MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

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Some information has been withheld for the following reasons:

- Commercial information
- Confidential advice to Government

Commercial in Confidence

Office of the Minister for Economic Development

Cabinet Economic Development Committee

Update on the Venture Capital Fund's Progress and the Wider Capital Markets

Proposal

1 This paper responds to the Committee's invitation to provide an update on the Venture Capital Fund.

Executive Summary

2 On 6 May 2020, the Committee invited the Minister for Economic Development to provide an update as soon as practicable on the Venture Capital Fund and its operation [DEV-20-MIN-0066].

3 Following its launch in February 2020, the Venture Capital Fund has taken significant steps to be investment ready, including setting up the Elevate Investment Committee with three internationally experienced independent members. Commercial Information [redacted]

4 Commercial Information [redacted] (once matched with Elevate NZ Venture funds) could be deployed into the ecosystem in the next 18 months to three years from early July.

5 The Elevate NZ Venture Fund is an important intervention for a small set of companies, which are very high growth and in the early stages of development.

6 At this stage we are not seeing market turmoil – currency, bond markets and swap markets are steady at this stage. However forecasts by the OECD are for FDI to fall by least 30 per cent in 2020 under optimistic scenarios.

7 Our delivery agencies, including NZTE, report that foreign investment is already becoming difficult with increased uncertainty affecting large projects, and tighter cross-border movements making due diligence and execution difficult. This has the potential to significantly affect access to capital for a broad range of companies over the coming months.

8 While the Elevate NZ Venture Fund should support New Zealand's early stage high growth firms, complemented by other measures (eg the $150 million R&D Loan Scheme), other 'gaps' warrant further support.

9 The Small Business Council and officials from MBIE and NZTE have previously identified a capital gap for smaller but more mature companies (with revenues between $3 million and $30 million) that are not typical venture capital targets (ie they have slower growth rates) and fall below the typical private equity (PE) range. Many of these are in important and growing sectors like food and beverage or advanced manufacturing and are key to export growth.

10 While domestic private equity markets have been growing, mid-tier and non-listed larger companies have still relied on foreign investment for buyers or deal brokers with specific skills, industry expertise, connections or scale. Given the likely magnitude of the impact of COVID-19 on particular industries and the relatively small size of New Zealand's private capital markets, there could also be a gap for medium-to large-sized companies that are not listed on public exchanges.

11 Confidential advice to Government [redacted]

12 Confidential advice to Government [redacted]

13 We must ensure we have a detailed monitoring system in place to scrutinise individual firms to understand their changing capital needs and monitor emergent financial distress at a more granular level.

14 I also propose relooking at our foreign investment attraction strategy in the post COVID world and particularly how we attract high quality firms to New Zealand. This could leverage off a possible "comparative advantage" of having less COVID imposed disease and business restrictions than other countries, and our currently heightened brand and reputation in the international market.

Relation to government priorities

15 The Government's Economic Plan identifies eight key shifts and policy action the economy needs to transition to more productive, sustainable and inclusive growth. For success, it articulates that deeper pools of capital are available to invest in infrastructure and grow New Zealand's productive assets.

16 As part of the Government's economic response to COVID-19 I am focused on seeing investment and specifically deeper investment in the early stage capital markets remain a priority as we respond to COVID-19.

17 This Government has committed to growing early stage markets through the new venture capital fund of funds. Announced as part of Budget 2019, a new Venture Capital Fund was established during 2019 and early 2020. It is operated by the New Zealand Venture Investment Fund (NZVIF) on behalf of the Guardians of New Zealand Superannuation.

18 As part of that process in March 2020, NZVIF was rebranded to become New Zealand Growth Capital Partners (NZGCP), and the Venture Capital Fund was launched as the Elevate NZ Venture Fund.

19 The Elevate NZ Venture Fund is a $300 million fund of funds programme that looks to fill the capital gap for high-growth New Zealand firms at the Series A and B fund raising stages.

