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**
16 August 2021	Options to Improve Small- and Medium-sized Enterprises' Access to Finance	Office of the Minister of Finance, Office of the Minister for Economic and Regional Development
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**

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Improving Access to Growth Funding

Slide pack on the Business Growth Fund model of bank-led equity participation

October 2021

New Zealand Government

Policy background

Why it matters

- Access to finance is a critical component of firm growth.
- Firms need finance to:
  - build capability (training, hiring skills, boards)
  - conduct R&D
  - invest in new equipment and processes
  - increase operating scale and access new markets.
- Finance is also critical for firms to be more sustainable (eg invest in more efficient equipment/processes).
- Internationally – access to particular types of finance or for particular market segments is lacking. This includes:
  - limited patient capital
  - finance for firms with few tangible assets (ie collateral) or low current revenues to growth ambitions
  - finance for small or new firms or for those in new/emerging sectors where market information is low.

What it looks like in New Zealand

- MBIE has investigated conditions for SMEs, and particularly those earning $3m-$30m in revenue (typically employing 6-50 staff).
- MBIE estimate there are ~37,000 firms in this segment (including 1,500 Māori businesses).
- Although broadly markets are capital-flush, there are specific gaps and a mismatches between needs of suppliers of debt/equity and those needing finance.
- These include:
  - a shortage of capital market intermediaries in niche segments (eg growth capital for SMEs)
  - prudential regulation/risk weightings, and the opportunity cost of banks lending/investing equity in SMEs over other assets
  - SMEs not willing to give up control, financial awareness, investor readiness
  - high transaction costs vs risk adjusted returns.

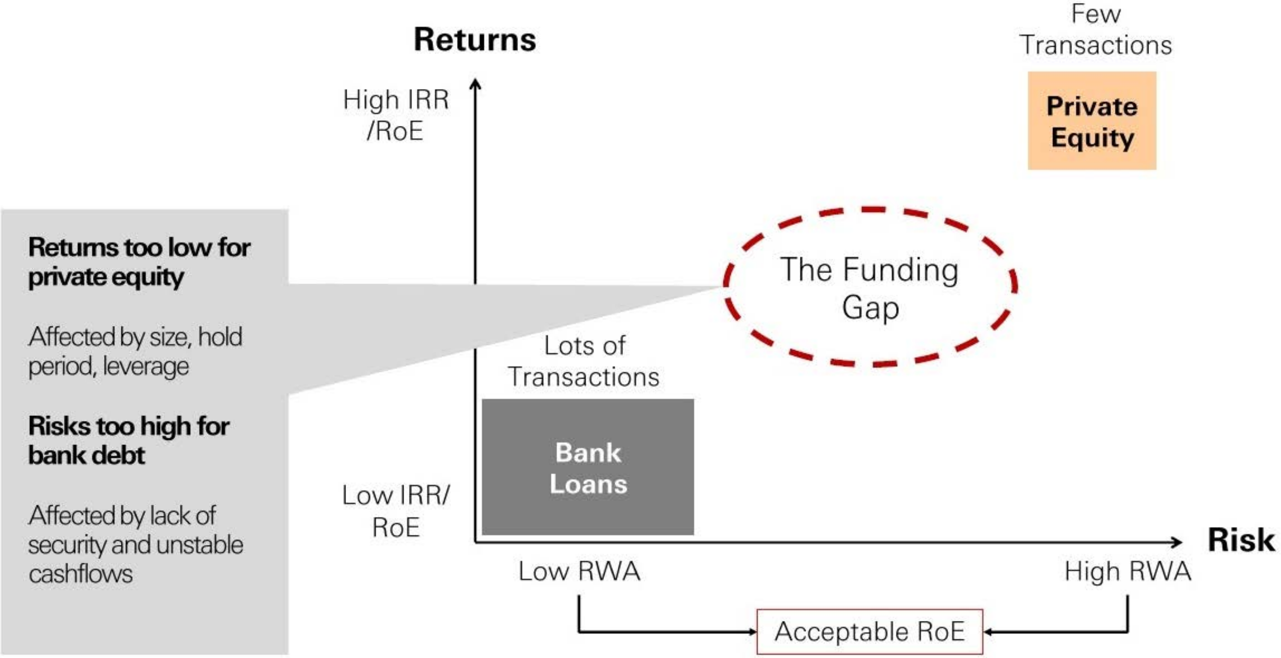
To reduce this bottleneck, Cabinet's recently agreed to MBIE further exploring the Business Growth Fund (BGF) model with the objective of helping SMEs to build capability, grow and internationalise, and to develop a market for investing in this sector.

