Ensuring Venture Capital Plays its Part in Growing the NZ Economy

New Zealand Private Equity & Venture Capital Association

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NZVCA
NEW ZEALAND PRIVATE EQUITY &
VENTURE CAPITAL ASSOCIATION INC

Purpose

The purpose of this report from the New Zealand Private Equity and Venture Capital Association (NZVCA)[1] is to alert government to the currently unsustainable state of the New Zealand venture capital market and to recommend changes to government policy to ensure this market's survival in the short term and that it is fit for purpose in the long term.

Summary

The primary engines of growth in developed economies involve innovation and its successful commercialisation. The government recognised this imperative in its election commitments to additional funding for innovation and R&D (despite current financial constraints), and to improving the commercialisation process of output from CRIs. Venture capital funds are key capital providers to young innovative firms prior to these businesses having the track record to access more traditional debt or equity sources.

A New Zealand venture capital market has developed over the last nine years, assisted by the NZVIF programme, but it is still in an emergent state. Over this period this market has invested in excess of $500 million in venture businesses, with these businesses now earning $250 million in annual revenues (mostly from exports), employing over 1,000 people, and having revenues per employee of $250,000 (versus a NZ average of $140,000). This is a very good start to a healthy public/private partnership, but only the beginning of what is possible.

The global financial crisis and continuing global unrest has hit international venture capital markets hard, including in New Zealand. It is difficult currently for New Zealand venture fund managers to raise further funds. The relatively narrow focus of the NZVIF programme on earlier stage investing does not, in its current form, provide the necessary support. If left to run its course this dynamic will result in the demise of New Zealand's venture capital market along with its associated infrastructure.

If this were to occur, we foresee the policy cycle that has taken place a number of times over the last thirty years repeating itself in a few years time, as the gap in funding for venture businesses becomes apparent and the government of the day once again tries to kick-start a venture capital market (or some equivalent). The NZVCA considers this undesirable outcome and potential waste of resources could be averted by careful policy re-orientation now.

There are three policy areas that require attention in order for New Zealand's venture capital market to survive in the short term and to be fit for purpose to help grow the economy over the long term. They are:

- **Introduce a longer term view and greater flexibility into the NZVIF venture capital programme.** The NZVIF programme needs to be more nimble to adjust to market realities, while at the same being clearer as to its long term intentions. This could be best achieved by shifting responsibility to the NZVIF Board for proposing programme policies that best enable it to achieve its objectives, with shareholding Ministers having the role to approve or decline such policies. Alternatively, at a minimum we recommend adjusting policies for the NZVIF that enable it to operate more flexibly and effectively. We note the Capital Markets Development Taskforce in 2009 supported the continuation of the NZVIF model and recommended it be enabled to be more innovative in its approach.

1 The NZVCA's mission is to develop a world-best venture capital and private equity environment for the benefit of investors and entrepreneurs in New Zealand. The NZVCA acknowledges NZTE's financial support for the preparation of this report.

- **Create a more favourable environment for investors to invest in venture capital funds.** This includes improving access for investor-class immigrants to venture capital investment opportunities; including venture capital in any further government guidance to NZ Super on investing in the local economy; lowering barriers to KiwiSaver Scheme Providers to invest in local venture capital funds; and providing tax incentives for investment in venture capital.
- **Maintain and grow the venture capital market infrastructure.** This includes creating opportunity for the venture capital sector to provide input into the Ministry of Science & Innovation's initiatives to commercialise output from public-good science; maintaining the operational funding for NZVIF's market development work and for NZTE's promotion of New Zealand as an investment destination and its in-market support for exporting businesses; supporting capability building with funded venture capital internships; and addressing tax impediments to international capital flows.

Introduction

The primary engines of growth in developed economies rely on capabilities to innovate. Such innovation touches all sectors and is capable of creating incremental change to existing products and services, step changes in existing sectors, and even creating whole new sectors. Innovation and its successful commercialisation translate into higher productivity levels, improved standards of living, and greater consumer choice.

Economies that are capable of nurturing and harnessing effective innovation systems are today's leaders and will continue to be the leaders of tomorrow.[2] They will find themselves in the self-reinforcing situation of being able to attract the talent and other resources to maintain momentum. Such innovation systems are best thought of as an eco-system, comprising a number of interdependent parts. The ongoing availability of capital to fuel innovation at a reasonable price is critical to the sustainability of any innovation system.

