MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

Ministers	Hon Grant Robertson	**Portfolios**	Finance
	Hon Stuart Nash		Economic and Regional Development
Title of Cabinet paper	Options to Improve Small- and Medium-sized Enterprises' Access to Finance	**Date to be published**	By 22 July 2022

List of documents that have been proactively released		
Date	**Title**	**Author**
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16 August 2021	Options to Improve Small- and Medium-sized Enterprises' Access to Finance CBC-21-MIN-0067	Cabinet Office
October 2021	Improving Access to Growth Funding – Slide pack	MBIE

Information redacted **No**

Any information redacted in this document is redacted in accordance with MBIE's policy on Proactive Release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

In Confidence

Office of the Minister of Finance

Office of the Minister for Economic and Regional Development

Cabinet Business Committee

Options to Improve Small- and Medium-sized Enterprises' Access to Finance

Proposal

1 To inform Cabinet of the findings of the investigation into improving small- and medium-sized enterprises' (SMEs) access to finance, and to seek agreement for further detailed work on a Business Growth Fund option.

Relation to government priorities

2 This Government has committed to:

2.1 a Five Point Plan for New Zealand's economic recovery from COVID-19 supporting small businesses with practical support to grow and thrive

2.2 investigate permanent financing options for smaller businesses, as outlined in Labour's 2020 Election Manifesto and the Speech from the Throne.

3 This proposal also aligns with:

3.1 two of the Small Business Council's 2019 Small Business Strategy recommendations to improve access to appropriate finance options for smaller businesses

3.2 lifting Māori and Pasifika enterprise outcomes and our approach to industry policy, aimed at growing more innovative industries and lifting the productivity, sustainability and inclusivity of key sectors.

Executive summary

4 In July 2020, the Cabinet Economic Development Committee noted that the Minister of Finance and the Minister for Economic Development would investigate options to support SMEs earning $3 million-$30 million revenue to access to finance and report back with an update on progress [DEV-20-MIN-0119].

5 In carrying out this work, officials have identified a range of problems with both firms' access to finance, and capability. These problems play out differently in two distinct business segments; micro firms (ie those earning less than $3m revenue) and larger SMEs (ie firms earning $3m-$30m revenue).

6 We will advance work to support micro firms, but first we are prioritising work on improving access to finance for SMEs earning $3m-$30m revenue. These SMEs are more likely to contribute to economic and regional development and may help to improve New Zealand’s productivity performance.

7 Access to finance is a critical component of firm growth, as it enables firms to build capability, conduct R&D, invest, and access new markets which drives productivity and underpins future economic growth.

Policy objectives for SMEs earning $3m-$30m revenue

8 Although there is inherent uncertainty in the data, we think a capital gap exists that is exacerbated by SMEs’ financing and capability problems which acts as a bottleneck. This constrains a number of growth-focused businesses from developing their growth strategies and then seeking investment to accelerate their growth.

9 To try to reduce this potential bottleneck, our objectives for improving access to finance for SMEs earning $3m-$30m revenue are to:

9.1 help them grow, build capability, and internationalise

9.2 develop a market for investing in this business segment (ie look to crowd-in other investors).

Multifaceted problems with no silver bullet

10 While access to finance challenges for SMEs occur in almost all countries, firms in New Zealand face a unique set of market problems and arguably have higher barriers to grow and scale (size and distance). These issues are well catalogued in various reports from the New Zealand Productivity Commission.[1]

11 Yet SMEs in New Zealand have fewer financial products and government programmes to help compared to most of our OECD peer countries.

12 While debt and equity finance are generally available, there are specific issues with some underdeveloped capital markets that are important for intermediating capital from lenders/investors to firms. Non-collateralised debt is also very expensive, creating a barrier to borrowing for many business owners with an ambition to grow.

13 Recent policy initiatives have led to more development of New Zealand’s start-up or early-stage capital markets, but most SMEs fall outside of the target market for this finance. Lower-growth, more mature SMEs (ie SMEs earning $3m-$30m revenue), or those in particular non-tech sectors, often have a proven track record but still struggle to get growth capital or to invest in technology, processes, and new capability using only existing cash flows.

[1] For example, the recent final report *New Zealand firms: Reaching for the frontier*.

14 Finance is particularly poorly matched with micro firms and SMEs (including Māori SMEs). There are:

14.1 mismatches in the supply of funding and information asymmetries which lead to a lack of financial intermediaries, products, research, and a financial system dominated by a risk-averse banking sector

14.2 high costs of due diligence relative to the small scale, and higher risk, of potential investments directly contributing to a shortage of capable investors

14.3 banks and investors that view micro firms, niche sectors, exporters, Māori business models, and sustainability initiatives as particularly risky and 'unbankable'

14.4 few intermediaries that can channel funds from better capitalised sources (like institutional investors) into SMEs.

15 Many SMEs earning $3m-$30m revenue are often too small to publicly list and to attract investment from the relatively small number of private investors looking to invest in SMEs, such as private equity (PE) firms. Investors highlight numerous challenges and costs relative to expected risk and returns (eg time needed to transact, and for due diligence relative to expected returns).

16 Due to the underdeveloped market and a lack of a financial intermediaries, we believe intervention is warranted. There will be no single-point solution to these multifaceted issues, instead we recommend a multi-pronged approach; seeing existing reforms (eg in tax and banking) and initiatives to improve capability (eg Business.govt.nz and New Zealand Trade and Enterprise (NZTE) services) alongside other options for the future to create positive system changes for SMEs and an export-led recovery.