What is the Business Growth Fund Model?

The BGF model

- The BGF model is a particular type of private equity fund that pools bank capital to create a fund of scale.
- BGFs operate commercially, and make investment decisions independently of shareholders, to provide a source of long-term patient minority capital (in the form of equity and equity-like investments) to SMEs.
- The model bridges the **funding gap between bank loans** and **mid-market private equity**.
- BGFs provide minority-only, patient growth capital that **allows owners and founders to retain control** of what they've built while leveraging capital and capability support to achieve their growth aspirations.
- BGFs are **a proven investment model** that has generated hundreds of successful growth outcomes for businesses internationally.
- Internationally, the setup of a BGF has also required the Central Bank, or an Act of Parliament, to provide ring-fenced preferential capital treatment of banks' risk weighted equity exposures.

Addressing the challenge of SMEs needing growth capital



Focus of the international Business Growth Funds

Similar models are operating in the UK, Ireland, Canada, and Australia. Typically privately-led, setup and managed on a commercial basis – though the Australian BGF is a unique public-private partnership between the federal government and six major banks.

Basic structure

- They are commercial evergreen funds with a focus on investing in **profitable SMEs looking to grow**.
- **BGFs are independently managed** (eg private company) with Board, CE, and with an investment committee which makes the investment choices.
- **Ideal businesses to invest in**:
    - SMEs (eg in NZ SMEs earning $3m-$30m in revenue)
    - profitable businesses (2-3 year track record of profitability)
    - unique value proposition (ie defensible market position)
    - significant growth potential
    - headquartered locally.

What they do

- Up to 49% minority equity stake.
- $5-15m initial capital injection (and for example, an additional $15m in subsequent rounds – $30m total).
- Provide SMEs with access to a senior talent network and take a board position.
- Co-invest with other equity partners or invest alongside bank debt.
- Flexible patient investment instruments (ie equity and/or convertible notes).
- Cash out to existing shareholders.

What they don't do

- Start-ups and unproven business models (ie seed stage or venture capital investments).
- Controlling equity stakes.
- Change of control buyouts.
- Distressed investments.
- Natural resources extraction.
- Central Bank regulated businesses.
- Real estate businesses.

How this differs from private equity funds

Purpose-built for SME businesses

- Angels and VC focuses on smaller, earlier stage investments, and PE and public capital markets focus on larger transactions, BGFs are uniquely focused on providing growth capital to SMEs.

Patient, long-term capital

- BGF funding has no hard exit deadlines, allowing it to work collaboratively with management teams to identify the most appropriate time and path to exit. Internationally, the average investment duration appears to be 3-5 years.

Minority investor, leaving more SMEs open to investment

- BGFs are always minority investors (<50% shareholders). With a seat on the board, they offer guidance and expertise, but always leave owners in control. As such owners are less worried about takeovers, leaving more solid businesses open to investment and expansion.

