



New Zealand Venture Investment Fund Ltd

Statement of Intent

1 July 2006 - 30 June 2011

“A strategic cornerstone investor in a vibrant early stage venture capital market”

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Introduction

This Statement of Intent is submitted by the Board of Directors of the New Zealand Venture Investment Fund Limited pursuant to section 141 of the Crown Entities Act 2004. It sets out the intentions and objectives for the New Zealand Venture Investment Fund Limited for the period 1 July 2006 to 30 June 2011.



J R Grant
Chairman



P J M Taylor
Deputy Chairman

Operating Framework for the New Zealand Venture Investment Fund Limited (NZVIF)

Purpose

To be a strategic cornerstone investor in a vibrant early stage venture capital market. This will be achieved through establishing effective investment partnerships, acting as a prudent investor and supporting the development of an internationally competitive and reputable early stage venture capital market.

Core Business

The New Zealand Venture Investment Fund Limited (NZVIF) is responsible for managing two early stage investment programmes on behalf on the New Zealand Government. These two investment programmes are the:

- **VIF Venture Capital Programme** a \$160 million venture capital programme established as a fund of funds¹, and
- **Seed Co-investment Programme** a \$40 million direct co-investment programme

Whilst each programme has its own specific goals, the overarching goal for the Government investment is the development of a vibrant early stage capital market, both formal (venture capital) and informal (angel). The key mechanism by which NZVIF implements both Programmes is by partnering with experienced private sector investors. NZVIF is responsible for identifying and establishing partnerships with private sector investors and ensuring that appropriate governance, monitoring and reporting arrangements are in place. NZVIF is also charged with establishing the Programmes in such a way as to contribute to achieving each Programmes specific goals, as agreed by Cabinet. NZVIF will not influence the investment decisions made by the private sector investors, beyond ensuring that the investments fit the relevant Programme eligibility criteria.²

The vibrant self-sustaining early stage investment market envisaged through the achievement of the NZVIF goals is an integral part of the Government Growth and Innovation Framework (GIF). Maintaining strong working relationships with other parties involved in delivery of the innovation goals is vital to the success of both investment programmes. NZVIF can also play a valuable role in other public or private programmes, where appropriate, to support the achievement of GIF related initiatives. This would be particularly appropriate where NZVIF early stage investment and venture capital fund of funds experience and expertise is relevant.

¹ A venture capital Fund of Funds is a fund that invests in venture capital funds as opposed to private companies. This model is widely used by Governments that wish to assist the development and growth of their local venture capital market and the commercialisation of innovative young companies

² NZVIF, alongside other significant investors, has a governance role on the Investor Advisory Committees of the VIF Venture Capital Funds. In respect of the Seed Co-investment Programme NZVIF will be a passive investor investing alongside co-investment partners; however NZVIF will reserve certain shareholder rights and may be required to exercise these rights, including making subsequent investment decisions in certain circumstances.

Background

Early stage investment capital is recognised internationally for the key role it plays in the innovation process, especially in creating jobs and stimulating economic activity. Hence, many OECD governments already have or are now implementing programmes to mobilise both angel investment and/or venture capital investment in support of small innovative firms and thus encourage investment in this high risk, high growth potential sector. Programmes include incentives to attract investment, activities to share investor risk, direct investment and supportive policy instruments.

In the 2002 Budget the New Zealand Government committed \$100 million for investment through the VIF Venture Capital Programme. NZVIF is mandated to invest the NZ\$100 million, alongside private sector co-investors, in a series of privately managed venture capital investment funds (VIF Venture Capital Funds) that will typically operate for 10 years. The focus of the VIF Venture Capital Funds is early stage investment in innovative businesses with high growth potential. NZVIF is a minority investor and intends to co-invest, alongside private sector investors, on a 1:2 ratio. The VIF Venture Capital Fund managers will select, invest in and assist the growth of innovative young companies, for the life of the fund.

