2020 trends in venture capital

AUTHORS

Marko Trivun

Shane Thomas

The last few years of the venture capital (VC) ecosystem were defined by explosive growth and record VC fundraising.

As we start a new year, our Emerging Companies and VC Practice outlines three predictions for key developments in the Canadian VC environment in 2020. First, we expect to see a renewed focus by companies on strong corporate governance to temper headline risk. We also predict that debt will increase as a percentage of venture financials. Lastly, our practice group expects the excitement surrounding direct listings in the U.S. will not likely be replicated in Canada.

Prediction: 2020 will see venture-backed companies focus on strong corporate governance.

A prevailing theme in 2019 was the corporate governance deficiencies in mature venture-backed companies. This issue was not exclusive to mature venture-backed companies, but they drew most of the media's attention. Considering this, we predict that in 2020 a greater emphasis will be placed by both the investor community and company management to identify and treat the deficiencies in corporate governance. This may include changes to the board composition, more protective provisions for minority shareholders and the implementation of corporate policies at an earlier stage of the company.

VC investors with a board nominee are presented with a conflict resulting from the fiduciary duty he or she owes to the preferred shareholders of whom he or she is a nominee, and the fiduciary duty owed to the common shareholders at large. Each director must act with a view to the best interests of the corporation, as opposed to his or her own interests or those of a specific constituency of the company. Educating directors on how to properly discharge their duties may also be a good step in improving governance.

Good corporate governance is absolutely critical in venture-backed companies, particularly as these companies increasingly forego the public markets in favour of the private markets. Because the public markets are less tolerant to the "any path necessary to profitability" narrative than the private markets appear to be, an indirect benefit of the IPO process is that it can shine a light on deficiencies in corporate governance that the public markets are unwilling to overlook.

Prediction: While it will not challenge traditional VC investing, certain mature startups will give more consideration to using debt as an alternative source of capital.

Startups with revenue are not strictly limited to equity financing as a source of capital and can explore other avenues. In particular, debt financing provides a strategic alternative for certain revenue-generating startups. The innovations seen in startup debt financing in the last few years have begun to address the traditional cost of borrowing through debt financing.

In 2019, we witnessed the growth of innovative debt lending sources for early-stage startups. For example, ClearBanc has invested in approximately 800 startups and popularized the "20-Min Term Sheet" in an effort to demonstrate that startups could access capital fast. Silicon Valley Bank opened its Canadian headquarters in Toronto in 2019, bringing with it decades of experience providing debt financing to technology companies. Lighter Capital uses a revenue-based financing model—it lends money to companies in return for a percentage of revenue until a multiple of the principal is paid off.

In addition, in recent years the Big Five Banks have increased their focus in lending capital to early-stage startups. CIBC Innovation Banking (launched following CIBC's acquisition of Wellington Financial) is a prominent player in the startup debt financing space, specializing in the C$2-5 million investment range for technology startups. The Bank of Montreal announced the creation of its Technology & Innovation Banking Group in April 2019. Since 2016, the Royal Bank of Canada has partnered with Espresso Capital, as its preferred venture debt partner, to provide financing to technology companies.

Ultimately, startups need to weigh the balance of securing capital by way of debt, which can take the form of: a) accounts receivable financing; or b) working capital line of credit. The benefits of debt financing are that it can usually be arranged more quickly than equity financings and does not require the establishment of a valuation as part of the process. On the other hand, companies must counterbalance the benefits with the fact that in the case of venture debt there will likely be a security interest taken in the company's assets and that the company must adhere to negative covenants and conditions.

Prediction: The excitement over primary direct listings in the U.S. will not be replicated in Canada.

In the last year, there has been much discussion of whether primary direct listings, used by both Slack and Spotify, are going to be increasingly used by venture-backed companies to go public. Rumours concerning a possible AirBnB primary direct listing in 2020 have only further fanned those flames.

More telling, however, have been the recent filings made by each of NYSE and NASDAQ to allow companies to go public through a primary direct listing. In November 2019, NYSE's filing with the SEC sought to expand the practice of primary direct listings, following the listings of Spotify and Slack on its exchange, to allow investors to sell their shares at listing so long as at least US$250 million was being sold. NYSE's proposal was rejected by the SEC and it appears that NYSE will appeal the decision. Similarly, NASDAQ filed an amended proposal in December 2019 with the SEC to allow companies to undertake a primary direct listing. Under NASDAQ's amended proposal, companies would have to sell at least US$100 million in connection with the primary direct listing.

From our vantage point it does not appear that the same level of fervor for primary direct listings exists in the Canadian market. Firstly, primary direct listings are not permitted on the TSX or the TSXV. A direct listing is only possible on the TSX or TSXV if the company is already listed on another exchange, so long as the company can meet TSX's listing standards. Furthermore, given the relative low number of Canadian unicorns, as compared to the U.S., the motivation for reform, in order to permit primary direct listings on these exchanges, does not appear to be as pressing.

Final thoughts

We will monitor how these predictions play out in 2020, while also being alert to events that shift the tectonic plates of the venture capital ecosystem. This should make for a compelling reflection article in Q4.