THE KEMBALL GROUP

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The Dog's Bark

Canada's Capital Markets Outlook for SMEs 2015: Significantly Improved Access to Funds.

Implications for Angels and Entrepreneurs

IMPROVED ACCESS

Our view is that the set of exemptions provides a solid foundation upon which to build a world-class capital market to finance high-potential new entrants.

In recognition that Canada's future prosperity requires removal of constraints on access to capital for early stage high potential opportunities, our securities administrators have acted to increase the number of sources of supply of capital for early stage, non-natural resources firms seeking equity capital. On May 5th 2015 four Canada wide exemptions will be available from the time consuming rigors and prohibitive costs of issuing a prospectus. They are:

1. Securities issued via Crowd Funding intended for start-ups
2. Offering Memorandum (not currently available in Ontario)
3. Friends and Family and Close Business Associates (Not allowed for many years in Ontario)
4. Accredited investors (basically unchanged)

The OSC website's SME Institute provides information on the ins and outs of each exemptions in the OSC"s eyes - http://www.osc.gov.on.ca/documents/en/Companies/sme_20150121_raising-capital.pdf , including the caveat that introduction in Ontario may be delayed unless action by the Ontario Legislature occurs. If an entrepreneur is considering raising capital in 2015 there is substantial value in digging into the thought process leading to the current set of exemptions. These are also available on the CSA and OSC websites. Among the "details" is clarity that more than one exemption may be used simultaneously.

Our view is that the set of exemptions provides a solid foundation upon which to build a world class capital market to finance high potential new entrants. For the two key actors, entrepreneurs and investors, our joint responsibility is to create a sound set of practices in respect of each of first three of these exemptions. Regardless of the exemption, the common requirement is to build a company's capability to earn profits from sales. Hence the point of departure would be to adapt the lines being developed by accredited investors who are angels and members of groups or the Canadian and US Angel Associations, NACO and ACA respectively. The end result sought is to build more businesses that create wealth; more wealth than will be dissipated by the percentage of mistakes and misfortune than has been the case to date.

IMPLICATIONS

The most important implications do not flow from the specifics of either the individual exemptions or their combinations. Common to all exemptions is a requirement that the investor acknowledge in writing that they can lose all of the funds invested in transactions under these exemptions and that the securities are not likely saleable to others. In short investors are committed until their capital is returned and a return on it is obtained.

Introduction of the written risk of loss provision will prove to be of great value to both sides of the transaction, and extend to include intermediaries such as Crowd Funding Portals and Exempt Market Dealers. There will not be the wrong kind of money mixed with the right kind of money. Entrepreneurs will be spared the ongoing agony of dealing with those from whom they never should have sought or been offered or accepted funds. Angels will no longer encounter the barrier posed by having the wrong kind of money already in place from investors who don't accept that the reality of funding early stage firms is that the odds are stacked against a return of capital or a return on it.

Support for our view of the efficacy of this common process comes from the body of economics popularized in *Thinking Fast and Slow* by Daniel Khaneman. Most people weight the risk of loss twice as heavily as the prospect of gain. Indeed many investors cannot stomach the risk of loss of capital, including those who meet securities commissions' definition of accredited. Many individuals who are eligible to use the accredited investor exemption are very risk averse in our experience and should not participate in such financings.

While increasing the total number of individuals who could purchase a security, currently a pool of limited to 1.3 % of taxpayers, the net change in the number in the pool of those actually willing to invest in early stage firms remains to be demonstrated. Our take is that on balance, introduction of a written "Risk Acknowledgement ", will improve the ability of the capital markets to supply the right kind of money from the right kind of people.

Entrepreneurs' attention should now shift to their real challenge, use of the proceeds to create wealth. Investors will come to grips with the reality that to make money requires making a number of investments, twenty at a minimum. From a Canada wide perspective there should be fewer firms unable to raise the amounts required to grasp the opportunity. The knock on consequence will be that more entrepreneurs and angels will come face to face with the really hard stuff, using the money well to grasp the opportunity in a global marketplace.

Entrepreneurs

More sources of money is good. But it is tougher for entrepreneurs who now must decide from amongst more available alternatives. The pre money search preparation burden will be higher: each entrepreneur first needs to decide what kind of money they and the business should seek before starting to chase it.