Exploring a Business Growth Fund for SMEs earning $3m-$30m revenue

17 Officials identified a long list of options to support SMEs' access to finance. The options address the problems identified to varying degrees, using different instruments, agents, and government resources (both money and time). All options are used internationally to varying degrees.

18 After focusing on a short-list of options, we are now seeking your agreement to a detailed investigation into a **Business Growth Fund** – which typically involves incentivising the banking sector (through ring-fenced prudential requirements) to pool patient equity capital for SMEs. As well as exploring this type of Fund with banks, we would also like, in time, to test the appetite of insurers, institutional investors (eg KiwiSaver fund managers or Crown financial institutions), and iwi investors.

19 Attractions of this Business Growth Fund option are:

19.1 it would provide a source of long-term patient minority capital (in the form of equity or long-term debt) to SMEs – making it a more accessible investor for SMEs with concerns of dilution of ownership rights

19.2 as an independently managed fund at scale, it would have coverage across a variety of regions and sectors providing portfolio diversification benefits

19.3 banking sector involvement can support deal generation and leverage existing public and privately provided capability support to benefit investee companies. Increased investment equity and recapitalised balance sheets may in turn unlock additional debt finance.

20 New Zealand does not currently have a patient equity fund which gives minority-stake support to SMEs. A Business Growth Fund would be a unique offering and is worthy of deeper exploration. Our hope is that this option could be one of the next steps in New Zealand's financial markets towards better matching the demand and supply of finance through more diverse investment and lending to more capable SMEs.

21 Options with a Business Growth Fund must be viewed in relation to any other tax or regulatory changes, and as part of a broader system affecting investment into productive businesses. While tax and regulatory changes often have broader impacts, they are blunt tools and can have adverse unintended consequences.

22 We will task Ministry of Business, Innovation and Employment (MBIE) officials to carry out the detailed examination of the Business Growth Fund option, in consultation with the Treasury. This model depends on the willingness of banks to support this type of arrangement, and officials are working carefully on engagement plans, understanding what worked well in other jurisdictions.

Background

23 The Small Business Council, MBIE and NZTE have all previously identified a capital gap for lower-growth, and more mature SMEs. SMEs (with revenues between $3 million and $30 million) are important to New Zealand's economic and regional growth, and an export-led recovery.

24 In July 2020, DEV Committee noted that the Minister of Finance and the Minister for Economic Development would direct officials to investigate options to support SMEs earning $3m-$30m revenue to access finance and report back on progress [DEV-20-MIN-0119].

Putting the issues in context

25 While it is always hard to conclusively prove a capital gap, particularly where there may be a missing market, it is clear that New Zealand has low business investment per worker and mismatched pools of capital in particular areas.[2]

26 Some of the issues constraining SMEs' access to finance are not unique. However, in New Zealand, finance problems are part of a broader range of factors limiting New Zealand's productivity.[3] In combination, these problems disproportionately impact economic, regional, and firm development.

27 The New Zealand situation is compounded by lacking the co-ordinated action found in other OECD countries, the most sophisticated of which also deploy a wider range of products, institutions, tax and regulatory settings to support their policy objectives (see **Appendix One**). For example, development banks, open banking, co-investment funds, subsidised financing and lending/investing and investment tax incentives.

Debt finance

28 Banks tend to be the main source of finance for SMEs likely because there are few other known or widely used alternatives. The banking sector dominates business lending in New Zealand accounting for around 96 per cent of total business lending.

29 Banks typically only lend against positive cash flow or for non-niche capital expenditure – generally secured by way of personal guarantees or shareholder assets.

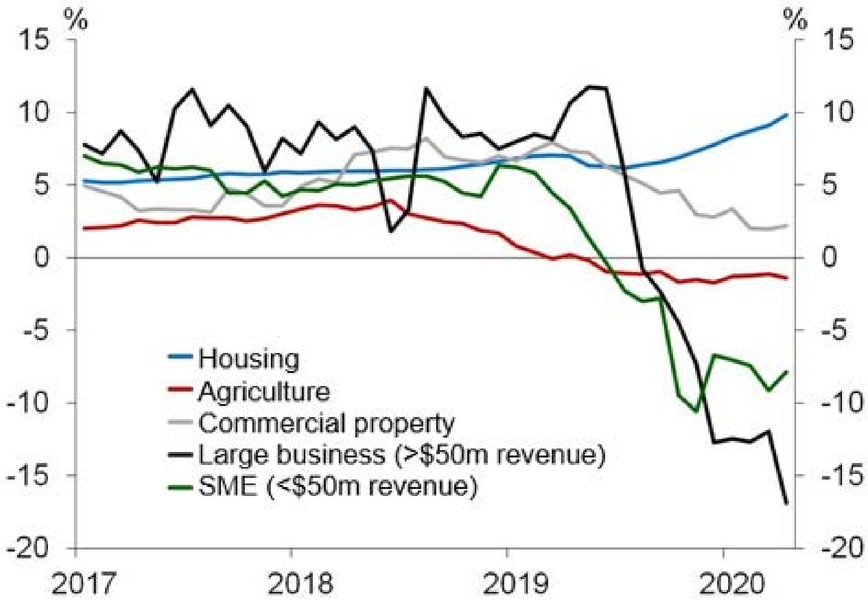
30 The Reserve Bank of New Zealand's (RBNZ) May 2021 *Financial Stability Report* indicated that total bank lending to businesses has fallen since 2019, reflecting subdued demand and low investment.

31 Figure one below, highlights reduced lending rates to firms of differing sizes, including SMEs.

[2] For example the reports of the 2009 Capital Market Development Taskforce and Capital Markets 2029 both highlight specific underdeveloped capital markets and that certain business segments, including SMEs, are underserviced.

