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# Keep your eyes on equity prize

By Franceska Banga

The tremendous upheavals in the global finance markets, drunk after years of cheap credit, are having far-reaching effects. Particularly worrying are concerns about the foundations underpinning some segments of the investment markets, such as private or "unlisted" equity investments.

While these concerns have some validity in offshore markets, there are strong signals that, at least in the New Zealand context, certain segments of the unlisted equities market still represent a significant investment opportunity.

The recently released 2007 Ernst & Young New Zealand Venture Capital Monitor illustrates the continued growth of the local private investment market in recent years.

Locally in 2007, we saw \$1.2 billion invested across 85 deals - total investment matching the record set in 2006. While this persistence of investment activity is impressive, private equity investment still represents only 7 per cent of all local merger and acquisition (M&A) activity.

By contrast, globally between 2000 and 2006, private equity investment grew from 5 to 20 per cent of all M&A activity. Our market is at an earlier stage of development.

As private equity investment becomes better understood by New Zealand institutional investors and new fund structures emerge which make it easier to invest, we can expect to follow a similar trend.

Investment performance of New Zealand private equity fund managers should also be a critical factor for local investors. Initial research undertaken by the NZ Venture Investment Fund indicates that New Zealand private equity investment has returned in excess of 20 per cent per annum over the last five years.

Our private equity investment market has now clearly developed into three distinct segments: "venture capital" into new, young companies; "mid-market private equity" involving medium-sized businesses; and "large private equity" into big corporates. These each have different characteristics in respect to risk and return profiles as well as the potential opportunities they offer New Zealand investors. Of these three segments, the large private equity segment accounted for 77 per cent of the total dollar value of 2007 investments, made up of two investments into mature businesses with high barriers to entry.

These large leveraged buy-outs - Yellow Pages is a recent example that has attracted media attention - were transacted by large offshore private equity investment funds. While changing ownership of New Zealand companies into foreign hands will continue to be an emotive subject, the level of offshore private equity investment (particularly Australian) interest on our shores is an inevitable byproduct of the relative depth of Australian capital markets, together with unprecedented growth in global private equity investment activity.

We can expect to see a continued decline in activity in this large end of the market, following on from the shake-out in global credit markets.

But it is inevitable that large well-run New Zealand businesses will continue to be targeted by large offshore investors.

So what are the opportunities for the New Zealand investor community?

The mid-market private equity investment segment is the most exciting area from a New Zealand investor perspective. Mid-market deals increased in 2007, with 23 investments and \$205 million invested. Typically, these investments involve local private equity funds investing into local privately-owned companies with promising growth potential. Investment performance is driven by new capital being injected to enable business growth, together with production efficiencies.

The mid-market investment trend can be expected to continue, as baby-boomers look to release capital from their businesses over the next few years.

Well managed, mid-market businesses with good growth prospects are likely to be the mainstay of the New Zealand private investment market and have a key role to play in our medium-term economic growth and sustainability.

This investment segment is a rich source of investment opportunities for institutional investors wishing to diversify their equities portfolio and gain access to the New Zealand unlisted equities market. Manager selection is critical in achieving a good return on investment, and investing through a fund of funds is likely to be the most effective way to access a diverse range of investment opportunities.

A vibrant venture capital industry is a key driver of future capital market activity and economic growth, and the New Zealand venture capital market is showing all the hallmarks of a promising future.

Venture capital investment reached a new high of \$88 million invested in 2007, with 60 deals transacted.

This sector is dominated by New Zealand investors - typically wealthy individuals and families - who have an appetite for early stage, high-risk technology

investment. Institutional investors should also consider making an investment allocation to venture capital as part of a well diversified portfolio. For a relatively small investment, institutional investors can get early access to a range of high growth, innovation-based New Zealand industries.

For New Zealand investors, the mid-market and venture capital segments are the space to watch as serious investment opportunities are to be found. In global terms, these segments remain relatively untapped and, fortunately for local investors, of less interest to large offshore private equity investment funds. Not because they are not attractive investments, but because it takes as much time and effort to assess smaller opportunities as it does larger ones.

Given the massive scale of some offshore private equity investment funds, many New Zealand investment opportunities are just too small - one big fish is much more attractive than 10 small ones.

The opportunity New Zealand institutional investors have right now is in our own capital markets, including unlisted equities. While our private equity investment market is still small, historical investment performance over the past five years has been very good, typically in the range of 20 to 25 per cent per annum for the investable universe.

The prospect of continued strong investment performance of our local private investment market - together with KiwiSaver increasing the pools of investment funds - bodes well for high-performing New Zealand companies seeking growth capital or investment from new owners. As local institutional investors build understanding of the opportunities in private equity markets, this will support an investment trend which will help retain our best companies.

The next five to 10 years is likely to see large numbers of small to medium-sized businesses available for sale as the baby boomer business owners begin exiting, further increasing the investment opportunities for private equity investment in New Zealand. Local investors and companies should be seizing the opportunities available on our own doorstep.

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