Background

20 New Zealand is a capital shallow economy with a long-run of productivity underperformance reflecting its weak international connections, small insular domestic markets, and low investment. With the onset of COVID-19, there has been a significant decline in investment in capital markets globally. Faced with lower incomes, weaker global demand, and higher uncertainty, New Zealand firms have cancelled or delayed planned investments. This is reflected in the *May ANZ Business Outlook*, which shows a drop-off in firms' investment intentions.

21 The Reserve Bank of New Zealand noted in their May Monetary Policy Statement that investment is likely to remain low for a prolonged period of time, given the subdued economic outlook and heightened uncertainty.

22 Weak business investment and New Zealand's capital shallow economy has always a challenge and may now become a significant barrier to recovery for more firms.

Investment is expected to decline globally due to the pandemic

23 The RBNZ notes that total bank lending balances have contracted by a little under one per cent in April, but expectations are that the global investment environment will be more challenging as economies work through recoveries. The OECD has forecast that there could be a drop of global FDI flows of around 30 per cent in 2020 even under their most optimistic scenario for the success of the public health and economic support policy measures taken by governments to address the COVID-19 pandemic and the resulting recession.[1]

24 This is due to the pandemic hitting at a time when global FDI flows were at their lowest level since 2010. In addition, global corporate debt was at record levels when the pandemic hit. High levels of global corporate debt could limit the ability of companies to survive the pandemic, let alone support their foreign affiliates or pursue new investments.

25 Historically a large proportion of existing FDI in New Zealand was market-seeking – aimed at servicing the domestic market (for example, Australian investment in banking, insurance and retailing, with some manufacturing for the trans-Tasman market) and resource-seeking (for example, North American investment in forestry). More recently targeted attraction programmes, including those in the investment attraction taskforce and run by New Zealand Trade and Enterprise and MBIE's Innovative Partnerships team have worked at attracting high quality and catalytic investment to support nascent sectors, or particular industries and regions.

Reform of the Overseas Investment Act 2005

26 On 6 May 2020, Associate Minister of Finance, Hon David Parker, introduced a paper to bring forward reforms to New Zealand's Overseas Investment Act ([DEV-20-MIN-0066 refers]. In particular it introduces a national test to provide oversight of

[1] OECD (2020) *Foreign direct investment flows in the time of COVID-19* https://read.oecd-ilibrary.org/view/?ref=132_132646-g8as4msdp9&title=Foreign-direct-investment-flows-in-the-time-of-COVID-19

foreign investment in New Zealand's most strategically important assets, and introduces a temporary emergency notification power that would require an overseas person to notify the government of any investment in an existing business or certain business assets that would not ordinarily require consent.

27 The Committee agreed to a range of reforms to the Overseas Investment Act 2005, including agreeing to introduce the Overseas Investment (COVID-19 Emergency Measures) Amendment Bill that allows the responsible Minister to impose conditions on, decline, or unwind transactions reviewable under the temporary emergency notification power where they are contrary to New Zealand's national interest.

28 The Ministers for Foreign Affairs, Finance and Associate Finance (Hon David Parker) have the delegated authority to review the temporary emergency notification power every 90 days. It will remain in place only as long as it is necessary to protect the essential interests of New Zealand while the COVID-19 pandemic and its economic aftermath continues to have significant impact in New Zealand.

29 The Committee noted that if we were to prevent overseas entities acquiring a substantial share in companies due to some national interest or security reason, we would need to ensure there were other avenues for those companies to raise debt or equity or be acquired. In light of this the Committee requested a progress update on the Venture Capital Fund [DEV-20-MIN-0066 refers].

Venture Capital Fund (Elevate NZ Venture Fund) progress update

30 Following its soft launch in February 2020, the Elevate NZ Venture Fund has taken significant steps to be investment ready. The Investment Committee has appointed three independent members from a high calibre pool of potential appointments. Danny Lee (Partner, Blue Pool Capital Limited, based in Hong Kong), Matt Ocko (Partner, DCVC, based in San Francisco) and Dana Settle (Partner, Greycroft and Director of US NVCA, based in Los Angeles) have joined.