[3] Many New Zealand firms operate in small, insular domestic markets, and have been slow to invest in knowledge-based assets (such as R&D, management capability, and new technologies). Generally, technology diffusion and resource reallocation do not work as well as they could, competition is weak, and low capital investment per worker has worsened via high population growth in recent decades.

Figure one: Registered banks' lending by type, annual percentage change



Source: Reserve Bank of New Zealand

32 There are few non-bank lenders[4] in New Zealand, particularly those offering non-collateralised or affordable finance. More importantly, they are not on the radar of many firms and there are few (but increasingly more) 'digital-only' lenders compared to other advanced economies.

Equity finance

33 In the market for equity finance, companies can access a small, growing angel investment community, a niche crowdfunding market, and a small but growing venture capital (VC) market. This is supported by the funds run by New Zealand Growth Capital Partners Ltd (NZGCP). The target of angel and VC investment is predominantly high-growth companies.

34 There are also trade sales (selling entire businesses), and private investors outside of formal PE funds. To diversify portfolios, increasingly, private investors want access to non-listed firms, but don't know how to engage them – although some recent initiatives may help (eg Catalist Markets Ltd).[5]

35 Most SMEs appear unable to access equity capital for expansion. However, officials are aware of a small number of growth-oriented PE funds aimed at actively investing and often controlling lower-growth, and more mature SMEs (ie SMEs earning $3m-$30m revenue).

[4] Non-bank lenders include licensed non-bank deposit takers, building societies, and asset finance companies.
[5] Cabinet has recently approved regulations to enable Catalist Markets Ltd's (Catalist) new financial product market (a stock exchange designed for growth-oriented SMEs). Catalist hope this market will benefit SMEs looking to raise capital (of around $2-$20m) to grow, but who cannot easily afford the costs of listing on a traditional stock exchange such as New Zealand's Exchange (NZX).

36 The majority of institutional investors (eg KiwiSaver fund managers) do not directly invest in New Zealand firms and typically are not willing to enter the New Zealand PE or VC markets directly. This is likely due to a range of factors[6] and with a strong focus on returns for their own investors/members.

Evidence of problems

Quantitative evidence is limited

37 The extent to which real and perceived finance constraints are holding firms back is inherently difficult to measure. The two most promising surveys both have sampling problems:

37.1 Stats NZ's annual Business Operations Survey (BOS) only includes firms with greater than six employees, so it is impossible to know how well findings reflect micro firm experiences. However, the aggregate BOS results for finance-seeking SMEs with 6-50 employees illustrate:

37.1.1 around 16 per cent that seek equity finance report that they are equity finance constrained, with 43 per cent of these 'constrained' firms indicating that they are not able to access equity at all

37.1.2 around 12 per cent that seek debt finance report they are debt finance constrained, with one third of them reporting they are not able to access debt at all.

37.2 MYOB's periodic Business Monitor found that during 2020 a third of small businesses struggled to access finance. This survey focuses on businesses directly involved in the farming, fisheries and forestry industries so it is impossible to know how well these findings represent other sectors.

38 Both of these surveys are based on firms' self-reported responses. They are not based on a neutral commercial assessment about whether the respondent ought to have access to finance. We cannot tell if the finance constraints reflect the firm's real risk to financiers or other factors.

Qualitative evidence suggests several problems

39 Officials explored the nature of SMEs' access to finance limitations as well as the willingness of private financiers to invest or lend. This work involved engagement with firms, capital market participants, industry bodies, government agencies and firm advisors. Officials conducted research and interviews, exploring the overall market sentiment and trends in the supply, demand and intermediation of finance to SMEs.

[6] Factors include the cost of doing due-diligence - these investors struggle to make the economics of investing in these companies work - and that many SMEs lack the capability and the resources needed to access significant equity capital.

40 This engagement highlighted that there is no shortage of financial capital at this time, but the problem is that it is poorly matched with productive New Zealand firms. There is:

40.1 a mismatch in the supply of funding interacting with market information asymmetries leading to a lack of financial intermediaries, products, research, and a financial system dominated by a risk-averse banking sector

40.2 a lack of firm financial capability including investment-readiness, and awareness of different finance options and the pros and cons of these options

40.3 a high cost of due diligence relative to the small scale of potential investments directly contributing to a shortage of capable investors

40.4 an environment where banks and investors can view niche sectors, exporters, Māori business models, and sustainability initiatives as risky and 'unbankable'.

41 Officials found problems affecting access to finance – and also firms' capability – play out differently in two distinct business segments, that of micro firms (ie those earning less than $3m revenue) and SMEs earning $3m-$30m revenue. **Appendix Two** has a stylised representation of financial market segments and firm characteristics.

Micro firms

42 At the smaller end of the scale, micro firms are worthy of attention but unless we first work to understand and address the bottleneck further up the firm development pathway, we will shift rather than solve problems identified with firms' access to finance.

43 New Zealand debt markets typically assist micro firms with working capital rather than expansion capital. Micro firms typically have capability challenges and struggle to access credit and working capital without collateral or reliable cash flow, and face very high interest rates.

44 As well as borrowing money from family and friends, most firms try to borrow from banks. Micro firms generally don't present well to banks and if they also lack sufficient collateral, they may be unable to borrow on an unsecured basis. Due to the small average size of loans, and the disproportionate costs of obtaining information and administering a loan, it is also potentially unprofitable for banks to lend to this segment.