In July 2005, the New Zealand Government committed \$40 million for investment through the Seed Co-investment Programme. NZVIF is mandated to co-investment alongside selected private investor groups (co-investment partners) into early stage businesses with strong potential for growth, on up to a 1:1 basis, with a maximum of \$250,000 of NZVIF investment in any one early stage company. The co-investment partners are responsible for making the investment decisions, including the terms on which these investments are made and are responsible for the ongoing monitoring of the investments.

In the 2006 Budget the New Zealand Government committed a further \$60 million for investment through the VIF Venture Capital Programme. The mandate under which NZVIF will invest this capital has yet to be finalised, although this is expected to be confirmed towards the end of 2006.

In June 2002 NZVIF was incorporated as a Crown Owned Company thus providing it with autonomy and ensuring that the Government is distanced from any risks that might arise through the investment operations of the NZVIF Programmes. Governance and oversight of all NZVIF operations is provided by an independent Board selected for their relevant commercial and venture capital experience. Five staff provide management and administration services from an Auckland based office.

Key Roles and Responsibilities of NZVIF for 2006/07

The main operating objectives for 2006/07 are:

- Continue implementation of VIF Venture Capital Programme investment round taking into account any revision to the mandate.
- Identify and establish new co-investment partnerships with angel investor groups.

A summary of NZVIF overall roles and responsibilities for 2006/07 are set out below.

Implement best practice investment arrangements

- Utilise best practice selection methodology and due diligence processes
- Establish new early stage and venture capital investment partnerships, taking a commercially prudent approach
- Prudent portfolio investment, within mandate
- Best practice Governance, Monitoring & Reporting Arrangements established with fund managers/co-investment partners

Effective Stakeholder Management

- Maintain effective relationships with Government
 - SOI prepared based on 5 year plan
 - Regular Reporting to the Government on NZVIF Performance including:
 - Quarterly Reports, Annual Report, and Performance & Achievement Report
 - Ministerial briefings as required to ensure “no surprises”
 - Provide input to officials on early stage and venture capital (access to capital) policy work
 - Identify opportunities for NZVIF to create shareholder value over the medium term
- Effective Investor and Fund Manager relations
 - Maintain relationships with existing co-investors and fund managers through formal arrangements
- Effective Stakeholder Communications

Foster development of the NZ early stage and venture capital investment market

- Support industry development initiatives, alongside other stakeholders such as NZVCA
- Support market education initiatives
- Advise and report on market develop and trends, to Government and other stakeholders

Attract early stage and venture capital investment into NZ market

- Engagement with prospective co-investors/angel networks
- Market NZVIF to selected institutional investors and Fund of Funds
- Develop NZ market profile alongside NZVCA/NZTE
 - Undertake new product development

Maintain ongoing organisational capability to deliver on objectives

- Ensure appropriate level of resources and systems are in place
- Annual review of all management & governance policies to ensure compliance with legislative and other requirements.

NZVIF Operating Performance

NZVIF is required to report on certain performance measures to be delivered, against the NZVIF operating budget. These requirements are set out in the Statement of Service Performance in Annex 1. Table 1 sets out the financial performance forecasts for NZVIF.

