Movac

19 September 2019

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New Zealand

The Venture Capital Fund

Thank you for the opportunity to respond to the "Policy Statement on the Venture Capital Fund Act 2019", this is a very positive initiative. One which, carefully implemented, has the potential to have a significant positive impact on both the success of the New Zealand entrepreneurial eco-system and the development of the New Zealand Venture Capital industry.

Movac has been an active investor and leader in the eco-system for over 20-years. In that time, we have been Founders, active Angel Investors, a Series A Venture investment manager and more recently a Series B/C Venture investment manager, focused on growth. We have partnered with government across the old NZVIF and SCIF programmes and our portfolio companies have worked closely with Callaghan and NZTE. We are the only New Zealand fund manager to return its capital to NZVIF, with more to come. We have seen the best in the NZVIF programme and the worst, most recently when a significant commitment to Fund 4 was materially modified late in our capital raise process.

This experience means we're well placed to look back on what has and hasn't worked and project forward to what will become a fully functioning eco-system.

This letter sets out firstly, some general comments on the policy and then secondly specific comments on the Policy Statement.

General comments

The policy sets out two objectives:

1. increasing the venture capital available to New Zealand entities; and
2. developing New Zealand's venture capital markets to function more effectively.

From our discussions, it clear that there is urgency to the first of these and recognition but no clarity, at this stage, to what the second might look like and what else might be required to achieve that objective. The focus on the first, which encourages an open posture toward Foreign Fund managers who may be able to get started faster, will undermine the latter if not deployed with great care.

We've previously, suggested that New Zealand Venture industry should be aspiring for something like:

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An industry underpinned by a diverse group of dedicated New Zealand investment managers that:

a) represents the spectrum of opportunities in New Zealand, and
b) delivers value to both the companies they invest in – by helping them grow – and the investors that they represent – by delivering a return that reflects the level of risk taken.

This means, 3 to 4 Venture Funds, of slightly different vintages, that become sustainable over the long-term by building a successful track-record of returns for their investors.

Such a statement would help balance how you think about directing funds to "true" New Zealand funds versus foreign funds with a New Zealand "bolt-on". Two-years from now, the policy, as written, could result in:

Ok – Good outcome		Bad outcome
3x True New Zealand Managers		1x True New Zealand Managers
2x NZ Connected Managers	***or***	3x NZ Connected Managers
1x Foreign Manager		2x Foreign Manager
= 6 Managers		= 6 Managers

The difference in these outcomes will depend on implementation.

What's needed for a fully functioning eco-system?

In our experience:

1. Great entrepreneurial businesses
2. Experienced, connected, investments managers
3. A supportive investment community

Taking (1) as a given in this context and dealing with (2) and (3):

Creating world-class New Zealand Venture managers

The prior incarnation of NZVIF used to invest in "capability development" for up and coming New Zealand venture managers. It also tried, without much luck, to source foreign capital for New Zealand fund managers. For "true" New Zealand venture managers the VCF programme requires that we have another go at this. The challenge, however, is that the institutions given the implementation mandate for this no longer have any capability or experience in this area. NZVIF needs to rebuild this capability and up until now NZ Super has actively avoided investing in "venture".

What could be done?

1. Ensure that the NZVIF Board is representative of the eco-system that needs to be created. Consider supplementing the NZVIF Board with an industry advisory board.

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2. Ensure that the NZVIF (or NZTE) strategy and budget has a clear allocation towards eco-system development.
3. Ensure that the fee base that "true" New Zealand funds receive through the programme is reasonable, given their fund size and the capability that needs to be created.

Past, practical eco-system building initiatives have included:

- Using credible international investment advisers to "coach" new Venture Managers on the selection criteria used by institutional investors to evaluate them.
- Organising New Zealand Inc. Fund Manager pitch events to selected investors in key offshore markets, in the same way that NZTE supports NZ companies to pitch to overseas managers.

Imagine where we might be if a small fraction of the government effort that's put into the development of our entrepreneurial eco-system went into the development of our future Venture fund managers? We used to do a small amount but no longer.