31 Elevate has also appointed Randy Komisar (an entrepreneur, investor, lecturer and author and previously with Kleiner Perkins, based in San Francisco) as a strategic adviser to the fund. Randy's role includes assisting the funds that Elevate invests in with best practice operational and investment procedures as well as enhancing their international connectivity.

32 The quality of representation on the Elevate Investment Committee is a critical success factor, to promote capability, reach and independence as New Zealand companies establish a global presence. The Guardians of New Zealand Superannuation provided support to this process. NZGCP's appointment of a majority of independent members to the Elevate Investment Committee and the introduction of a requirement that Elevate Investment Committee decisions will require 75 per cent member agreement reflect Guardians' guidance.

33 Below is a summary of key points:

33.1 The Elevate NZ Venture Fund Commercial Information

33.2 Commercial Information for consideration against the nine point conviction framework that has been developed with the Guardians of New Zealand Superannuation. Commercial Information

33.3 Commercial Information those declined have received communications indicating factors that would need to be addressed for reconsideration.

33.4 Of the funds at detailed due diligence:

33.4.1 Commercial Information

33.4.2 Commercial Information

33.5 Although it is hard to estimate the timing of downstream investment into New Zealand companies, Commercial Information

34 Commercial Information (once matched with Elevate NZ Venture funds) could be deployed into the ecosystem in the next 18 months to three years. This amount of capital will be higher than there has ever been in the venture capital space.

35 Officials conferred with the Guardians of New Zealand Superannuation and NZGCP to assure that no immediate policy changes to the Elevate NZ Venture Fund are required in the wake of COVID-19 impacts on capital markets. Market interest has been high and in some cases Funds have reached first close, meaning that investments can already take place.

36 Commercial Information Conversely, potential Funds believe there are opportunities being presented by the COVID-19 disruption. My officials see three key areas to monitor closely over the next 12 months, as the economic impacts evolve, to ensure there is sufficient New Zealand-based capital to avoid New Zealand's promising businesses being forced to seek overseas capital by default:

36.1 <u>Capacity</u>: The number of funds that will approach NZGCP over the next 12 months.

36.2 <u>Demand</u>: The success of those funds in raising matching capital from private investors.

36.3 <u>Supply</u>: A maintained momentum in the market with a strong pipeline of deals from the angel/seed market.

37 In the current environment, NZGCP is experiencing a significant increase in companies approaching them for funding (both existing portfolio companies and companies fund raising for the first time). At the same time, they are seeing a decline in angel/seed private capital activity.

38 Feedback from the market suggests angel investors particularly have held back almost all investment into new deals as the perceived risk is too high. They are focusing on existing investments and protecting their assets. Many are only focusing on the best businesses rather than their entire portfolio. If angel investors are looking to invest, however, the levels of investment are lower than usual (for example, raises expected to be around $1 million are attracting $200,000 levels of private capital).

39 The Minister of Finance and I are considering NZGCP's role, and the associated investment caps, in relation to the angel/seed market. I will shortly be providing the NZGCP Board with a letter to set out my expectations for the company in delivering the Elevate NZ and Aspire NZ (seed capital) Funds.