In New Zealand and internationally the capital to fuel the early stages of innovation comes from a variety of sources including from friends and family of those involved, wealthy individuals or wealthy family offices, government support, corporate venturing, angel investors (i.e. those with investable sums and the time to engage themselves in some way) and venture capital funds. However, when the sums required exceed about $2 million (in the NZ context) venture capital funds are often the only source of capital until the business has established itself sufficiently to qualify for funding from more traditional sources (e.g. from traditional equity markets and bank debt funding).

This report charts the history of venture capital in New Zealand thus far, identifies issues with the current state of the venture capital market, and recommends public policy settings necessary to take it forward. The stakes are high for the NZ economy in ensuring innovation and its commercialisation by new firms is adequately funded, as these businesses are an important component of the path to lifting our productivity levels, increasing exports, and improving our living standards.

2 The National Party's *Economic Development Action Plan: Building a Stronger Economy*, 2011, points 92 – 96 recognise the importance of innovation, R&D and its commercialisation process to economic growth.

A BRIEF HISTORY OF VENTURE CAPITAL IN NEW ZEALAND

The modern form of venture capital has its origins in the US and grew out of opportunities to commercialise technologies developed in the Second World War. Venture capital firms emerged to address three inter-related issues in the commercialisation cycle; to sort the promising firms from the many applicants, to govern those firms in a focused way that limits the inherent agency problems, and to develop a certifying role for bringing new firms to the public capital markets. Their development was assisted by government grant programmes.

The current institutional structures for venture capital funds emerged in the 1970s and comprise a pool of capital associated with a fund manager, who is paid a retainer but whose primary reward is a share of the capital growth of the fund over its life (usually about 10 years). This model has proliferated internationally, continues to be used, and has been adopted in New Zealand.

There was little structure to the New Zealand venture capital market until the early 2000s. Prior to that venture capital was typically provided by corporates (usually internally), by government grant schemes or institutions set up to fund these activities (e.g. the Development Finance Corporation and the Greenstone Fund), or by wealthy individuals or family offices. However none of these initiatives resulted in the emergence of an identifiable venture capital market.

In 2002 the government established the New Zealand Venture Investment Fund (NZVIF) with the following four objectives:

- To accelerate development of the venture capital industry by increasing the level of early stage investment activity in the New Zealand market;
- To develop a larger pool of people in New Zealand's venture capital market with skills and expertise in early stage investment;
- To facilitate commercialisation of innovations from the Crown Research Institutes (CRIs), universities and the private sector; and
- To get more New Zealand businesses on paths to global success by increasing their access to international experts, networks and market knowledge.

The design of NZVIF was modelled on the successful Israeli Yozma funds which had been a government initiative in the early 1990s to commercialise opportunities arising out of Israel's strong domestic science and technology base.[3] The NZVIF initiative arose in the context of other initiatives (government and private) aimed at raising the long term performance of the New Zealand economy, including the Growth & Innovation Framework, the Knowledge Wave, the formation of KEA (Kiwi Expatriate Association), the New Zealand Institute, and so forth.

It is notable that the NZVIF mandate from the outset was wider than just the provision of capital and encompassed building the infrastructure[4] of a venture capital market as well as being the catalyst for the formation of venture capital funds. In recent years New Zealand Trade and Enterprise (NZTE) has also assisted the development of the venture capital market by providing international connections and networks to help link venture fund managers with investors, and providing in-market assistance and connectivity for venture businesses wishing to export or form commercial linkages off-shore.

The Capital Markets Development Taskforce supported the continuation of the NZVIF model and recommended it be enabled to be more innovative in its approach.[5]

The following four graphs provide an overview of progress of the venture capital market over recent years.[6]

Figure 1 illustrates the total venture investments made since 2003, with the NZVIF and private contributions identified separately. The outcome illustrates that the NZVIF programme has been the catalyst as intended for other investors to participate in this market.

