



## **SPEECH: Asset Allocation Summit NZ 2008**

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*8 July 2008*

### **New Zealand Private Equity: An opportunity too good to leave to others**

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Private equity in New Zealand is an asset class which is of immense interest to overseas investors with Australian and other offshore funds investing into New Zealand in a considerable way.

If we are considered as competing with the states of Australia for capital, New Zealand usually ranks in the top three investment destinations for PE investment from Australian committed capital.

Recent interest from Sovereign wealth funds and other large offshore pension schemes all point to the conclusion that offshore investors do not need convincing that the NZ PE story is a strong one.

Yet, for the New Zealand institutional investor, it is an area of investment which is seen as too hard, risky, disadvantaged due to a lack of liquidity, and without the returns to justify the investment.

The two views are inherently contradictory. If NZ private equity is an attractive proposition to one set of investors – overseas institutions – it does not make sense that it is seen as an ugly proposition to another set of investors – domestic institutions. Unless the latter group is right? So, who is correct?

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Firstly, let us provide some context to what constitutes the NZ private equity market and the level of activity. We are using private equity in its broadest meaning. This includes venture capital, buyouts, and special situations.

Private equity is a subset of alternative assets and reflects all equity investment in unlisted businesses, and in public companies where the investment has the character of a private equity transaction.

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Private equity is broadly split into two subcategories:

- Venture Capital – which is equity investment in companies that have undeveloped, or developing, products or revenue with high growth potential. They might be at the angel and seed stage, or at the slightly later venture capital stage.
- Buyouts – which is a leveraged investment (both equity and debt) in typically more mature companies with established business plans, which are in need of capital to finance expansions, consolidations or spinouts of divisions or subsidiaries.

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Many of these companies invested in by PE managers are household names. Many are owned and run by the baby-boom generation, now aged between the mid-50s and mid-60s. They include names like MetroGlass and EziBuy, Max and Express. They are very well run. They are highly profitable, and could do even better. And they are keen for new investment. They are, in fact, no different from many of the public equities which New Zealand institutions invest in every week. There are, however, far more of them.

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Private equity offers the opportunity to access the considerable amount of business activity which is not captured by the public markets. Unlisted companies comprise seven of our top ten companies, 66 percent of our top 50 companies, 69 percent of our top 100 companies, and 80 percent of our top 200 companies. Whilst not all of these are open for investment (either in the public or private market), many are. Without an exposure to New Zealand private equity, investors are not able to invest in a significant portion of the New Zealand economy. In the New Zealand context, the paucity of quality investment opportunities on the listed market makes it even more important that a prudent investor gains exposure to investments in the private equity and venture capital sectors.

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There is a considerable amount of activity in the sector already. Locally in 2007, we saw \$1.2 billion invested across 85 deals - total investment matching the record set in 2006.

If we look at where this capital comes from only about 20% of the capital invested was sourced from institutions.

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While this persistence of investment activity is impressive. The market remains relatively underdeveloped when compared to our major trading partners. Private equity investment still represents only seven percent of all local merger and acquisition activity. By contrast, globally between 2000 and 2006, private equity investment grew from 5 to 20 percent of all M&A activity.

As private equity investment becomes better understood by New Zealand institutional investors and new fund managers emerge, we can expect to follow a similar trend.

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Having established that there is considerable scope and opportunity within the New Zealand PE market, how does it compare as an investment when compared to the public markets?

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Initial research undertaken by the NZ Venture Investment Fund indicates that New Zealand private equity investment has returned in excess of 20 percent per annum over the last five years.

This compares favorably with offshore PE returns.

The data also illustrates the results which are available from private equity. As the table shows, private equity returns have consistently offered a premium to public equities' as a result of active management by the PE managers in the portfolio companies.

It is a brave person in a room full of Investment professionals that puts figures up in a presentation and asserts that they are facts and implores the fellow professionals to adopt the proposed investment strategy without challenge.