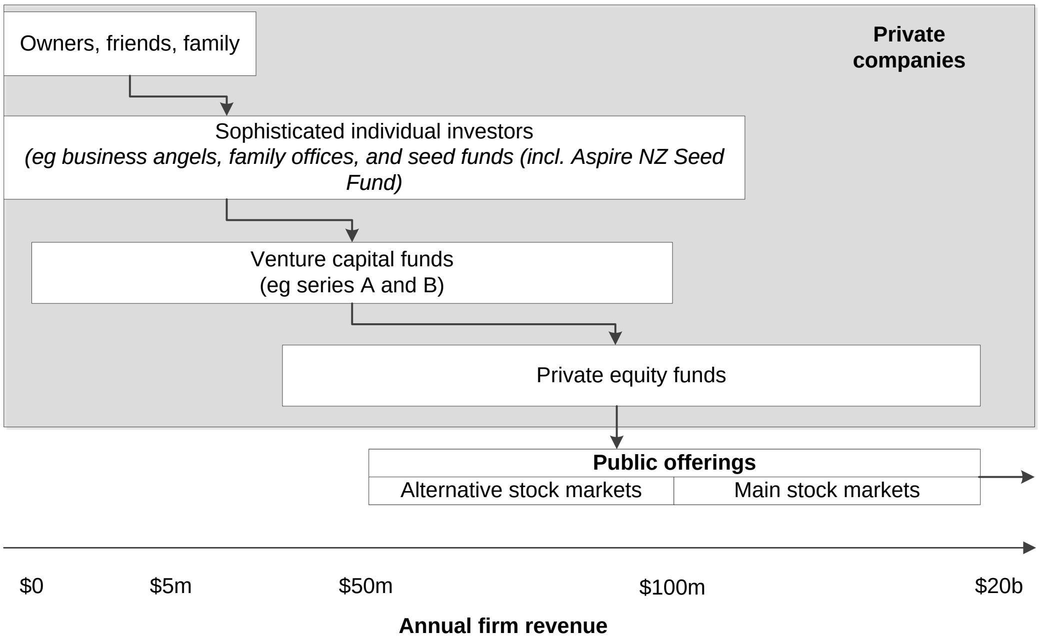
40 Altogether I am pleased with the recruitment of the Elevate Investment Committee and the strategic advisor as a substantial long-term benefit to establishing New Zealand's growth capital market. The Elevate NZ Venture Fund and the Aspire NZ Seed Fund are well placed to support investment into promising high-growth New Zealand businesses in the next six to eight weeks. I will reaffirm the Government's desire to ensure this timeframe does not slip.

Venture capital is a small part of the broader capital market

41 The Elevate NZ Venture Fund is an important component of the broader capital market, but serves a relatively small and niche segment of it. The Figure below highlights typical equity funding sources.

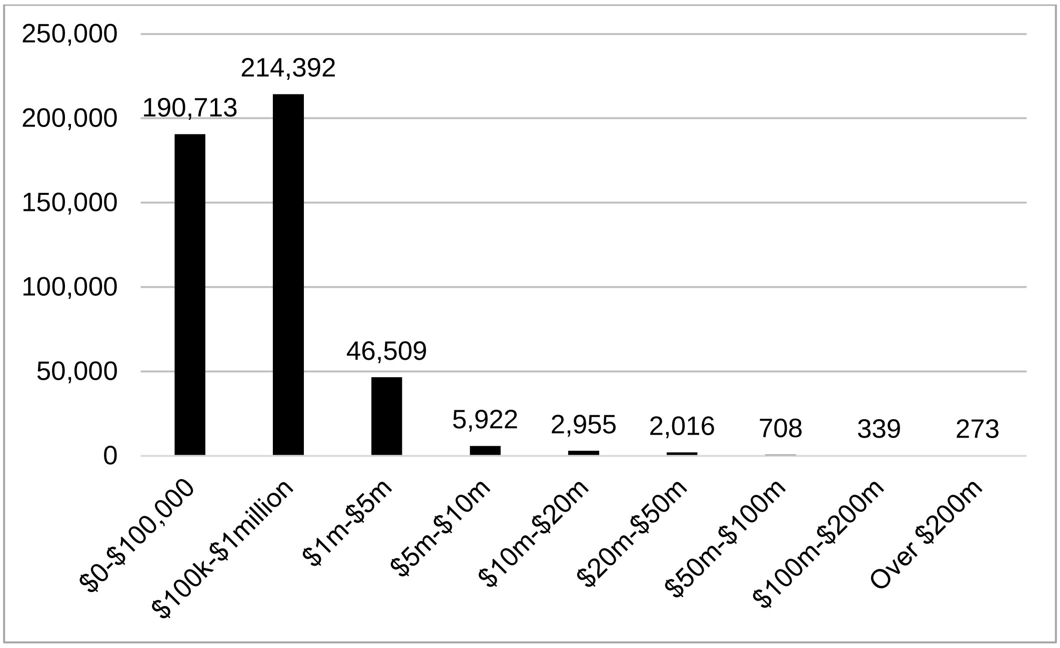
42 Company valuations in venture capital deals vary greatly and could be anywhere from $5 million to $100 million, depending on a company's intellectual property, value proposition and anticipated future earnings. Similarly when classified by revenue, venture capital recipients could range from pre-revenue or below $1 million per annum up to $50 million and beyond. Importantly, these companies represent a small component of the broader category of companies in those same revenue classifications.

