

## **SPEECH: Superfunds Conference 2009**

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### **New Zealand Private Equity: The opportunity**

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Private equity investment in New Zealand is currently the focus of some interest. The recent Jobs Summit raised the issue of the establishment of a variety of funds, primarily as a means to boost investment into companies which will otherwise struggle to raise capital in the current economic environment.

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Private equity, however, is much more than a rescue tool in troubled times. It is an asset class which should be of much more interest to the New Zealand institutional investor. Indeed, when we look at New Zealand's overall capital markets performance, the lack of institutional involvement in private equity investment is a notable feature. It is, arguably, the 'missing link' of New Zealand's capital markets.

My address today is somewhat problematic in that private equity is facing the same sorts of decline in investment and asset values that we are seeing across asset classes. Now is hardly the time to extol the returns from private equity, nor any asset class. Moreover, the past year's results are completely abnormal – or so we hope. Therefore, many of the statistics I will use are drawn from data before the cataclysmic events of last September and since. While that might make this presentation rather Pollyannaish – I think everyone in this room fervently prays for a return to more normal times.

Having set out some of the historical reasons for private equities, I will also outline why a fund-of-fund approach could provide the best way to access the investment class. I will also explain why investment in New Zealand private equities is in your *interest*, by helping to foster a more dynamic domestic economy which itself drives higher investment returns.

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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.

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 private equity 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 Kathmandu, Whitcoulls, and Rakon. 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 six of our top ten companies, 60 percent of our top 50 companies, 66 percent of our top 100 companies, and 73 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 limited number 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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While the 2008 data is to be released, you can expect to see a very large fall in private equity activity, largely due to the absence of any major deal or leveraged buyout in the last 18 months. But prior to the world financial meltdown, there was a considerable amount of activity in the sector. Locally in 2007, we saw \$1.2 billion invested across 85 deals - total investment matching the record set in 2006.

There is, however, a positive aspect to the current environment. We are now experiencing what could well be vintage years for those with investment funds available. Private equity, just like other asset classes, follows cyclical patterns in terms of investment and returns. We are experiencing a severe downturn but that comes after a number of boom years for raising funds and means highly favourable investment conditions now exist. Furthermore, the fundamentals of the New Zealand private equity

industry are sound. We have high quality teams. Our fund managers have good track records of performance over the past 15 years and will be looking to make investments in what is a good market for buyers.

Obviously, levels of investment have changed markedly in the last six months, as it has for every investment class. But using more normal times as a point of analysis, private equity investment has a track record of impressive returns.

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Analysis 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 five years to end of June 2007. What it shows is that private equity has delivered premium returns over public equities in New Zealand, Australia, and the United States.

Why is this? Active management by the private equity managers in the portfolio companies plays a big part. We also believe the New Zealand private equity sector has more underlying companies to choose from in executing its investment strategies than the unlisted sector which produce 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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So why don't New Zealand institutions invest in private equity? We estimate that only 20 percent of the invested capital in New Zealand private equity in 2007 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.

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.

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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. 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.

An 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.

All this makes investing in private equity 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.

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 invest systematically 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.

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.

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- 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.

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Private equity, like venture capital, is a riskier 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. The key to it is in careful manager selection. The spread between upper quartile and bottom quartile fund managers is far greater for private equity than any other asset class. If you are consistently choosing managers who are in the top quartile of returns, you will enjoy excellent returns. New Zealand has fund management teams made up of experienced people that have a record in generating returns from investing private equity into companies. A robust investment process will focus both on the individuals within the fund management team, together with the combined team dynamics and experience. At the heart of selection the process is an assessment of the integrity, stability and capability of the fund manager and whether the team has the commitment and investment experience to produce superior returns for investors.

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Illiquidity can also be addressed. A fund-of-funds approach can limit 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.

While a number of New Zealand private equity and venture capital managers have demonstrated sufficiently successful track records to attract Australian investor attention, New Zealand investors have largely stayed away.

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Last year, Australian research showed how attractive private equity is to their institutions and how they have gone about it. Over ninety 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 was around six percent of total assets. Fund-of-fund investment has been the most popular type of private equity investment with – prior to the credit crunch - an average allocation of 71 percent of private equity allocations.

What this shows is that the Australians have invested into private equity in a systematic way, year-on-year, with a significant preference for the fund-of-fund approach. That is the mechanics of how you could invest in New Zealand private equity if you were of a mind to. The key question is: are you of a mind to?

It would appear not. Recent analysis of cash inflows to the default Kiwisaver providers reveals that the majority of money is going into default schemes which have a conservative risk profile. Indeed, the products that may in future include an allocation to private equity at present are only a small scale. The average size is \$40 million which is too small to contemplate a meaning allocation to private equity. Based on the cash flows observed since Kiwisaver's inception, it is likely to take another three to five years before these pools will be of sufficient scale to consider private equity investment.

