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The NZ Venture Capital Monitor 2002

Plus 1st quarter results 2003

New Zealand Venture Capital Association Inc

The NZ Venture Capital Monitor 2002

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Welcome to the inaugural New Zealand Venture Capital Monitor. This report is based on responses received from New Zealand's leading venture capital and private equity firms.

This and future surveys will enable us to:

- create accurate information on the size and structure of the venture capital and private equity industry in New Zealand;
- facilitate analysis of industry trends and portfolio returns over time;
- better quantify the impact of the industry on the New Zealand economy; and
- assist generally in developing the venture capital and private equity industry in New Zealand.

Respondents to this inaugural survey ranged from funds focussed on seed and early stage companies through to private equity funds focussing more on later stage opportunities. The survey was sent to 35 venture capital and private equity firms and the results of this survey are based on data collected from 18 firms. We believe the firms that contributed data represent a significant proportion of both the investment funds and activity in the industry.

Important findings from this inaugural survey are:

- committed capital for the industry as at 31 December 2002 was approximately NZ$973 million, and of that NZ$461 million was available for investment;
- 39 deals were reported for the year with an investment value of approximately NZ$87 million, an average of NZ$2.2 million per deal;
- the most active sectors in terms of number of investments were IT/software (12) and communications (6) with the industrial manufacturing sector accounting for the highest value of capital invested during the year;
- later stage investments accounted for 63% of investment made, while earlier stage investments accounted for a further 20%; and
- there has been a promising start to the first quarter of 2003 with 9 deals and a total invested of NZ$23 million being reported.

Thank you for your interest in, and support of, this initiative.

Jon Hooper
Director
Ernst & Young Ltd

Christopher Twiss
Executive Director
New Zealand Venture Capital Association

Review of 2002

New Zealand

A Billion Dollar Industry

It is unlikely anyone would argue that 2002 was a year of significant challenge for the global venture capital and private equity industry. Still attempting to recover from the effects of the technology downturn, it had to contend with economic uncertainty, corporate accounting scandals and the effects of terrorist attacks and wars. These factors resulted in a difficult fundraising environment, less investment opportunities, a significant focus on managing portfolio companies and tough exit conditions.

In addition to the global factors, the local market was also impacted by the delay in finalising the terms and completing the private capital fundraising for the government-backed New Zealand Venture Investment Fund ("NZVIF").

Despite these factors, the results of our inaugural survey are extremely encouraging and prove that the New Zealand venture capital and private equity industry is well positioned to have a significant role in the future growth of our economy.

To understand the role that venture capital and private equity can play in improving our global competitiveness and economic strength it is worth considering a recent study commissioned by the British Venture Capital Association[1]. The results of this study indicate that, over the last five years, private equity backed companies have had a considerable impact on the economic performance and global competitiveness of the UK, achieving both sales and employee growth substantially in excess of national performance.

To fully appreciate the potential impact that the venture capital and private equity industry in New Zealand will have going forward it is important to provide a context. One of the key indicators to consider is the size of the New Zealand industry.

Based on the data collected, there was approximately NZ$973 million of committed capital as at 31 December 2002. Committed capital includes both funds invested as well as funds available for investment.

"...there was approximately NZ$973 million of committed capital as at 31 December 2002."

Of the NZ$973 million, approximately NZ$512 million has already been invested leaving approximately NZ$461 million available for investment at 31 December 2002. This represents NZ$249 of committed capital per capita and 0.8% of GDP.

Interestingly, this level of committed capital positions New Zealand favourably when compared to Australia, which has committed capital of around NZ$8 billion[2] representing around NZ$406 per capita and around 1.0% of GDP. However there is clearly room for more growth.

"Of the NZ$973 million of committed capital, approximately NZ$512 million has already been invested leaving approximately NZ$461 million available for investment at 31 December 2002..."

[1] *The Economic Impact of Private Equity in the UK, BVCA.*

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So Young, but Nearly 40

In collecting information regarding the deals undertaken in 2002, we sought to capture a number of standard variables, which included the stage of investment, industry sector, deal size and investment mechanism. Within each of these categories there are obviously a number of sub-categories and, wherever possible, we have used internationally accepted descriptions to facilitate comparisons with offshore markets. We will continue to develop the most relevant and appropriate survey parameters over time in consultation with the industry.