Fig 1: Cumulative venture investment

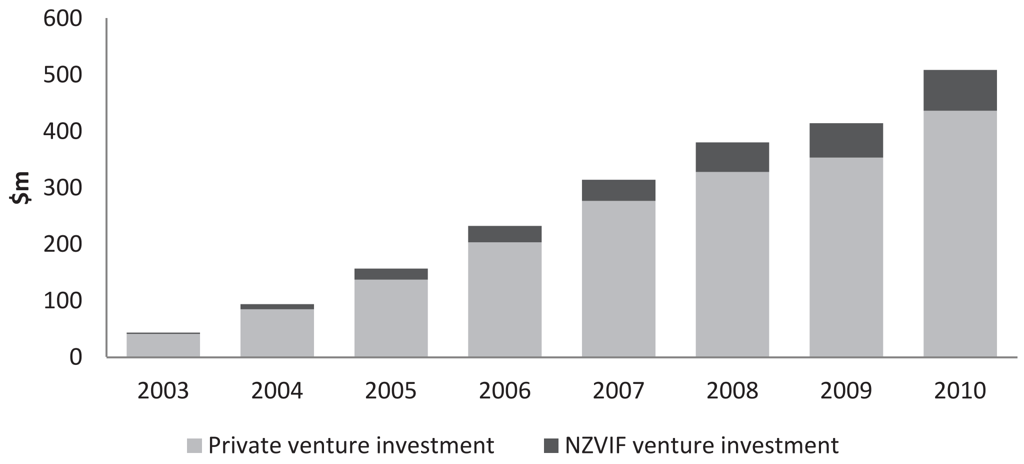
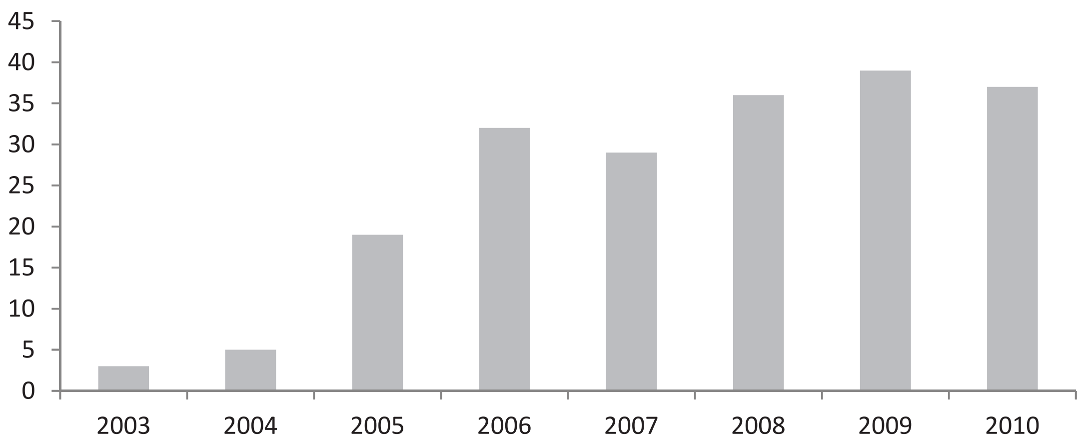


Figure 2 plots the number of active venture-backed companies in each year.

Fig 2: Number of active venture-backed companies



5 See pages 60 – 64 of *Capital Markets Matter: Report of the Capital Markets Development Taskforce*, December 2009

6 Figure 1 data are sourced from the New Zealand Private Equity and Venture Capital Monitor 2010 and NZVIF sources. Data for Figures 2 – 4 and the Appendix are from NZVIF sources.

Figure 3 sets out the aggregate annual revenues of these venture-backed companies, with export and non-export sources identified separately.[7] We note the high proportion of export revenues from these young businesses.

