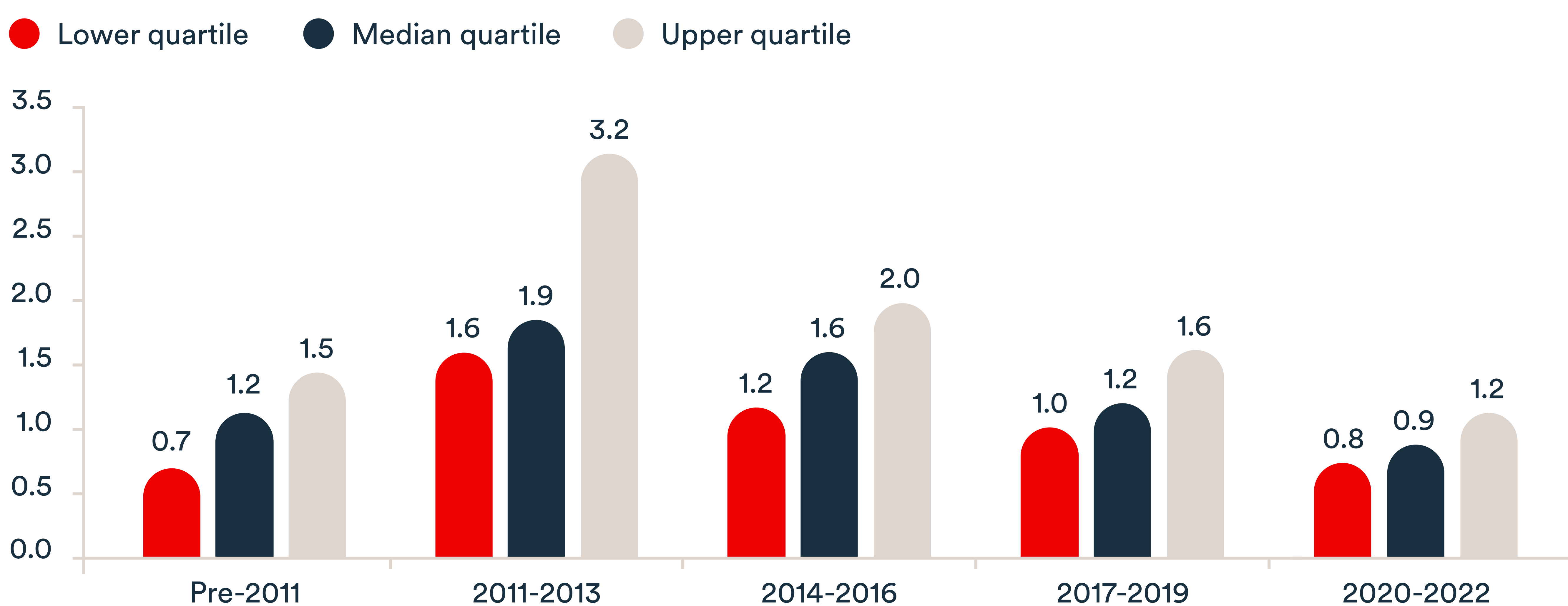
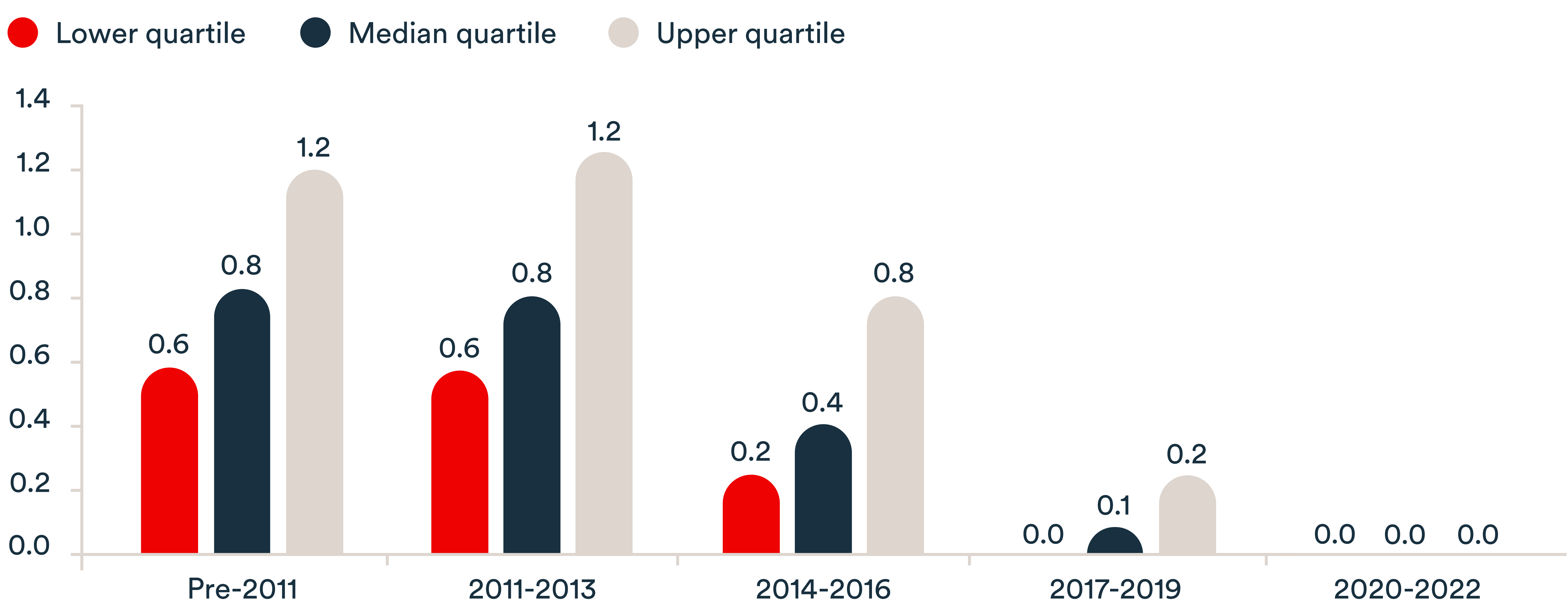


Figure 6: DPI across vintages

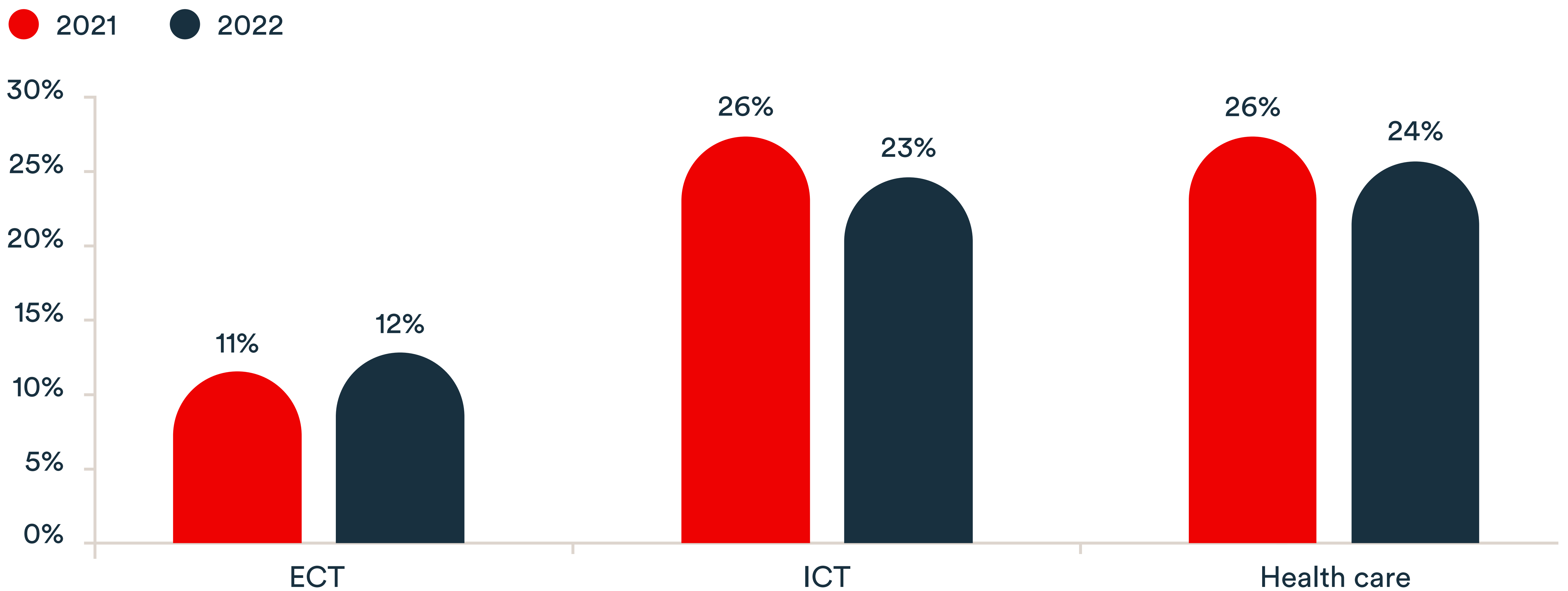


Source: BDC Capital fund investment data for VC funds headquartered in Canada.
*Excludes any foreign-based funds active in Canada.
**Returns are net to BDC Capital.

[6] The J-curve is a visual representation of the typical pattern of returns in venture capital and private equity funds, where losses are incurred in the early years, but successful investments generate significant returns in later years.

Sector-based performance declined within Canada compared to last year and was most evident within the ICT space, where 10-year gross IRRs dropped by 3 percentage points, and health care saw a slight decrease of 2 percentage points. Energy and cleantech (ECT) improved its 10-year gross performance by 1 percentage point.

Figure 7: 10-year gross IRR by sector in Canada



Source: BDC analysis
*Includes all BDC VC direct and Bridge Financing Program companies and available indirect underlying companies (VC indirect, cleantech indirect, VCCI/VCAP).
**Sector returns for 2022 10-year IRR are calculated using the most recent data available as of March 30, 2023 for the period ending December 31, 2022.