45 We recommend that officials work closely with other stakeholders on these issues facing micro firms after advancing work to improve access to finance for SMEs earning $3m-$30m revenue. Their challenges are not unique to New Zealand, so learning from other jurisdictions will be instructive. The objective of supporting micro firms' access to finance would be less likely about productivity, and more about inclusion in debt markets.

46 In this context we note the work that the RBNZ and the Treasury are co-sponsoring on Māori SMEs' access to capital. While hard to quantify, there has been a longstanding sense that Māori businesses have experienced disproportionate challenges in financial markets.[7] The project is engaging with banks, Māori SMEs and other key stakeholders and undertaking quantitative research to assess the extent of the issue and to develop policy options in September 2021. A final report is due to be published in February 2022. We hope this work informs future work to better support micro firms' access to finance as well as those earning $3m-$30m revenue.

SMEs earning $3m-$30m revenue

47 We are primarily interested in SMEs earning $3m-$30m revenue, that might typically employ between six and 50 staff. There are approximately 37,000 firms (including 1,500 Māori businesses) fitting this description, employing around a third of all employees.

48 A small subset are high-growth firms, eligible for a range of support (eg from Callaghan Innovation and NZGCP). While these firms are impossible to identify in advance (because of their dynamism), ultimately, we need to create an environment in which more firms reach and sustain high growth.

49 We have been most interested in understanding SMEs that have a proven track record yet can still struggle to access equity and debt finance. The exact size of this business segment is hard to quantify, however we estimate that in any given year there would be 2,500-5,000 SMEs actively seeking finance.

Objectives for SMEs earning $3m-$30m revenue

50 Productivity growth and economic development are the main goals in improving access to finance for SMEs earning $3m-$30m revenue. New Zealand needs more productive SMEs with solid prospects to grow and internationalise to support economic and regional development.

51 There appears to be a funding gap and financing constraints for SMEs earning $3m-$30m revenue, which limits a number of growth-focused SMEs that have potential but require new investment or follow-on expansion capital to accelerate their growth.

52 To reduce this potential bottleneck, a key objective is to develop the market for investing in this segment, with the hope to 'crowd-in' other investors.

53 This will take time to address, and the government may need to take on more risk than commercial markets to aid the market development process.

[7] Fewer loans get granted for several reasons including an absence of security (as Māori own less property and are more likely associated with collective land, which is seen as harder to liquefy). It is possible that Māori firms are more likely to seek outcomes which are broader than financial gains, a model not traditionally well understood by financiers. Additionally, it is likely that cultural and network biases have contributed to providers decisions as well as capability constraints on the demand side.

54 By combining existing capability initiatives with potentially a diversified set of affordable and accessible finance options for SMEs, an ideal future state involves private capital and financial markets better matching the demand and supply of finance through more diverse investment and lending supported by:

54.1 finance products which are better suited to enabling the growth of SMEs with institutional investors playing an increasing role in time

54.2 higher capability at the firm-level to support increased awareness of financial options, improve information quality, and reduce the transaction cost for investors

54.3 a wider range of, and higher capability from, financial intermediaries (eg private capital providers and non-bank lenders) to engage with SMEs to give them the awareness, know-how and connections to access finance for growth.

Factors affecting the matching of finance to SMEs

55 New Zealand’s capital markets, and in particular the smaller end of the debt finance and PE markets, are underdeveloped. Issues extend across both debt and equity finance:

55.1 Debt finance - New Zealand SMEs are faced with a narrow range of lenders, pay internationally high interest rates, and typically to access credit and working capital must risk personal assets to get loans (eg offer their home as collateral).

55.2 Equity finance - SMEs often lack the capability, investor readiness, and willingness to relinquish control to access significant equity capital. This is a problem where equity is the most appropriate source of expansion capital. These issues either mean that SMEs are not on the radar of the small number of PE firms, or there are grounds for investors providing funding which is contingent on capability improvements.

56 While there may be sufficient capital ready for investment, it is evident that there is an inefficient market for matching private capital to firms and a lack of intermediaries (eg equity fund managers) at scale to justify the time and cost of analysis to match the capital with the desire for funding from SMEs.

57 The most significant PE firms are focused on larger firms. These PE firms are highly selective and want to invest in more capable firms to grow the size of their fund. Larger deals offer better returns than investing in smaller SMEs – as PE firms have the same fixed costs of carrying out due diligence before an active investment is made.

58 This has a flow-on effect of constraining the availability of PE capital and reduces the likelihood of an effective match between SMEs and investors of “smart capital” with requisite market, product or business knowledge.

Factors and capability considerations affecting SME demand for finance

59 There are factors contributing to SMEs with good prospects missing out on finance.

Factors	Description
Lack of financial capability to source and manage capital	• Banks are seen as the only source of debt finance; many firms have little or no awareness of non-bank borrowing or equity (albeit amongst limited options). • Compared with larger firms, directors and managers of SMEs are less likely to be aware of the potential benefits of equity financing or to appreciate capital structuring and finance options. • There is also a potential absence of information for the firm seeking capital about the capital raising process and for the investor community on good investment opportunities (although this is starting to shift).
The capital sourcing process is resource intensive	• Beyond their day-to-day work, staff must develop the documentation for lenders and/or investors (business plans, financial forecasts and investor presentations) in which they may lack experience. • The lack of intermediaries means that firms may not find an investor with the appropriate product expertise or market knowledge and may miss out on the investment altogether. • There may be easier returns from continued investment into New Zealand's property market.
Good prospects but high risk	• Growth minded companies that are developing new processes, technology and closer to the productivity frontier may lack the physical collateral, positive cash-flow and/or proven product required by mainstream lenders. • New Zealand's small domestic market forces niche companies to internationalise earlier than similar firms in larger economies, as expansion abroad is a relatively big outlay compared to current revenue. As such, these New Zealand-based internationally focused firms are perceived to be higher risk.
Lack of aspiration or fear the loss of control	• For many businesses which are either riskier or have lower collateral, bank debt is not the appropriate market solution. But the majority of owner/operator firms do not want to give up control of their business/livelihood and benefit from little or no significant competition forcing them to consider growth or change.