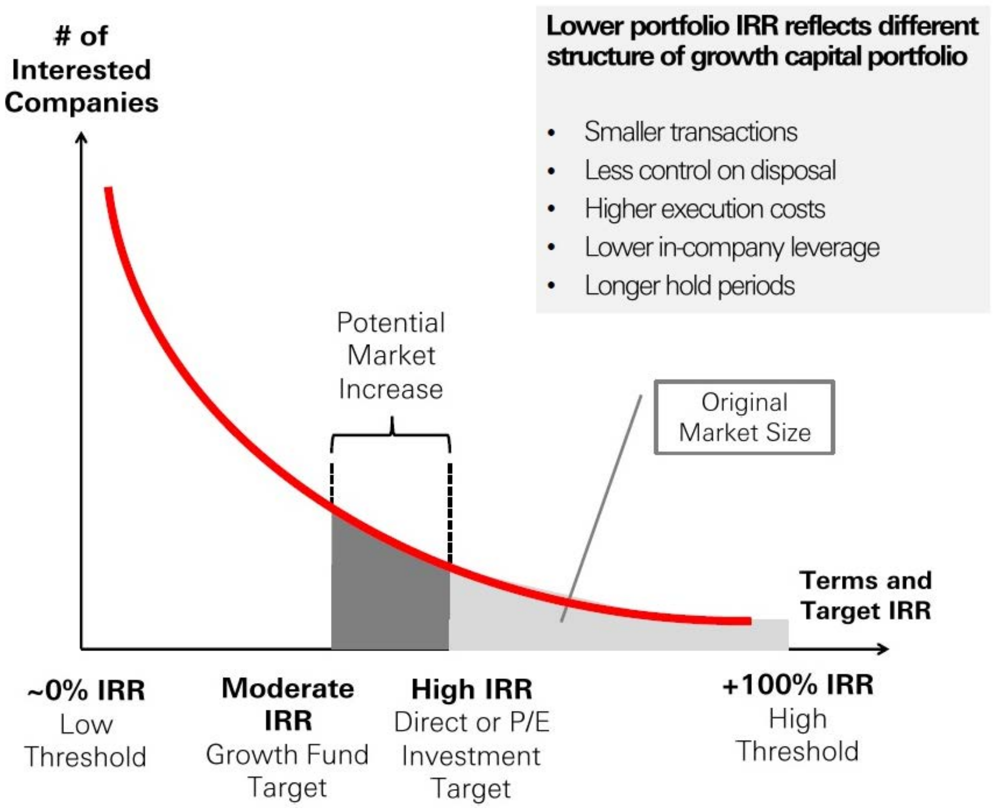
Talent network and capability building

- It's about more than just financial backing. BGFs are active investors who provide strategic support and access to talent networks, including business leaders, sector experts and board-level non-executives. Also partner with capability building providers.

Realistic growth expectations

- Traditional private equity investment funds push for aggressive growth plans and short-term results. BGFs have more modest return expectations allowing business owners to set their own growth targets and time horizons.

Ability to extend market investment capacity



Stylised market landscape in New Zealand

		Investment characteristics		
	Business characteristics	**Equity cheque size**	**Typical investments**	**Investors**
Seed/Venture capital Early stage companies with high-growth potential but yet to demonstrate commercial viability (eg pre-revenue, pre-profit businesses).	• Yet to demonstrate commercial viability of business model. • Cash-flow negative.	• Up to ~$5m	• Minority investment. • 5 – 10+ year investment horizon.	• Growing ecosystem of incubators, angel investors, and VC funds.
Growth equity Companies with demonstrated track record of profitability with further growth aspirations.	• Founder/Owner run and in-process of building out full executive team. • Demonstrated competitive advantage in chosen market segments and rapidly capturing market share or building a new market for products/services. • Cash-flow positive.	• $1m – $20m, with capacity to follow-on for further opportunities.	• Minority* / Majority investment. • 3 – 10 year investment horizon.	• Few professional investing teams (especially offering minority capital). • Some family offices/HNW individuals.
Mid-market buy-outs Larger private or listed companies.	• Professional management teams and established support functions. • Operating in established (proven) markets and holding significant market share. • Cash-flow positive.	• $10m – $50m	• Majority control. • 3 – 5 year investment horizon.	• Active ecosystem of mid-market PE in New Zealand market with dozens of funds.
Large buy-outs Large companies with dominant market positions but more limited top-line growth opportunities in their markets.	• Professional management teams and established support functions. • Operating in established (proven) markets with leading market share. • Cash-flow positive.	• $100m+	• Majority control. • 3 – 5 year investment horizon.	• Few large domestic and international funds.

* Internationally BGFs only do minority investments.

Value proposition to banks

The Business Growth Fund model allows banks to participate in equity investments in the SME sector, and brings some of the following benefits:

Financial benefits

- Specific and appropriate risk weightings to bank capital exposures to the Business Growth Fund can increase the financial returns to banks relative to default risk weighting for banks' equity investments
- Scale is critical, both financially and operationally, and allows portfolio diversification which together justify the risk-weighting.

Reputational/Relationship benefits

- By pooling capital this enables banks to support local businesses and minimises any inherent conflict of interest issues a single bank making equity investments may face.
- Helps banks contribute to a broader NZ Inc initiative, and to further support the economic recovery from Covid-19 disruptions.

Investment portfolio benefits

- Allows shareholder banks to refer SME clients in cases where equity finance would be more appropriate than additional debt.
- Where investee companies grow over time, they increase their capacity to borrow from banks.
- Reduces the risk from existing SME bank clients and their outstanding debt (by connecting founders and entrepreneurs to expertise and wider networks, or by deleveraging balance sheets).