Notwithstanding this healthy debate it is NZVIF contention that the New Zealand PE market returns story has been proven. The New Zealand PE sector has more underlying companies to choose from in executing its investment strategies than the unlisted sector, produces high returns at an acceptable risk and – based on overseas trends – has significant opportunity for growth.

We believe strongly that the industry has established a track record that requires a higher level of examination from investment professionals and fund managers within New Zealand.

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The Australians twigged to the benefits of PE around a decade ago. Before then, the Australian private equity market was in a similar state to where the NZ market is today. Just as there exists an industry-wide reluctance to invest into private equity here, so too

was the case in Australia. Then, around ten years ago, the Australians began taking the plunge and began investing in a concerted, systematic way. Australia has seen spectacular growth in managed funds, with investment funds under management quadrupling between 1991 and 2006 to exceed A\$1 trillion.

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According to an Australian School of Business Research Paper published in April, 94 percent of the major funds are investing in private equities for the return, diversification, and risk reduction benefits, with a total of \$22 billion committed to the asset class.

Their committed allocation to private equity is expected to remain around six percent of total assets. As I discussed previously above a significant portion of this capital is finding its way into New Zealand companies.

Fund-of-Fund investment is the most popular type of private equity investment with an average allocation of 71 percent of current private equity allocations. And the institutions expect an average absolute return from private equities of 11.6 percent and an out performance of public equity of 3.4 percent.

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Comparable data for New Zealand is difficult to come by but we estimate that only 20 percent of the invested capital in New Zealand PE last year came from New Zealand institutions, with as little as \$250 million committed from the industry. This compares to close to \$7 billion committed from the eight largest fund managers in New Zealand to the listed sector.

In summary New Zealand institutions are very reluctant to invest in this sector in alternative assets and private equity. The question is why?

NZVIF has undertaken extensive market research into New Zealand institutions' asset allocations and has developed key observations from this research that provide an insight as to why there is limited investment by New Zealand institutional investors in the private equity market. We identified five key reasons.

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We lack scale. The New Zealand institutional investment market is fairly small by international standards. The lack of compulsory superannuation or significant incentives for saving through managed funds, combined with New Zealanders' propensity for property investment, has resulted in a relatively small market and many institutional managers can only make small allocations. Of the 576 registered superannuation schemes in New Zealand, only 77 have assets in excess of \$50 million with an average size of \$225 million. The challenge facing domestic institutions is that investing in private equity is more expensive than investing in bonds or equities. The level of

information asymmetry for alternatives means that proportionately more time and money need to be spent on due diligence, investment personnel and other expenses.

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Another interesting feature of the New Zealand market is the retail nature of most managed funds. Essentially this means that most investment products have redemption options allowing investors to remove their funds at short notice should they wish to. This retail nature forces managers to have higher allocations to more liquid assets such as bonds and equities to meet potential redemptions. This also makes it hard for managers to maintain their strategic asset allocations, so, for example, a five percent allocation to private equity may well rise as redemptions reduce the overall size of the fund. The introduction of KiwiSaver plans that require contributions to be held until retirement should reduce volatility for fund managers.

There is an inherent illiquidity in private equity. Private equity tends to be a long-term investment and has long holding periods (three-plus years). This inherent illiquidity means investors are limited in their ability to withdraw capital early. Given the retail nature of funds in New Zealand, this is a real issue for institutional investors.

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Resources are an issue. I have to say, having spoken to too many of you over the last six months, you are not the happiest bunch of workers I've seen. Leaving aside the challenges of the current market conditions, a consistent message I have received is the lack of core resource you have available to you to manage the complexities of your businesses. We are not in Australia; we do not have large growing super funds with investment team to match. We do have shareholders seeking a return on their investment in the Investment companies they have exposure to!