Option to improve access to finance for SMEs earning $3m-$30m revenue

60 We think direct intervention is required to:

60.1 diversify the set of finance options to stimulate more investment into SMEs and nurture an unproven SME asset class

60.2 improve the capability of productive SMEs to reduce the financing risk burden and accelerate business growth

60.3 minimise the transaction costs and co-ordination failures between SMEs and financial intermediaries.

61 The broad spectrum of options we reviewed were for government to reduce the cost and risk associated with financing firms. The options addressed the debt, equity and capability problems facing SMEs and involved different agents (ie utilising government entities or working via private investors/lenders). We also looked at a high-level at tax and other regulatory

settings. While tax and regulatory changes often have broader impacts, they are blunt tools and can have adverse unintended consequences.

62 After considering a short-list of options detailed in **Appendix Three**, we are now seeking your agreement to carry out further detailed investigation of a Business Growth Fund for New Zealand.

63 The Business Growth Fund model typically involves seeding or incentivising the banking or insurance sectors to pool equity capital to create a fund, at scale, to independently provide a source of long-term patient minority capital to SMEs (in the form of equity or long-term debt).

64 While we are encouraged by what other countries have done with these models, we are not beholden to working only with banks and insurers to explore this option. In time, we would like to also test the appetite of institutional investors and iwi investors too.

The Business Growth Fund model

65 This option was first proposed by the Small Business Council in 2019. The Small Business Council cited Business Growth Funds successfully operating in a number of countries including the UK, Ireland and Canada. Australia has now also established their own Business Growth Fund.

66 These Business Growth Funds have all come about differently depending on the characteristics and finance challenges in each jurisdiction. They have typically involved the government incentivising[8] the creation of the Business Growth Funds. Australia is unique in that the Federal government committed, via their superannuation fund, up to A$100m alongside six banks to create an A$540m fund of scale, with the ambition to have an A$1b fund in time.

67 Business Growth Funds are set up to independently provide a source of long-term patient minority capital (in the form of equity or long-term debt) to SMEs. Patient capital means investing for longer than normal (eg up to 10 years) and minority in this context means not taking a controlling stake in the business. This is important for SMEs who appear threatened by investment models that take control of their business.

68 Internationally, Business Growth Funds have all been setup, to varying degrees, to:

68.1 increase the availability of patient minority capital to SMEs and increase the level of investment

68.2 allow banks that own the Business Growth Fund to refer SMEs to it in cases where the banks believe that equity finance would be more appropriate than additional debt finance

[8] This typically requires the Central Bank, or an Act of Parliament, to relax prudential capital adequacy requirements for the banks that opt-in to enable them to treat their equity investment into the Business Growth Fund differently when calculating their regulatory capital requirements.

68.3 support job creation, prevent SMEs from selling too quickly and enable them to scale up and become larger firms to support economic growth

68.4 invest in established SMEs with a track record of revenue growth and profitability – typically 10-30 SMEs each year

68.5 invest minority economic interests of between 10-49 per cent of total, fully diluted, share capital in SMEs for an average investment duration of five to seven years

68.6 partner SMEs they invest in with capability support (eg strategic advice, investment readiness, and talent network referrals).

69 The likely benefits of this option are the degree to which it can:

69.1 address the identified issues facing SMEs

69.2 provide a pipeline of capable, investment ready firms for follow-on investment by public or private investors

69.3 draw on expertise and the networks of other Business Growth Funds around the world to start from a tried and tested base.

70 New Zealand does not currently have a PE fund at scale providing long-term patient minority capital to SMEs. Patient minority-stake investment is a less threatening form of equity finance and is likely to be a useful way of introducing tailored intensive capability support to investee SMEs. As such a Business Growth Fund would be a unique offering and potentially beneficial for broader capital market development in potentially establishing a new SME asset class.

71 Further investigation would identify:

71.1 how willing the New Zealand banking sector (and in time, insurers, and institutional and iwi investors) might be in assisting SMEs access finance and to pool their capital to create a fund of scale

71.2 the impact a fund could have on the total amount of capital available through existing channels (either debt or equity) to SMEs, noting that banks are facing higher regulatory capital adequacy requirements in the future, which may serve to disincentive business lending.

72 The most important consideration is the willingness of banks to support this type of model in New Zealand, and officials are working carefully on engagement plans now. Lessons from other jurisdictions, particularly Australia, are a key focus.

73 Additional considerations include the time needed to establish such a fund and distribute funds to SMEs. The Australian bank-centred model was first announced in 2019 and we understand is only now close to concluding its first investment.

74 This investigation will keep well connected with the forthcoming thinking on the medium-term economic strategy.

Firm capability considerations

75 Firms that get finance (particularly equity) will often use part of that investment to bolster their capability. Whether this is about management capacity or related to new product/system capability, it is rare for expansion capital not to be used for capability enhancement in some form.

76 Offering training vouchers or programmes, even if free, to time-poor, under-staffed firms, where the benefit is not clearly understood, does not always result in desired outcomes. This is particularly problematic where the firm is at a size that it cannot afford to hire managers or establish a board, and/or to delegate operational/everyday tasks such that the owner is able to free up time to focus on more strategic matters.

