LWCM

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Ministry of Business, Innovation and Employment ("MBIE")
Venture Capital Fund ("VCF")

Submission on the Draft Policy Statement on the Venture Capital Fund Act 2019

20 September 2019

Thank you for the opportunity to submit on the draft Policy Statement for the Venture Capital Fund ("VCF"). At LWCM we are fully committed to developing the New Zealand VC ecosystem, and we believe that a well-crafted and executed policy could have a tremendous impact on job creation, wealth and on reducing emissions.

1: About the Submitter

This submission is made by LWCM Limited, the Manager of Punakaiki Fund Limited, which is one of a handful of active New Zealand Venture Capital Funds.

LWCM Limited is the manager of Punakaiki Fund Limited, a venture capital investment company with $50 million of investments across 19 different high growth business.

Punakaiki Fund invests exclusively into New Zealand companies and has a particular focus on both Software as a Service and technology intensive businesses. The fund has invested over $30 million into 20 companies ranging from seed to later stage growth, with an increasing focus on the Series A stage ($2-3 million) where we see the greatest opportunity. The investments that form the vast majority of the value of the portfolio are Vend, Timely, Raygun, Onceit, Mobi2Go, RedSeed, Conqa, Melon Health, Weirdly, Boardingware, Coherent Solutions, Devoli, Mindfull and Everedge IP. The returns so far from the portfolio companies (based on exits, dividends and internal valuations) show an IRR of 20.6%, as at the end of June 2019.

Overall Punakaiki Fund holds investments in companies with combined last 12-month revenue of over $120 million and employing over 700 people.

Since the initial Punakaiki Fund investment into each company, the revenue from portfolio companies has increased by an average of 6.6x and a median of 3.9x.

Punakaiki Fund has over 830 shareholders, who are almost entirely based in New Zealand, while the handful of offshore investors are all New Zealand citizens. This compares with typical GP/LP structures where the number of investors is typically in the 10-100 range, and who make larger commitments over time. Punakaiki Fund has no investment from the New Zealand government - neither directly from NZVIF, nor through entities like NZ Super or ACC.

The fund commenced in April 2014 with a share price of $10 and has raised over $33 million through a series of retail and wholesale offers, along with share issues to acquire shares in portfolio companies. With the iNAV/share of around $22.50 in June 2019, the

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investors who purchased shares in April 2014 and exercised all attached options have generated an IRR of 18.6%. This is above, for example, the expected return for venture capital of 16% set by the Yale Investment Office. A number of investors have sold their shares, and essentially all of them have made positive returns, despite share trading happening at a discount to the net asset value.

The structure of Punakaiki Fund is set up to be very similar to the GP/LP structure, but with crucial differences that provide advantages to founders and investors. There is a very strong Board in place, the Manager can be removed through a majority vote, the retail share offers are scrutinised and regulated by the Financial Market Authority and the shares in Punakaiki fund can be, and are, traded - mainly between investors. The fund intends to list, and will have a set-up similar to Bailador, the ASX-listed Australian VC fund run by David Kirk, or Infratil, the NZX-listed infrastructure PE fund.

The advantage for portfolio companies is that as an evergreen fund, Punakaiki Fund has no mandate to rush companies to exit. The patient approach allows the successful companies time to grow into substantial corporations, generating a larger number of sustainable NZ jobs, tax revenue and economic benefit for New Zealand than early exits do.

LWCM has a founder centric approach, publishes diversity statistics in our annual report and is, recognising there is still a way to go, New Zealand's leader in venture capital in investing in women and Maori led companies. LWCM has led by example to help the industry shift to more founder centric investment contracts and publishes a wide variety of documents, including quarterly and annual reports, audited accounts and more on our website: https://punakaikifund.co.nz/key-documents/

LWCM is founded by Lance Wiggs and Chris Humphreys, who met while trying to launch Pacific Fibre, an ambitious project to improve New Zealand's international internet connectivity. They have completed almost 100 investments together, and have a growing team of professionals, including Olo Brown, Bridget Winstone-Kight (on maternity leave), Thomas Chung and James Pope. With James leaving to go offshore, LWCM has recruited two new people (with Thomas already on board as a contractor) and has made offers to two others. The team will be 6-8 people by the end of the financial year. We note that LWCM has retained Jez Weston, who is with MBIE, on a part time basis to work on an unrelated (climate) fund proposal.