In addition to these variables, we asked respondents to provide information regarding the investee company turnover, EBIT and number of employees at the time of investment. The intention of capturing this data is to provide a basis for measuring the actual economic impact that venture capital and private equity has on these entities. It will be interesting to monitor how the industry performs in this respect relative to other international venture capital and private equity industries such as those in Australia and the UK.

Based on the survey responses received, it is clear that the New Zealand industry has a diversified investment base which covers a broad range of sectors. There were 39 deals reported during 2002 with an investment value in excess of NZ$87 million, representing an average of around NZ$2.2 million per deal.

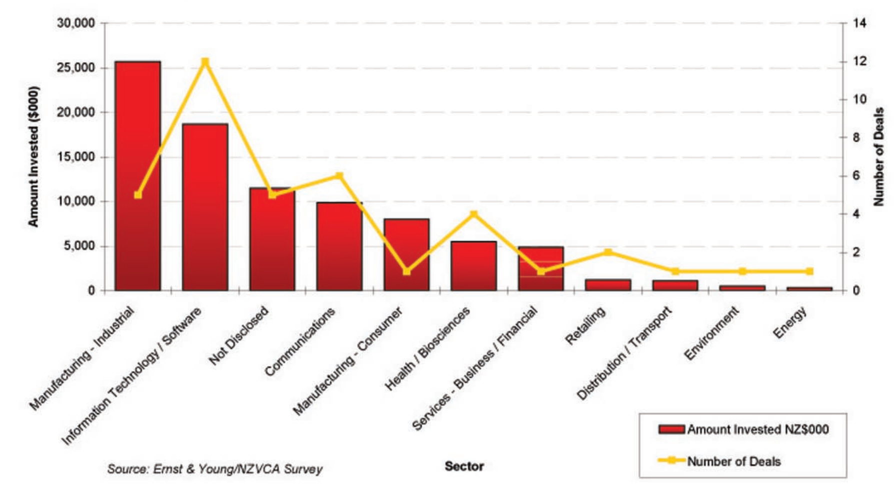
In terms of the number of deals done, the most active sectors were IT/software (12 deals) and communications (6 deals), which combined accounted for 33% of the value of investments recorded. The popularity of these sectors is mirrored internationally and is discussed later in this survey when reflecting on the global perspective for 2002.

The activity is also reflective of the relatively new breed of government and private initiatives focusing on developing specialist industry sectors, such as the targets set by the government Information and Communications Technology ("ICT") Taskforce of having 100 ICT companies turning over $100 million each by 2012. Whilst ICT currently accounts for approximately 4.3% of New Zealand GDP and generates over $1 billion of export revenue, the ICT Taskforce has identified the potential for the sector to grow to 10% of GDP within the 10-year timeframe.

Health and biosciences investment was low in comparison to the level of deals reported internationally in this sector, with a total of four deals totalling NZ$5.5 million or 6% of funds invested during 2002. This indicates that New Zealand still has a long way to go before this sector can be viewed as a rising star. The launch of a NZVIF biotech fund should assist in this sector's growth.

The other sector that featured prominently is the traditional safe-house of manufacturing, which accounted for NZ$26 million (29%) of investments. These investments were typically in more mature later stage businesses.

Figure 1 - New Zealand Venture Capital Investments by Sector - 2002



"...there were 39 deals reported during 2002 with an investment value in excess of NZ$87 million..."

"...the most active sectors were IT/software (12 deals) and communications (6 deals)..."

[2] *Source: Australian Bureau of Statistics at 30 June 2002*

Within later stage investments it was interesting to note that only two management buy-outs/buy-ins were reported during 2002, comprising 10% by value of deals done. However, one suspects that with the number of small and medium sized family-owned businesses operating in New Zealand, together with demographic changes, significant succession issues will appear across a number of industries. When combined with a developing venture capital and private equity market, buy-outs should play a larger part in future surveys.

Looking further at investments by stage, it is interesting to note that later stage investments (including expansion, mature, MBO/MBI, turnaround and replacement) accounted for 63% of the value of investments made in 2002. In comparison, start up, seed and early stage transactions accounted for 20% of the total invested for the year.

It will be worth monitoring the relative stages of investee companies as the NZVIF funding comes on line. Certainly, we expect that there will be an increase in the number of deals at the earlier stage as the 2003 year progresses.
Geographically, Auckland proved to be the most active city with NZ$43 million (49%) of the transactions for the year with Christchurch contributing NZ$23 million (27%) to the total. Other investments were dispersed throughout the country.