Figure 1: Example of a growth path for a venture-financed start-up



43 For example there are around 1,200 companies classified as early stage companies in New Zealand per Callaghan Innovation's Scale-up ecosystem database, but there are more than 425,000 firms in New Zealand with revenue below $1 million.

Figure 2: Firm size by annual turnover



44 More mature companies typically seek capital from other sources. This could be in the form of corporate bonds, or equity in both private and public markets. Private markets include amongst others Private Equity (PE) funds, family offices, and alternatives like crowdfunding.

45 Typically venture capital funds invest in high-risk, high-growth firms in their early stages of development that are too small to raise capital in the public markets or unable to secure a bank loan because of untested business models and low collateral. Usually these are young companies with a disruptive innovation or business models that have high expected growth in revenue and returns. Venture capital funds typically do not invest in more established companies or those with a more ‘normal’ growth trajectory.

46 The Elevate NZ Venture Fund is targeted at the investment stages often termed Series A and B, where the majority of deals will be valued between $2 million and $20 million. Such investments usually follow earlier funding rounds, at the seed or start-up stage, where Angel investors form a key component.

47 The venture capital market depends on a pipeline of start-ups, strong research and innovation, and entrepreneurs commercialising research and development. Developing more technology-intensive or innovative firms and sectors is a critical component of our efforts to transform the economy and we have been raising the support for this segment of the economy in recent times. It is important that we continue to support these companies during the recovery and rebuild of our economy.

Private capital markets are relatively under-developed with pre-existing gaps

48 In New Zealand there has been a long-standing concern that financial system development has been inhibited by the relatively underdeveloped nature of New Zealand's corporate bond and equity markets. In particular past capital market reviews have pointed to a stock exchange (the NZX) that is small by global standards and struggling to attract new listings, and private markets that are growing, but not necessarily serving the full range of New Zealand investors.[2]

49 These reviews have also found that neither public nor private markets serve the full range of companies by size or investment stage. While the Elevate NZ Venture Fund will bring much needed capital to the venture investment stages, it will do little to address a historical gap that smaller firms (with revenue between $3-$30 million) face in accessing growth capital. This includes companies that, for example, are more mature but still lack scale. That is, they are able to generate revenue and profit but are unable to generate sufficient cash to fund major expansions, acquisitions or other investments.

50 In the post-COVID-19 world we would also expect a number of distressed companies that need to restructure their balance sheets (for example to reduce the amount of debt leverage). Historically, the capital gap has been at the smaller end, but given the likely scale of the impact on particular industries and the relatively small size of New Zealand's private capital markets, there could also be a gap for medium to large companies.

51 While PE markets have expanded successfully in New Zealand, many are still focused on taking controlling stakes as key to effecting their growth or turnaround strategy. While there is significant capital (dry powder) already raised in PE funds, they are usually highly selective, invest in only a few deals a year after extensive due diligence, and often wait until companies are distressed.[3]

52 The PE industry, including not only the quantum of funds under management, but also the availability of deal brokers, are unlikely to service the entire market's needs. The market is sub-scale especially when so many firms are unlikely to want to take on significantly more debt.