More sources means better odds of getting the right amount of money to get started and keep going, not just better prices (lower cost). A rejection or a lot of them from accredited investors does not necessarily mean the investment is without merit, though it should give pause for reflection. It may well mean that the offer simply did not successfully compete for time, attention and affection with those who rejected it. It could have done so six months earlier or later, or if it had been better prepared. The additional exemptions will provide additional sources and allow more scope for learning by doing. Persistence is more likely to be rewarded.

It is tough because it requires more thinking about whom to approach, when and for how much. The entrepreneurs' fund raising burden shifts from which accelerators and angel(s) should funds be sought to, would a combination of several sources serve our business better?

To illustrate, is the first step to get proof of product acceptance from prepaid orders from business customers and or consumers as Pebble famously did– the right crowd – and then seek equity crowd funding? Combine these with funds from angels and Friends and Family and Close Business Associates? When? How? Typically this latter group provides funds before angels. Or perhaps the approach should be to plan to cross the funding chasm between your initial funds from customers and the need to expand by use of an Offering Memorandum?

For entrepreneurs seeking funds under the Crowdfunding exemption, an additional burden will be selection of the Portal to be used. There are virtually no long established portals dealing with investors who are not accredited. It will be of interest to observe whether viable new entrant portals specializing in non- accredited investors emerge or those with experience with accredited investors, essentially the angel community, expand their range of activities. Or will the portals be a blend of both types of firms five years from now. Will Crowd Funding Portals seek to distinguish themselves by the quality of their clients' offerings of securities to draw investors and thereafter retain them?

Given the obvious benefits to the entrepreneur of combining funds raised under more than one exemption, we would expect to see portals and Exempt Market Dealers (EMD) alignments evolve much as occurred amongst the banks, insurance companies and trust companies when their activities were distinct by law.

Accelerators may emerge as “angels” for their graduates by forward integration and either own and operate a Crowd Funding Portal or form alignments with them and EMD’s.

Angels

Angels are plagued by the reality that 95% of those seeking money from them should not. Despite the fact that the widely stated 7-2-1 rule of early stage investing is wrong, angels still need to invest in at least twenty transactions to obtain a reasonable return on capital. Half will lose all capital. Thus angels investing $25,000 per opportunity need to allocate total capital of $500,000.

A consequence is that there is no fit between the amount needed by the firm and the capacity of individual angels or even small group to provide that amount. Either no funds will be provided or the work that has to be done to grasp the opportunity will be inadequately funded. The first outcome arises because prudent angels fund a firm to estimated cash flow breakeven. The second occurs because the entrepreneur and angels agree to play Russian roulette, with most of the chambers loaded. To avoid the first outcome prudent angels typically engage in time consuming syndicate creation with peer angel groups. Regardless, the current situation exacerbates the task of raising the needed funds amongst a restricted number of sources.

- The implications for the angel community are:
- reduction of the burden of dealing with those entrepreneurs who are not a good fit with angel financing in particular not being able to pay double digit multiples on capital raised by building a business
- the fewer entrepreneurs seeking funding from angels would be of higher levels of potential opportunity and potential capability to grasp it;
- a need to deliver on “smart” money capability, which will include substantive knowledge of funds that complement theirs from governments in particular
- removal of the need for a large number of group members amongst whom to raise funds;
- increasing numbers of lone angels, accredited investors acting on their own and not in groups who would syndicate with those using other exemptions
- increases in the number of groups because some will become expert at syndications with those using other exemptions allowing them to put up less money per deal and still fund to the breakeven level;
- Two tiered membership in angel groups with a subgroup consistently putting in the one hundred plus hours of due diligence required on a transaction; and
- A change in exit strategy focus from a single liquidity event expectation to a continuing stream of liquidity events such as dividend payments or royalty streams. Multiple liquidity events imply the emergence of a class of investors who will form private firms that remain private. In turn this raises the prospect that by bringing their knowledge to the table and aligning their incentives 100% with the founders, structuring others’ investments to the same alignment or even a liquidity preference ahead of theirs and the founders, these investors will not be subject to securities regulators purview.

In summary we believe that the new exemptions offer more people the opportunity to invest in the generation of Canada’s capacity to build businesses which will create the wealth needed to produce jobs in firms competing internationally, jobs Canada needs to support our society's infrastructure. Capacity building will occur because profits are the route to return of capital and return on capital will reshape mindsets.

The Kemball Group *focuses on high-growth Canadian entrepreneurs who want to sustain 20% plus year-over-year growth for 10 years or more. We help these Canadian innovators beat the odds in building highly successful businesses, without giving up control.*

We offer entrepreneurs investment banking services in the private equity market place including our angel financing and crowdfunding programs.