Divestment Activity

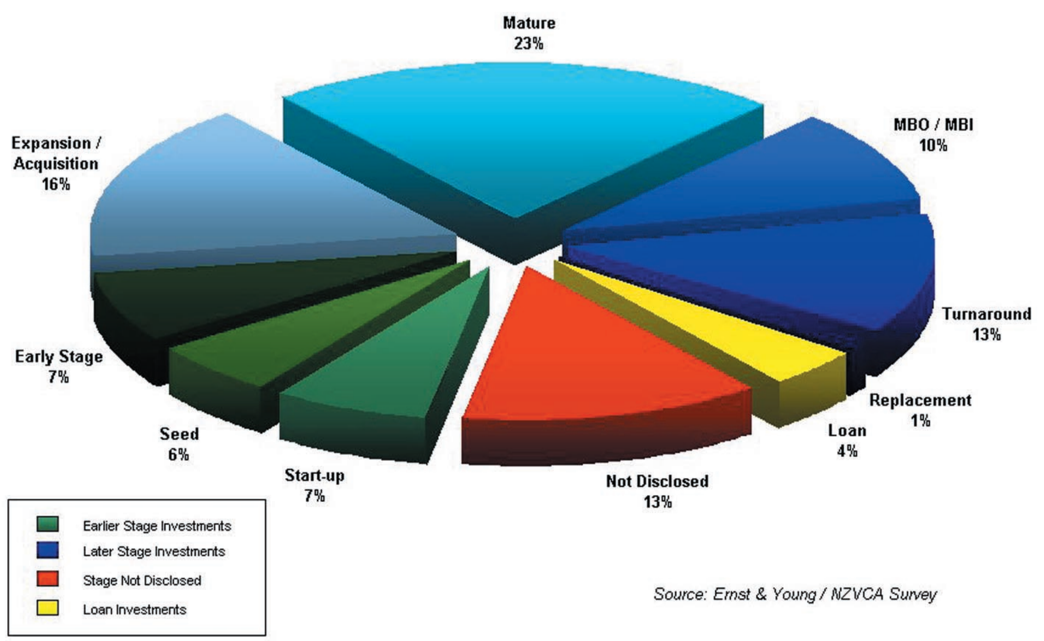
In line with the difficult exit conditions overseas and the relatively early stage of the New Zealand venture capital and private equity industry, only three divestments were recorded for 2002.

All of the exits were by way of trade sale, with two acquirers being from New Zealand and the third from Australia. The sectors involved were manufacturing (consumer), communications and health/biosciences, with the average length of investment being around five years.

Fund Performance

The relative youth of New Zealand's venture capital and private equity industry means that only a small proportion of funds are able to report a meaningful running fund performance rate. As funds mature and divestment activity increases, we will be able to report in more detail on investment returns.

Figure 2 - New Zealand Venture Capital Investment Value by Stage - 2002



Source: Ernst & Young / NZVCA Survey

"...later stage investments accounted for 63% of the value of investments made in 2002...early stage transactions accounted for 20% ..."

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Global 2002 – Keeping it in Perspective