A supportive investment community

The programme brings back an important ingredient to the market that's been missing over the last three years – institutional scale capital. It does not, however, do anything to address the matching private capital challenge in New Zealand. This challenge has been well documented through other "forums" but for completeness our experience is:

- **The challenge with New Zealand institutions** – Movac's current fund is the first venture type fund raised in New Zealand that received institutional support. It received that support by adopting a more conservative Series B/C style investment mandate. We are yet to see meaningful institutional support in New Zealand for Series A Venture funds. ACC did it in the first wave of funds established under NZVIF in the early 2000's but no one else recently.
- **The Kiwi Saver dilemma** – Kiwi Saver managers, as a general rule, have not invested in "alternative assets" of which venture funds are a small element, but this category also includes private equity, infrastructure and property. The world leading endowment funds have 20% – 40% of their funds allocated in this category and the trend is increasing given the persistently low interest rate environment investors face globally. Our Kiwi Saver industry runs a real risk of creating further wealth disparity by not resetting how it invests. When Kiwi Saver managers eventually wake-up they will rightly look to back managers who have an established track-record. They are, therefore, most likely, 2nd fund potential investors not 1st fund potential investors.
- **Brokers and Private Wealth Managers** – in our experience advisors are running scared from the FMA. They require independent research to be completed on investment opportunities before they will recommend them to clients. This won't happen for new venture funds. Movac might have enough history and performance under its belt (after 20 years) for this to happen in our next funds.

Adding to this challenge, multiple government programmes are trying to tap the same set of private investors, at the same time – the Callaghan Incubator programme and the new VCF programme.

There are green shoots, those New Zealand managers who can demonstrate a track-record have a shot at getting modest sized funds up, but the system likely needs to see more to encourage private capital to flow, in the short-term.

What could be done to move the dial? The only sharp tool government has, which has proven highly effectively in Australia and the UK is tax incentives.

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A positive bias to New Zealand fund mangers

The policy, as drafted, sets a low threshold for foreign fund managers to set up in New Zealand and take advantage of the New Zealand Connected Fund definition of the VCF. With no disrespect to the managers currently exploring setting up in New Zealand, over the last 20 years we've seen a number of off-shore funds fly-in, stay for a while, grab the best deals and then up-sticks and head off somewhere else when they get bored or there is an economic downturn.

In our view, we need New Zealand fund managers that have the passion and long-term commitment to seeing a sustainable and vibrant New Zealand eco-system. While unlikely, the current policy could see 100% of the VCF allocated to Foreign Fund managers, it presents that flexibility. We comment more on this in the detail below.

Comments on the Policy Statement

Definitions

Co-investment *means an investment made by the VCF directly into a New Zealand Entity alongside an Underlying Fund, where that Underlying Fund is completing a Follow-on Investment and the VCF is not the lead investor and relies on the due diligence of the manager of that Underlying Fund.*
Suggest you reserve the flexibility for VCF to invest directly, on the advice of the manager, after the Underlying Fund has expended its resources or hit its fund limits. This provides a potential avenue for fund managers to manage capital risk. We do not support this approach when it is used by institutional investors to reduce the fees they pay, particularly to sub-scale funds.

Note: When new Fund Managers start-out they will nearly always be "sub-scale" (~$50M). This is a dynamic that exists globally. Subsequent funds will be bigger as a track-record gets established. We shouldn't be afraid of this in New Zealand. This is the reality. The VCF should ideally seed a mix of funds, with the more mature Managers attracting larger funds and the new Managers smaller funds. The important test will be whether they can support the capability to execute their investment strategy.

Follow-on Investment *means additional investments into existing portfolio Entities that the Underlying Fund manager determines are required or reasonably advisable in order to protect, support or enhance an investment made by that Underlying Fund during its investment period.*
Investment Period is typically a defined term in a fund investment agreement. It is normally defined as 5-years and represent the period of time that a fund is allowed to make its initial investment into companies. It's also the period of time that the manager is allowed to charge a fee on committed capital vs deployed and reserved capital. We raise this point as a fund manager will generally always reserve capital to make follow-on investments after the Investment Period.

Net Committed Capital *means the total funds committed to the VCF (including any Recycled Funds available for reinvestment), minus the anticipated fees, obligations, expenses and liabilities to be incurred by the VCF.*
We assume this means that VCF is paying the NZVIF costs? Will this be split with SCIF? What does this mean in terms of capital available to be deployed into Underlying Funds? Assuming this programme can be administered for under $2m a year, this would imply $30m reserved for operating costs over the 15-year life? If you also take out a 20% allocation for co-investment then it means that approximately $210M will be available to commit to Funds. Assuming 6 to 7 funds receive commitments from VCF this would suggest average commitments of ~$30m.