Stylised examples comparing capital deduction vs. risk weighted assets

Key assumptions used below: 10% Return on Investment, 5% Funding cost

Example: Unleveraged Direct Investment model		
Investment	$100m	Capital deduction
Equity	**$100m**	
Income from Fund	$10m	
Return on Equity	10%	**Unattractive equity returns**
Example: Assuming 400% risk weighting		
Investment	$100m	
Equity	**$42m**	= 10.5% capital ratio x 400% risk weighting
Other Bank Funding	$58m	Inherent with bank funding mix
Total funding	$100m	
Income from Fund	$10m	
Other Funding Cost	($2.9m)	= Funding of $73.75m @ 5% funding cost
Return	$7.1m	
Return on Equity	17%	**Unattractive equity returns**
Example: Assuming 250% risk weighting as used by APRA in Australia		
Investment	$100m	
Equity	**$26.3m**	= 10.5% capital ratio x 250% risk weighting used by APRA in Australia)
Other Bank Funding	$73.7m	Inherent with bank funding mix
Total funding	$100m	
Income from Fund	$10m	
Other Funding Cost	($3.7m)	= Funding of $73.75m @ 5% funding cost
Return	$6.3m	
Return on Equity	24%	**Above threshold equity returns**

Value proposition to businesses

The Business Growth Fund model facilitates capital from banks to SMEs, and brings some of the following benefits to companies:

Access to Patient Capital

- Many SMEs simply cannot access equity capital for growth or equity release.
- Patient investors, developing long-term meaningful relationships.
- Co-investment opportunities for family offices or other private equity.

Access to capability and networks

- In between high-touch and passive investing, this model presents a hybrid approach and introduces SMEs to talent networks, and/or makes recommendations for non-executive director selection and appointments.
- Depending on design, this could also be linked to existing private or public programmes (capability support, business education, coaching, advisory or governance networks etc).

Retain control

- Enables SME owners to retain control, or set a longer succession plans in place.

Raise awareness

- Many SMEs see growth/transition as just too hard, or have resigned themselves to bootstrapping growth, given the limited financing options available.
- This not only creates a new asset class – where SMEs might be eligible, but can help raise awareness of different investment products and the benefits of taking on growth capital and raising sights.

Broader value proposition

Economic Development goals

BGFs have a commercial focus but they bring many ***broad economic benefits*** to the countries concerned.

- They act as a catalyst for growth in the SME sector by connecting founders and entrepreneurs to the capital, expertise and wider networks they need to succeed.
- When companies scale – this can drive employment, innovation, and economic activity.

More likely to ***retain business in New Zealand***

- An evergreen patient capital fund means there is less pressure on fund managers to seek a liquidity event. In NZ where there are few buyers, this often means the company is sold offshore (and may exit NZ altogether).
- The minority stake keeps NZ owners involved for longer.

Complements other government programmes

- Patient capital is complementary to many programmes: the Industry transformation plans (ITPs), growing exports, commercialising science/R&D funding, scaling companies into frontier firms including Māori firms, transitioning firms to be more sustainable.

Complements existing private sector

For existing private investors in the market, a BGF can be seen as ***a complementary fund, rather than a competing one***.

- Creates an asset class (which was virtually non-existent before) and raises the overall capacity of capital markets.
- For the existing private market, a BGF would be a source of deal flow – growing businesses to a scale where larger mid-market funds or public exchanges become viable exit pathways.

Works with capability building private service providers (like talent networks, business educators, analysts /consultants)

- There may be an opportunity to become part of a broader in-talent network that gets leveraged to conduct DD on SMEs (or make referrals), or to provide capability support as part of the BGF investing (eg board positions, or referrals for key staff/training programmes).

Next steps

MBIE's immediate next steps are going to be iterative, at this stage they envisage three broad stages:

Stage One

Engage interested stakeholders

October 2021

Stage Two

Analyse policy options

Continue engaging stakeholders

October 2021 - February 2022

Stage Three

Determine stakeholders' and Ministers' willingness to proceed

~March 2022

Putting on a wider lens:

- **Internationally:** The BGF model has generally been established within 18-24 months:
    - six to twelve months for policy work and to get shareholders (eg investor) commitments
    - roughly 12 months from hire of CEO to first investment.

APPENDIX

The UK Example

- Born out of the global financial crisis, the UK BGF was founded in 2011 by five shareholding banks: Barclays, HSBC, Lloyds Banking Group, NatWest and Standard Chartered, which collectively provided £2.5b to invest in SMEs on a commercial basis, while partnering them with capability support.
- With a permanent balance sheet they are now recycling proceeds from more than 100 successful exits into new investments, creating an evergreen source of equity growth capital. The UK BGF also launched in Ireland in 2017, where it is backed by the Ireland Strategic Investment Fund, AIB, Bank of Ireland, and Ulster Bank who committed a total of €250m.