Fig 3: Annual revenue of venture-backed companies

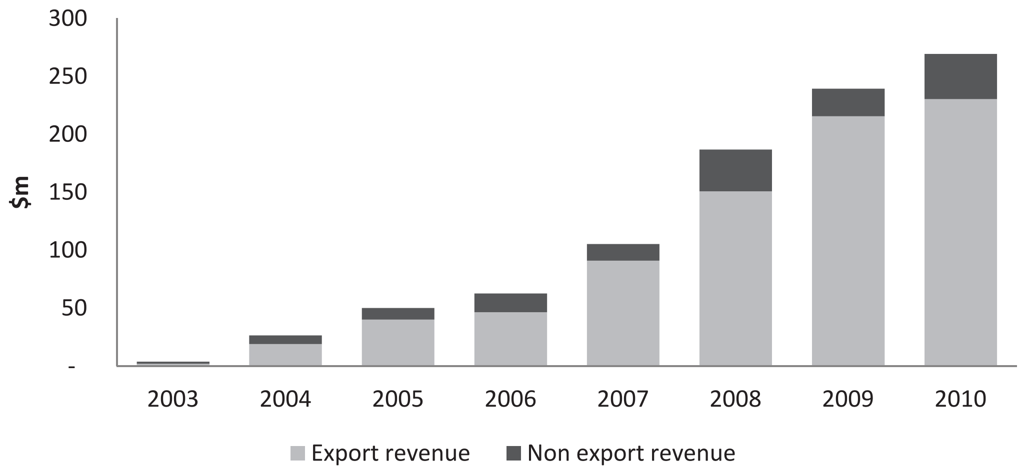
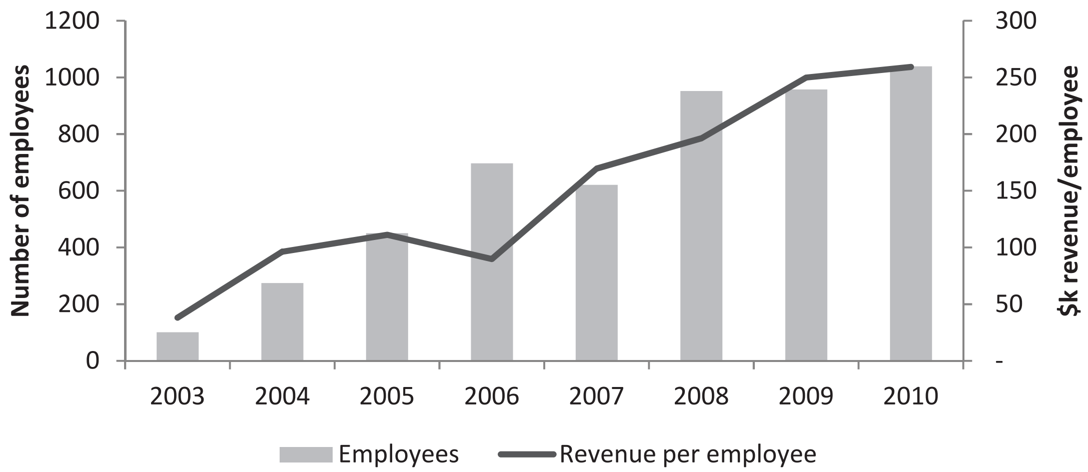


Figure 4 illustrates the aggregate number of employees in these venture-backed companies each year and annual revenue per employee. These are impressive outcomes for young businesses operating largely in export markets. The average revenue per employee of New Zealand businesses with 6 to 50 employees is $140,000.[8]

Fig 4: Number of employees and revenue/employee



The appendix provides data on the stages at which venture capital funds invested in these businesses, their commercialisation sources, and the sectors in which they operate.

7 For year on year comparison purposes the 2010 numbers include a large successful business that was exited by its venture capital fund manager in 2009.

8 This is an average over 2007 - 2009, see page 42 of *SMEs in New Zealand: Structure and Dynamics, Ministry of Economic Development*, September 2011

Current issues with NZ's venture capital market

Contrary to previous attempts by government to create a venture capital market, over the last nine years an identifiable and functioning venture capital market has emerged along with the supporting infrastructure. This has been achieved by modest levels of public resources and (appropriately) larger contributions from other investors. It is a very good example of a public/private partnership functioning well, with each partner playing to its strengths and neither squeezing the other out.

However, the further development of NZ's venture capital market is at a critical stage. It has been hit by a number of events which, cumulatively, have stalled progress. The global financial crisis took hold at a time when the good performers from the first crop of investee firms were approaching the stage of needing post-venture funding, but for most this has been curtailed.

The resulting economic downturn has not only made it much more difficult for these young businesses to grow and move forward, it is also resulting in the original venture capital funds performing poorly to average, and thereby not having a strong record to point to when raising their next fund. This situation is exacerbated by the aversion to risk that the financial crisis has brought about on the part of investors, which has hit the venture capital sector worldwide very hard. This sector has always been very cyclical and it is currently in a deep trough.