New Zealand Connection
We find this part of the policy statement the most challenging. It makes it very easy for a Foreign Fund to set up in New Zealand and compete directly with less established New Zealand fund

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managers – for both dealflow and scarce New Zealand private capital. For the much larger Foreign Funds, with a passing interest in New Zealand, the VCF will represent a **low cost option** to enter the market and take advantage of the programme in way that will not ultimately be in New Zealand's interest. **We've been down this path before**. While Movac is well established, and we're not intimated by the competition, we see this part of the definition as a real threat to new New Zealand managers becoming established:

- **The initial wave of true NZ Funds are likely to be small**. $40m - $80m. Fund size will be a function of the experience of the manager and New Zealand institutional appetite to enter the Series A market. Fund size determines fees, team size and the ability to invest in value added activities like conferences, international network building, etc.
- **Contrast this with a $300m+ established Australian fund placing one person in New Zealand and raising a bolt-on fund**. They have a significantly larger fee base, a massive $3T+ institutional market that's starting to support Venture, and a favourable domestic tax regime. For the right proposition they should not have an issue raising a fund that targets New Zealand for investment. In short, Australian funds don't need capital support to focus on New Zealand, but would rightly assess this as a **low-cost option** to place a bet on New Zealand.

That said, if we accept that one of the key objectives for this programme is to get money to work quickly then we suggest you consider:

1. Creating three definitions of Fund types:
    - New Zealand Funds (for the "true" New Zealand funds);
    - Funds with a New Zealand connection; and
    - Foreign Funds.

2. Direct the majority of the VCF towards New Zealand Funds (70% NZ, 30% rest)

3. Tilt the matching capital ratio in favour the true New Zealand fund manager. 1:1 for the New Zealand Manager; 1:3 for the New Zealand connection manager; and 1:3 for the Foreign fund (if this is needed)

4. Increase the hurdle for New Zealand connection to include:
    - One New Zealand resident who is a "senior carry partner" in the Fund and holds an Investment Committee vote, plus
    - one New Zealand resident analyst.

We need to build manager capability in New Zealand, so **need people with a permanent connection to New Zealand to be developed** and gain experience through the programme. On the assumption that the Foreign Fund will not be permanent, the people must be permanent, or if they're not a penalty should apply (lost carry).

The current policy wording creates the real possibility that more than 50% of the VCF could be invested in offshore managers with only a tentative connection to New Zealand. In the 20-years we've been in market we've seen many foreign funds fly-in, pick across the best deals in New Zealand and then leave when their circumstances or economic conditions change, leaving nothing behind. We don't want to see this happen again.

Those in charge of administering the VCF will need to be vigilant to ensure that the mandate is maintained. Previously three offshore funds have been given "local" status (Two Taiwanese and One US) – Two funds had no intention of following the intent of the funding and broke their mandates within two-years. The other manager left the country after approximately three-years and invested outside of its investment mandate.

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In the event that you stay with the current settings, the hurdle for being a New Zealand connected fund is so low that the Foreign Fund carve out would seem unnecessary.

***New Zealand Entity** – [where at least 20 per cent of [tangible assets][assets] (by value) or employees and independent contractors (by number) are located in New Zealand, and both (1) the voting control is held by one or more New Zealand residents for tax purposes, and (2) the majority of its senior leadership team are New Zealand residents for tax purposes.*
We assume that the test for this definition will only apply **at the time that the first investment is made into a company**. We raise this as it is not uncommon for leadership of a New Zealand business to move offshore, closer to its key markets. We'd also recommend that point (2) be removed. If the majority of the economic benefit is flowing back to New Zealand, then why would we be concerned where the leadership is located? Don't constrain the businesses or the Underlying Funds from doing the right thing for the business and value creation.

***Seed Capital** means capital provided in a capital raising in which the total amount being raised in that round is from (and including) NZ$100,000 to (but excluding) NZ$2 million and where that capital is being raised for the purposes of early stage growth.*
Note: We have seen pre-Series A rounds at > $2M. This tends to happen in the deeper IP companies that need to invest more heavily to "prove their underlying technology" before sourcing their first commercialisation round. Companies like Rocket Labs, Aroa Biosorgery, Power-by-Proxi, Mint Innovation etc. **Given the 25% carve out our view is that this definition is workable.**

***Series A/ B definition** – means capital provided in a capital raising in which the total amount being raised in that round is from (and including) NZ$2 million to (and including) NZ$20 million and where that capital is being raised for the purposes of early stage growth.*
Our view is that this definition with a carve out for some seed deals should work. To be clear, we interpret this definition to apply to the investment round size, not the amount committed by an individual fund to a deal. This enables funds to work together on investments that they may otherwise struggle to get full conviction on.

You may consider whether the range is increased to NZ$2M - $30M. In our experience, investment round sizes are becoming larger and this would pre-bake in some additional flexibility. This definition is likely to find its way into the Investment Agreements of Underlying Fund Managers and once there will be hard to modify.