The public capital markets are relatively small

53 New Zealand's distance, small insular domestic markets and the structure of the New Zealand business sector has meant that the majority of firms are not of sufficient scale to justify listing on the stock market, due to prohibitive issuance costs and high compliance standards.

54 This has been exacerbated by recent global stock market trends which have seen larger trading volumes, and more traders, but a halving of the number of publically listed firms. Trade volumes and investor access are boosted through the fractionalisation of investment opportunities (via schemes like Sharesies) and the rise of passive investments and exchange traded funds.

[2] For example, *Capital Markets Matter* (2009) and *Growing New Zealand's Capital Markets 2029* (2019).

[3] The forthcoming private capital monitor will show that funds already raised in the private equity space have over $1 billion of committed capital. However a large $400 million private equity fund, like that recently raised by Direct Capital, might typically invest in 7-10 deals over the course of the fund, and usually 2-3 deals a year.

55 However, trading commissions have declined and broker research coverage has fallen, making it harder for smaller companies. The outcome is that the domestic stock market is unlikely to provide capital to most companies in New Zealand.

56 The stock market does provide sufficient access to capital for the firms that are at the size and scale to have already listed. Some NZX listed firms, particularly those in sectors directly impacted by COVID-19, have successfully raised capital in recently. These include the likes of Auckland airport ($1.2b), Z Energy ($350m), Kathmandu ($207m). Up to June 2020, there were 14 capital raises between $10 million and $100 million and 4 capital raises over $100 million and in NZX listed equity markets.