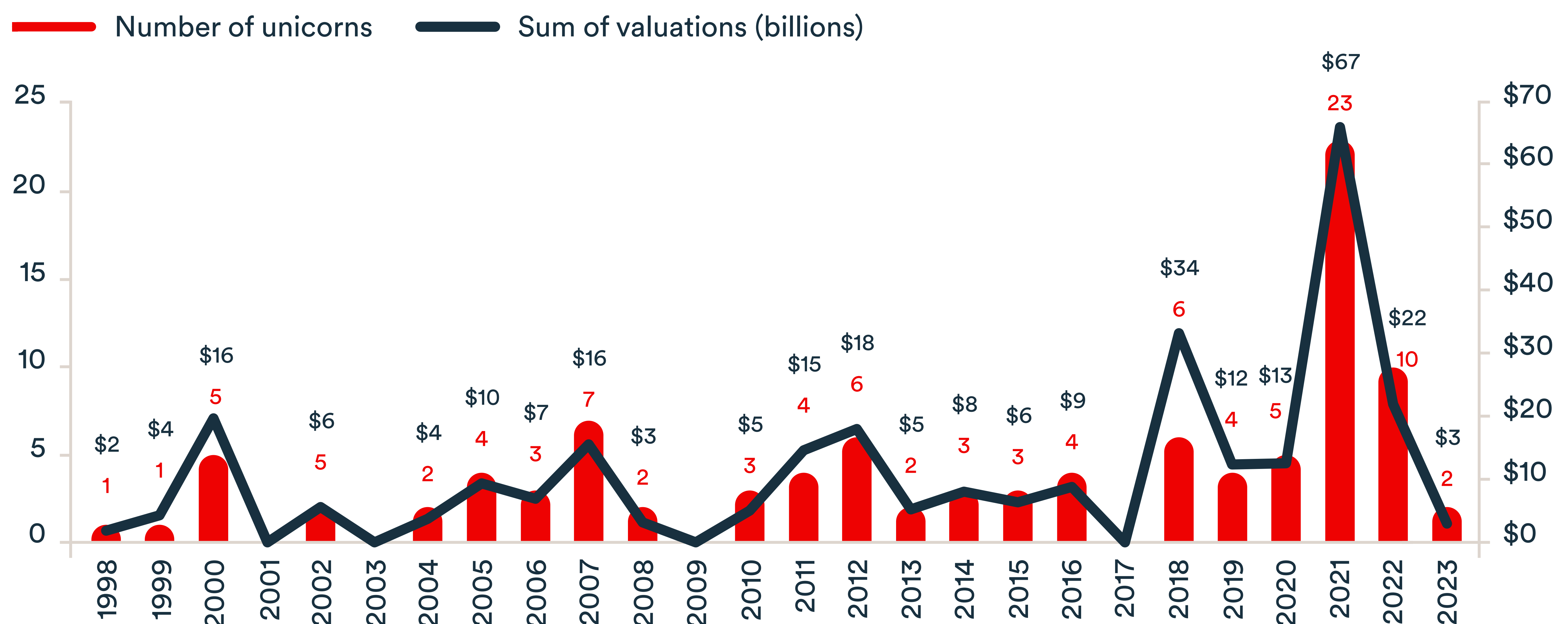
Rich unicorn history; subdued exit environment in the near term

Over the past 25 years, Canada produced 100+ unicorns. The population of unicorns took a median of seven years to reach that status.

2021 was a record year for Canadian unicorns, with 23 VC and private equity-backed companies reaching a $1 billion valuation. These were collectively valued at $67 billion. Despite the slowdown in 2022, 10 companies achieved a $1 billion valuation.

Some of the notable unicorns Canada generated include Shopify, Hopper, Paper, ApplyBoard, 1Password and Wealthsimple.

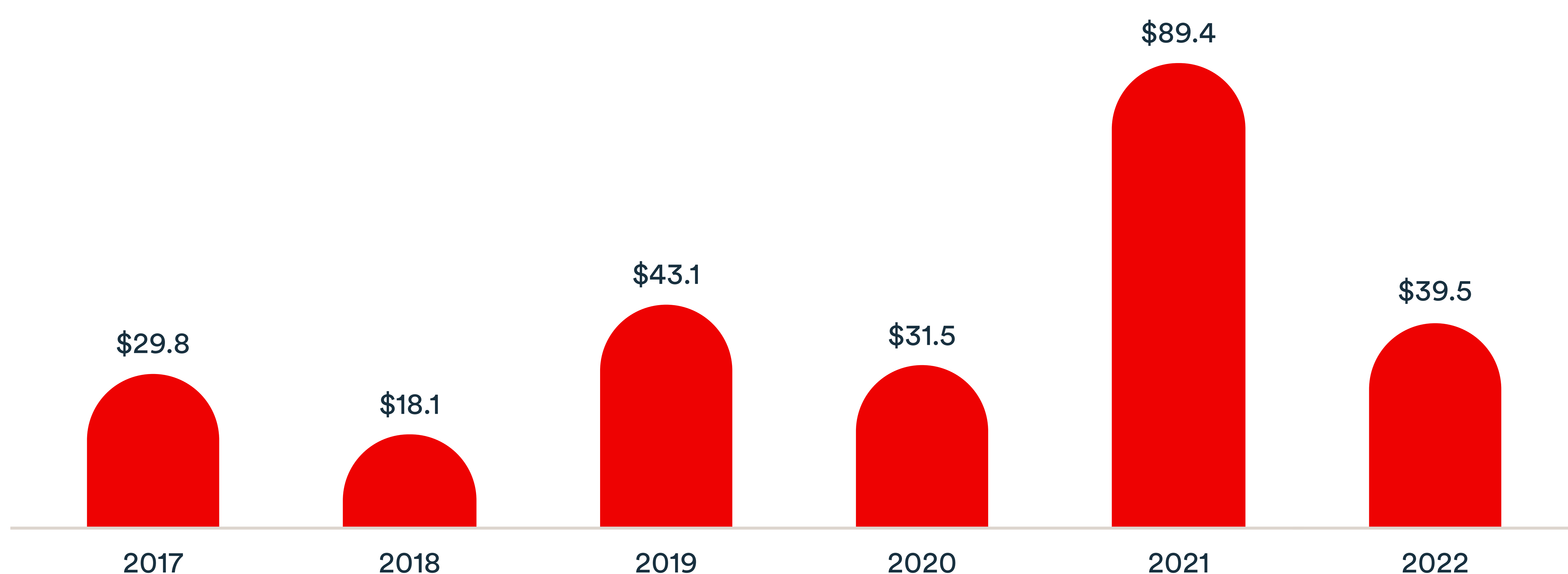
Figure 8: New unicorns in Canada, per year



Sources: Pitchbook, BDC analysis
*Includes Canadian VC- and PE-backed companies that became unicorns for the first time in that year.

However, Canadian exit values took a hit in 2022, mirroring the public market declines and reverting to historical averages. With the increased cost of capital for investors and acquirers, company valuations fell as future cash flows were discounted at higher rates.

Figure 9: Median VC exit values in Canada ($ millions)



Sources: Pitchbook, BDC analysis

Over the year, this valuation reset gradually moved from public to private markets, creating a gap between sellers and buyers in tech mergers and acquisitions (M&A). Buyers were benchmarking public comparables while private market sellers were still expecting 2021-level valuations. As a result, M&A sale processes took much longer to complete. Many sellers decided to postpone deals and wait for better market conditions. The transactions that did take place occurred at markedly lower valuations. The valuation gap has begun to close in 2023 as sellers are coming to terms with the current financing environment.

GPs with dry powder will continue to be selective in their investments. The pressure to complete deals within unrealistically short timeframes has eased off and investors will be able to focus appropriately on due diligence. Anecdotally, at least 50% of companies in Canada and up to 70% in the U.S. will need to raise capital over the next 12 months. This will also continue to close the bid-ask spread.

As many start-ups burn through their cash reserves, M&A may become a more attractive option for those who cannot raise subsequent financing rounds. As valuations decrease further below 2021 levels, many investors anticipate an uptick in corporate M&A in the latter half of 2023. Strategic buyers with solid balance sheets may see this period as an opportunity to acquire start-ups they rely on for technology or other services.

M&A may become a more attractive option for those who cannot raise subsequent financing rounds.

IPOs dried up in 2022; the SPAC boom was short-lived

Many companies successfully seized the opportunity to raise capital at the heights of the public markets and 2021 was a record-setting year for Canadian VC-backed initial public offerings (IPOs). However, subdued public market valuations in 2022 restricted the options of VC-backed companies looking to exit through an IPO.

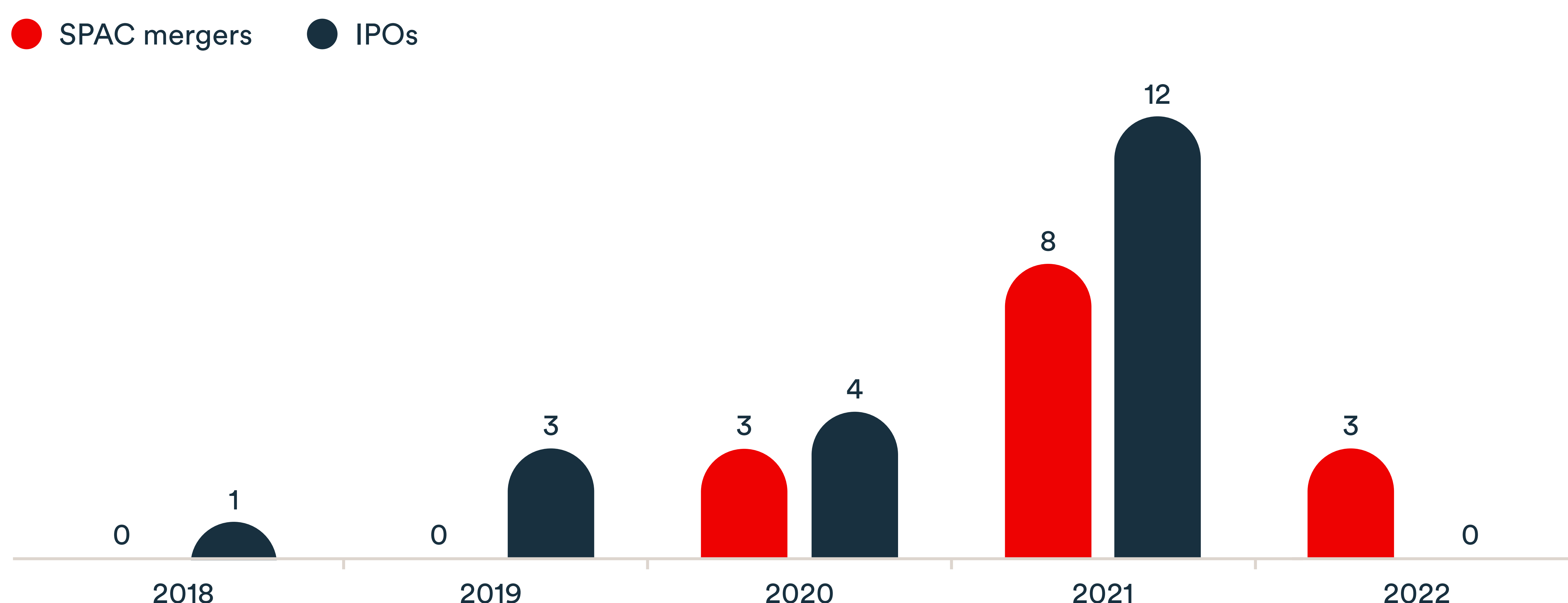
Prevailing factors such as low interest rates and the resulting increased liquidity in the market led to another phenomenon. Starting in 2020, Canadian VC-backed companies started using special purpose acquisition companies (SPACs) as a vehicle to go public. SPACs emerged as an alternative to traditional IPOs, offering a streamlined listing process, the expertise of a seasoned financial sponsor and the ability for companies to use financial projections in their disclosures. SPACs became popular for some Canadian retail investors who could not access private equity or allocations in traditional IPOs, although they quickly fell under criticism for being structured in ways that benefitted sponsors even if they could not source and execute a favourable deal.