The funding capacity of the seven existing NZ venture capital funds is largely committed and therefore they have little capacity to invest in new investee firms. This means firms needing venture funding of about $2 – 10 m are finding it almost impossible to secure venture backing locally and this issue will get worse on current settings. A small number of investee firms have over recent years successfully secured venture funding from off-shore (e.g. Atlantis Healthcare, Biovittoria, CODA, LanzaTech, Open Cloud, Proacta and Zephyr). However, the process of attracting venture capital off-shore is long, hard and expensive, and particularly so if local venture capital funds are not participating. The larger off-shore venture capital funds are best thought of as complements to the local ones (capable of providing larger capital sums but drawing on local governance) rather than substitutes. From a NZ economic perspective greater benefits accrue locally from greater participation of local venture capital funds.

A further complication for fund raising is the composition of the New Zealand capital markets. The pool of institutional investors that are likely investors in venture capital funds is small and dominated by two institutions – NZ Super and ACC. The Capital Market Development Taskforce identified this lack of depth in our capital markets as an issue for the sourcing of venture capital.[9] The track record of the venture capital sector thus far leads these investors to be cautious, and the absence of their involvement makes it very difficult for fund managers to raise capital from others (locally and internationally) who tend to look to these two large players for a lead.

Further, KiwiSaver policies create barriers to these rapidly increasing pools of capital investing in local venture capital funds. These barriers include defined management expense ratios in the default Schemes, the portability requirements on all Schemes which lead to the need for certain liquidity levels, and pending disclosure requirements which may bias Scheme Providers away from investing in actively managed funds due to their higher management expense ratios (if disclosures have the effect of emphasising these expense ratios over net returns). While we recognise the wider purpose of these various policies, they are having an unintended effect of creating barriers for the Scheme Providers to invest in the venture capital sector.

9 See pages 60 - 64, ibid

This all adds up to a New Zealand venture capital fund being a very difficult business to operate and to grow right now. The relatively narrow focus of the NZVIF programme on earlier stage investing does not, in its current form, provide the necessary support. Most venture capital fund managers operate, or would prefer to operate a wider mandate than covered by the NZVIF programme. If left to run its course this dynamic will result in the demise of New Zealand's venture capital market and the associated market infrastructure established by the sector over recent years.

If this were to occur, we foresee the policy cycle that has taken place a number of times over the last thirty years or so repeating itself in a few years time. Once the economy picks up the gap in funding for venture businesses will become more apparent and the government of the day will once again try to kick-start a venture capital market (or some equivalent). The NZVCA considers this undesirable outcome and potential waste of resources could be averted by careful policy re-orientation now, to which we now turn.

PUBLIC POLICY IMPERATIVES

In order for New Zealand's venture capital market to survive in the short term, and to be fit for purpose to help grow the economy over the long term, policy settings need to take account of the current difficult period and the emergent nature of this component of New Zealand's capital markets. We consider this could be achieved with policy settings that achieve the following:

- Introduce a longer term view and greater flexibility into the NZVIF venture capital programme.
- Create a more favourable environment for investors to invest in venture capital funds.
- Maintain and grow the venture capital market infrastructure.

1. Introduce a longer term view and greater flexibility into the NZVIF venture capital programme

The current NZVIF policy settings were designed to establish a venture capital market in a context where one didn't exist. There is now an imperative for the NZVIF programme to be both more nimble to respond to market imperatives and to also signal to the market its long term intentions, in order for market participants to be able to make good use of this support mechanism.

The current annual Statement of Corporate Intent (SCI) approach goes some way to signalling long-term NZVIF intentions, but it is conducted within the context of prescriptive policy settings, some of which are not well attuned to market realities, and any change involves a relatively cumbersome and slow policy review process. These policy settings cover, for example, the intended weightings of the fund across early stage and expansion investments, ratios of NZVIF and private capital matching at each stage, the maximum size of funds, whether there is an early buy-out option for private investors, and the way in which the programme can engage with off-shore investors (e.g. sovereign wealth funds) that require a degree of reciprocity in their home markets.