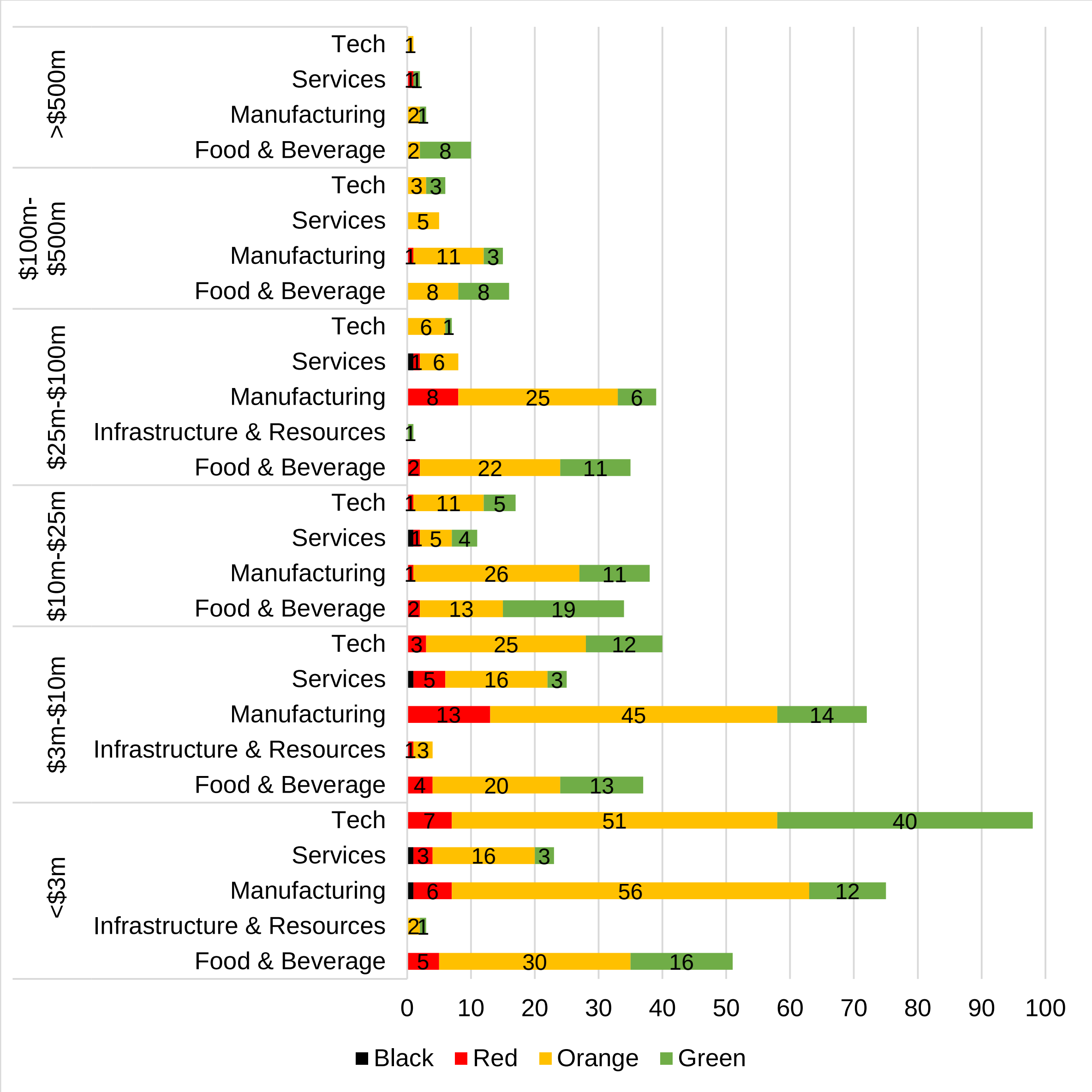
Sector specific gaps

57 There are particularly sectors where there are a large number of smaller companies that have historically struggled to access growth capital, and do not have the typical characteristics that would qualify them to be a venture capital target. For example, in the fast growing food and beverage, and specialised manufacturing sectors there are many companies in the $3-$30 million revenue space that are far too small to list, but also too small to attract investment from established PE firms.[4] Many of these companies also battle to attract additional debt as they are already strongly leveraged. Yet these firms are critical to our aspirations to grow our innovative industries, like those supported by the Industry Transformation Plans, and to grow value-added exports from New Zealand.

58 The figure below represents the top 700 companies (the Focus 700) that NZTE supports by international revenue band and sector. For example there are just under 80 manufacturing companies in the F700 with overseas revenue below $3 million. The colour categories represent their self-reported financial position, and can be interpreted as follows: **Black** means the firm is in financial distress, **Red** means there has been a marked decline in their financial position and they require immediate loan or equity support, **Orange** means that they have seen a decline in the financial position, but still consider their position to be strong and **Green** means they are financial sound and they are doing well.

[4] A PE firm doing 6-10 deals over the course of a fund, would typically want the investment cheque size to be larger, and hence the company to be of a larger scale.

Figure 3: Focus 700 customers by international revenue band and sector



Government economic response will improve liquidity, though firms will need recapitalising

59 The Government's economic response package is on an unprecedented scale. The business support measures aim to improve liquidity in the short to medium term (through wage subsidies and tax-loss carry-back mechanisms), facilitate the supply of credit (through the Business Finance Guarantee Scheme[5]) and support solvency through the easing of some insolvency requirements. These measures help preserve firm value and therefore reduce the need for additional financing.

[5] The scheme is delivered via the banks and is supported by a government guarantee to recognise the economic uncertainty involved in lending to firms during a crisis – the Government will take 80 per cent of the risk, while the banks will take 20 per cent. Commercial Information

Confidential advice to Government

60 Confidential advice to Government

61 Confidential advice to Government

62 Confidential advice to Government

63 Confidential advice to Government

64 NZGCP and the Elevate NZ Venture Fund are our long-term market-develoment interventions to help make sure New Zealand's high-growth firms have access to sufficent venture capital. This is complemented by a number of support initiatives aimed at even earlier firms and research and development including:

64.1 the R&D Tax Incentive Credit, Callaghan Innovation's R&D grants and the new short-term loan scheme to support R&D-performing businesses

64.2 Temporarily raising the amount that NZGCP can invest via the Aspire NZ Seed Fund, their seed-stage matched capital initiative

65 There may also however be merit in investigating if there are pertinent issues for the smaller, more mature firms below the $30 million revenue bracket that are unlikely to be served by taking on more debt and are too small for private equity to recapitalise.