While speed was once a primary factor for choosing the SPAC route, negotiations on valuation slowed the process significantly. As the valuation climate evolved throughout 2022, SPACs saw greater redemptions from investors who no longer viewed the deals as favourable, leading to fewer dollars raised or canceled mergers. Additionally, regulators began to clamp down on SPAC disclosure requirements, proposing new rules that would limit the presentation of forward-looking statements without legal liability. These factors suddenly made SPACs less attractive.

Since its peak in early 2021, Canadian SPAC formation has declined by more than 60%.[7] With a decline in exit opportunities, we also saw fewer SPACs successfully close on an acquisition target. By the end of 2022, only 22% of Canadian SPACs raised since 2020 had completed a successful merger.[8] Many SPACs that are still looking for a merger can be expected to dissolve, thus returning capital to shareholders.

The big question is whether SPACs will re-emerge as an alternative to IPOs once the economic environment improves. While the SPAC boom may be behind us, we believe SPACs will likely remain a viable path for some earlier-stage businesses looking to go public. Lower transaction costs, support from a financial sponsor and the ability to tap into a larger community of public investors can make SPACs a better alternative to traditional IPOs or direct listings. However, we believe the most successful SPAC mergers will be those that adopt more favourable deal terms to better align incentives between sponsors, investors and targets.

Figure 10: Canadian VC-backed IPOs and SPAC mergers



Sources: Pitchbook, CVCA, BDC internal data, BDC analysis

[7] Pitchbook, BDC analysis
[8] Pitchbook, BDC analysis

Canada mirrors global trends

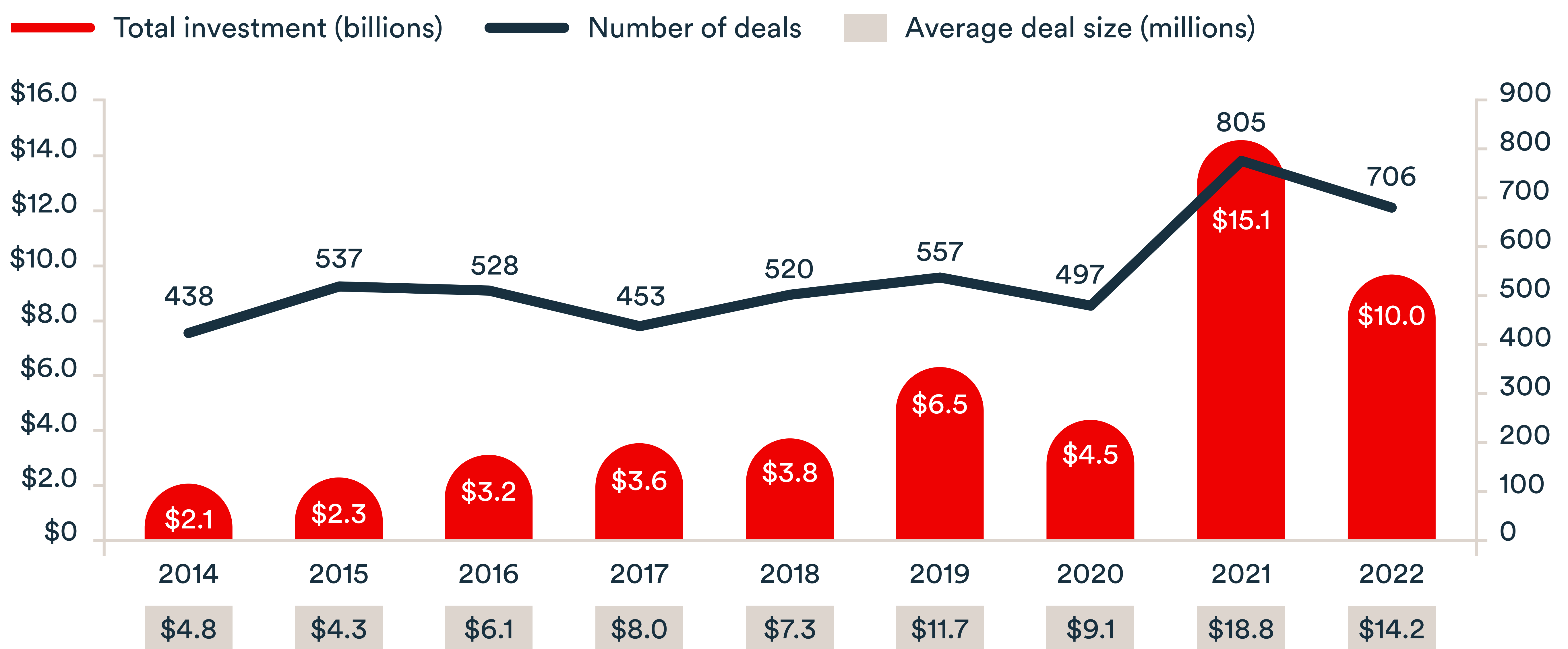
Despite the recent challenges in the VC industry, global venture capital deployment has steadily increased. Dollars invested have grown by a compound annual growth rate (CAGR) of 17% since 2014, with US$445 billion in 2022, representing a factor of 3.4x over 2014 levels. VC investments stabilized from 2018 to 2020 before doubling in 2021 and reaching an all-time high. The shift in market sentiment thereafter resulted in a 35% drop in global venture dollar volume in 2022.

Nevertheless, 2022 remained one of the best years global VC has witnessed in terms of total dollars invested across stages.

Total VC investment dollars in Canada have grown by a CGAR of 22% since 2014, reflecting the same robust growth observed internationally.

Meanwhile, 2021 was characterized by larger deal sizes, a high number of deals and record-levels of dollars invested; worrying signs of sharply higher valuations and an uptick in investment pacing suggest the year was something of an anomaly. A return to more historical norms in VC activity will lead to more sustainable and financially resilient asset class growth over time.

Figure 11: Total VC investment and number of deals in Canada

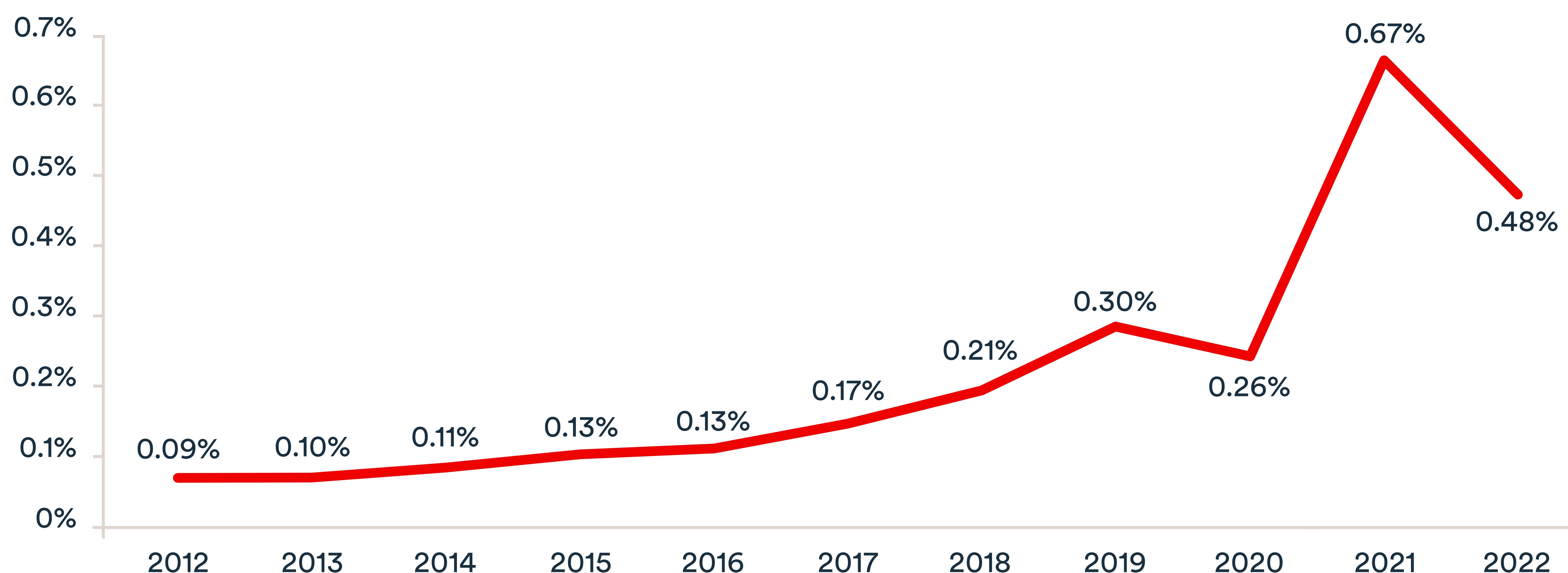


Sources: CVCA, BDC analysis

Total VC investment dollars in Canada have grown by a CAGR of 22% since 2014.

Unsurprisingly, VC investment as a percentage of Canadian GDP decreased from its all-time high of 0.67% in 2021 to 0.48% in 2022. Despite this 28% decrease, the VC investment-to-GDP ratio remains in line with the median for OECD countries.[9] Of the other significant OECD countries, only Switzerland increased its percentage by a marginal amount, whereas others, such as France and Finland, remained relatively unchanged. Moreover, Canada's contraction was less severe than in the United States (down 37%). Other countries, such as Denmark and Ireland, saw their proportions halved.

Figure 12: VC investment in Canada as a percentage of GDP



Sources: OECD, Pitchbook

Seed stage showed resiliency and cleantech gained steam

The pullback in investment over the past year occurred across the VC activity spectrum.

Investment at the growth stage recorded the most significant declines in capital invested and deal count, while seed-stage investment only saw a modest year-over-year decline.

