Response to the Policy Statement on the Venture Capital Fund Act 2019

Consultation September 2019

Background

Igrow New Zealand has been involved in the early stage venture market in New Zealand since 2000, providing advice to more than 200 early stage businesses, predominately around capital raising. We supported these companies in raising more than $200 million from a range of investors both locally and internationally. We also advised a range of central and local government agencies in the area of innovation programmes covering a range of sectors.

Objectives

When NZVIF was created it had two key objectives:

- Money to companies
- Creating a sustainable Venture Capital ecosystem.

NZVIF achieved the first of these when it was formed in the early 2000s but failed on the second. This is because the only way to create a sustainable industry in New Zealand is if investors and entrepreneurs secure investment returns over the cost of capital (that is risk adjusted).

In my view there are three key elements in a successful Venture Community:

- Quality deal flow from earlier stages in the ecosystem
- Experienced and capable fund managers with capital to deploy
- Channels to follow on funding.

While the VCF proposal looks to address the second of these elements, the other two are potential sources of significant conflict for the overall programme. Clearly addressing these elements is outside of the scope of this consultation however the failure of government initiatives to provide a more co-ordinated approach to venture capital has been a huge missed opportunity over the past 20 years. Unfortunately, this has been compounded by an apparent lack of accountability of many in the sector.

Another of the stated VCF objectives is to retain companies in New Zealand rather than having them receive investment from offshore. In my view this is counterproductive in the extreme. Venture capital has become an international activity and local companies that are looking to raise Series A and beyond will quite rightly continue to look offshore for high quality investors - not only for the dollars required today but as a channel to further rounds.

The very best of New Zealand businesses will in my view continue to be funded from international investors, which is positive in that it attracts investors to this market and allows companies to become successful, when local funding may not achieve that.

At best the VCF intervention will shift the problem from A and B to the C, D and later rounds.

Size of Intervention

The proposed VCF intervention is $300 million, post fees and carve outs for non A and B rounds and international deals, the amount of capital that could be invested into Series A and B in New Zealand might be lower than $100m. If this is invested, for example over 10 years, the intervention could be as low as $10m per year, compared with the 'funding gap' of $150m – $250m identified by MBIE.

The stated 'funding gap' appears to be driven from the level of angel activity and then looking at international conversion rates from angel to Series A etc. There is a major flaw in this approach as it assumes the quality of the angel investment is on a par with that internationally. I suggest that that is not the case and that the gap would be significantly lower if adjusted for deal quality. For evidence of this please consider:

- Returns on the NZVIF portfolio
- Lack of international investment into our sector compared with other developing countries
- Increasing valuations for quality deals which indicates that there is no shortage of capital for these deals
- Incentives in the angel community to "spray and prey" and for managers to collect fees on dollars invested, not on value created
- Number of deals SCIF has rejected that Angel Investors are funding, since moving to an active role
- Review of the Tech incubator programme and its relative limited success.

The real issue however is that the level of VC investment into New Zealand is low and this country will continue to fall behind unless we can develop a stronger ecosystem producing quality companies that are internationally competitive.

The risk to the VCF programme is the objective of dollars out the door dominates and we see a repeat of NZVIF 1.0 – ie, investment into a wide range of companies that have limited real chance of success. Or worse, the VCF funds will be used to prop up poor investment decisions made by angel groups. It was very disturbing to read the following comment in the consultation document in relation to companies not being able to raise a Series A:

"…we run the risk of damaging investor returns and confidence……"

I really struggle to see how it is a government issue if qualified investors decide to invest in businesses that fail, or if they fail to make an acceptable return. What New Zealand should be seeing (if this was a genuine concern) would be less investment into fewer companies.

It is also strange that the government has promoted Equity Crowd Funding to less sophisticated investors, often on much higher valuations and lower quality businesses. Surely these investors deserve greater protection.

Fund of Funds Approach

I totally support the fund of funds approach and believe that the success or failure of this programme will come down to the selection of the fund managers. My comments:

- The proposed 20% co-investment / carve out pool is unnecessary. If there is confidence in the fund managers' capability, they should be allowed to make investment decisions. VCF's success will rely on its ability to attract and back high-class investment managers.
- The option of a carve out fund creates issues including:
  - Conflicts of interest
  - Having to build a quality team in direct competition for talent with other fund managers
  - Adds additional costs to the programme.
  - If this is to be done, the new team must be built within the Super Fund and not by NZVIF, for the above reason and others.
- Fund managers will game the system. The best deals looking for Series C will raise from outside the carve out fund potentially via the other LPs in the fund. It is highly unlikely that the best deals will be presented to this fund. It will inevitably be used to support more marginal projects and therefore will result in sub-optimal returns.
- The allocation or co-investment with international funds, should only be with funds that are clearly credible and have the potential to add value to the New Zealand ecosystem in the future, even if only on a deal by deal basis.

Investment Stages

It is appropriate that funds have the right to invest at earlier and later stages, although the issue will be how Series A and B are managed. As it stands, the level of funding into A and B is limited and, to reduce risk, investors are likely to favour Series B over A.

Suggestions on how this issue and others can be managed:

- Any investment by a fund manager into a Series C round, should be conditional on them having invested at Series A. This will avoid managers holding back to cherry pick and invest in deals later. A similar provision could be made for B rounds, but that may be too restrictive

- VCF managers should not be allowed to invest into companies where they or associated entities are already investors. The conflicts are too great, and NZVIF, when taking a proactive role in seed investments, uncovered very poor due diligence and other behaviour. If the fund wants to invest in a follow-on round of an existing business, the level should be capped as a percentage of the total funding round (say 30%) and no more in dollar terms than the largest other investor.
- Funds should not be permitted to charge investee companies for any services or other items prior to or after an investment is made. Their input should be recognised in the terms of the deal negotiated with the investee company. The current system around incubators, accelerators and angels is highly questionable as to the quality and value of services being provided. For these companies to be successful, they need the best advisors and investors they can secure, not 'friends of friends'.
- Any of the VCFs should not be allowed to co-fund in the same investment round as NZVIF and SCIF, otherwise there is a doubling up of funds from the government and potential conflicts of interest. Investing in a subsequent round to one invested by SCIF should be permitted.

Definitions

I suggest that the definitions are relatively flexible in nature. Managers should be able to get a secure permission to invest prior to making an investment where there is doubt. Broadly, if the investment is helping New Zealand companies and entrepreneurs, and our reputation in the global community, then investment should be considered.

Summary

I believe that the main objective must be to create a sustainable industry driving long term value for investors and founders. If this time this is not achieved, we will be having the same discussions in another 20 years' time.

My key advice is that the selection of quality fund managers is critical. VCF should not fund managers that cannot demonstrate the credentials that show they can add value. It is better to be slower in allocating funds, than to give the funds to poor quality teams. The role of VCF should then be to monitor those funds and hold the funds and themselves accountable, with very strict conflict of interest requirements. This is to ensure that the government is not gamed as it has been in the past. Once the managers are selected, let them do their job.

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