77 PE and VC investors tend to address capability deficits by insisting on improved management or governance (and taking a seat on the board). This is sometimes referred to as ‘smart capital’. There is a range of capability development and investor readiness programmes already on offer within government.[9] We want to understand how this support could be linked to, or even be a requirement for, receiving finance from the Business Growth Fund.

Alignment with other activities

78 There are already multiple streams of work underway across government to address some of the issues described above:

78.1 the reforms to better equip the RBNZ to promote financial stability and put in place a new process for setting lending restrictions.

78.2 Cabinet’s recent approval of a financial product market by Catalist Markets Limited that will hopefully provide a more accessible avenue for SMEs to publicly list. Catalist ought to contribute to the overall market expansion for both intermediaries and retail and wholesale investors, and in time may crowd-in KiwiSaver funds (which, at an estimated $200b by 2030, will become an increasingly important source of both savings and potential investment funds).

79 It is important for all these streams of work to be seen together and be better aligned. Clearer over-arching strategic coherence and arrangements of many of the existing interventions that government is already making to help drive scale and efficiencies will be important too in time. It will be useful for agencies to all understand how and where they add-value and complement each other, relative to the private sector.

[9] Central government provides business and capability assistance through several organisations such as MBIE, Te Puni Kōkiri, NZTE, Callaghan Innovation, and MPI.

Advancing the work further

80 We will task officials to consider our preferred option of the Business Growth Fund against the following key selection criteria:

80.1 Targets the objective at scale: the extent to which the option targets those SMEs most likely to face problems in accessing finance because of a less well-developed market and market failures.

80.2 Additionality: the extent to which the option could catalyse private investment that would not have occurred.

80.3 Minimise distortions: the extent to which the option alters the payoffs and risks of investment to both the investor and the SME seeking the finance should be minimised.

80.4 Complement existing measures: the extent to which the option targets market development in areas not already targeted by existing interventions (eg NZ Green Investment Finance Ltd) and assists SMEs to access non-financial capability support.

80.5 Feasibility: the extent to which the option can be realistically implemented in a timely manner with the participation of key agents (eg agencies or the private sector).

81 While it may be possible for a potential Business Growth Fund to support the Government's broader objectives, similar funds in other countries are independent as a defining feature.

82 We will task MBIE officials, in consultation with the Treasury, to carry out further detailed policy work (eg pros/cons, implementation timeframes, cost, institutional form/governance, and any risks) on preferred options and best agents to potentially run a Business Growth Fund. We then intend to report back to DEV should a Business Growth Fund be a viable option in New Zealand.

Legislative Implications

83 Further detailed policy work may highlight the need for potential legislative changes.

Regulatory Impact Statement

84 A regulatory impact statement will be provided alongside final proposals for reform, as needed.

Climate Implications of Policy Assessment

85 A Climate Implications of Policy Assessment (CIPA) may be required depending on the outcome of the investigation into the proposed option.

Consultation

86 The Department of the Prime Minister and Cabinet has been informed of the contents of this paper and the following agencies were consulted in the development of this paper: The Treasury; MBIE; Ministry for Primary Industries; Te Puni Kōkiri; NZTE; and the RBNZ.

Proactive Release

87 The proactive release of this paper will be coordinated with any engagements with the banking sector. This may delay the release beyond 30 business days. Any proactive release will be subject to relevant redactions as appropriate, consistent with the Official Information Act 1982.

Recommendations

The Ministers of Finance and Economic and Regional Development recommend that the Committee:

1 **note** that the Small Business Council and officials from the Ministry of Business, Innovation and Employment and New Zealand Trade and Enterprise have previously identified a capital gap for smaller but more mature companies (with revenues between $3 million and $30 million) that are important for economic development and an export-led recovery;

2 **note** that in July 2020, the Cabinet Economic Development Committee noted that the Minister of Finance and the Minister for Economic Development would investigate options to support small- and medium-sized enterprises earning $3m-$30m revenue and report back with an update on progress [DEV-20-MIN-0119];

3 **note** that in carrying out the investigation over 2020 and 2021, officials have identified a range of problems with both access to finance and firm capability which affect two distinct business segments, micro firms and small- and medium-sized enterprises earning $3m-$30m revenue;

4 **agree** to prioritise advancing work to improve access to finance for small- and medium-sized enterprises earning $3m-$30m revenue, and subsequently advance work to support micro-firms;

5 **note** the business segment of small- and medium-sized enterprises earning $3m-$30m revenue face challenges associated with accessing expansion capital in the form of both debt and equity finance;

6 **agree** the objective for this work is to:

 6.1 improve access to finance for small- and medium-sized enterprises earning $3m-$30m revenue to build capability, grow, and internationalise;

 6.2 develop a market for investing in this business segment (ie to crowd-in other investors);

7 **agree** that improving access to finance for small- and medium-sized enterprises is important from a productivity perspective;

Options to improve access to finance for small- and medium-sized enterprises

8 **note** that officials have identified a number of options to support both business segments and focused on the most viable options worthy of further investigation;

9 **note** officials have provided advice on a short list of options including a:

9.1 Direct Investment Fund (pilot, with the potential to scale);

9.2 Fund of Funds;

9.3 Business Growth Fund;

9.4 Credit Guarantee Scheme;

9.5 Development Finance Institution;

10 **invite** the Ministers of Finance and Economic and Regional Development to carry out further detailed policy work on the Business Growth Fund option;

11 **note** the Ministers of Finance and Economic and Regional Development will direct the Ministry of Business, Innovation and Employment, in consultation with the Treasury, to carry out further detailed investigation of the Business Growth Fund option;

12 **note** further detailed investigation will identify the typical design parameters of the Business Growth Fund option and compare them against a set of five selection criteria;

13 **note** the Ministers of Finance and Economic and Regional Development intend to report back to Cabinet Economic Development Committee on the outcome of the detailed investigation of the Business Growth Fund option should a Business Growth Fund be a viable option in New Zealand.