Lance Wiggs has a long history in the high growth ecosystem in New Zealand, assisting Trade Me from early 2004 (including showing the founders and investors the value of the company), and guiding them, as advisor to the CEO, during the sale to Fairfax for $750 million. He has assisted an estimated over two hundred companies via NZTE's Better by Design, Better by Capital and Investments programs, and was the Chair of the ICT and was a member of the Physical Science Investment Committees for Return on Science, leading the recruitment of the initial wave of students into the program. Lance's work with the NZTE Investments program was recently featured om Maori TV: https://teaomaori.news/maori-businessman-seeks-dragons-den-funding-edible-hemp

Chris Humphreys is based in Te Anau and is responsible for the robustness of the internal processes, including the investment processes. Full bios for Chris and Lance and more information about LWCM and Punakaiki Fund is available on the Punakaiki Fund website: https://punakaikifund.co.nz/

2: Guiding Principles that inform our submission

Punakaiki Fund was established in response to Lance's assessment well over 10 years ago that New Zealand had a yawning funding gap for excellent high growth investments. LWCM believes that if the VCF is implemented properly it could provide a much-needed boost to the sector with long lasting positive effects to the start-up ecosystem and wider economy.

However, we also caution that a poor implementation could create perverse incentives and do very real damage to a sector that has rapidly matured over the last five years, all with minimal government funding support.

The following core principles provide the foundation for our submission:

Fairness: Commitment of New Zealand government's funds must be fair, which means the criteria, process and results of applying for funds are well understood, unbiased and transparent. There should be equal access to the Fund-of-funds, and the selection of the initial funds should be based on well understood criteria and use an open and transparent process.

Seed and grow the sector: We see that venture capital investing is based on an apprenticeship model, where great investors learn by doing. This includes the addition of new staff to managers, first time managers starting a fund, migrants from angel funds to venture funds, and new entrants to a market such as New Zealand. The industry standard is that the first fund is relatively small, allowing larger investors observe the results, with most institutional investors avoiding first (or second) funds. We believe that **this program should make it easier for a large number of small first venture capital funds to be created** and ramp up investment to managers with more experience in New Zealand venture capital.

Benefits for New Zealand: The major benefits of the fund should go to New Zealand entities and people, including the founders and staff of companies being invested into, the other investors in those companies, the investment managers who allocate the funds to companies, and the investors (e.g. limited partners) who are encouraged to invest alongside the New Zealand government funding.

Activate New Zealand Investors: The $300 million fund should activate investment from New Zealand based private investors, from private individuals all the way to institutional investors such as retail funds, Kiwisaver funds, ACC and NZ Super. A key metric of success will be the future participation of investors of all classes in the venture capital fund space. All investor types should have access to the venture capital investment asset class, regardless of their net worth, investment experience or amount available to invest

Allocation by managers not the Fund-of-funds: The funds should be allocated by managers not the Fund-of-funds. This builds manager experience, ensures there is a funding multiplier and ensures that the Fund-of-funds is acting only in that role. It also removes conflict, if NZVIF is the manager, with the SCIF program, which does participate in Series A and B rounds.

High speed of deployment: The funding should be allocated in a way where, initially, the deployment of those funds to companies is rapid yet considered, so that the program can show early results.

Appropriate governance, manager process and VCF Processes: The required criteria and processes for funds to attract investment should be related to their scale. The program should ensure that, for example, a $15 million fund is not required to meet the hurdles that a $1 billion fund would need to meet. Smaller funds will likely have tiny and even part time teams and need to prove themselves before raising additional funds. Finally, the Fund-of-funds itself should be subject to rigorous pre-investment scrutiny and meet all of the normal thresholds for a conviction review from NZ Super.