It is common in negotiations between potential fund managers, other investors and NZVIF for some of these policy settings to stall progress, with the NZVIF having limited ability to negotiate workable solutions that would nevertheless still deliver on the NZVIF objectives. A similar issue arises where a fund manager wishes to raise a fund that is primarily committed to venture capital (as defined in the NZVIF mandate) but also wishes to retain some flexibility to invest in businesses that fall outside this mandate. This form of flexibility is very important to some fund managers (and particularly so in the current climate) but is difficult to accommodate within the NZVIF mandate, even though the venture capital component of such a fund is consistent with the NZVIF objectives. Thus the current prescriptive policy settings have the effect of blocking NZVIF support to fund managers that could support achievement of the NZVIF objectives.

NZVCA recommends a better approach from an accountability perspective, and one that would allow NZVIF to be more nimble, would be for the NZVIF Board to be provided the scope to propose to shareholding Ministers the policy settings that would enable NZVIF to best meet its objectives, and for shareholding Ministers to have the role to approve or decline such policies. It would also be useful if this approach resulted in shareholding Ministers clarifying their long term (say 10 year) intentions for the NZVIF programme, in order to provide the market greater certainty.

If this approach is not acceptable, then at a minimum the NZVCA recommends current NZVIF programme policies be modified to enable NZVIF to operate more flexibly and effectively in pursuit of its objectives.

2. Create a more favourable environment for investors to invest in venture capital funds

Investment in venture capital funds requires a commitment of usually about ten years (and the fund manager commits to manage the fund for the same period). This commitment period poses challenges for some investors. In addition, off-shore institutional investors usually take into account the degree of local institutional support as part of their due diligence, and particularly look to involvement of any local sovereign wealth fund. Thus participation of local institutional investors, and particularly NZ Super, is an important part of growing the investor base for venture capital.

The NZVCA recommends the government undertakes the following initiatives:

- In relation to immigration policy and its implementation, where investment in New Zealand is part of the qualifying process (i.e. Investor Plus and Investor categories):
    - Refine the implementation process to ensure opportunities to invest in venture capital funds in New Zealand are presented and made accessible to potential migrants. This could be achieved within existing policy.
    - Review policy in relation to the qualifying asset classes for these immigration categories with a view to weighting favourably those asset classes that most directly contribute to growing the New Zealand economy, including venture capital funds.
- If government is minded to provide further guidance to NZ Super to invest a portion of its funds in growing the local economy, that it include in such guidance that some of this investment be channelled into venture capital.
- Review KiwiSaver polices with a view to lowering barriers to Scheme Providers to invest in local venture capital funds that arise from portability requirements (and the resulting need for liquidity), and from management expense ratio issues (both the defined level of these ratios for default Scheme Providers and possible disclosure requirements that may lead to a focus on this ratio above net returns).
- Consider tax incentives for investment in venture capital funds.

3. Maintain and grow the venture capital market infrastructure

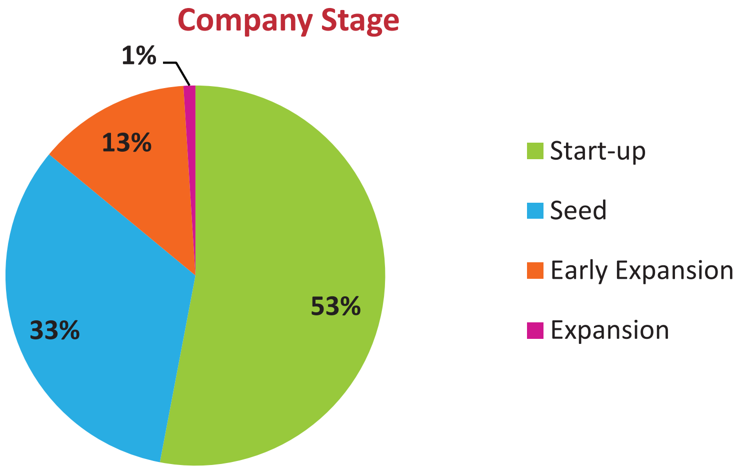
The venture capital market infrastructure is relatively unique to it and is critical to this market functioning efficiently. This infrastructure has been developed gradually over the last nine years but would dissipate quickly if left unattended, or if the market stalled. NZVIF originally played the primary role in developing this infrastructure but over recent years NZTE has also played a role, and in particular in assisting with connectivity in off-shore markets in relation to potential investors and export markets.