Table 1: NZVIF Forecast Consolidated Annual Financial Performance³

	2006/07	2007/08	2008/09	2009/10	2010/11
NZVIF operating results					
NZVIF revenue	\$1.89 m	\$1.89 m	\$1.89 m	\$1.89 m	\$1.89 m
Less NZVIF administration expenses	\$2.25 m ⁴	\$1.89 ⁵ m	\$1.89 m	\$1.89 m	\$1.89 m
NZVIF net operating deficit	-\$0.36 m	\$0	\$0	\$0	\$0
NZVIF investment portfolio results					
Less Fees paid to investment managers ⁶	\$2.43 m	\$3.00 m	\$3.52 m	\$4.41 m	\$4.25 m
Less Net Impairments in value of investments	\$1.7 m	\$2.6 m	\$3.8 m	\$5.0 m	\$5.8 m
Add Distributions received from realisation of investments	0	\$1.2 m	\$2.5 m	\$5.1 m	\$9.7 m
Add Increase in the value of investments	0	0	0	0	0
Add Buy out proceeds received	0	0	0	0	0
NZVIF net surplus/deficit	-\$4.49 m	-\$4.40 m	-\$4.82 m	-\$4.31 m	-\$0.35 m
NZVIF capital drawn down from Crown (cumulative since inception)	\$44.0 m - \$47.8 m	\$60.5 m - \$68.0 m	\$81.8 m - \$91.0 m	\$107.0 m - \$118.2 m	\$132.3 m - \$145.6 m
Value of NZVIF investments ⁷	\$31.2 m - \$35.0 m	\$41.0 m - \$48.5 m	\$52.5 m - \$61.7 m	\$63.3 m - \$72.8 m	\$68.8 m - \$80.5 m

³ The NZVIF forecasts for investment are based on the VIF Venture Capital Programme and Seed Co-investment Programme forecasts. .

⁴ Shortfall between NZVIF forecast administrative expenses and revenue is funded from the NZVIF balance sheet through drawdown of working capital.

⁵ Out year administration expense may change once the ongoing resource requirements for the administration of the Seed Co-investment Programme are known.

⁶ Comprises fees paid to VIF Venture Capital Fund managers and transaction fees paid to Seed Co-investment Fund partners

⁷ Value of investments represents holding value of NZVIF investment portfolio at financial year end and is net of reported impairments, realisation of investments and forecast impairments. There has been no allowance for revaluation of investments.

VIF Venture Capital Programme

Overview

NZVIF has invested in five VIF Venture Capital Funds following a rigorous selection process supported through independent professional due diligence and adoption of international best practice by the fund managers. It is anticipated that a further 1-2 managers will be established during 2006.

The main terms under which NZVIF have invested in a VIF Venture Capital Fund are:

- Managers must raise \$2 of private capital for every \$1 of NZVIF investment,
- Minimum fund size to be \$30m,
- Managers invest in and support development of innovative companies during the early stages of their development,
- Investors in each fund are provided with an option that is exercisable up to the end of the fifth year of the fund to buy out the NZVIF investment (capital plus interest only).
- Funds must typically operate for 10 years at which time all remaining investments must be realised and proceeds distributed to investors.

The following tables show the capital commitments that NZVIF will have made as at 30 June 2006.

Table 2: NZVIF Capital Commitments as at 30 June 2006

Committed Capital to VIF Venture Capital funds ⁸	\$60 million
Capital allocated in current investment round ⁹	\$15 million
Capital reserved for current investment round ¹⁰	\$25 million
Capital available for future rounds	\$60 million
Total NZVIF Venture Capital	\$160 million

NZVIF has made capital commitments to five VIF Venture Capital Funds amounting to \$60 million. The level of matching capital commitments received from private investors sums to \$120 million. NZVIF has reserved a further \$40 million for the participants in the current early stage

⁸ Committed capital is capital contractually committed by NZVIF to VIF Venture Capital Funds

⁹ Allocated capital is capital conditionally committed subject to the fund manager raising the matching private sector capital

¹⁰ Reserved capital is capital earmarked by NZVIF for a specific investment round. This capital will be committed subject to undertaking due diligence and agreeing terms with prospective managers. It is possible that not all this capital will be committed in the current round, in which case there will be further capital available for future rounds.

venture capital round. NZVIF intends to allocate the remaining capital that has not been committed as at 30 June 2006, once the terms of the mandate have been agreed with Government by undertaking further investment rounds over the next 2-4 years.

The Government Goals for the VIF Venture Capital Programme

Cabinet has agreed the following goals for the VIF Venture Capital Programme:

- To accelerate development of the venture capital industry by increasing the level of early stage investment activity in the New Zealand market;
- To develop a larger pool of people in New Zealand's venture capital market with skills and expertise in seed and start-up investment;
- To facilitate commercialisation of innovations from Crown Research Institutes (CRIs), Universities and the private sector; and
- To get more New Zealand businesses on paths to global success by increasing their access to international experts, networks and market knowledge.