Policies

Policy 2: NZ Fund Investments
(i) See earlier comments on "Funds with a New Zealand Connection". Our concern is that the current framework could result in **more than 50% of the VCF under the effective control of Foreign Funds.** The historical evidence is that there is no permanency to these managers staying present in New Zealand.

(ii) 25% Carve out. We interpret this provision to apply "at the time the Underlying Fund makes its initial investment". We like this flexibility but see no reason to extend this to late stage, Series C investments, as an initial investment. We would expect Funds to invest in later stage rounds as they follow-on. The Series C and above market is well covered in New Zealand by domestic Private Equity funds and Foreign Funds.

(iii) 10% Non-qualifying NZ entity investment limit. At the Underlying Fund level we would prefer this to be dropped and just included as part of the 25% carve-out, or increase the deal limit to 20%. The

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reason being that most Underlying Funds will have an "investment concentration limit" as part of their Investment Agreement; this limits the total amount that they can invest in any one deal. For example in Movac Fund 4, the limit is 15% of Funds under Management and generally we approach an investment with the view that we will back it, over multiple rounds, up to the concentration limit. We also have the ability to approach our LPAC to extend this to 20%. So, practically our view is that a 10% constraint imposed at the Underlying Fund level will be too limiting to be able to use this carve out effectively.

We would only seek to use this where there is still some sort of New Zealand connection, but that connection might fall outside of the definition in the policy statement. This would mean that the business is strongly connected to the international Kiwi diaspora - has been founded or co-founded by an offshore Kiwi and/or has strong New Zealand investment support.

These investments will help support building international networks.

Policy 3: Foreign Fund Investments

We're struggling to understand why this carve out exists. We see plenty of foreign funds actively investing in New Zealand companies. If this is included to offer particular stimulus to certain sectors in New Zealand then this should be explicitly defined. **We don't need to help offshore funds invest in ICT in New Zealand, they're here, doing it now.**

If Foreign Funds are included in the scope of VCF then we would expect that 100% of the VCF capital into those Funds is invested in New Zealand entities.

Policy 4: Co-Investment with Underlying Funds

In general, we're supportive of co-investment rights where the intent is to provide back-up support to the Manager enabling them to deploy additional capital to maximize the return from a Fund investment. Any co-investment should only be considered after the fund has deployed its maximum concentration limit.

We're not supportive of these rights where institutional investors use them to leverage fees down. This practise for small New Zealand Managers will undermine the objective of building capability.

Further, the VCF should not seek to leverage this as an exclusive right in the Fund and it should be a provision offered on a pari passu basis to all investors in the Fund.

Policy 5: Private capital requirements

See earlier comment on definition of New Zealand connection. Our view is:

(i) New Zealand Fund – 1:1 matching
(ii) Fund with a New Zealand connection – 1:3 matching
(iii) Foreign Fund – what problem are we trying to address here?

II. Government expectations

Policy 6: Government's expectation as to the timing in which VCF capital is deployed

Confirming that this means that the VCF can make capital commitments to funds for a period of 5-years, but that the Funds will be investing that capital outside of that window.

Policy 7: Government's expectation as to continued investment is that the VCF may commit further capital for investment for a "Secondary Investment Period"

Our view is that the programme should support at least "two full cycles" of investment and return. This provides the potential for that to happen. Under the previous structure Movac went one cycle

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with NZVIF and very nearly tripped over on the second cycle when NZVIF changed direction. Investment Managers need institutional investors committed, in-principle, to support them over at least two cycles. It takes that long to build track-record and experience in a team. The policy needs to have consistency and longevity.

Policy 8: Government's expectation as to the return of capital invested through the VCF is that at the completion of the programme all residual funds should be returned to the Crown (net of any costs and fees), which is expected to be a minimum of 15 years from the Commencement Date.

We interpret this as providing the flexibility for Second Investment Period funds to deliver returns outside the 15-year window.

Policy 9: In setting out terms with the VCF manager, the Guardians must have regard to the following aspects of the Government's economic strategy and plan to transition to a low carbon economy:

Rather than multiple guidelines making their way into investment documents we would prefer to see a consistent approach implemented through the best-practise ESG guidelines that New Zealand Super have implemented for their investments. Directionally these would seem aligned with Government policy.

Thank you for the opportunity to submit on the Policy Statement. Carefully implemented, we see the creation of the VCF as something that will be extremely positive for the New Zealand entrepreneurial and venture eco-system.

If you have any questions regarding our submission, we'd be happy to discuss these with you.

Best regards

Phil McCaw
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MOVAC

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