Figure 13: Year-over-year change in 2022 in capital invested and deal count

Stage	Percentage change in capital invested	Percentage change in deal count
Seed	(1%)	(8%)
Early stage	(37%)	(16%)
Late stage	(12%)	(21%)
Growth equity	(73%)	(33%)

Sources: CVCA; BDC analysis

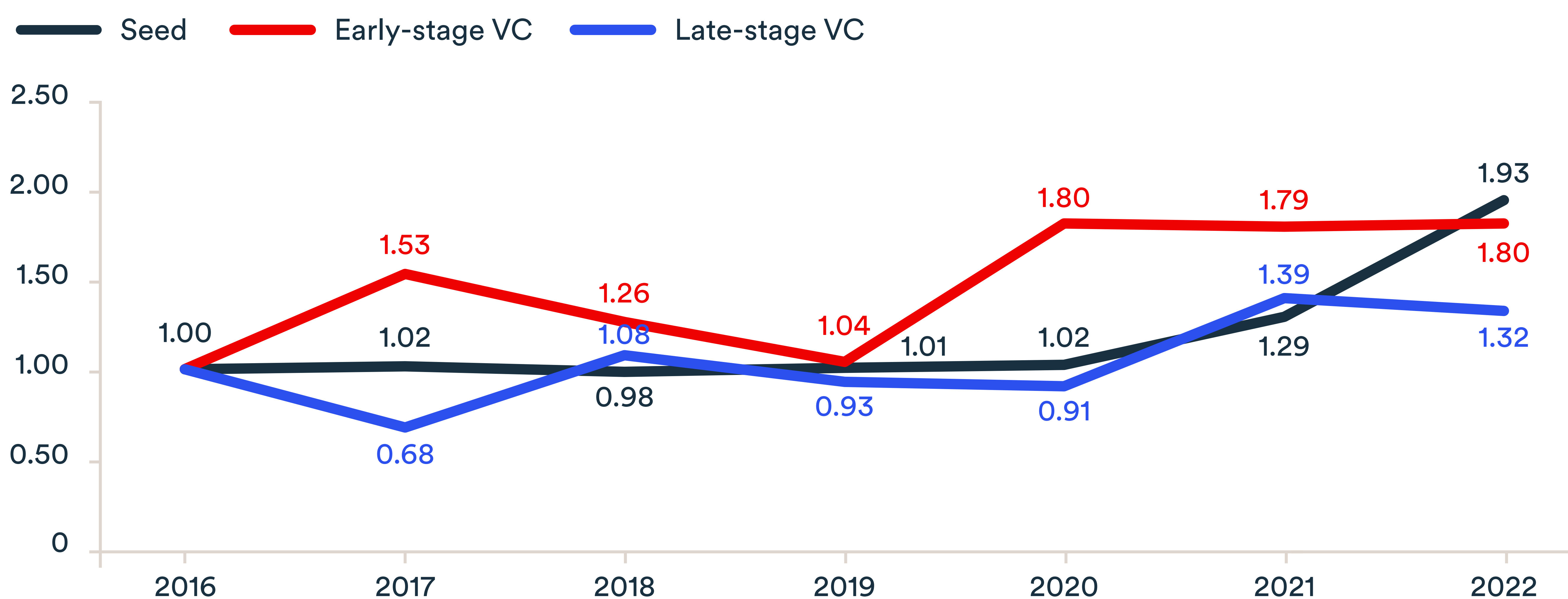
[9] Countries included are ones for which both Pitchbook VC invested data and OECD GDP data was available up to 2022. These 10 countries are: Switzerland, Germany, Denmark, Finland, France, the United Kingdom, Ireland, Sweden, the United States plus China.

Anecdotally, investors reported that while valuations increased significantly across the market between 2020 and 2021, seed-stage investments maintained the most reasonable levels. Hence, investors felt comfortable adhering to 2021 activity levels.

Since 2016, the average deal size for seed-stage deals remained relatively stable, except in 2021 and 2022, when capital reallocation from late-stage deals led to a more considerable uptick in seed-stage deals.

Early-stage deal sizes consistently expanded except in 2019. Late-stage deal sizes were more volatile, with bigger deal sizes in times of exuberance (2021) that tapered off in 2022 when overall VC activity slowed.

Figure 14: Median deal size change across stages - indexed to 2016

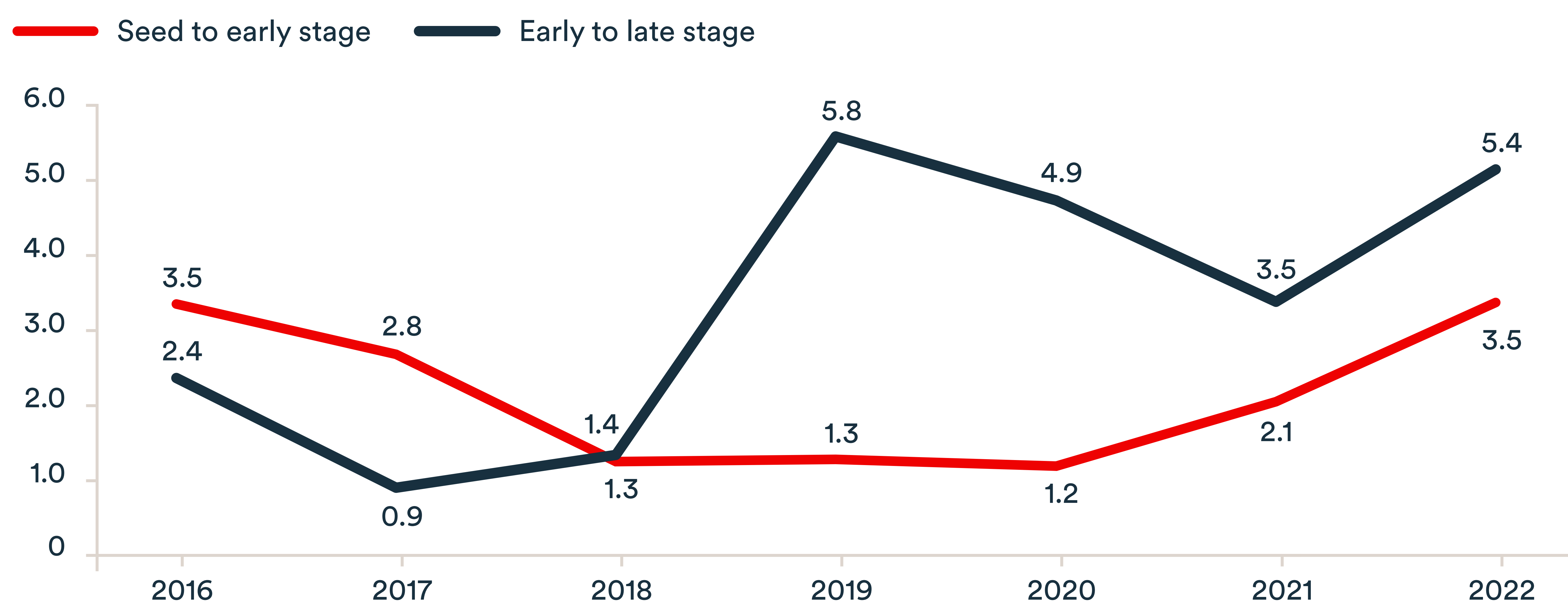


Sources: Pitchbook, BDC analysis

We analyzed the magnitude of the step-up in post-money valuations from seed to early stage and then from early to late stage. We note that in the 2016-2018 period, the step-up in valuations contracted across the stages. The trajectory diverged from 2018 to 2020, where the step-up in valuations from early to late stage expanded substantially, while seed to early stage stayed relatively flat. Post-2020, valuations expanded significantly from seed to early stage. The early to late stage step-up multiple saw a dip in 2021 before rising again in 2022.

Although seed valuations have yet to reset, investors may come to the conclusion that they are overvalued in the coming quarters. This feeds into our earlier observations concerning valuations and an expected reversion to the mean.

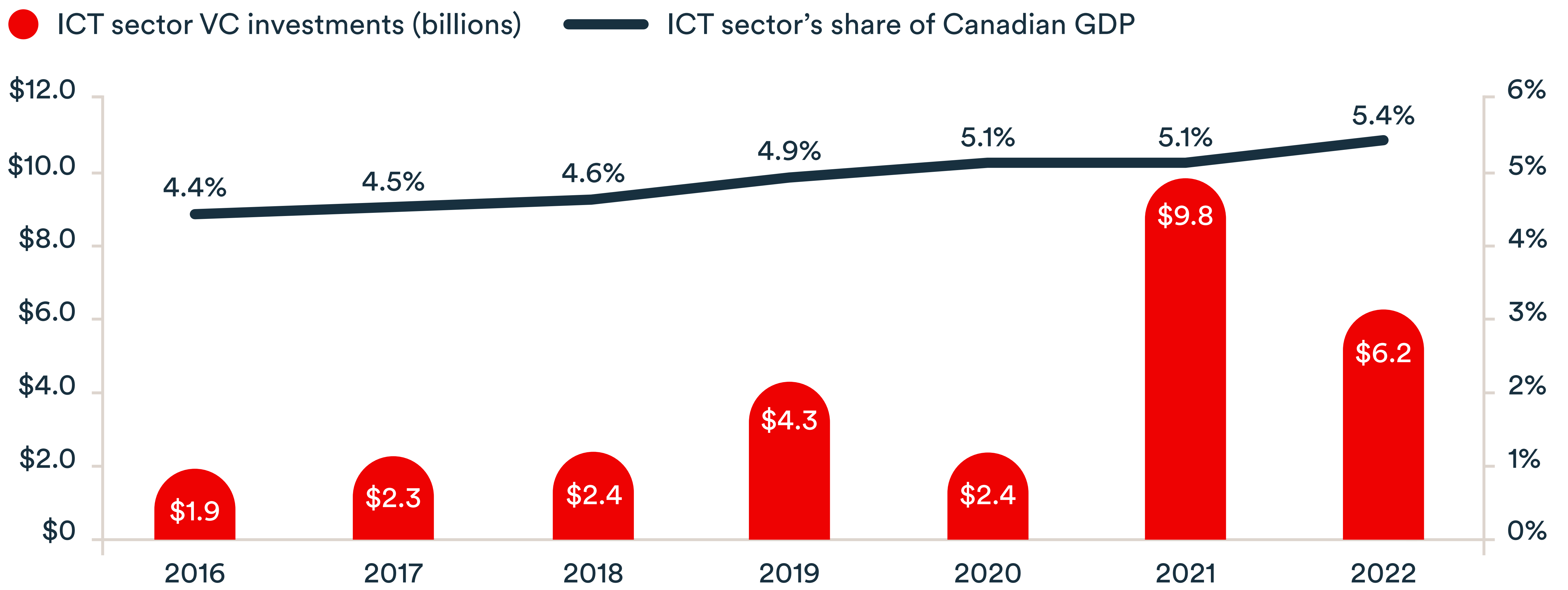
Figure 15: Step-up multiples across stages



Sources: Pitchbook, BDC analysis
*Seed- to early-stage step-up multiple: ratio of post-money median valuation at seed stage to pre-money median valuation at early stage.
**Early- to late-stage step-up multiple ratio of post-money median valuation at early stage to pre-money median valuation at late stage.