Long term focus: To build a competitive and world class VC industry in New Zealand we need to grow a community of experienced fund managers, investors and support staff. VC investing is much different to investing in later stage or publically listed companies as it is very hands on, requires an understanding of new technology and rapid change, and there is often a high chance of investment failure. The way to become a good VC investor is through hands on investment experience and exposure to both successful and unsuccessful early stage businesses. The number of experienced VC investors in NZ is currently low and an apprentice model is needed to train the next generation of investors and incentivise them to remain in New Zealand.

NZ Company, NZ Manager, Series A and B Focused: The program should reflect a policy goal of getting funding to New Zealand based companies of between $2 and $20 million, and via New Zealand venture capital managers.

3: Responses to the Questions

1. ***Do you agree with the proposed definitions? If not, please explain why.***

New Zealand Connection: We do not believe that having a single senior investment professional resident within New Zealand is sufficient in order for a venture capital fund or manager to have a strong enough connection to New Zealand for the purposes of the policy.

The definition of "New Zealand Connection" defines the difference between Foreign and New Zealand funds, however that definition allows for 100% foreign investor owned and managed funds to, for example, set up a small branch in New Zealand and present as New Zealand funds. Foreign funds already benefit from structural advantages in their domestic market. These include tax advantages for Limited Partners and other investors, vibrant investment fund communities that have established relationships with VC firms and a larger population of deal flow, investors and other funds in their market. They have better access to their local institutional investors and will be more likely to be granted early access to the VCF program as they are used to dealing with LPs like NZ Super. However, it is already relatively easy for them to set up a smaller fund in New Zealand, as, indeed, one fund is already doing without any support from the New Zealand government or material support from local investors.

Our concern is that the VCF legislation and policy as currently structured will likely have the unintended consequence of creating a "domestic" range of funds that are predominantly owned and operated by offshore entities.

The history of the investment banking industry in New Zealand tells us that offshore owners, despite intentions, tend to be fair weather friends, and when conditions turn, they are likely to scale down involvement or exit the market.

We are also concerned that they will import certain biases, and that they will not understand, or materially seek to understand Maori Owned businesses or businesses owned by other diverse founders.

While we agree that offshore funds should be supported to set up shop in New Zealand, we also see that the New Zealand based funds with predominantly New Zealand based investors should be recognized as a separate class of fund and to have goals and benefits specifically targeted to those funds.

New Zealand Fund: This term would define funds that are truly New Zealand grown and not an outpost of an offshore fund. Our suggestions are that there is a test of ownership of both the fund and the manager, where the only meaningful test of manager ownership is the allocation of management fees and carry. We suggest that funds where 80% of investment is from New Zealand investors (NZ Underlying Funds), and 80% of the management fee and the 80% of the carry (or equivalent) goes to New Zealand citizens or people with a resident visa. We see this definition is critical to ensure a true domestic funding community is developed.

New Zealand Connected (Fund): This term should be amended to add to the current definition minimum thresholds (say 30-50%) for all or two out of three of investor location, management fees and management carry.

For the New Zealand Connected definition we see that there should be requirements for a certain share of investment committee members to be based in New Zealand, to encourage the development of industry expertise within New Zealand.

The VCF will not have succeeded until the industry has local investors of all types making substantial commitments and returns from the New Zealand markets and local funds owned by local managers who controlling a substantial share of the market.

We also see there should be, for New Zealand Connected Funds, a required minimum portion of the manager of a venture capital fund to be owned by, or the benefits flow to, New Zealanders. In successful venture capital investing, profits flow not only to fund investors, but also to fund managers. These profits may then flow overseas when the manager has foreign owners. We prefer that much of the manager profits are retained within New Zealand and draw a parallel to the Objectives, which discusses concern related to the premature "sell-off of innovation to offshore interests" and "the substantial potential gains that investors can make in successful start-up businesses also being made overseas".

Alternatively, the definition of New Zealand Connected could be amended to the suggested New Zealand Fund definition.

As the Policy seeks to develop New Zealand's venture capital markets over time, including its participants, the Policy should encourage greater skill development within New Zealand venture capital environment, both at a senior and a junior level. This can be achieved by increasing the allocation to NZ Funds and tightening the requirements for the NZ Connected funds over time. We would expect this to result in a greater training and mentoring of junior New Zealand-based staff and senior investment professionals "spinning out" and creating their own venture capital management firms.