Building Blocks for VIF Venture Capital Programme Success

Achievement of the Government goals for the VIF Venture Capital Programme requires several fundamental building blocks:

- Fund managers who have the skills to assess the commercial potential of businesses and ventures at the early stage of their development and to assist those companies to grow and reach full commercial potential;
- Institutional investors willing to commit to invest in high risk ventures over a 10 year period;
- A steady stream of high quality potential investment opportunities flowing out of universities, crown research institutes and the private sector (known as 'deal flow');
- Competitive legal and tax environment;
- Well functioning capital markets, offering exit opportunities for venture backed companies.

Without these fundamentals the VIF Venture Capital Programme will struggle to achieve the objectives set by Government and it will be difficult for a sustainable venture capital market to develop and grow in NZ. For this reason a key role for NZVIF is to assist in ensuring that these building blocks are in place, to ensure the long-term success of the NZ venture capital market. Where the VIF Venture Capital Programme cannot play a direct role in establishing or strengthening these building blocks, NZVIF has a role in advising the Government on the requirements necessary for success. NZVIF is in a unique position to advise and support progress on a variety of issues related to the ongoing success of the NZ venture capital industry.

Future Developments

The overarching purpose of the VIF Venture Capital Programme, to accelerate the growth of the New Zealand venture capital market, will continue to be a key driver of future VIF Venture Capital Programme developments, combined with ensuring that the New Zealand venture capital market develops in a way that is sustainable in the medium term.

In 2005 the Government commissioned a review of the private equity/venture capital industry in New Zealand undertaken by LECG¹¹. The report gave a clear picture of the current state of the New Zealand venture capital market and recommended ways in which Government can provide appropriate support for its continued development. Included in the findings of this review was a recommendation that further investment be made through the VIF Venture Capital Programme. The report also recommended that the terms under which this is invested should be reviewed.

Whilst the VIF Venture Capital Programme has been successful to date in establishing five VIF Venture Capital Funds each with an international calibre investment team, the New Zealand venture capital market is still in its infancy and very small by international comparison¹². A lot more work is needed to ensure the medium term viability and sustained development of the industry, with a critical mass of experienced and successful venture capital investment managers who can lead the industry forward. Until the current VIF Venture Capital Programme starts to bear fruit, which is likely to take at least 4-6 years, and until the investment performance of the current cadre of VIF Venture Capital Fund managers is proven, there is a legitimate role for Government, to co-invest and provide incentives for private investors, to facilitate the sustained development of a credible New Zealand venture capital industry. The Government has recently announced a further \$60 million commitment to the VIF Venture Capital Programme, with a possible further \$40 million commitment subject to outcome of a review of the Programme in 2009.

Recent developments in the New Zealand regulatory environment, such as the draft limited partnership legislation as well as the transparent tax treatment for off-shore investors in VIF Venture Capital Funds, represent positive progress towards creating an environment that is conducive for institutional investors in venture capital. Consistent with its market development objectives NZVIF will continue to identify ways to increase the competitiveness of the local regulatory environment¹³. For example opportunities to improve Trans-Tasman harmonisation in respect of tax treatment and investment structures, such that off-shore institutional investors can regard Australia and New Zealand as a single investment opportunity¹⁴.

The lack of New Zealand institutional investor interest in venture capital investment, particularly for early stage ventures, remains a significant issue for the development of the New Zealand venture capital industry. Globally institutional investors, with their long-term investment view, are the cornerstone investors in venture capital funds. Without this investor support prospective New Zealand venture capital fund managers will face a major impediment to raising capital. Based on overseas experience it is anticipated that institutional investors generally will invest in later stage private equity opportunities to familiarise themselves with the asset class before investing in early stage venture capital opportunities. NZVIF will continue to undertake a venture capital education role, where there is interest, amongst New Zealand institutional investors and their gatekeepers. NZVIF will also look to research and develop suitable investment products to enable interested institutions access the asset class.