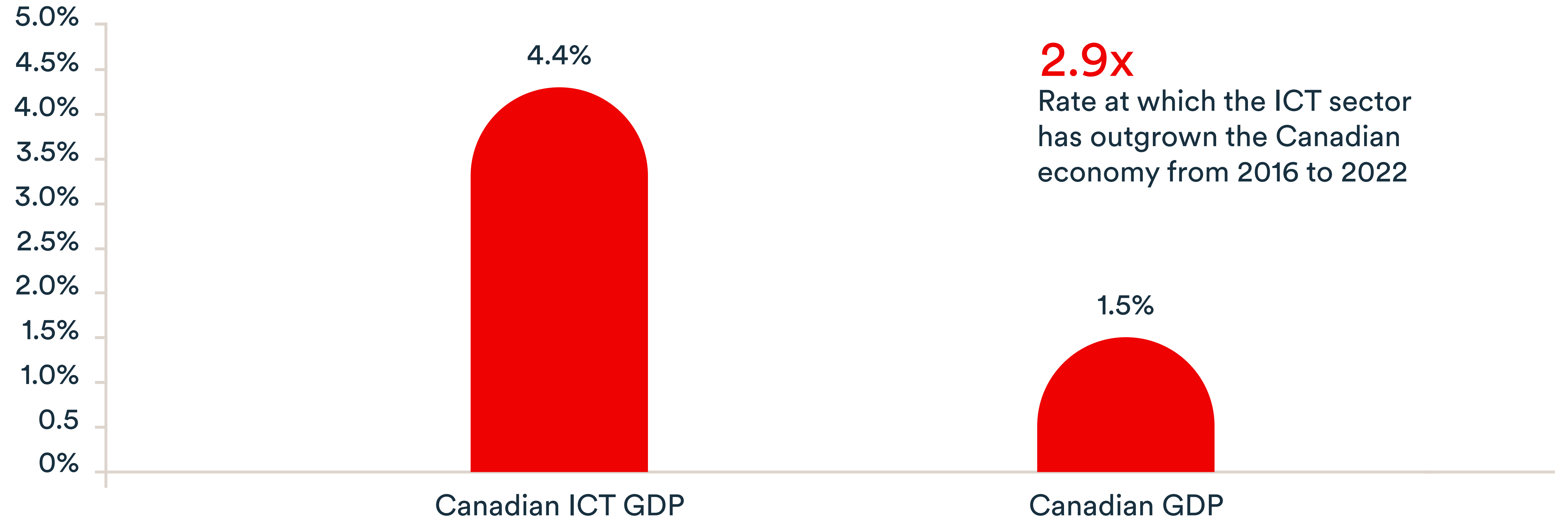
Despite some shifts in investment activity by sector, the importance of the information and communication technology (ICT) sector for VC investments remains unmatched. Investments in the ICT sector have grown at a compound annual growth rate of 4.4% from 2016 to 2022—compared to the overall economy's growth of 1.5% during the same period. This means that the ICT sector outpaced Canadian GDP growth by a factor of 2.9x. This rapid growth was fueled by VC dollars invested in the sector, which increased by a factor of 3.3x over the same period.

Figure 16: Canada ICT VC investments and ICT sector's share of GDP



Sources: CVCA, OECD, BDC analysis

Figure 17: Canadian ICT GDP vs. Canadian GDP (2016-2022 CAGR)

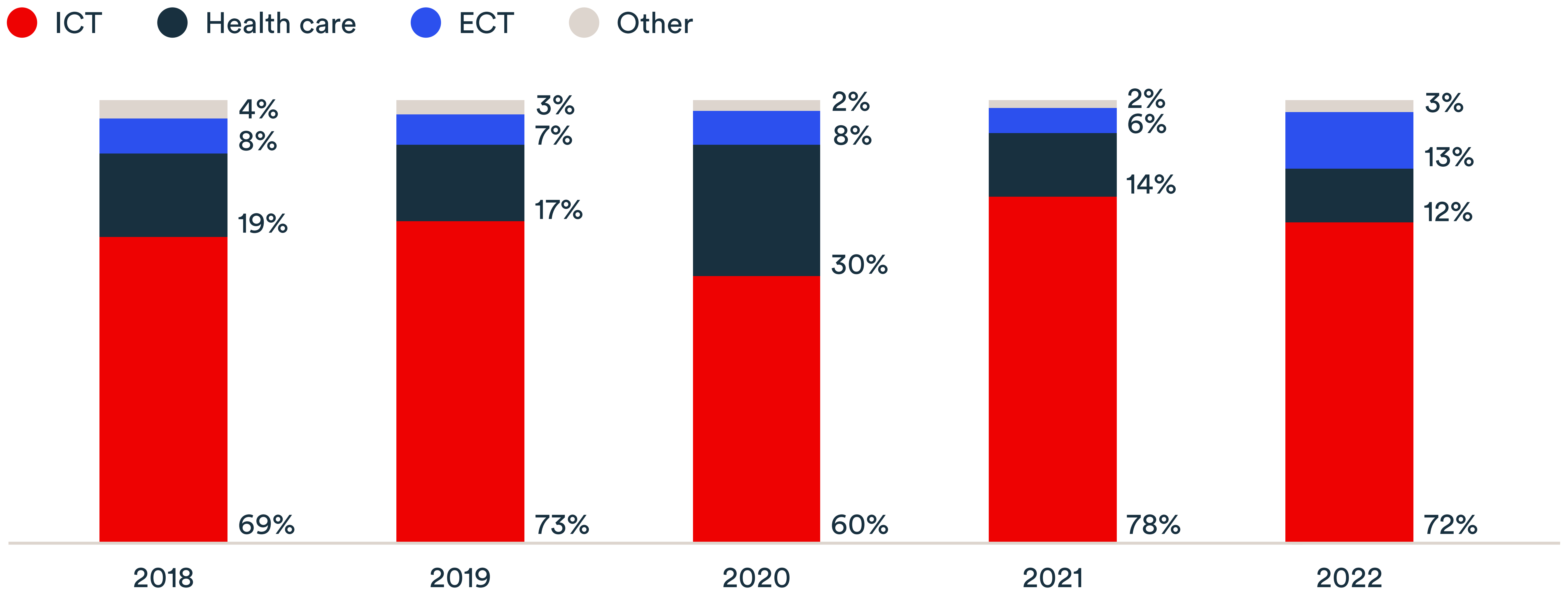


Sources: CVCA, OECD, BDC analysis
*CAGR: compound annual growth rate

Following an all time high in 2020, investment activity in health care continued to fall as a percentage of total VC dollars invested in Canada. However, investments in ECT, which had remained relatively stable over the past five years, more than doubled in 2022. This growth aligns with a commitment by national governments and private industry to step up their investment in climate tech solutions to meet publicly announced greenhouse gas emission reduction targets.

As detailed later in this report, Canadian clean economy fund managers are beginning to scale in response to global market demand.

Figure 18: Canada VC investment activity by sector



Source: CVCA, BDC analysis
* CVCA refers to cleantech sector, whereas we refer to this sector as the energy/cleantech sector.

The Government of Canada projects that over $US100 trillion in private capital will be invested worldwide over the next three decades to develop a global clean economy. To reach net zero by 2050, Canada would require average investments ranging from $60 billion to $140 billion per year.[10] Canada continues to position itself to secure a portion of the global private capital needed to transition to a clean economy.

It is unclear how the American Inflation Reduction Act (IRA) incentives will affect Canadian cleantech. There is concern that it could encourage Canadian cleantech companies to scale their business by undertaking projects in the U.S. over those in Canada. The clean economy measures in the most recent federal budget create incentives for the industry. We expect Canadian businesses to leverage these tax breaks and incentives to become more competitive, grow and attract more investments.

Canada can emerge as a sustainable economy leader by adopting Canadian cleantech solutions. To do so, Canada must look beyond VC to secure a portion of global private capital directed to the clean economy. It must also fund Canadian companies' growth equity and project equity needs as they look to establish commercial-scale climate solutions. In addition to increased capital, Canada must build actual physical assets in the form of sustainable infrastructure to help respond to our climate challenges.

In January, BDC launched a national ESG reporting template[11] — the first of its kind to be widely distributed within the Canadian venture capital and private equity industry. This template will help Canadian investors and private equity-backed companies meet future ESG regulatory requirements and rigorous reporting processes that may be forthcoming. As Canadian companies integrate ESG principles and gain a competitive advantage, we believe they will attract both clients and capital over time. Assisted by these standardized reporting guidelines, the Canadian VC and mid-market private equity funds can help advance Canada's effort toward ESG excellence across all sectors.

[10] Government of Canada, Budget 2023: https://www.budget.canada.ca/2023/report-rapport/chap3-en.html.
[11] More information can be found at the following link: https://www.bdc.ca/en/articles-tools/entrepreneur-toolkit/templates-business-guides/dei-reporting-template-canadian-gps.

Portfolio resilience

Cash crunch anticipated

We have entered a period where a company's success is linked to its ability to control costs and achieve profitability as fast as possible. For start-ups, cash flow matters again and growth must be balanced with prudent cost minimization.

Across our direct investments, it was clear that companies began to accept this new reality in 2022 as monthly cash burn declined steadily. This is in line with the broader VC-backed market. We took a snapshot of a portion of BDC's direct investments as of March 31, 2022 and analyzed the progression of their monthly cash burn over one year. Within this group of companies, nearly 60% reduced their net monthly burn.

Companies reduced net burn by increasing their focus on revenue generation and reducing discretionary expenses. While some companies resorted to lowering their headcount, many could extend their runway without doing so. Reducing headcount was frequently difficult to accept but necessary to prepare for an increasingly uncertain economic environment.

Despite considerable efforts to reduce monthly burn, many portfolio companies have less than 12 months of runway as of early 2023. We anticipate that companies in our portfolio and across the ecosystem will put a premium on cash in the coming months.

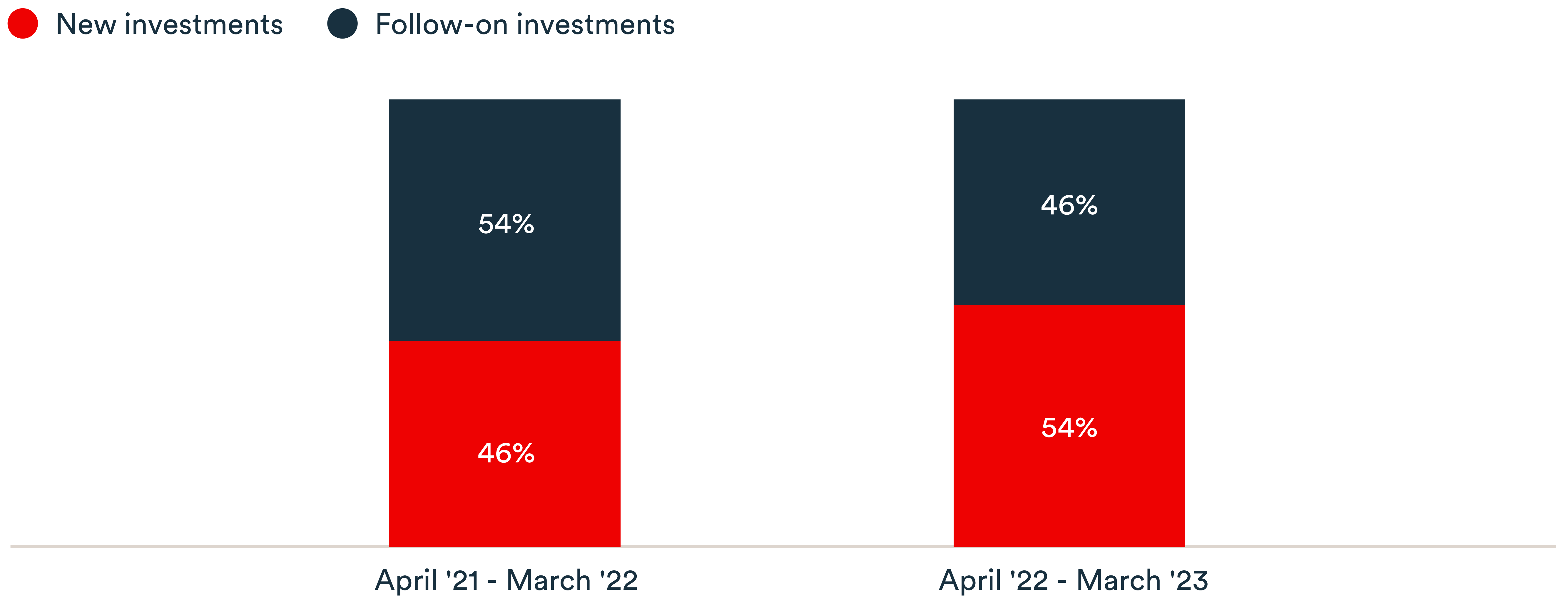
Marked increase in flat rounds

BDC has maintained its investment pacing, putting capital to work in promising new companies even as the cycle changed. In BDC's 2022 fiscal year (April '21 – March '22), 54% of dollars were applied to follow-on deals and 46% for new investments. Interestingly, these numbers have reversed in BDC's 2023 fiscal year (April '22 – March '23), meaning that a larger portion of dollars invested by BDC in fiscal 2023 have gone towards new portfolio companies. This change can be partially explained by the increase in allocation to new funds with a more recent vintage (less than 24 months). Indeed, our Deep Tech (2021 vintage) and Thrive (2022 vintage) funds were responsible for over 50% of new dollars invested in fiscal 2023. However, this also reflects sustaining a steady investment pace through economic cycles.