Note: The UK Government <u>did not</u> invest any funding into the privately setup UK BGF, but enabled the UK BGF through preferential capital requirements on the committed funds invested into the UK BGF.

Current position of the BGF

- Since 2011 the UK Business Growth Fund has:
    - invested £2.5b in 399 private and public companies across a variety of industries
    - provided £570m+ in follow on funding
    - exited 102 investments and realised £800m+ that was reinvested
    - Now has 16 offices in the UK and Ireland, with 74 per cent of the capital invested outside of London and the South-east of England.

Portfolio summary £'000:

Vintage	Invested Cost	Current Cost	Residual Value	Income	Proceeds	Total Return	MM*
2011	14,086	–	–	5,545	27,133	32,678	2.32
2012	230,948	94,895	102,699	55,923	148,825	307,446	1.33
2013	162,679	43,268	31,138	34,171	66,006	131,315	0.81
2014	304,724	174,794	134,454	76,797	152,186	363,438	1.19
2015	271,416	177,394	186,934	53,417	110,652	351,003	1.29
2016	438,734	257,956	281,518	75,062	222,516	579,095	1.32
2017	279,662	241,726	269,223	38,294	26,173	333,690	1.19
2018	393,927	362,056	496,708	43,519	62,635	602,863	1.53
2019	241,597	226,810	342,196	16,597	15,704	374,497	1.55
2020	254,157	254,070	288,401	7,149	–	295,550	1.16
Total	**2,591,930**	**1,832,968**	**2,133,271**	**406,474**	**831,830**	**3,371,575**	**1.30**

* Net asset value at 31/12/20, not estimated value on exit.

The Canadian Example

- The challenge that Canadian companies faced in accessing growth capital was highlighted by the Minister of Finance's Advisory Council for Economic Growth in 2017.
- The council recommended the government encourage the private sector to establish one or more business growth funds to provide patient capital for high-growth businesses through minority equity or loans for SMEs. The fund/s would consist of pre-committed capital from Canada's leading banks and financial institutions and receive 'appropriate capital treatment under the current Office of the Superintendent of Financial Institutions (OSFI) regulations'.
- In response:
  - The Canadian Government promised to implement changes to their insurance act, bank act and credit act to make risk capital more available and loosen capital adequacy ratios, but <u>did not</u> invest any funding.
  - The Canadian BGF was launched in June 2018 with an initial commitment of C$545 million from 13 banks and insurers.[1] Its aim is to make investments between C$3 million and C$20 million in established SMEs earning C$5m or more in annual revenue, a demonstrated growth trajectory, and a clear vision for accelerated growth. It seeks ownership stakes of between 10 per cent and 40 per cent.
- In October 2018, the fund made their first investment. So far, the Canadian BGF has invested over C$250m in 19 companies and made 12 follow-on investments, and exited two investments.

[1] CIBC, Royal Bank of Canada, Sun Life Financial, Toronto-Dominion Bank, Bank of Montreal Financial Group, Scotiabank, Manulife, HSBC, ATB Financial, Laurentian Bank Financial Group, Canada Life, National Bank of Canada, Canadian Western Bank Financial Group.

The Australian Example

- The Australian BGF or ABGF (based on the model of the UK BGF) was an April 2019 Coalition Election Commitment, Legislation was passed in early 2020.
- The Australian Government committed up to A$100m and partnered with ANZ, CBA, NAB, and Westpac (each committed A$100m) and HSBC and Macquarie (each committed A$20m) to the ABGF.
- This gives the ABGF an initial fund size of A$540m, with the ambition to grow the fund to A$1b as it matures.
- The ABGF is a for purpose, commercial fund and makes investment decisions independently of Government.
- The ABGF expects to:
  - increase the availability of patient equity capital to Australian SMEs and increase the overall level of investment
  - facilitate interstate and overseas trade and commerce
  - support job creation and economic growth in response to COVID-19
  - invest in established Australian SMEs with annual revenue between A$2m and A$100m and a track record of 3 consecutive years of revenue growth and profitability - this is expected to be 30–50 businesses each year
  - invest minority economic interests of typically between 10-40 per cent of total, fully-diluted, share capital (on an ‘as-converted’ basis) in Australian SMEs
  - partner Australian SMEs working with the ABGF with non-financial support (eg strategic advice, mentoring, talent management, and network referrals).