66 I suggest that this investigation be canvased as part of the upcoming wave 3 (Reset and Rebuild) advice that is being prepared as firms in this revenue range are going to need to succeed for the success of the Industry Transformation Plans and our goal of growing more innovative industries in New Zealand and lifting the productivity of our key sectors.

67 Confidential advice to Government

68 Confidential advice to Government

International investment and attraction of high quality companies

69 While FDI attraction is likely to be difficult under current global conditions, it remains important that we continue to support key sectors and leverage off international expertise, connectivity and technology.[6] There is also a potential time-bound opportunity for New Zealand to capitalise on what might become a new found source

[6] The New Zealand Productivity Commission for example cites the diffusion from the frontier as key to our productivity growth.

of comparative advantage, that we have fewer COIVD imposed limitations on business activity than many other jurisdictions, and have a heightened brand and reputation in the international market. This could mean that we are an attractive destination for many businesses to locate part of their operations.

70 I am exploring ways in which we could leverage off this time-bound advantage and encourage more beneficial and targeted foreign investment. This investment could complement our goals of transitioning the economy to be more productive, sustainable, and inclusive and support the industry transformation plans.

71 I will provide a further update to the Committee on business attraction options as soon as practicable.

Further options to support capital markets and equity finance

72 There are various other initiatives that should be kept in mind when exploring options to support other gaps in the capital market, including new proposed financial regulatory measures, and other sector or asset specific funds.

73 Confidential advice to Government

74 Confidential advice to Government

Financial Implications

75 There are no financial implications.

Human Rights

76 There are no human rights implications.

Consultation

77 The Treasury, New Zealand Growth Capital Partners, New Zealand Trade and Enterprise, the Reserve Bank of New Zealand, and the Financial Markets Authority were consulted in the development of this paper.

Communications

78 There are no communications required.

Proactive Release

79 I propose to proactively release this Cabinet paper, and associated minutes with any appropriate redactions within 30 working days.

Recommendations

The Minister for Economic Development recommends that the Committee:

1 **note** that on 6 May 2020, the Committee invited the Minister for Economic Development to provide an update as soon as practicable on the Venture Capital Fund and its operation [DEV-20-MIN-0066]

2 **note** that the Elevate NZ Venture Fund was launched in February 2020 and is progressing well; it has established its Elevate Investment Committee, Commercial Information

3 **note** the Elevate NZ Venture Fund remains on track to make its first allocations to funds by early July 2020

4 **note** that venture capital serves a small and niche subset of the capital markets, for high growth and early stage firms

5 **note** that officials view that early stage capital markets will be well served by the Elevate NZ Venture Fund and other early stage funding and research and development initiatives

6 **note** that we have not seen market turmoil as a result of COVID in the currency, bond and swap markets yet, but that forecasts by the OECD and others are for foreign direct investment to fall significantly

7 **note** that this has the potential to significantly affect access to capital for a broad range of companies over the coming months

8 **note** that officials are particularly concerned over two other capital gaps: smaller, non-venture capital firms in the $3-$30 million revenue range that have historically struggled for access to capital, and mid-tier and larger unlisted firms who might need to be recapitalised

9 **note** that many of these firms are important to regional growth and to future exports and in growing sectors like food and beverage and advanced manufacturing.

10 **note** that foreign direct investment has historically been an important source of capital for these firms

11 Confidential advice to Government

12 Confidential advice to Government

13 **note** that I propose working on options to increase the attraction of high quality companies to New Zealand, to leverage off a possible "comparative advantage" of having less COVID imposed disease and business restrictions than other countries.

Authorised for lodgement

Hon Phil Twyford

Minister for Economic Development