In terms of valuations in fiscal 2023, up rounds starkly declined while flat rounds have seen a substantial uptick compared to fiscal 2022. This result is not surprising given the contraction in valuations in public and private markets. To date, the down rounds have been restricted to 6% of the authorized dollars, primarily due to companies opting for nondilutive financing like venture debt to extend their cash runways. BDC's direct portfolio results align with broader industry trends, whereby venture debt witnessed a record year in 2022.

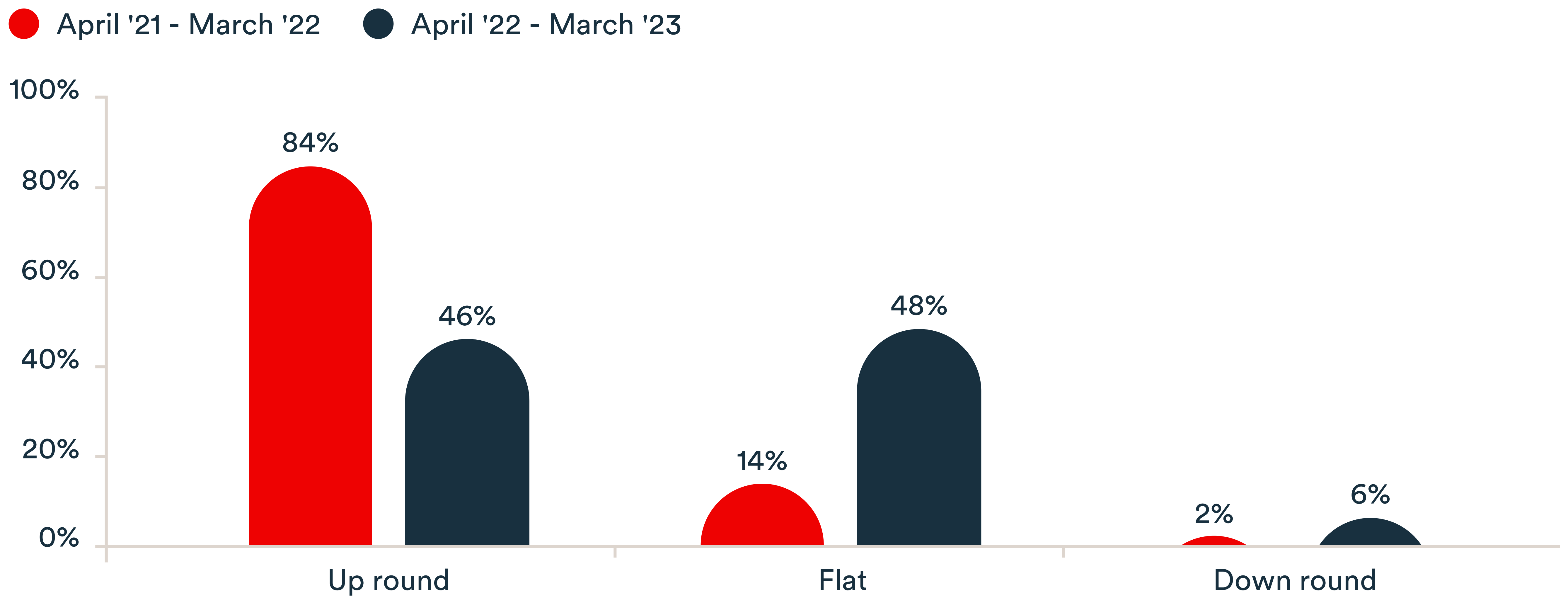
Our new investments were essentially in early-stage companies, while follow-ons were mostly for late-stage companies in fiscal 2023. In the case of seed-stage companies, our new investments decreased in fiscal 2023 while our follow-ons slightly increased.

Figure 19: New and follow-on investments across BDC's direct investments



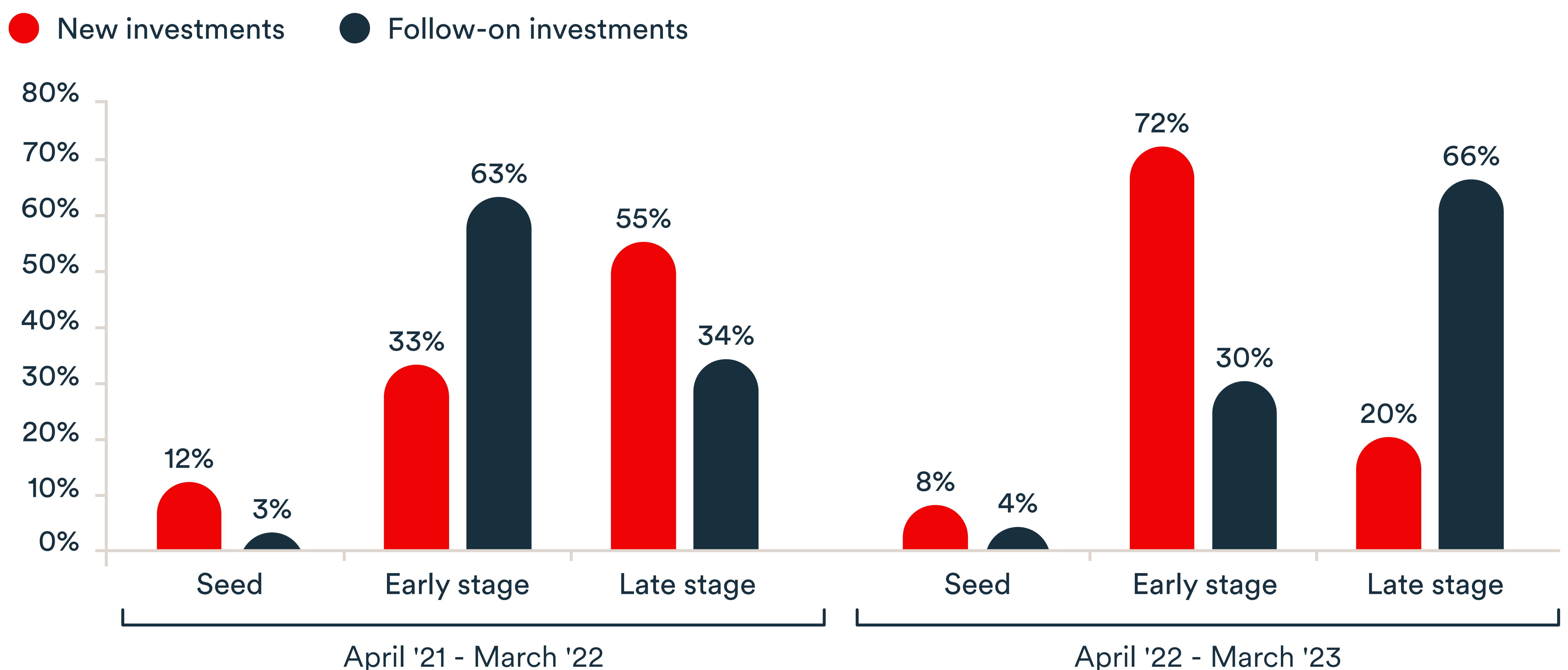
Source: BDC analysis
*Based on dollars invested through BDC direct investments.

Figure 20: Investments by valuation rounds across BDC's direct investments



Sources: BDC analysis
*Based on dollars invested through BDC direct investments.
**Investments by valuation rounds include new and follow-on investments.

Figure 21: Change in activity by investment stage across BDC's direct investments



Sources: BDC analysis
* Based on dollars invested through BDC direct investments.
** April - March represents BDC's fiscal year.

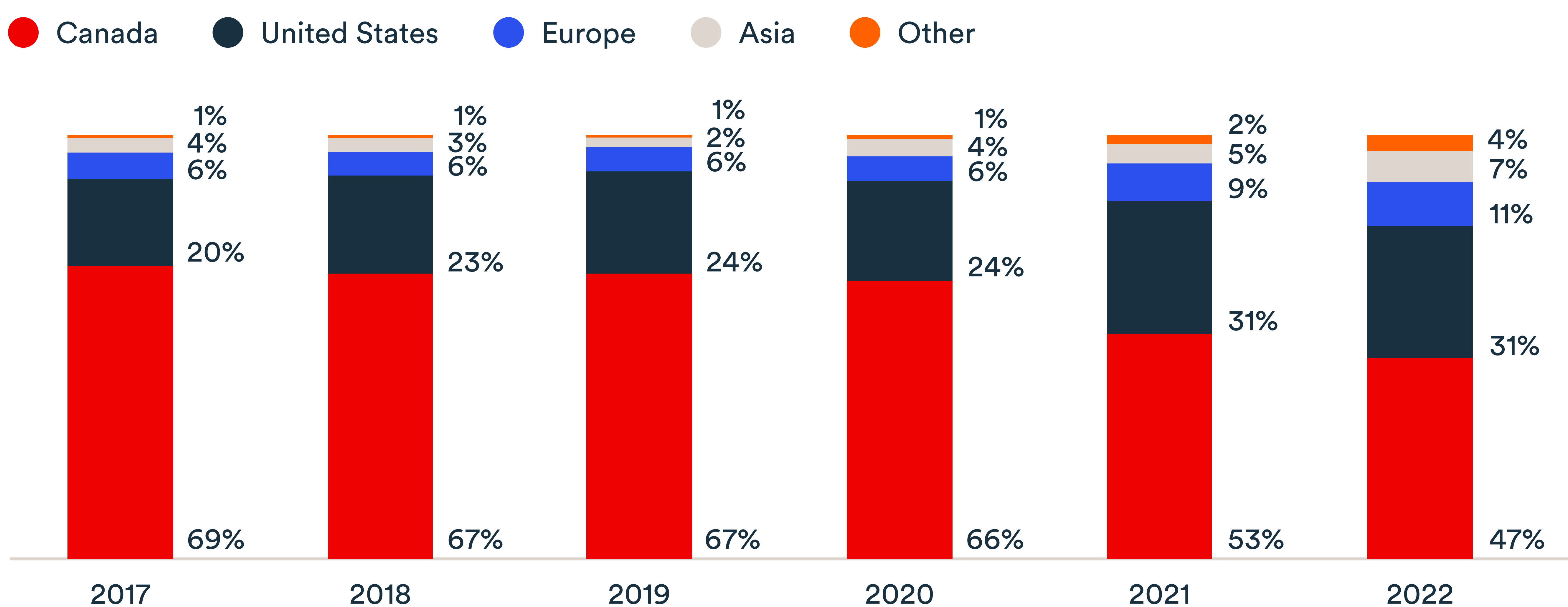
Investor ecosystem and capital availability

Increasing foreign investment within the Canadian market

2022 marked a milestone in Canadian VC as an international asset class. Despite the decrease in activity in 2022, foreign investment continued to flow into Canada's VC-backed companies. For the first time since 2005, over 50% of transactions in Canada originated from foreign investors. The percentage of Canadian deals in which U.S. investors were involved remained the same as in 2021.