Co-investment: This term should be removed as co-investment should not be part of the VCF program.

Fund-of-funds*:* We do not believe that VCF should allocate capital to Co-investment with Underlying funds. The definition of Fund-of-funds should be amended to remove the reference to Co-investments, and explicitly state that the Fund-of-funds will only be allocating capital via funds.

Seed Capital*:* This definition could be amended to state "up to $2 million" rather than the range of $100,000 to $2 million.

We see that any capital that is not allocated to investments between $2 and $20 million should not attract any funding from VCF. If a fund, for example, allocates 20% of their fund to seed investments, then only 80% of the fund should be eligible for co-investment, and VCF would have clawback rights if this ratio is exceeded.

Series A and B Capital*:* We see that the funding gap in New Zealand is from investors who are alone able to meet the $2-20m investment range. We already see groups of investors reaching that level, but the investment provided is "angel" and not venture capital and comes with a number of issues.

We would like this definition amended to make it clear that Series A and B Capital is capital where the investment by a fund to a company exceeds $2 million, and where the round size is up to $20 million. The unintended consequence of the current definition is that groups of funds might invest trivial amounts in a round (e.g. $200,000 each) and call it a Series A investment, where the market failure is in the larger checks being written quickly and with conviction.

Series C and C+ Capital: The definition of Series C and C+ Capital are all capital raisings which are not Seed or Series A or B capital raisings. Based on the definition of Seed Capital (NZ$100,000 to NZ$2 million), Series C and C+ Capital means any capital raising either less than NZ$100,000 or more than NZ$20 million. This definition should be modified to be only greater that NZ$20 million.

We see that any capital that is not allocated to investments between $2 and $20 million should not attract any funding from VCF. If a fund, for example, allocates 20% of their fund to Series C or higher investments, then only 80% of the fund should be eligible for co-investment, and VCF would have clawback rights if this ratio is exceeded.

Underlying Funds: We would like this definition to be expanded as below into "NZ underlying funds" and "Foreign Underlying Funds, as below.

We would also like this definition to exclude certain categories of funds (for matching purposes), including funds that are provided by any government entity - domestic (double dipping) or foreign (foreign funds) and funds that are not provided in cash form (e.g. share swaps).

We would like this definition to make it explicit that the type of investor is not material, just the location. It should also make clear that the timing of fundraising is not material, giving credit to funds that have already raised funds from private investors, and allowing investment in established funds that have not fully closed, could reopen or are evergreen. We see this is critical to getting funds working and to address bias against funds, like our own, that raised funds when NZVIF was not active.

We see that the following New Definitions are required:

LP/Investor: This definition should ensure that all investors into funds are treated equally - i.e. that funds from institutional investors are treated no differently than funds from retail or wholesale investors.

New Zealand based LP/investor: This defines the source of the capital for funds, which is defined by the residency of the ultimate owner of the funds.

NZ underlying funds: Where the LP/investors are NZ residents, along with the changes in definition to underlying funds above.

Foreign underlying funds: Where the LP/investors are foreign residents etc. Less credit should be given to funds from foreign sources.

Capability and connections: We heard this term used in passing at the workshop and would like it to be articulated in the policy. It appeared to be an important criterion for fund selection, and we would like to ensure that domestic funds are able to respond to this.

Viable Fund: We heard this term used in passing at the workshop and would like it to be articulated in the policy. If the fund of funds is only going to invest in "viable funds" then the term is clearly highly important. In our own experience we note that even tiny funds can be viable, as long as the principals are not full time, and that micro-funds may be (and currently is) the best way to identify the best fund managers.

2. ***Is the overall drafting of the Policy Statement objectives and definitions clear and consistent?***

Add an objective to explicitly promote investment from New Zealand investors (i.e. Limited Partners or other investors)

The Purpose of the Venture Capital Fund (VCF) does not include a mandate to improve the domestic venture capital ecosystem through amplifying the contribution from local investors, and this creates a cascade of issues that risk or do create inherent bias against domestic investors and domestic funds.