¹¹ Lerner, J. & Shepard, S. LECG 2005. *A study of New Zealand's venture capital market and implications for public policy*

¹² *ibid*, pg 5

¹³ *Venture capital is a global asset class, as such NZ needs to have competitive market in order to attract capital from off-shore*

¹⁴ *A seamless Trans-Tasman market would offer off-shore institutional investors a more attractive product with prospect of higher returns due to greater volume of quality deal flow and entrepreneurial talent, greater depth in capital markets, and wider pool of potential co-investment partners for the VC managers.*

VIF Venture Capital Programme Performance Targets and Measures

Overview

NZVIF has developed a framework of indicators that can be used to assess the performance of the VIF Venture Capital Programme. Specifically there are two areas of performance that can be measured:

- VIF Venture Capital Programme Targets
- Aggregate VIF Venture Capital Fund performance

The performance forecasts for the VIF Venture Capital Programme are based on the expected investment behaviour of the selected VIF Venture Capital Fund managers in the current market environment. As there are a wide range of variables that can influence these forecasts, certain assumptions have been made pertaining to the number of managers appointed, the timing of managers matching fund raising and start dates, the average number and size of initial and follow-on investments, and the number of investments across the stages of development made by the managers. The assumptions are based on the experience of the VIF Venture Capital Programme to date, the experience of the Innovation Investment Fund (IIF)¹⁵ programme in Australia (adjusted to reflect the relative immaturity of the early stage New Zealand venture capital market, for example, a slower investment rate and smaller average investment size), as well as feedback from the VIF Venture Capital Fund Managers on expected future investment activity. Any substantial deviation from the assumptions underpinning these forecasts may result in actual performance being significantly different from these indicative forecasts. Appendix 1 provides additional explanatory notes.

Current State of VIF Venture Capital Programme

The performance forecasts are made in the context of the current stage of development of the VIF Venture Capital Programme. To date the progress of the development of the VIF Venture Capital can be characterised by:

- Five venture capital funds invested in by NZVIF.
- Steady rate of new investments commensurate with the amount of capital available for investment.
- Limited follow-on investment rounds involving third parties and no upward revaluations of portfolio companies.
- Limited realisation of investments (only one to date).
- Several reported impairments in the value of portfolio companies.

The progress of the VIF Venture Capital Programme to date is consistent with expectations for an early stage venture capital investment programme. Whilst the rate of new investments has exceeded expectations it is still too early to assess the financial performance of the Programme which has yet to demonstrate an increase in value of investments. At this stage there is insufficient premium on the invested capital to make the buyout option a financially attractive opportunity for private sector investors and NZVIF will continue to assume that no buy out options will be exercised in the period covered by the SOI. However if there is a significant distribution or increase in value of the portfolio before the expiry of the buy out option then private sector investors may choose to exercise the option.

¹⁵ The IIF is an Australian government initiative with similar objectives to the VIF Venture Capital Programme, focussing on early stage technology companies with high growth potential. To date there have been two rounds in the IIF programme, the first in 1997 and the second in 2000. The IIF has also undertaken a pre-seed round in 2003.

VIF Venture Capital Programme Performance Targets

The VIF Venture Capital Programme will mainly be driven through the successful establishment and success of the VIF Venture Capital Funds. Nevertheless it is possible to distinguish specific VIF Venture Capital Programme targets.