However, involvement by investors from Asia, Europe and other non-north American regions increased by 6%. This diversification in the regional source of capital in Canada shows growing global recognition of the competitiveness of Canadian ventures and the attractiveness of the VC asset class in Canada.

Figure 22: Breakdown of VC investors in Canada by nation of origin (based on deal participation)

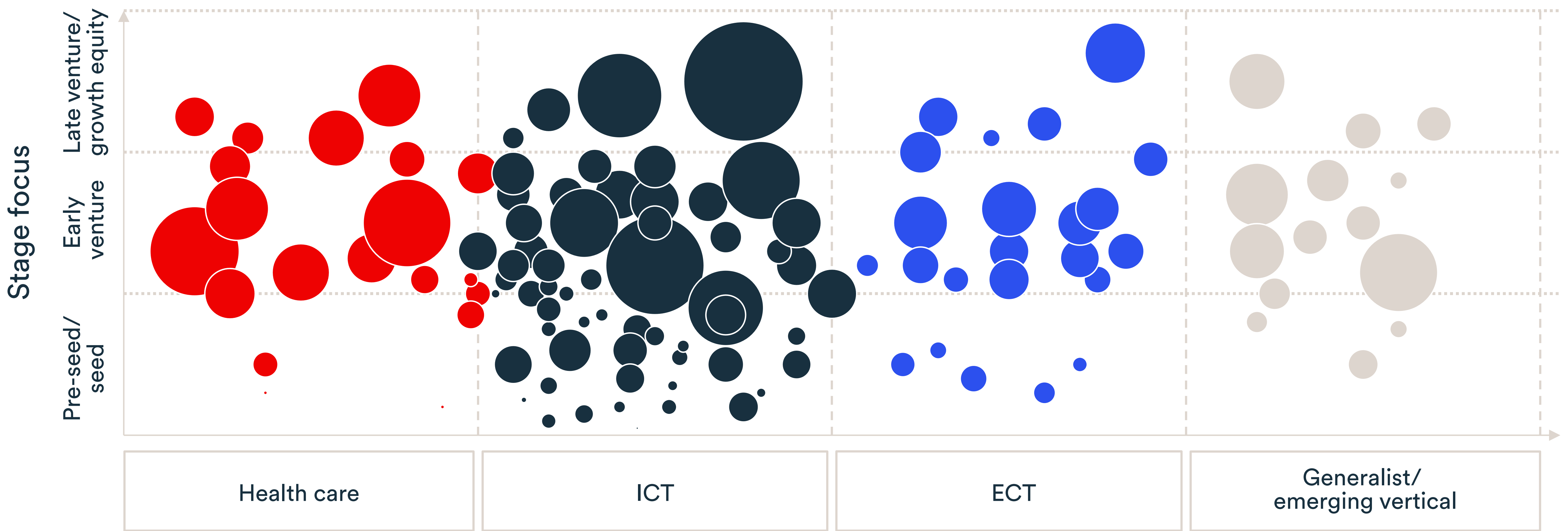


Sources: Refinitiv, BDC analysis.

A growing number of GPs in Canada

Capital formation across Canada's fund manager ecosystem has also blossomed. While the ICT sector remains the most active, the ECT and generalist verticals have developed considerably in the past decade.

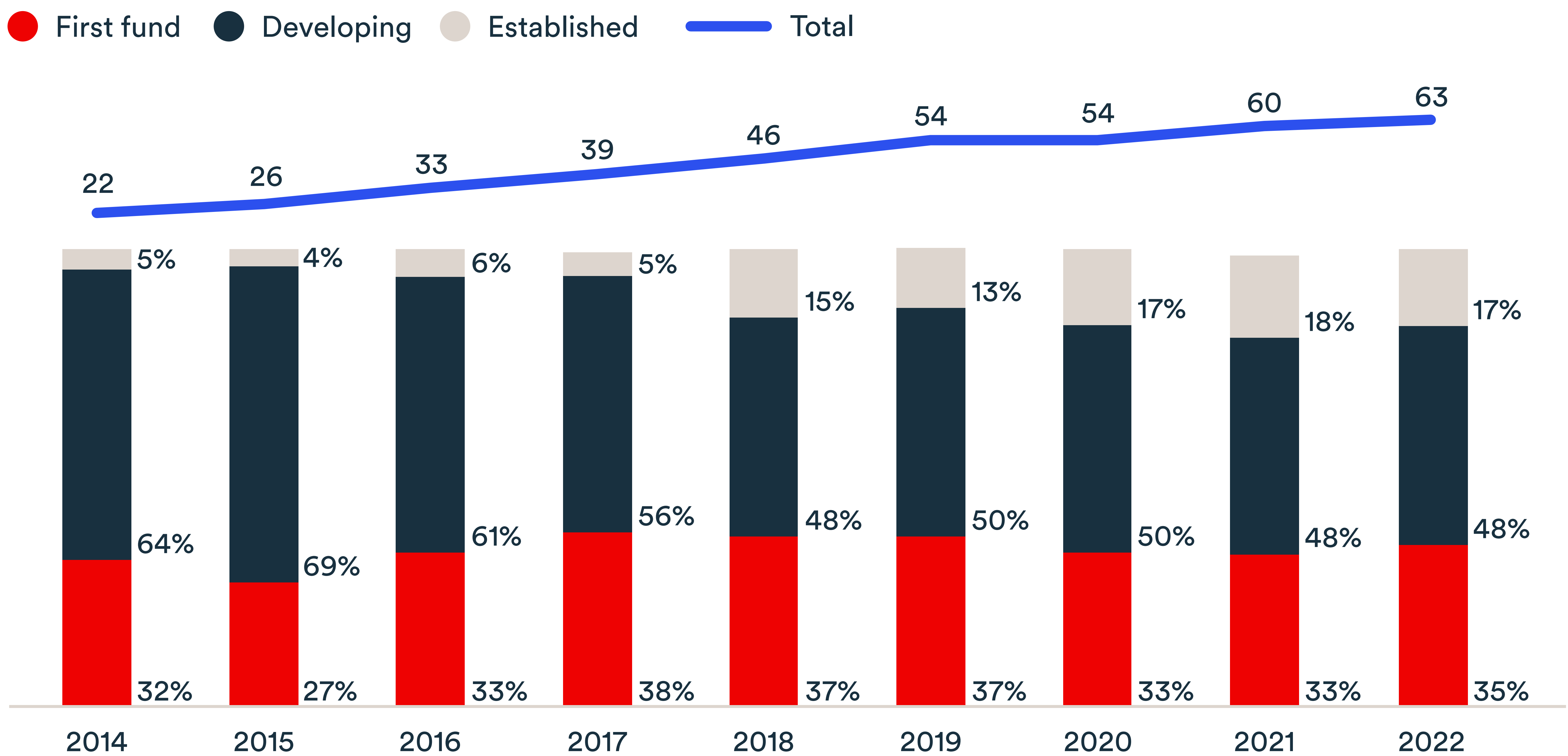
Figure 23: Active funds in Canada - 2023



Sources: BDC internal data, Pitchbook
* Bubble size represents actual/target fund size—not all capital may be deployed in Canada.
**Data includes Canadian private independent VC funds over $10M and BDC direct funds. Excludes funds of funds and accelerators.
*** Graphic presents only the most recent fund for each respective GP.

The total number of Canadian GPs continues to grow steadily. The ecosystem is also evolving with an increased number of established funds (Fund IV onwards). When excluding GPs where the most recent fund vintage is older than five years, we see that there were only twenty-two funds in Canada a decade ago, of which only 5% were established funds. By 2022, the number of funds had nearly tripled to 63. Nearly 20% of these funds were established funds.[12]

Figure 24: Percentage of active GPs in Canada, by maturity



Sources: BDC internal data, Pitchbook
* Active GPs are defined as those being within their investment periods.
** Data includes Canadian private independent VC funds over $10M. Excludes government funds, funds of funds, and accelerators.

[12] First fund for fund I, developing for fund II and III, and established for fund IV+.

2022 also saw an increase in the proportion of first-time funds in Canada. There was almost the same number of first-time GPs as developing GPs.

The median time between fundraising remained in line with the recent past, at three years.

However, the 2022 number likely reflects a lag in data. With the global challenges in fundraising, greater caution and slower deployment of capital by GPs, we expect median years since last fundraise to be higher for 2023.

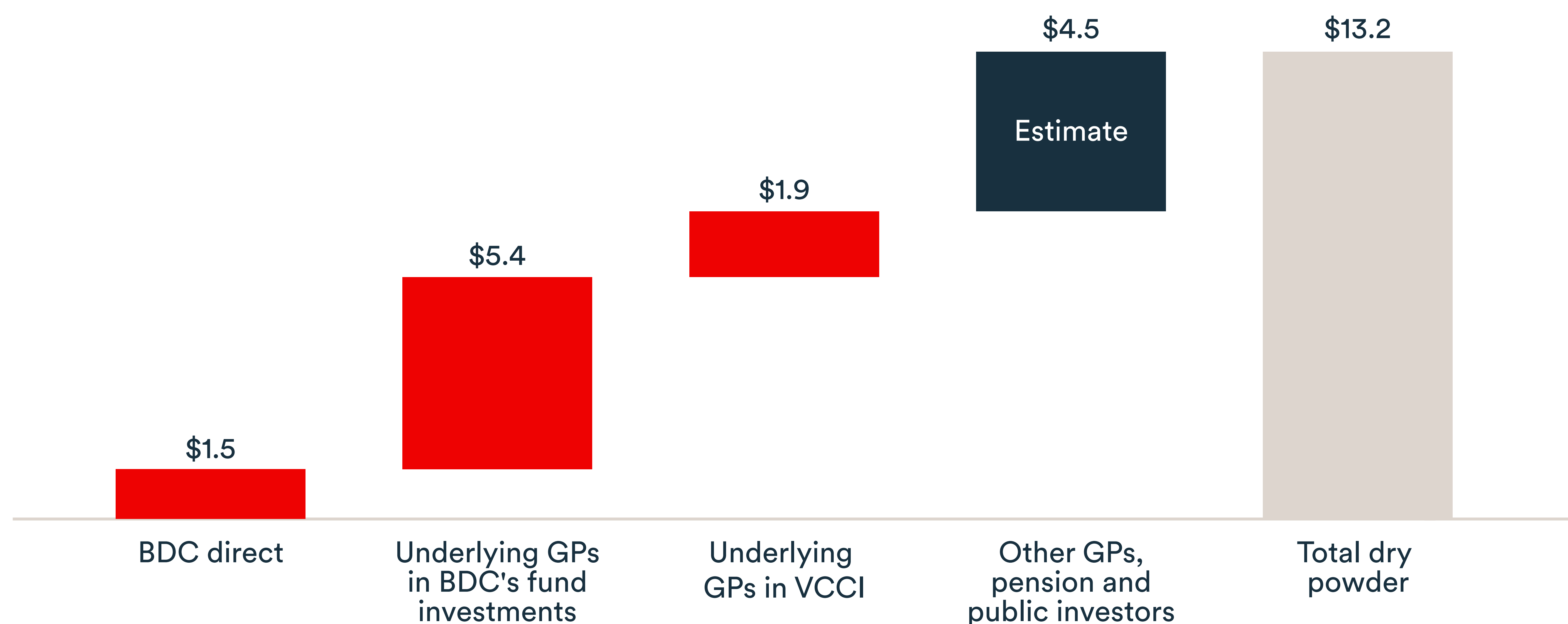
Canada-based VC investors have an estimated $13B in dry powder

Given the current economic environment, start-ups are justifiably concerned about the health of the ecosystem and the overall availability of capital. Some entrepreneurs may be concerned about sustained investor support as they attempt to grow their businesses through the downturn.