Yet you should be. 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. These are the companies which the New Zealand institutional investor needs to access.

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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. With traditional bank financing harder to access post the world financial meltdown, private equity investment will be much more attractive to many of our best mid-sized, privately owned companies.

New Zealand institutions should be seizing the opportunities available on our own doorstep. The opportunities are there. It is also in the interests of the people who invest with you – the New Zealand savers – for you to be investing back into the economy that supports their jobs.

If promising NZ companies could raise more growth capital here then, as a country, we all share in the benefits of success. It's a virtuous circle. Profits are returned here. Taxes are paid here. Dividends are distributed among the New Zealand investors. Our balance of payments position improves. And New Zealand domiciled companies are more likely to purchase inputs from other New Zealand companies, further generating jobs and income.

As a venture capitalist, let me also argue for you to also give far more attention to our young and early expansion companies. Not doing so, means you miss out on some real opportunities – opportunities that your sister institutions from Australia and elsewhere are only too happy to grab.

One of our top universities recently entered into a commercial investment partnership, alongside four Australian universities, with an Australian pension fund. The pension fund is committing around Aus\$30 million to commercialise the best intellectual property and breakthrough research from these universities. The trans-Tasman commercialisation fund is a great prospect for the universities, giving them a ready pool of capital to start the process of turning intellectual property into new high growth businesses.

It is also a clever idea for the pension fund. They get first look at these universities' emerging intellectual property and novel technologies. And with its deep pockets, they can keep on investing as the most promising opportunities rise to the top. For a relatively small amount of capital they have the chance to build a portfolio of the best-of-the-best high growth potential companies. This is how Silicon Valley came into being: universities, pension (endowment) funds and entrepreneurs coming together to invest and build the most promising ideas coming out of university research, into new technology companies.

The depressing aspect is the missed opportunity. Where are the New Zealand pension funds, taking a long term perspective, investing to secure options over a portfolio of the best future high growth investment opportunities? It seems odd that savers in Australia are gaining significant access to the returns generated by New Zealand companies, however to date there has been almost no institutional investment from New Zealand.

It would be great for New Zealanders to have the opportunity to share in future returns of intellectual property developed here. As a country, we have been investing in the development of the IP through the taxes which fund tertiary education and research and development. Wouldn't it be preferable for at least some of the returns from that investment to come back to New Zealanders in the long term?

What is often regarded as being too nationalistic here is seen as common sense in many other economies. Here there has been some raising of eyebrows over the government's proposal to require the New Zealand Superannuation Fund to invest 40 percent of its fund into local investments. Many other small countries and state jurisdictions regard state pension funds as important elements in fuelling domestic growth.

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A few months ago, I attended the North American Venture Capital Association conference in Quebec. It was eye-opening to hear of the willingness of these big funds to invest into their local capital markets. They invest in the gestation of an emerging intellectual property straight out of research, into a small start-up company, and

onwards through the various stages of its expansion into significant businesses. And they want to do more of it. They have a twenty five year horizon and regard part of their fiduciary responsibility to members is to ensure a vibrant future economy.

Can we replicate this model here? It is important we have a discussion now on how we can facilitate the investment of New Zealanders' retirement savings into the good opportunities which exist in our local market. We need the managers and trustees of these funds willing to engage on how we invest in our great intellectual property in a way that builds that investment into significant companies - the next generation of Fonterras, Fisher & Paykels, and Fletcher Buildings.

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It could mean public private partnerships, with the Crown investing on commercial terms alongside private capital. Infrastructure development is the obvious area for PPPs, but there is scope to employ the PPP model in broadening our capital markets, including private equity and venture capital.

Our existing venture capital funds are around \$20 million to \$30 million in size and there are only a handful of funds actively investing – overall the level of investment is still very low by OECD comparisons. In order to build companies from the early stage through to a well-established, successful company, we need \$100 million plus available for investment in growth companies every year. This requires full participation by our pension funds, year after year.

There are also considerable private equity opportunities, where many baby-boomers have built successful privately-owned businesses but are now heading towards retirement and looking to sell. Many of these opportunities – often they are well-run, successful businesses worth \$30 million to \$100 million and more – will fall into the hands of offshore institutions. It would be nice to see New Zealand pension funds investing too, with some of the returns going to the New Zealand investors.

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It is time the New Zealand investment community, the business community, the research community, and the government and its various agencies involved in economic growth debated these issues. It began at the Jobs Summit. But we need to consider private equity investment not just as a response to current economic exigencies, but as a viable and responsible way to foster domestic investment in our own economy for the benefit of investors and us all.

Thank you.