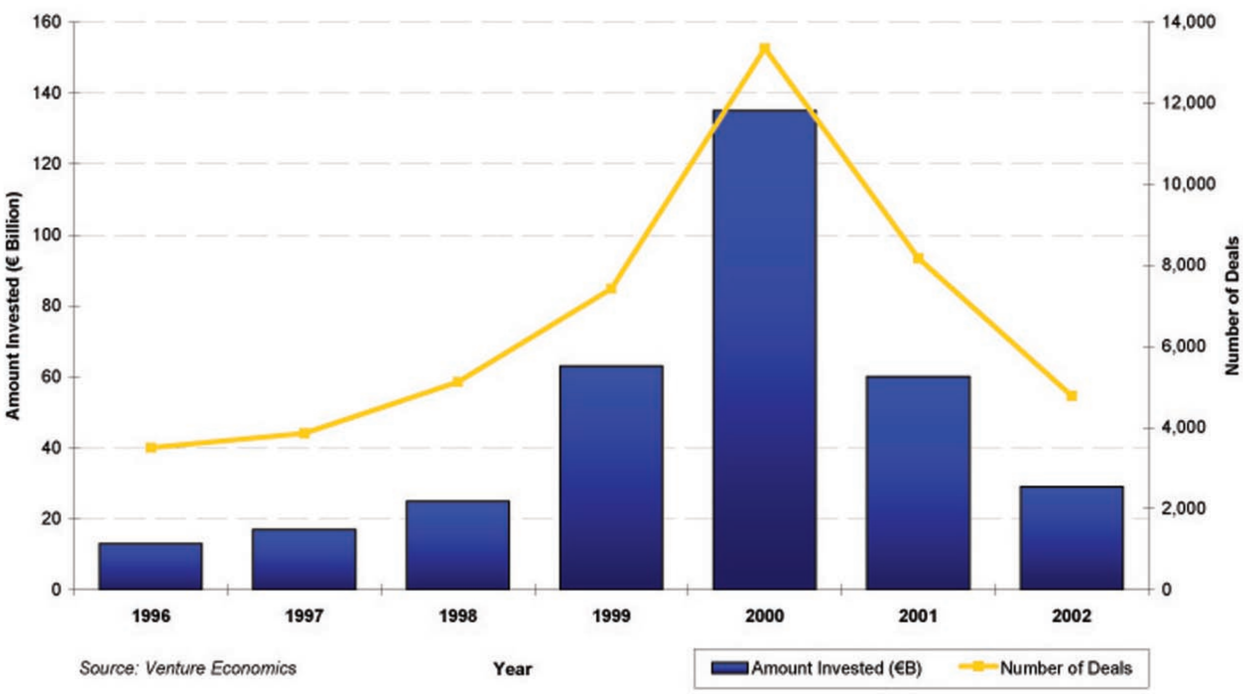
Whilst 2002 was undoubtedly a difficult year, global investment is best viewed in the context of the amount invested in the venture capital and private equity industry from 1996 to 2002 as shown in Figure 3 below. The peaks experienced during the technology bubble from 1999 to 2001 clearly stand out as an anomaly and 2002 continues the trend established in 1996 to 1998 of modest, but steady, growth in the industry.

Another phenomenon that occurred during 2002 was the realignment of investor pre-money valuations to more realistic levels. Money was still available for good companies and the pool of talent remaining from the boom meant that top quality management could at last staff these companies on an international basis.

History has also shown us that companies founded during a downturn will produce leaders of the future, with examples of such companies including Cisco Systems, Genentech and Vodafone. Others that have survived this period will go forward in better shape when economies rebound.

Technology and communications continued to dominate global investment activity. However, of note was the growing interest in life sciences which appears to be the rising star. Both of these sectors appeared attractive to investors as they offered potential to provide solutions to issues of increasing importance in the 21st century, such as aging populations, combined with the potential to access a global market.

Figure 3 - Global Venture Capital Investment - 1996 to 2002



Source: Venture Economics

January to March 2003

New Zealand (1st quarter results)

Too Early to Call

The promise shown in the venture capital and private equity industry for 2002 did not materialise for the first quarter of 2003. The war in Iraq and the associated economic uncertainty, combined with the fact that the first quarter is often an administratively focussed period for funds, contributed to a decrease in global investment for the quarter.

The survey results show that the first quarter of 2003 proved to be a quiet one from a fund raising perspective with only an estimated NZ$5 million of new capital being raised, reflecting the continued impact of the negative factors identified in 2002. However, we anticipate the second and third quarters of 2003 will be more active following the closing of a number of NZVIF funds in those periods.