Going into 2023, Canada-based VC investors, including BDC, have an estimated $13.2 billion in dry powder. This capital will be allocated to follow-ons and new investments in the coming years, helping to re-energize the start-up ecosystem. We feel that GPs will continue to increase their focus on follow-ons relative to new investments, as they continue to shore up their existing portfolio, insulating their best investments from any further market shifts.

Despite significant amounts of dry powder, GPs will continue to deploy capital at a slower pace than in 2021 and early 2022 for various reasons. In a market where declining valuations have not yet entirely played out, GPs will continue to be selective and measured in their commitments to new portfolio companies. Additionally, GPs may be under increased pressure from their LPs to slow the pace of capital calls. Most LPs are experiencing fewer distributions and significant write-downs across their portfolios, limiting their ability to re-up to existing partner funds.

Figure 25: Dry powder across Canadian VCs (billions)



Sources: BDC internal data; BDC analysis; Pitchbook
*Numbers do not sum to total due to rounding.
**For the purposes of this analysis, dry powder is defined as uncalled capital, less expected future management fees.
***Dry powder is estimated as at December 31, 2022 in billions, using the most recent data available as of March 31st, 2023.
****Underlying GPs in VCCI: includes investors that benefit from VCCI and were not already included via BDC's fund investments.
*****Other GPs: estimate is based on a non-exhaustive list of Canadian GPs that do not benefit from VCCI and for which BDC is not a limited partner.
******Other pension and public investors: estimate is based on historical investment activity since 2017.

It is also important to consider that not all dry powder held by Canadian investors will make it into the hands of domestic start-ups. Since 2018, Canadian investors have accounted for nearly 45% of all dollars invested in Canadian start-ups, with the remainder coming from foreign investors.[13]

Historically, U.S. investors were heavily invested in Canadian start-ups. With U.S. venture investors sitting on nearly US$300 billion[14] of dry powder as of Q3 2022, Canadian start-ups have an opportunity to tap into these funds. In 2023, while we expect Canadian start-ups to benefit from the dry powder held by investors globally, they may experience less access. This is because in periods of economic volatility foreign investors retrench back to their home markets.

VC participation from Canadian corporates is on the rise

Corporate venture capital (CVC) acts as an additional source of funds to support the tech ecosystem. Although estimating the amount of dry powder this class of investor holds is difficult, we reviewed their participation within the VC ecosystem through deal activity. The broader market saw investors slowing down from 2021 to 2022, whereas Canadian CVCs increased their pace. Since 2018, Canadian CVCs have more than doubled their deal participation.

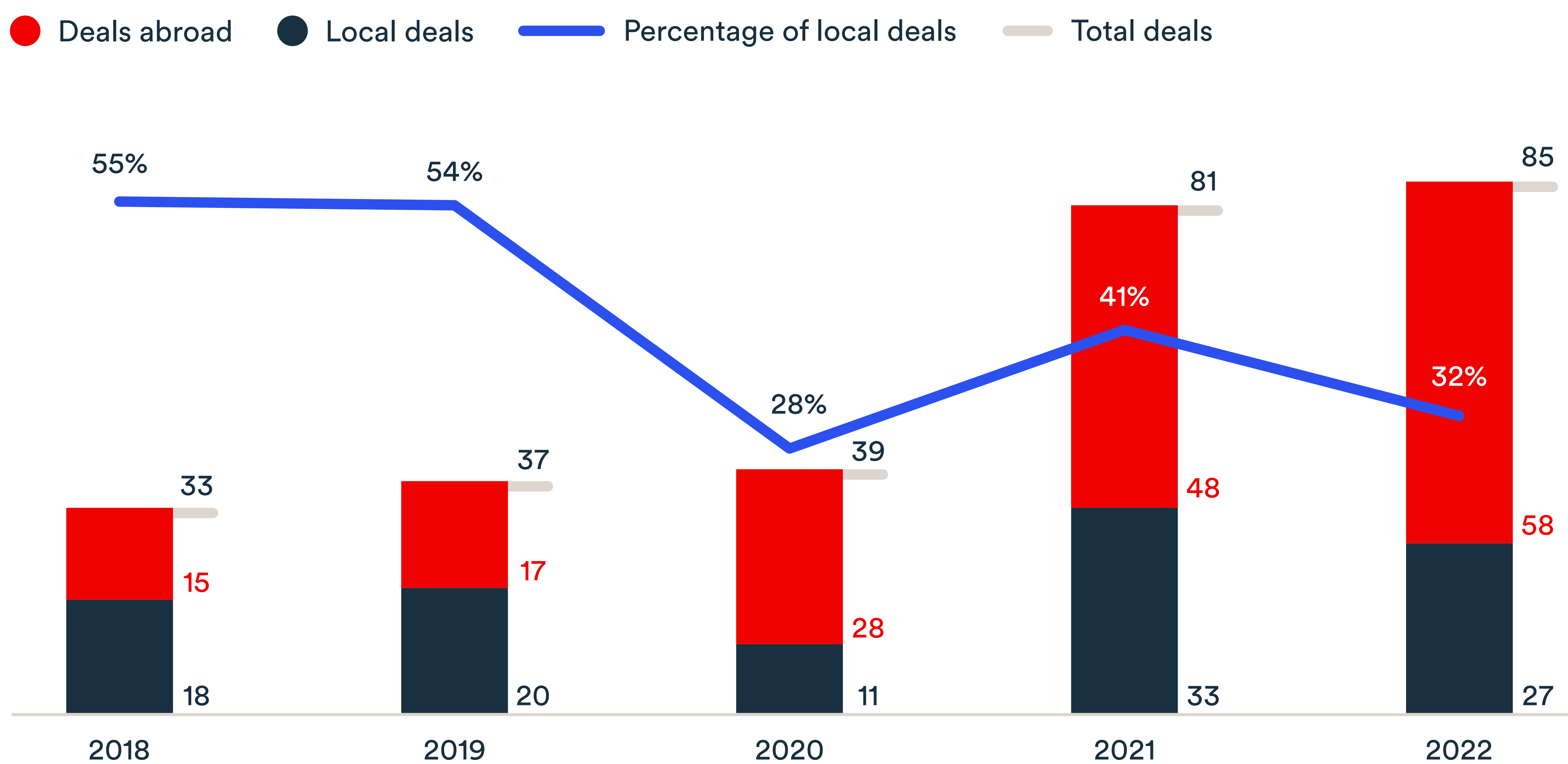
However, they have recently been more active abroad than at home, with foreign-based deals now accounting for the majority of their transaction activity.

Of the eighty-five deals that included Canadian CVC participation in 2022, 25% are attributable to corporates in the financial and insurance sectors, with an additional 18% attributable to a single operator in telecom.

There was negligible participation from those in the energy and industrial sectors. While the energy and industrial sectors account for a generous portion of Canada's economy and include some of its largest businesses, these segments of corporate Canada are not, for the most part, active in VC. Most participation from Canadian CVCs (over 50% of deals) occurs at the early stages (seed, Series A).

Going forward, we anticipate some uptick in deal participation from Canadian CVCs as more businesses who recently came around to the benefits of corporate venturing in 2022 begin to deploy capital. However, corporate engagement in VC will likely remain cyclical, reflecting the challenge of shifting corporate priorities. It is also a function of the lack of established VC platforms with a history of sustained returns within Canada's most prominent corporate groups.

Figure 26: Canadian corporate participation in VC deals



Sources: Pitchbook, BDC internal data, BDC analysis
*Includes all deals with participation from a Canadian corporation.
**Dollars invested by each Canadian corporation is confidential and therefore not publicly available.

[13] Refinitiv, BDC analysis of total equity dollars invested
[14] Source: Pitchbook

A fundamental shift in mindset

The VC market has swung from exuberance to caution. The bar is now much higher for those wishing to access capital, whether they be fund managers or entrepreneurs. In practical terms, this means a fundamental shift in mindset has started to filter through for both start-ups and investors.

Start-ups must be prepared to demonstrate how their product is critical for customers and how they efficiently use capital to grow amid a downturn. Founders and CEOs need to retain a strong CFO who can help them pivot in an agile way and closely manage cash burn and resource allocation. This will involve assessing every single dollar the start-up is spending with a mind to cut expenses sooner rather than later. As economic growth slows, some large companies are reducing headcount—freeing up great talent while easing recruitment and retention; start-ups should plan accordingly.

Entrepreneurs thinking about fundraising should consider being flexible across multiple vectors, including valuation, the amount they are looking to raise and the terms they are willing to accept. This will help them attract more investors. During this period in the cycle, investors will be looking for ways to protect their ultimate returns with investor-favourable deal terms such as: liquidation preference multiples, anti-dilution rights and redemption rights. Securing capital with several of these terms in place will create a precedent for future fundraisings. Start-ups, especially in the early-stage, will have to weigh the benefits of securing capital against the potential future burden.

Periods of turbulence necessarily result in a shake-up of the market and cause attrition. However, the return to sustainable levels of growth is positive for founders and investors. Companies that successfully raise capital will do so at valuations that will enable investors to earn robust returns as the economy recovers. This descent from market peaks and its waterfall effect within the VC market should cause investor wariness but not herald a retreat. The good news is that there is still growth to be had in Canadian venture capital as it is a key driver of the innovation economy.

Although BDC’s activity is a fraction (~4%) of the total market, we are proud to partner with 70 GPs across 130 funds, in addition to deploying novel investment initiatives such as the Thrive platform. We will remain highly visible with partnerships held at all levels of the VC ecosystem and by leading initiatives such as launching GP Academy Finance and Operations Edition, as well as pushing forward the implementation of the ESG reporting template. We continue to drive towards building an efficient, ESG consistent and entrepreneurship-driven economy, both through indirect and direct investment as well as through ecosystem development activities.

BDC is here to help

- Learn more about BDC Capital and our work with some of the country's most innovative firms.

For more information

1 888 INFO-BDC (1 888 463-6232)

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