Written submission (September 2019) - Draft Policy Statement on the Venture Capital Fund Act 2019

Submitted by The Snowball Effect Limited (company # 3564791)

- **Purpose**: New Zealand Venture Capital Market participant contribution to the consultation document and Draft Policy Statement on the Venture Capital Fund Act 2019.
- **About**: Snowball Effect is New Zealand's leading private investment platform, raising Series A investment for New Zealand businesses. To date, Snowball Effect has raised $55 million of capital for high-growth New Zealand businesses.
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Introduction

Since its inception in 2014, Snowball Effect has raised approximately $55 million of Series A capital for New Zealand businesses. The Snowball Effect business was founded specifically to address the Series A funding gap by connecting Series A investors with companies seeking Series A capital. We are therefore well versed in the shallowness of the early-stage capital markets in New Zealand, and we welcome the Government's initiative to make $300 million of investment available via a new Venture Capital Fund (VCF).

Having been at the coal face addressing the Series A funding gap for the past 5 years, we have a strong understanding of the work required to raise Series A capital. Beyond the venture capital investments we have facilitated into high growth New Zealand businesses, we are also experienced in raising investment for established funds operating in the New Zealand market, such as the Punakaiki venture capital fund, and the Castlerock Partners private equity fund.

This experience working with Series A investors and investee companies means we are uniquely positioned to understand the issues present in the market. The new VCF funding has the potential to revitalise the early stage capital markets, however, it will be crucial to implement the new VCF within a framework that ensures the VCF achieves its stated objectives whilst ensuring Government funds are injected to have the greatest impact.

Objectives

The stated purpose of the VCF is to contribute to a sustainable and productive economy by:

1. Increasing the venture capital available to New Zealand entities; and
2. Developing New Zealand's venture capital markets to function more effectively so that over time:

a. More venture capital becomes available to New Zealand entities from sources other than the Venture Capital Fund, and
b. New Zealand entities that receive venture capital become more likely to grow into successful and sustainable businesses.

In the context of the stated objective to increase venture capital availability and encourage the market to function more effectively, we believe it is important to acknowledge the initiatives already underway in the private sector. The VCF is not intended to be an all-encompassing solution to achieve these objectives on its own, therefore, the private participants that are currently addressing the stated objectives should be adequately considered in the scope of the policy statement.

<u>Increase capital available to New Zealand entities</u>

The draft policy states that "as the number of start-ups in New Zealand continues to grow, this has led to the increased ~~the~~ reliance upon foreign capital to support New Zealand early-stage entities, which increases the risk of earlier-than-necessary sell off of New Zealand innovation to offshore interests". We agree with this statement, however believe it contradicts the fact that the draft policy has a direct intention to give VCF capital to Foreign Funds (up to 30%), and furthermore, provides for a total allowance of "10% of the aggregate investable capital of all Underlying Funds with a New Zealand Connection... allocated for investment in Entities that do not qualify as New Zealand Entities." As a result, the draft policy wording contradicts objective number 1 by earmarking some of the VCF capital for non-New Zealand Entities. Refer to recommendation 3.

<u>Develop New Zealand's venture capital market</u>

New Zealand Connection

We see merit in having offshore skills interested in participating in New Zealand's venture capital ecosystem, however the operative part of this concept needs to ensure there are no loopholes that allow offshore funds to structure themselves to look like a fund with a New Zealand connection but ultimately have the ability to use VCF funds in a manner not intended by the policy statement.

Foreign Funds

The language in the policy statement needs to be that "up to 30% of the capital 'can be' (rather than 'is') invested alongside foreign funds...".

As stated in objective number 2, by developing New Zealand's venture capital market, "more venture capital is expected to become available to New Zealand entities from sources other than the VCF". With this objective in mind, it would be logical to assume that the VCF which is designed to attract other investments, should not be aiming to achieve the objective by giving up to 30% of the VCF to Foreign Funds from the outset. The policy wording therefore contradicts objective number 2. Refer to recommendation number 2.

The rationale for the 30% allocation is that it “allows for foreign funds with specific skill sets, industry focus, or value proposition that benefits the New Zealand ecosystem, but where:

- a New Zealand domiciled fund is impractical, or
- domestic deal flow is insufficient to justify a stand-alone fund (or may result in a sub-scale fund)”

Whilst we agree that experience and expertise from Foreign Funds operating in New Zealand is a positive factor for the development of New Zealand’s venture capital ecosystem, we believe the ecosystem needs to attract these funds on its own accord, and we do not agree that VCF funds should be used for this purpose. There are numerous examples of Foreign Funds already setting up operations in New Zealand without a VCF incentive. Furthermore, the rationale of funding Foreign Funds as a result of a New Zealand domiciled fund being impractical or deal flow being insufficient contradicts the reason for them operating here.