The Objectives of the policy statement should add three elements:

Firstly, there should be an objective to increase investment from New Zealand (e.g. limited partner) investors into New Zealand targets VC funds. This is an obvious gap that was identified at the workshop, and mirrors a gap identified by the retail sector for investment into private companies in New Zealand

Secondly there should be an objective to increase the number of and scale of funds managed by New Zealand connected and New Zealand owned managers, with, say, defined targets for 2, 5 and 10 years.

Finally, there should be objectives and measures for investment into Maori and women owned businesses, as well as funds allocated to fund managers with Maori and women principals. Ignoring this risks the development of systematic bias in investments.

3. ***Do you agree with the proposed policies as set out in the Policy Statement? If not, please explain why.***

Policy 1: Investment Model

We can accept the Investment Model but do not agree with the definition of Fund-of-funds and recommend that it is amended as discussed in response to Question 1.

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Policy 2: NZ Fund Investments

The policy proposes that a minimum of 70% of the Net Committed Capital is made available for investment into funds with a "New Zealand connection".

We see the allocation of funds should be 20% foreign, 40% "New Zealand connected" (with foreign control and/or investors, and 40%-100% "New Zealand Funds (locally controlled and local investors). As explained elsewhere access to capital is not the issue for foreign funds, and we would prefer an even lower percentage of foreign, if not zero. We also see that the percentage should decline over time as successful foreign funds become more local.

Policy 2: NZ Fund investments

As covered under the definition section we strongly see that either an additional definition for true NZ funds is required, or the NZ Connection definition is tightened considerably.

We note that as written only 42% of the $300m would be allocated to New Zealand managers and Series A and B investments, which could be argued is failing the policy objectives. The amount of funds allocated to both NZ funds and Series A and B should be significantly higher, so that at least 80% of the $300m is allocated by NZ Funds to Series A and B.

Policy 3: Foreign Fund investments

We note that high quality Foreign Funds from well-functioning foreign markets are not likely to be capital constrained. The ability to secure additional funding from the Venture Capital Fund should not be motivational for these Foreign Funds to come to New Zealand and invest in New Zealand Entities.

These Foreign Funds will come to New Zealand to invest because of the high-quality investment opportunities that are present here versus the opportunities that are available in their domestic markets. The availability of Venture Capital Fund funding to Foreign Funds may result in poorer quality Foreign Funds that have difficulty raising capital in their domestic markets coming to New Zealand due to the availability of capital from the Venture Capital Fund.

There is an unintended consequence. Higher quality (and thus better funded) Foreign Funds are likely to invest in New Zealand Entities due to the investment opportunities available in New Zealand rather than the availability of additional capital. Lower quality Foreign Funds are likely to be more driven by the availability of capital. Thus, this policy will attract lower quality funds.

Another unintended consequence is for Australian Funds that already allocate 20% to NZ, where they may opportunistically seek additional capital from the Venture Capital Fund to increase funds under management, but this may not lead to a material increase in deployment of capital in New Zealand Entities. (e.g. a $200m Foreign Fund may designate 20% of its funds for investing in New Zealand Entities ($40m), apply to the Venture Capital Fund for funding and receive $20m. It is now a $220m fund. Its 20% allocation to investing in New Zealand entities has now slightly increased to $44m - i.e. a $20m investment from the Venture Investment Fund has resulted in only $4m of additional investment into New Zealand Entities).

We also note that profits from Foreign Funds flow not only largely to foreign investors, but also entirely to Foreign Fund managers. This exporting of Foreign Fund manager profits is not beneficial to New Zealand when compared to investing in funds with a New Zealand Connection where most or all these profits are retained within New Zealand.

We see that investment from foreign funds should be lowered or eliminated, and that consideration be given to lowering the ratio of VCF funding to underlying capital.

Policy 4: Co-investment with Underlying Funds

Based on the proposed policies, $60 million would be allocated to co-investments ($42 million co-invested alongside NZ Connection funds and $18 million co-invested alongside Foreign funds).