Investment and Divestment Activity

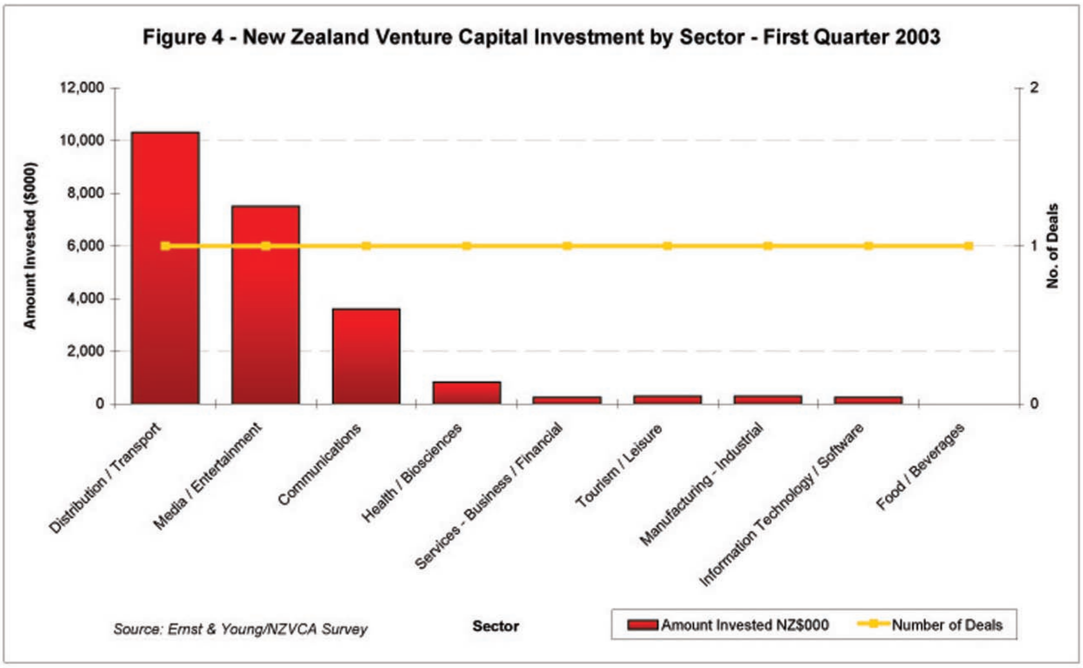
New Zealand did not appear to suffer the same comparative level of downturn in the first quarter of 2003 as that experienced internationally. Nine investments were reported for the quarter with a total deal value in excess of NZ$23 million. The average investment of around NZ$2.6 million was slightly higher than the average for 2002 of NZ$2.2 million.

The investments were made across a range of sectors with, as expected, no clear pattern emerging for the first quarter and no sector recording more that one investment. However, as the year progresses, a pattern will no doubt emerge and it will be interesting to review this in line with international results.

The distribution/transport sector recorded the only MBO of the quarter, accounting for 44% of total funds invested. Indeed, looking at the results for the period, this was a quarter in which "old-economy" businesses ruled the day.

Seed and early stage investments accounted for five of the transactions but with only 21% of the funds invested, whilst four expansion and MBO/MBI transactions accounted for the majority 79% of funds invested. This obviously reflects the more mature nature, and thus greater funding requirement, for the later stage businesses.

Only one divestment was recorded for the quarter, which was executed by way of a share buy-back. The investee company's turnover had reportedly increased by around 50% to around NZ$50 million on exit, with the investment having been held for around two and a half years. The question is whether this level of growth would have been possible without the injection of venture capital funding.



"Nine investments were reported for the quarter with a total deal value in excess of NZ$23 million."

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Global Perspective – The Start of Another Challenging Year?

The factors affecting the global markets in 2002 continued to affect the international venture capital and private equity markets in the first quarter of 2003.

In the USA alone, quarterly investment dropped to below US$4 billion for the first time in five years. Only three industries were reported as showing an increase in investment, with the remaining 13 categories remaining flat or declining. This drop was also attributed to an ongoing lack of exit opportunities and the continuing requirement to deal with under-performing portfolio investments.

The decline in the USA was mirrored in Europe where investment dropped almost 40% from the previous quarter to €639 million (US$690 million). Investment was down in all sectors with the exception of the retail segment, although one bright note was the increase in the median amount of capital raised, which was the highest since the fourth quarter of 2000. This was attributed to an increase in the number of later stage investments.

The outlook for the second quarter of 2003 should be more positive as the venture capital and private equity industry gets into its stride for the year and provided the major world economies stabilise. However, caution appears to remain the name of the game and material increases in investment activity would seem to be unlikely.

Current Industry Challenges

Whilst the New Zealand venture capital and private equity industry has clearly developed significantly since its inception in the early 1980's, it would be misleading to think the industry is mature or that it is without a number of challenges going forward.

Of concern is the current tax regime in New Zealand, particularly as it relates to offshore investors and funds. Due largely to tax considerations, offshore investors are all to frequently faced with unfamiliar and complex investment structures and, as a result, do not progress beyond an initial appraisal.

In particular, the New Zealand tax regime specifically prohibits flow-through tax structures, which are otherwise the norm in overseas markets. Notwithstanding the absence of a capital gains regime in New Zealand, there is also a risk that venture capital and private equity funds may be taxed on their investment gains, potentially resulting in lower returns to investors through a venture capital fund than if the investment was made directly.