Authorised for lodgement

Hon Grant Robertson	Hon Stuart Nash
Minister of Finance	Minister for Economic and Regional Development

Appendix One: OECD comparison of policies that support access to finance

The table below summarises OECD country policies that foster firms' access to finance in 2018/19. This is an overview of broad categories, not of policy instruments.

Since the development of this table, New Zealand also had in place the temporary Business Finance Guarantee Scheme, and introduced the Small Business Cash flow (Loan) Scheme administered by Inland Revenue.

	Government loan guarantees	Direct lending to SMEs	Subsidised interest rates	SME banks	Support for start-up finance			SME equity investment
					Guarantees and loans for start-ups	Venture capital funds	Business angels' co-investment	
Australia		✓			✓	✓	✓**	✓*
Austria	✓	✓	✓	✓	✓	✓*	✓	
Canada	✓	✓		✓	✓	✓	✓**	✓*
Chile	✓		✓	✓	✓	✓		
Denmark	✓	✓		✓	✓	✓	✓*	✓
Estonia	✓	✓	✓	✓	✓	✓	✓*	✓
Finland	✓		✓	✓	✓	✓	✓*	
France	✓	✓	✓	✓	✓	✓	✓	✓
Ireland	✓	✓		✓	✓	✓	✓*	✓*
Israel	✓	✓		✓	✓	✓	✓	
Japan	✓	✓		✓	✓	✓		
South Korea	✓	✓		✓	✓	✓	✓	
Netherlands	✓	✓		✓	✓	✓*	✓*	
New Zealand	✓*					✓	✓	
Norway	✓	✓		✓	✓	✓		
Poland	✓	✓*	✓*	✓	✓	✓*	✓*	✓
Sweden	✓	✓		✓	✓	✓*		
Switzerland	✓							
Turkey	✓	✓	✓	✓	✓	✓	✓	✓
UK	✓	✓		✓	✓	✓	✓	✓*
USA	✓	✓				✓		✓
	* For exporters only (via NZ Export Credit)	* In co-operation with the EU only					** At the regional level only	* Also have Business Growth Funds

Source: Adapted from the OECD Scoreboard on Financing SMEs and Entrepreneurs 2020

Key
Green: Functioning market
Amber: Underdeveloped market with issues
Grey: Not the market's focus

Appendix Two: Stylised representation of financial market and enterprise segments

		Includes non-financial businesses with GST turnover greater than $30,000 per annum (p.a). Table excludes financial sector businesses, general government institutions, non-profit institutions and households.	**Business segments**					**Financial market segment characteristics**			
			High-growth potential enterprises	**Micro firms***	**Small- and medium-sized enterprises (SMEs)**	**Medium- and large-sized enterprises**	**Large-global enterprises**	**Expected returns**	**Cost** (eg interest rate or fees)	**Sector focus**	**Indicative market size**
		Number of non-financial businesses	<5%	~12% or ~59,000	~7% or ~37,000	<1% or ~2,000	<1% or ~1,500				
		Businesses by revenue range	-	$1m - $3m	$3m - $30m	>$30m	>$100m				
		Businesses by employee range	-	1 - 5	6 - 50	50 - 100	>100				
Financial market segments	**Private debt**	**Registered banks** *Dominant market share*		Struggle without collateral or reliable cash flow to make repayments and face very high interest rates				Low	Low	All sectors	$180b p.a
		Non-bank lenders *Low market share, increasing number of digital providers*						Moderate /High	Moderate /High		$7b+ p.a
	Private equity	**Angel/Seed capital**	Focus of New Zealand Growth Capital Partners Ltd					High	High	Generally in the IT sector	$100m+ p.a 100 deals p.a
		Venture capital						Very High	High		$160m+ p.a 50 deals p.a
		Crowdfunding *Small niche market*						Moderate	Moderate /High	All sectors	$20m p.a 27 deals p.a
		Mid-market private equity *Typically investments in enterprises with a value <$150m*			Investors face high transaction costs relative to expected risk/return			Moderate /High	Moderate /High	All sectors	$350m+ p.a 20 deals p.a
		Buy-out private equity *Typically investments in enterprises with a value >$150m*									$500m+ p.a 3 deals p.a
	Public debt & equity	**Publicly listed issuers** *200+ unique NZX listed issuers, typical focus of institutional investors and KiwiSaver fund managers*	Focus of Catalist Markets Ltd		Focus of Catalist Markets Ltd	Focus of NZX Ltd		Moderate	Low	All sectors	$15b+ p.a 500+ capital raises p.a

Sources: Statistics New Zealand, FMA, RBNZ, Angel Association New Zealand, NZ Private Capital, NZX

*While 80% or ~400,000 non-financial businesses have zero employees or have revenue of <$1m

