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20Th September 2019

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

To the: Ministry of Business, Innovation & Employment

Personal details:

This submission is from KDK Ventures, 301/100 Parnell Road, Auckland.

Thank you for the workshop in Auckland on the 12th September 2019 and wish to follow up with the below written submission.

We can be contacted at directors@kdkventures.com.

Who are We:

KDK Ventures is a New Zealand based investment firm that partners with exceptional businesses to accelerate their growth and help them win. KDK Ventures provides Series A & B financing to high growth enterprise technology companies in underserved sectors.

KDK's Founders, Jonty Kelt, Tom Darby, Zak Darby and Ric Kayne have over 80 years combined investing experience globally, and KDK's advisory committee has over another 70 years combined investing experience. The firm offers two strategies: An Early Stage Strategy targeting innovative early-stage companies disrupting large incumbent markets by leveraging technology, creativity, and talent. And a Growth Strategy targeting fast-growing enterprise technology companies that need capital and support to successfully scale. KDK's founding principals have invested in 50+ companies across both Early-Stage and later stage Growth strategies, with historical returns of >35% IRR. The goal of the firm for its investors is to deliver strong risk-adjusted returns through its niche focus, sourcing advantage, international value-add network and playbook for growth.

Our submission about the Policy Statement on the Venture Capital Fund Act 2019 is laid out in the pages to follow.

Kayne Darby Kelt

Submission

We support the intent of the Venture Capital Fund Act 2019 (the 'Act') and believe it will help develop New Zealand's venture capital markets and increase the venture capital available to New Zealand technology companies.

In addition to increased Series A and Series B funding, the purpose of the Act as stated is:

> "developing New Zealand's venture capital markets to function more effectively so that over time New Zealand entities that receive venture capital are more likely to grow into successful and sustainable businesses"

Based on our combined 80+ years of investing experience and the principals investing over USD$100M into technology companies in New Zealand, Australia and the USA, we wish to comment about what we see as some of the needs of a successful ecosystem to ensure that as many as possible New Zealand entities that receive venture capital do grow into successful and sustainable businesses.

For New Zealand companies to flourish on the international scene we need a venture capital ecosystem that consists of portfolio companies, private investors in VC funds ('Limited Partners') and the VC firm managers. The objectives and needs of each of these stakeholders needs to be addressed and considered in the collective to promote a healthy and sustainable ecosystem.

1. Portfolio Companies

   Successful companies are a sum of parts and while capital is an important part that the Act will help with, the best chance of success is a business supported by capital providers who can bring more than capital to the table. To compete internationally, companies need capital providers who have expertise, a deep international network, and access to talent. The expertise, network, and access to talent is an additional growth engine for companies via things like customer introductions, building out sales teams, access to further capital and relationships with strategic acquirers.

   Additionally, and as highlighted in the Industry Consultation Document, companies benefit from capital providers who can also bring best practise from other more developed venture capital geographies, the United States in particular (being the largest VC and technology market in the world). Access to "smart capital" is a key want for any founder and business.

   New Zealand companies will benefit over the longer term from New Zealand based Investment Firms (as opposed to overseas based investment firms) that understand the local ecosystem and take the time to develop long-term relationships with them ahead of their need for capital. New Zealand based investment firms are also more likely to endure past the retirement of any government funding initiatives ensuring the longevity of our ecosystem.

2. Limited Partners

   To attract private capital into venture capital markets, investors are concerned with the expertise and network of the VC management team so that the VC firm can help its portfolio companies win and not primarily be competing on valuation to secure investment deal flow, a situation that has the risk of creating a valuation bubble that is to the long-term detriment of the ecosystem.

3. Investment Managers / VC Firms

VC Firms need to operate at a large enough size and scale to bring the connections and expertise required to help New Zealand companies and attract private investment internationally. Scale is important to allow VC Firms to have a successful business to build relationships to call upon and to have a wider network of talent, advisors, investors and deep learnings to apply to companies to help them win. Scale is hard to achieve investing in New Zealand companies only. As New Zealand is a smaller market, it is hard to attract international investment if the investment managers are raising capital to only invest in New Zealand. If there is more flexibility for New Zealand based investment firms to invest overseas then it will make it easier for those firms to reach a meaningful scale. Operating at scale also allows flexibility for investment managers, this means that they can eventually be specialist investors like in more developed VC markets (e.g financial technology specialist, artificial intelligence, agriculture-tech etc), this would in turn create a better support system to drive innovative and more competitive technology companies founded in New Zealand.

In support of the Act and its stated objectives we would like to suggest the following changes to the Policy Statement on the Venture Capital Fund Act 2019: Please note that any Capitalized words below have the same meaning as in the definition section of the Policy Statement on the Venture Capital Fund Act 2019.

1. New Zealand Connection Definition

We believe that the "New Zealand Connection" Definition should distinguish between a New Zealand based investment firm and an overseas based Investment Firm with a New Zealand connection. New Zealand based investment firm should have a higher allocation of minimum investment with an up to limit for overseas based firms with a New Zealand Connection.