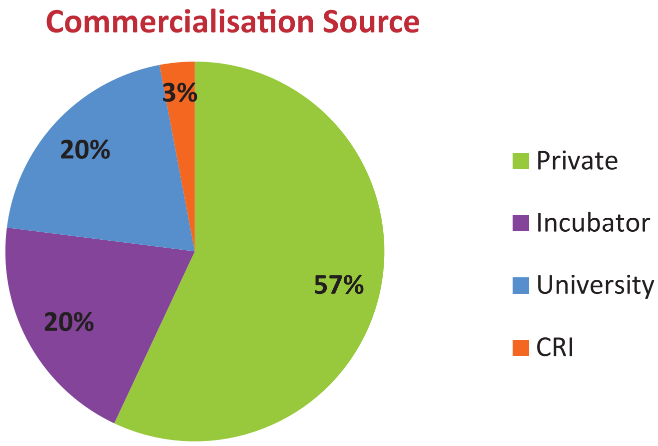
The high priority items that require government support are:

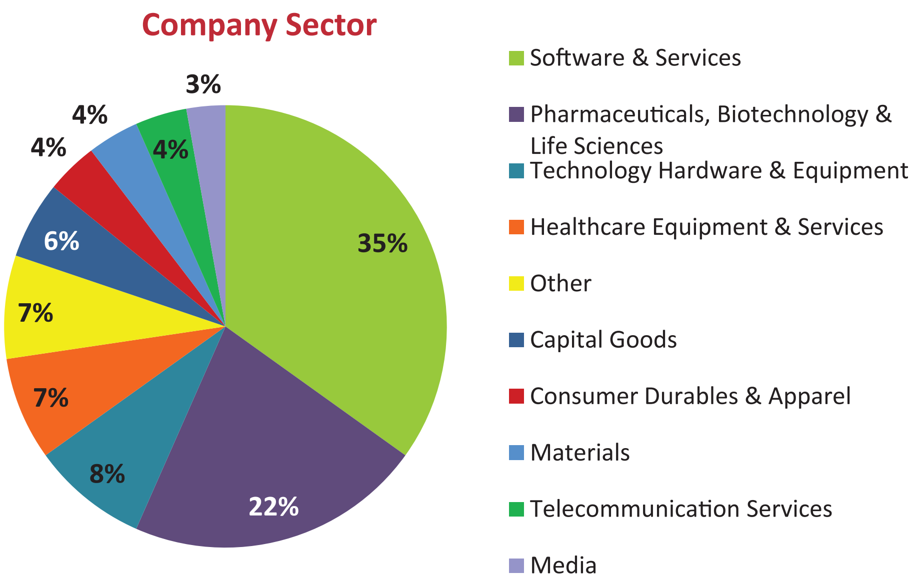
- Create opportunity for venture capital specialists to provide policy input early in the development of the new Ministry of Science & Innovation's initiatives to commercialise intellectual property from investment in public-good science, in order to ensure these initiatives are aligned with and dovetail into sustainable and effective commercialisation processes.
- Maintain operational funding to NZVIF for its venture capital market development activities.
- Support capability building with funded internships for both new and existing venture capital fund managers to expand the domestic skill base.
- Maintain NZTE support for promotion of New Zealand as an investment destination:
    - For the staging of investor forums in strategic locations and ongoing support with investor networks.
    - Where possible, include direct Ministerial involvement in these investor forums.
- Maintain NZTE support to assist in-market connectivity and networks for venture businesses that are looking to export or to form commercial linkages in offshore markets.
- Maintain commitment to the Limited Partnership legislation and its tax look-though features and address continuing tax impediments to international flows of capital, e.g. those faced by non-NZ resident investors investing in a NZ fund, or by a NZ fund wishing to relocate an investee business offshore.

APPENDIX

Company stage, sector and source of venture-backed companies invested in by NZ venture capital funds







THE REPORT

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The report was prepared for the New Zealand Private Equity and Venture Capital Association by Stuart Shepherd, Sapere Research Group.

About Sapere Research Group

Stuart Shepherd is a Director of Sapere Research Group (Sapere), based in Auckland, and advises primarily in the areas of regulatory economics, business strategy, and public policy issues.

Sapere Research Group is one of the largest expert services firms in Australasia. Sapere provides independent expert testimony, strategic advisory services, data analytics and other advice to Australasia's private sector corporate clients, major law firms, government agencies, and regulatory bodies.

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About the New Zealand Private Equity and Venture Capital Association (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.

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