We do not believe that the fund should have any allocation to Co-investments alongside Underlying or Foreign Funds. We note the strong consensus for this at the industry workshop in Auckland and draw attention to the below:

- A $60 million allocation to Co-investments, combined with NZSCIF's existing $80-$160 million fund ($8-16m per year over 10 years) would make the NZVIF/NZSCIF by far the largest pool of early-stage investment capital in the New Zealand market. NZ VC funds should not be competing with NZVIF and NZ government for investments.
- Under the Policy Statement, any capital allocated to Underlying Funds requires at least a matching investment from external investors and therefore has a multiplier effect. The Co-investment allocation has no fund matching requirement. $60 million allocated to Co-investments represents a 20% reduction in external funding being required compared to a scenario where the $60 million is allocated to Underlying Funds which require matched external investment.
- The size of the fund is $300 million less the cost of administering the fund. Any amount spent on administration will not be available for investment into Underlying Funds and companies with a need for capital. The cost of administration of VCF can be materially reduced if NZVIF adheres to the strict mandate of selecting Underlying Funds to invest in and does not employ an investment team for making Co-investment decisions.
- There is a clear conflict of interest between NZVIF and NZSCIF, which could both be participating in Series A investments, and NZVIF as a Fund of funds manager. NZVIF Would likely be in direct competition with the Underlying Funds which are being selected by NZVIF. This could lead to distortions in market pricing and returns, or affect the Fund-of-funds ability to make unbiased decisions about which Underlying Funds to invest in.
- Side-car investment vehicles are typically structured to allow large LP's/Investors to pay lower performance and/or management fees in exchange for providing a cornerstone investment. It is our understanding that VCF will not

be negotiating lower fees for their investment into Underlying Funds as VC Funds depend on reasonable fees to fund operations and remain viable. If VCF investments into Underlying Funds will be paying the same fees as other LP's/Investors, then there is no need for Side-car investments and the capital should be allocated into the Underlying Fund directly.

- s9(2)(ba)(i) [redacted]

Policy 6: Timing

We see that the timing of commitments should be front-loaded so that companies receive funding earlier. We would like clear expectations to be set for the amount of funds to be committed and disbursed in the first 2 and 5 years.

Policy 7: Secondary Period

We would prefer that this is addressed at the time, so that there is a formal review before rollover.

Policy 8: Return of Capital

No comment

Policy 9: Economic Strategy

We were unable to comment on this but agree that the NZ Government should not be investing directly or indirectly in high emissions industries, and that lowering emissions is critical.

Other Policies:

Statistics: We see it is reasonable to require that any entity accepting government funding agree to publication (i.e. on a public website) of basic information including their investments (amounts by company), holding value and returns, and overall metrics such as TVPI, DPI and IRR. They should also report other metrics such as total company revenue, equity weighted revenue and employment.

These would ideally be on a quarterly but certainly on an annual basis.

The fund of funds manager would aggregate these in detail and overall to provide an effective mechanism to track results.

4. ***Do you think the policies will achieve the objectives of the Venture Capital Fund as set out in the objectives section of the Policy Statement? If not, please explain why.***

As it stands, we do not believe the VCF objectives will be met by the policy, and even see that the results could be negative for the ecosystem. This is due to the inherent advantage that offshore funds will have in becoming recipients of the funding, the chilling effect of the funding on funds that do not attract funding and the inherent conflict that NZVIF as the manager presents. We are concerned that it will not develop a truly New Zealand funding ecosystem, which will exacerbate the existing industry against Maori owned businesses, and likely diverse founders per se.

5. ***Do you have any other comments?***

5.1 Timing and review for this process

The timing of this and the VCF Bill submission processes is very compressed, and at LWCM we have struggled to do these justice. We are concerned that the industry, especially active funds, has little capacity to give the feedback required.

The accelerated legislation and policy process has not provisioned for industry feedback to a revised version of the policy, and makes for a very limited time to feed back on the legislation. Given the two pieces of work are moving in parallel we see that the speed and structure of the approach may lead to unintended poor policy and legislation outcomes.

As mentioned by many in the workshop we request that MBIE provide the NZ venture capital industry an opportunity to review the revised policy after it has been redrafted.

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LWCM Limited (LWCM) is the manager of Punakaiki Fund Limited