Table 3: Indicative VIF Venture Capital Programme Performance (cumulative since inception)

	2006/07	2007/08	2008/09	2009/10	2010/11
Number of companies invested in through VIF Venture Capital Programme ¹⁶	38 - 45	45 - 54	54 - 63	63 - 76	72 - 85
Number of seed and start up investments	25 - 29	30 - 35	35 - 40	40 - 45	44 - 50
Number of companies exporting	19 - 26	28 - 37	36 - 45	42 - 53	48 - 59
Number of deals from Crown Research Institutes & Universities	8 - 10	10 - 12	11 - 13	13 - 15	14 - 16
Number of investments by VIF Venture Capital Funds ¹⁷	42 - 49	50 - 59	59 - 70	70 - 85	80 - 95
Number of VIF Venture Capital Funds invested in by NZVIF ¹⁸	8	9	10	12	12
Amount committed to VIF Venture Capital Funds ¹⁹	\$90 m	\$110 m	\$125 m	\$160 m	\$160 m
Number of key investment personnel	21	24	27	33	33
Cumulative amount invested through the VIF Venture Capital Programme (NZVIF & private sector)	\$126 m - \$142 m	\$165 m - \$191 m	\$212 m - \$243 m	\$265 m - \$302 m	\$317 m - \$360 m
Capital drawn down from Crown for investment through the VIF Venture Capital Programme	\$41.4 m - \$45.2 m	\$54.2 m - \$61.7 m	\$69.8 m - \$78.9 m	\$87.5 m - \$98.7 m	\$104.9 m - \$118.2 m

¹⁶ The difference between the number of companies invested through the VIF Venture Capital Programme and the number of investments made by VIF Venture Capital Funds is due to co-investment between VIF Venture Capital Fund managers

¹⁷ Number of investments made by VIF Venture Capital Funds is based on each manager making on average 2-3 new investments each year. It is expected that each fund will make on average a total of 8-12 investments over the five year active investment period.

¹⁸ NZVIF expects that existing VIF Venture Capital funds will seek to establish new venture capital funds once they have substantially completed investing their current funds. New funds established by existing managers will be considered for investment by NZVIF based on the investment quality of the proposal and programme market development objectives.

¹⁹ Capital committed to VIF Venture Capital Funds that have raised the matching private sector capital on a 1:2 ratio

Aggregate VIF Venture Capital Fund Performance

The combined investment performance of the VIF Venture Capital Funds is the key driver of NZVIF (fund of fund) investment performance. VIF Venture Capital Fund managers are fully responsible for making investment decisions, without influence from NZVIF. The exercise of the buy-out option will also influence NZVIF investment performance.

Table 4: VIF Venture Capital Funds - Indicative Annual Investment Performance

	2006/07	2007/08	2008/09	2009/10	2010/11
Value of investments made by VIF Venture Capital Funds – opening position (forecast)	\$21.7 m	\$29.7 m - \$33.5 m	\$36.7 m - \$44.2 m	\$44.5 m - \$53.7 m	\$50.9 m - \$60.4 m
New investments by VIF Venture Capital Fund managers	\$9.7 m - \$13.5 m	\$10.0 m - \$13.7 m	\$12.3 m - \$14.0 m	\$13.7 m - \$14.0 m	\$13.5 m - \$15.7 m
Net impairment in the value of investments	\$1.7 m	\$1.8 m	\$2.0 m	\$2.2 m	\$2.2 m
Increase in the value of investments	0	0	0	0	0
Distributions received from realisation of investments	0	\$1.2 m	\$2.5 m	\$5.1 m	\$9.7 m
Buy out proceeds received	0	0	0	0	0
Value of investments held by VIF Venture Capital Funds at year end ²⁰	\$29.7 m - \$33.5 m	\$36.7 m - \$44.2 m	\$44.5 m - \$53.7 m	\$50.9 m - \$60.4 m	\$52.5 m - \$64.2 m

²⁰ Value of investments represents holding value of NZVIF Venture Capital investment portfolio and is net of reported and forecast impairments and realisation of investments.