Our reasoning is that New Zealand based investment firms of scale will be better for the ecosystem in the long-run than overseas based investment firms that are less likely to maintain a presence in New Zealand post the retirement of any government funding initiatives.

2. New Zealand Entity Definition

We believe the proposed definition is too restrictive and suggest broadening it to a "New Zealand domiciled company or founded company" and remove the other prescriptive requirements noted below. Our suggested change is based on the following reasons:

I. "the majority of its employees and independent contractors (by number) in New Zealand"
   - There is a skills shortage of software developers in New Zealand. Companies have to outsource/ insource overseas developers to fill the gap, over time as

a business grows the proportion of overseas developers within a New Zealand business will likely increase
  - Almost all companies sell software internationally as the addressable market in New Zealand is too small. To be successful, companies need in-country resource such as sales and support staff in the markets they operate to interface with customers and grow a presence as a trusted brand. As New Zealand companies sell into larger offshore markets, a greater proportion of employees can be expected to be based offshore, and it is often not practical nor economical having all business functions based in New Zealand, when most of the customers are not

II. "the majority of its [tangible assets] (by value) located in New Zealand":
  - Tangible assets are not a metric often used for software companies, as they are asset-light and selling software code packaged as a product, this is the primary business of an early-stage company in New Zealand, and it is an intangible asset

III. "(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 resident for tax purposes"
  - We believe companies should be flexible to make the best decision at the time when it comes to capital and hiring senior leadership. The requirement above could lead to companies making a decision based on meeting the prescriptive requirement rather than hiring the best person for a senior leadership role or taking on "smart capital" from the most suited investment partner. Overtime this could be an impediment to maximizing the number of successful New Zealand companies

It is highly unlikely that offshore companies seeking investment would try to misuse or game a narrower definition of New Zealand Entity, as it is far easier for offshore companies to obtain capital from a provider within its local market without having to go through the rigmarole, time, effort and money of redomiciling to a New Zealand entity and also becoming subject to New Zealand tax.

3. <u>Series A and B Capital Definition</u>

We support the current definition for stages of companies and investment using monetary bands and avoiding the confusion of attempting to apply varying nomenclature to define what stage the company is. We suggest that the definition is amended to:

> "capital provided in a capital raising in which the total amount being raised in that round is typically from NZ$4 million to NZ$30 million and where the majority of the capital being raised for growth purposes."

The reason we have suggested the change in definition is:

I. The use of "typically" allows industry guidance on what constitutes a series A and B in the usual case but helpfully preserves flexibility for when a Series A or B may not strictly fit the definition or there is a legitimate business reason for deviating outside the prescribed range. For example:

- making an investment in tranches mitigates the founder dilution and allows time for business milestones to be hit before the next investment tranche is made; and
- making a toehold (small initial) investment in a company as a means of developing a relationship for a future investment round

II. Increasing the range of Series A & B to $4M to $30M is more in line with where we have seen the funding gap in the market

III. Including "where the majority of the capital is being raised for growth purposes" allows for some liquidity to be provided as part of the round

IV. Providing liquidity enables clean-up of a fragmented shareholder base / cap table or an exit for shareholders that are not supportive of the company's business plan that includes venture capital

V. Providing liquidity to earlier investors enables recycling of angel money to be reinvested in the ecosystem

VI. Providing some liquidity to founders enables them to diversify a small proportion of their wealth that is often made up disproportionately (or exclusively) of their company

VII. Removing "for the purposes of early stage growth" avoids confusion with the nomenclature of what constitutes "early stage growth" and is consistent with MBIE's earlier stated approach of "not define these, but leave this up to the venture funds and the fund-of-funds to determine whether they fit their criteria"

4. <u>Policy 2: NZ Fund Investments</u>

The Investment requirement in New Zealand Entities should be broadened to Australasia or allowance for investment in companies that do not qualify as New Zealand Entities should be increased to 30%

Our reasoning is noted below:

I. An Australasia fund is a more compelling story to raise private capital as it alleviates any concerns from limited partners over the size of the New Zealand market. Encouraging an international limited partner base increases the available pool of capital available in New Zealand's ecosystem. International limited partners bring additional connections and expertise that is an important resource for helping New Zealand based companies succeed in overseas markets

II. Potential New Zealand based portfolio companies need assessing through an international lens and benchmarked against global peers to ensure that the right innovative companies are being funded. Broadening the mandate to allow more investment in overseas based firms incentivises the VC firms to have an international lens and global benchmark

III. A VC firm will achieve the scale necessary to attract expertise, specialisation and further build out an international network to help New Zealand portfolio companies

IV. Allows VC firm to invest in international companies that are complimentary to New Zealand portfolio companies for shared learnings and best practise

V. Increasing the universe of available portfolio companies will enable better risk adjusted returns that will in turn attract more capital into the ecosystem and give New Zealand based private investors the confidence to invest in VC funds

Thank you for taking the time to read our submission and we welcome any questions or an opportunity to discuss further in person.

Sincerely

Jonty Kelt **Tom Darby** **Zak Darby**

KDK Ventures Limited