Many countries, most notably Australia following the introduction of the Venture Capital Limited Partnership regime, enable flow-through tax treatment and provide exemptions from taxable gains derived by eligible investors.

New Zealand is also competing against other countries such as Ireland and Israel that have offered considerable incentives to businesses to establish operations in certain locations, in addition to creating a friendly venture capital tax structure. In a climate in which raising funds is already difficult, New Zealand's tax structure provides an unnecessary barrier to attracting new investment.

The introduction of an internationally recognised limited liability partnership structure that permits gains and losses to flow through to the actual investors, combined with other targeted changes to existing legislation, would bring New Zealand into line with international best practice in the venture capital and private equity industry.

We are very pleased to report that the government has signalled an intention to address this issue and the New Zealand Venture Capital Association ("NZVCA") is now actively working with relevant government officials on this initiative. The common objective is to have a new legislative regime for the industry in place by early 2004.

Also inhibiting industry growth is the lack of an established asset class for the venture capital and private equity market amongst New Zealand institutions. The allocation of 4.5% of the government superannuation fund for New Zealand "growth assets", which includes private equity investment, is potentially helpful but this compares to 8.5% being made available to overseas "growth assets". Much still needs to be done to properly establish the asset class as an attractive option for local (as well as offshore) institutions.

Finally, while there arguably is no shortage of ideas in many industries, there is a common perception that New Zealand suffers from a lack of management experience in areas such as the commercialisation of new technologies and successfully growing international companies.

Factors such as the establishment of industry cluster groups and incubators, establishing more and better links with foreign venture capital and private equity partners and the increasing ability of New Zealand to attract talented individuals to its shores will all assist in bridging the perceived lack of management experience in this industry.

The History of New Zealand's Venture Capital Industry

This is an exciting time for the New Zealand venture capital and private equity industry. There is no doubt that it has grown significantly in recent years as confidence in, and awareness of, the industry has improved. To date, the industry has been shaped by a variety of key events and factors, some of which are highlighted below.

Whilst this growth has not been without its challenges, we believe that a number of local and global factors presently exist that suggest that the industry is poised for a period of significant growth in terms of both its nature and scale.

September 2003	Launch of the New Zealand Venture Capital Monitor
April 2003	Appointment of Christopher Twiss as Executive Director of the NZVCA
October 2002	First investment by a NZVIF Manager
October 2001	NZVCA re-launched
August 2001	NZVIF established
May 2001	Government announces establishment of NZVIF
April 2000	Dot.com bubble bursts
March 2000	NASDAQ reaches all time high
March 2000	New Capital Market launched by the New Zealand Stock Exchange
December 1993	Greenstone Fund makes its first investment
March 1993	New Zealand's first private equity fund, the Greenstone Fund, is launched (a government-backed initiative)
July 1992	Australian Development Capital Association (later renamed the Australian Venture Capital Association) established
October 1990	Trade Development Board announces intention to establish a new venture capital fund
September 1989	International Competitiveness Taskforce identifies lack of venture capital as a major impediment to growth
October 1987	NZVCA disbanded
October 1987	Stock market crash
May 1986	NZVCA formed
January 1983	British Venture Capital Association founded
During 1973	National Venture Capital Association (USA) established

About the Survey

The Survey

If you are aware of a colleague that did not receive a copy of the New Zealand Venture Capital Monitor or if you would like to participate in future surveys, please contact either Jon Hooper at Ernst & Young or Christopher Twiss at the NZVCA. Contact details are provided below.

Ernst & Young Entrepreneurial Services

The Ernst & Young Entrepreneurial Services group is a global leader in providing specialised advisory services to businesses in high growth markets. Globally, Ernst & Young is involved in the analysis of the venture capital industry in association with VentureOne. Our New Zealand team has over 15 years experience in the local entrepreneurial marketplace and a dedicated team of over 20 partners and 300 staff to provide integrated business solutions.

For further information about the New Zealand Venture Capital Monitor or to find out more about Ernst & Young, please contact one of the specialists noted below.

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About the NZVCA

The NZVCA is a not-for-profit industry body committed to developing the venture capital and private equity industry in New Zealand. Its core objectives include the promotion of the industry and the asset class on both a domestic and international basis and working to create a world-class venture capital and private equity environment.
Members include venture capital and private equity investors, financial organisations, professional advisors, academic organisations and government or quasi-government agencies.

For further information about the NZVCA please contact:

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