Appendix Three: Initial high-level assessment of suite of the proposed options

Option	Description	Example	Problems the option addresses	Reasons for why the option is preferred/not preferred
Business Growth Fund	An independently managed fund at scale providing a source of long-term patient minority capital (in the form of equity or long-term debt) to SMEs. International examples typically involve the government incentivising banks or insurers to pool capital to create a fund at scale (via the Central Bank or Parliament relaxing specific prudential capital adequacy requirements).	Relatively successful Business Growth Fund models have emerged in the UK, Ireland, and Canada. Australia has recently (both Federally and in Victoria) announced the setup of Government-seeded Business Growth Funds.	This option could improve the provision of equity finance and long-term debt finance. It could alleviate firms' access to equity by being a patient minority investor addressing SMEs' reluctance of relinquishing control (as the fund would only take minority-stakes) and providing capability support. Increased equity and recapitalised balance sheets may unlock additional debt finance. *Note*: In the UK, Canada and Australia, Business Growth Funds were setup within roughly 18-24 months (6-12 months for policy work and to get investor commitments, and roughly 12 months from hire of CEO to first investment).	**Why this option is preferred**: This is an internationally proven option to create a fund at scale, specifically to provide SMEs with patient capital and non-financial capability support. This option has the most potential to crowd-in investors while still only taking minority-stakes investments (addressing SMEs' reluctance to relinquish control). Further work on this option could involve testing the appetite of institutional and other investors (it does not need to be limited to banks following its establishment). Partnering with banks may help to leverage existing business information held by banks. Having established banks involved with an independent entity originating deals, could lend credibility and help crowd-in other investors into the prospective investee firms.
Direct Investment Fund via a pilot administered by Kānoa - REDIU	Provide direct finance or co-investment into SMEs including due diligence and support coordinated via Kānoa - REDIU and Crown Regional Holdings Ltd.	Particular programmes within Ireland's Strategic Investment Fund.	This option would improve the provision of equity and long-term debt finance by the Crown taking on risk that the market won't bear and the high costs of due diligence and transactions. This option addresses both the SME fear of relinquishing control (as the fund would only take with minority-stakes) and could provide cornerstone investments and crowd-in private investors.	**Considerations**: While this is an increasingly common model internationally, other funds like these are usually targeted at larger investments in strategic projects or companies, or they might make multiple investments across a value chain to catalyse a sector or region. Our preference is to involve private investors from the outset. While: • this is a relatively fast option - it could take 6-12 months to setup a Direct Investment Fund pilot. Crown Regional Holdings Ltd as a Schedule 4A company could allow such a Fund to scale if institutional investment was attracted to invest into the company • Kānoa - REDIU could case manage and couple target firms with existing government capability support.
Fund of Funds model	A publicly owned equity fund that could invest alongside private sector investors in a series of privately managed equity funds which then invest in SMEs. The private sector proposes innovative ways to manage identified issues with matching capital.	New Zealand Growth Capital Partners Ltd's (NZGCP's) Elevate NZ Venture Fund that invests in privately managed venture capital funds. The British Business Bank's patient capital programme is similar.	This option could improve the provision of equity finance and may provide confidence for prospective fund managers to raise private capital. It could be designed for PE providers that focus on minority stakes (which is more unusual in the existing PE market). It could make firms aware of a new avenue to raise capital. This could result in development of intermediaries and specialist SME investing fund managers. NZGCP's mandate could be extended to run another fund of funds.	**Considerations**: It is not clear that providing a new government fund of funds would attract new private sector fund managers or change investment thesis of existing PE funds, and that they would be able to attract the private capital required to match public funding initially. Experienced fund managers seek higher returns from more active investment models (which tend to buy-in rather than build capability), and typically require exits in a shorter time frame (ie not patient capital). Additionally: • the likely timeframe to setup another Fund of Funds model would be similar to the time Elevate NZ Venture Fund took to setup and deploy capital (roughly 15 months) • scale would depend on the time private funds may take to establish or reorient themselves or raise capital privately.
Credit Guarantee Scheme	A scheme to guarantee, at scale, loans for SMEs to grow and export. This option has the potential to respond to the recent New Zealand Export Credit review and learn from the Business Finance Guarantee Scheme (including guarantying loans from both bank and non-bank lenders).	New Zealand Export Credit's loan guarantee scheme, and more recently, the Business Finance Guarantee Scheme which was intended to temporarily help businesses deal with the impact of COVID-19.	This option would primarily address issues relating to accessing debt finance. It might be able to address the problems with firms' facing relatively high interest rates, or not getting access to credit if they have insufficient collateral (either personal assets or within the business). If non-bank lenders were also involved, it may help to increase bank competition.	**Considerations**: We do not recommend further investigation of this option as it is unlikely to require financiers to provide, or couple with the finance, non-financial capability support to firms. Additionally: • we want to be sure of capturing the lessons from the recent the Small Business Cash Flow (Loan) Scheme and the Business Finance Guarantee Scheme, and changes to the banking regulatory environment over the last years before introducing another Credit Guarantee Scheme • it has been difficult to verify additionality in similar international programmes.
Development finance institution	Consolidating existing programmes in a new institution with a focus on SMEs' access to finance, emergency business support delivery, and providing a strategic framework for all government development investment.	Relatively successful models operate overseas (eg Canada, Singapore). The UK also brought together a suite of initiatives in the form of the British Business Bank to provide access to finance programmes at scale.	This option primarily addresses the fractured landscape for firm finance support across the machinery of government. It could consolidate or deliver several programmes that address existing or new issues faced by New Zealand firms trying to access debt or equity finance and capability support. It could increase coverage, efficiency, reduce duplication of effort.	**Considerations**: This option is primarily a structural solution to several problems beyond the narrow focus of this work; we think this is a good long-term option to investigate. Additionally, it could take significant time to carry out streamlining existing programmes, but this could be enabled by a phased approach or programme of consolidation overtime, which could start with a Direct Investment Fund administered by Kānoa - REDIU, or a Fund of Funds model run by NZGCP as above.