This makes investing in PE doubly challenging. There is no doubt that investing in private equity is much more resource intensive than investing in public markets. At a simple level, the markets aren't public! Information is difficult to access and making comparisons between different managers is complex.

Furthermore, post-investment monitoring of funds is more resource intensive. For a fund that intends to allocate, say, 5 percent on a \$1 billion fund size, the costs of running an in-house alternative investment programme may prove to be prohibitive. Given that the majority of New Zealand institutions have assets of less than \$5 billion, many institutional investors do not currently have the resources to employ in-house private equity expertise.

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These reasons and objections are all, in themselves, valid. But they can also be overcome. And we should bear in mind that similar or equally valid objections can be found for almost any investment class.

If the New Zealand institutional investors are to follow the Australian example and take the plunge into private equity – particularly given our constraints around resources, understanding and scale – how should they go about it?

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We recommend the development of a systematic programme of private equity investing that over time builds a portfolio of assets across stage, vintage, managers, industries and geographies,

In our view, this can only be best executed through investing across a number of Funds, or through a Fund-of-funds.

Execution of this strategy will require institutions to make a medium term commitment to the asset class both in terms of resource and capital. Private equity is an expert market, where the right skills, experience and resources are vital in order to succeed. You will need to build internal capability to execute the strategy or probably more realistically for many of you build relationships with Fund-of-fund managers that can execute this strategy on your behalf.

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Investing in private equity via a fund-of-funds is an established method of accessing private equity globally, and a number of key advantages are apparent.

- Small capital commitments will not allow for the geographic, vintage, sector and manager spread that we recommend. Fund-of-funds can address the lack of scale in the NZ market place by pooling capital across the market place.
- The issue of risk is also best managed via a fund-of-funds approach.
- Fund-of-funds address some of the inherent liquidity issues faced by investors as a result of the just-in-time drawdowns of capital from investors, which are invested over a number of years. If institutional investors stagger their investments into several funds, or fund-of-funds products over several years, they can quite accurately develop a 'stable and predictable cash cycle' for their private equity programmes.
- Fund-of-funds managers are established to undertake these specialist functions and are able - as a result of greater scale - to offer the investor a service that they typically are unable to replicate cost effectively - unless they have a scale of operation that is often in excess of \$10 billion.

Private equity might be a risky asset, but a private equity investment is not necessarily so. By diversifying into private equity as part of a portfolio, you enhance returns and lower total portfolio risk.

Well managed, mid-market businesses with good growth prospects are likely to be the emainstay of the New Zealand private investment market and have a key role to play in our medium-term economic growth and sustainability. These are the companies which the New Zealand institutional investor needs to access.

New Zealand institutions need to do so in order to widen the scope of their investment strategies as it becomes increasingly difficult to generate their target returns from existing investment strategies. Overseas experience shows that institutions will look to include allocations to alternative assets, including private equity, in the search for excess returns.

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.

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The New Zealand Venture Investment Fund is the established Fund-of-fund in the new Zealand market place which is managing capital in the PE space. We are raising an institutional investor product for the New Zealand market at present that can address many of the objections which institutions face.

Accessing private equity via a fund-of-funds such as that offered by NZVIF allows institutions to gain access to a portfolio of private equity funds in a cost-effective manner.

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.

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New Zealand institutions should be seizing the opportunities available on our own doorstep. We have quality privately owned companies. We have quality private equity investment managers generating quality returns. We have quality offshore capital enjoying these quality opportunities. What is lacking is quality New Zealand capital.

New Zealand institutional investors need to take a rational leap of faith. Many of the reasons why you institutions don't invest in New Zealand private equity – lack of scale,

lack of resource, lack of understanding – will disappear in a virtuous circle once that initial decision is taken to invest in private equity.

If our institutions take that step, in five to ten years we might be where our Australian cousins are now. There,

It is time for New Zealand institutions to do likewise. It's time to invest in New Zealand private equities. It is in your interests. And it is in New Zealand's interests too.