The primary objective of the VCF should be to drive a New Zealand centric solution for the revitalisation of New Zealand’s venture capital industry, and the VCF should not place an overemphasis on the need for foreign skills and experience before allowing for a New Zealand centric solution. A well funded and vibrant market will attract its own talent.

Allocation of funds

The wording for the allocation of funds needs to be watertight to ensure that the allocation of capital is only to New Zealand Entities, other than in well-defined circumstances. These circumstances need to be defined as exceptions to a blanket rule that VCF capital is only available to New Zealand Entities.

The current drafting suggests 10% of VCF capital could end up allocated for investment in foreign entities. We appreciate the need for exceptions to the rule of capital only being allocated to New Zealand Entities for Series A & B transactions in instances such as Funds needing to undertake follow on investment (e.g. Series C), or when a New Zealand Entity ceases to be a New Zealand Entity post the initial investment, however these need to be defined exceptions to the rule, rather than an allowance. If these exceptions are drafted as an allowance, this will leave the legislation open to interpretation and may cause unintended consequences such as an overweight exposure to Series C investments.

Allowance for seed investment

The argument for the allowance of investments in Seed rounds to alleviate the fears ‘foreign or first-time funds’ may have regarding Seed investors being on the cap table with pre-emptive rights is flawed. It is common practice both in New Zealand and globally to have

Seed investors on the cap table holding pre-emptive rights. The existing Seed investment ecosystem should not be undermined by VCF funding that is intended to fix a Series A & B funding gap, by having the VCF funding going to Foreign Funds with the ability to invest at the seed stage with funding from the New Zealand Government. Again, this undermines the stated objective of the VCF.

Seed investments by funds with a New Zealand Connection should be capped at 5% of VCF funding received. Refer to recommendation number 4.

VCF Co-investment (20% of the total funds)

This allowance should not be restricted to funds that have already received VCF funding. The VCF should reserve the right to be able to invest VCF funds alongside Series A & B transactions involving investors who are not prior recipients of VCF funding. For example, firms such as Snowball Effect have been directly addressing the key objective of the VCF by executing Series A capital raises. VCF co-investment in these types of transactions should therefore sit within the mandate of the VCF co-investment allowance of 20% of total funds.

Furthermore, this allocation should always be restricted to Series A and not be left aside for Series C and C+, which would be counter to the objective of the VCF.

Definitions

<u>Investment Stages</u>

We agree that it is logical to define the stages of investment using monetary bands, however believe these bands should be set within a New Zealand specific context that takes account of factors such as the size of our population, the size of the capital pool, the size of the markets that investee companies operate in, and the capital requirements of investee companies seeking venture capital in New Zealand. When accounting for the smaller size of each of these criteria, and factoring in our real-world experience of what classifies Seed, Series A, and Series B funding, it is clear that the monetary bands in a New Zealand context are different from the bands as they are defined outside of New Zealand, and should remain so. Specifically, we believe most Series A rounds are $1 million to $5 million in New Zealand. Refer to recommendation number 5.

<u>New Zealand Entities</u>

The definition of New Zealand Entities should be aligned to the foreign entity tax rules that are already in place.

Summary of recommendations

1. Foreign Funds - the language in the policy statement needs to be that "up to X% of the capital ‘can be’ (rather than 'is') invested alongside foreign funds...".
2. Allocation to Foreign Funds - cap this at 10% rather than 30% as is currently drafted. The objectives of the VCF should not be so heavily weighted towards Foreign Funds from the outset.
3. Allocation of funds - ensure that the allocation of capital is only to New Zealand Entities, other than in well-defined circumstances. These circumstances need to be defined as exceptions to the blanket rule that VCF capital is only available to New Zealand Entities. Exceptions to include follow on investments which may be Series C investments, and exposure to non-New Zealand Entities that were New Zealand Entities at the time of the original investment.
4. Seed investments - seed investments should only be allowed by funds with a New Zealand Connection and should be capped at 5% of total VCF funding received.
5. Investment stages - we propose the following bands are suitable for New Zealand:
    - Seed capital: up to $1 million.
    - Series A: $1-5 million.
    - Series B: up to $20 million.

<u>Conclusion</u>

We commend the Government for attempting to reinvigorate the early-stage capital markets with a significant injection of Series A & B capital. As a market participant who has been operating across several parts of the ecosystem for a number of years, we understand the challenges the VCF policy is trying to address.

We believe it is imperative that the VCF is implemented under a framework that is relevant to the unique conditions of the New Zealand market. Whilst we appreciate the desire to attract foreign expertise to improve the venture capital ecosystem, we believe the ecosystem with the help of VCF funding should be able to attract foreign participants by virtue of the opportunities the industry presents, without the incentive of funding from the Government.

In order to achieve the stated objectives, we recommend due consideration is given to this submission and the specific recommendations contained within it.