VIF Venture Capital Programme and VIF Venture Capital Fund Forecast Assumptions

The forecasts and modelling included in this SOI are based on the following assumptions:

- Total of 11 VIF Venture Capital Funds, five operating in 2005/06, with two further funds established in 2006/07, one each in 2007/08 and 2008/09 and two in 2009/2010.
- New funds are established on the same terms as existing funds
- Average number of investments per fund 8 – 12, based on anticipated fund sizes in a range of \$30 – \$60 million.
- Average range of investment size by stage:
 - Seed: \$0.5 – 1.5 million invested in tranches over 2 years
 - Start up: \$1 - 3 million invested in tranches over 2 years
 - Early Expansion: \$3 – 5 million invested in tranches over 2 years
 - Follow on investment: \$3 - 5 million, subject to portfolio 15% limit
- VIF Venture Capital Fund managers co-invest together on 20% of investments
- Some follow-on investment is expected to be made beyond year 5 of a fund's life. It is assumed fund managers will on average reserve between 20 - 30% of the funds capital for follow-on investment.
- NZVIF invests on a 1:2 ratio with private sector investors.
- NZVIF assumes no realisation of investments in the first five years of a VIF Venture Capital Fund's life, therefore distributions from the realisation of investments are assumed from 2007//08 onwards. Forecast distributions resulting from the realisation of investments will impact on the value of NZVIF investment portfolio. Refer to Appendix 1 for further explanation.
- Buy Out option – based on the current stage of development of the VIF VC Programme, no forecasts regarding the exercise of the buy out option have been made. Appendix 1 contains further explanation of the buy out option.
- Forecast impairments are based on the experience of the VIF Venture Capital Programme to date, the level of impairments are based on historical average of 15% of annual investment.
- Companies exporting – 3/4 of seed and start-up companies exporting within 3 years, 1/3 of early expansion companies exporting in year of initial investment with the balance in the year following the initial investment.
- Deals sourced or linkages with CRIs and Universities – 1/3 of all seed and start up investments.
- All investments valued in accordance with industry guidelines, with no forecast increases in value, refer Appendix 1 for further explanation.
- VIF Venture Capital Fund operating costs based on average management fees of 2.5% (of capital commitment) p.a., other fund costs of \$60,000 (per fund) per annum and an average establishment cost per fund to NZVIF of \$50,000 (only in the year that each Fund becomes operational).

These assumptions are based on current conditions for venture capital investment globally, combined with the impact of the average fund size being relatively small when compared to international norms.

Seed Co-investment Programme

Overview

The Seed Co-investment Fund is a Government investment programme aimed at providing seed funding for early stage businesses with strong potential for growth. The Seed Co-investment Programme has \$40 million of funding available for co-investment alongside selected private investor groups. There is an upper funding cap of \$250,000 per investment with a requirement for at least 50:50 matching funding from private investors. \$4 million is the maximum amount that any private investor group may access for co-investment. The Government's objective for the Seed Co-investment Programme is primarily market development and is focused on developing the seed and early stage investment community (primarily the angel investor community) within New Zealand and providing investment into companies that have:

- Innovative and technology/R&D intensive firms seeking to develop unproven markets or technology;
- Firms with assets that are difficult to value (such as intellectual property);
- Those firms who find access to funding difficult because they have a lack of readily available collateral, no steady cash flow to service debt, and no track record of business operation.

Government Goals for the Seed Co-investment Programme

The market development objectives of the Seed Co-investment Programme are to:

- Accelerate the development of greater professional capacity in the market for intermediating funds between investors and newer technology-based firms;
- Increase the scale and enhance developed networks for early stage investment;
- Increase the depth in the specialist skills needed to assess and manage early-stage technology-based investment;
- Catalyse investment that would not have occurred without the programme.

Current State of the New Zealand informal early stage investment market

At present the professional angel investor community in New Zealand is very small, as a recent survey by Infometrics²¹ has suggested that the informal New Zealand capital market is no more than 1-2 times the size of the venture capital market as compared to 10 times in the more developed United States and Scandinavian markets. The angel investment market in New Zealand is currently characterised by:

- Only one angel investor club/network operating with a formal membership structure, a core of active angel investors and a process for bringing deals forward for review has been identified;
- A few small angel investor groups which comprise individuals who have capacity to make 1-3 investments each year, around the \$250,000-\$500,000 level. These groups tend to be tightly knit comprising people who are active angels, investing their own money.
- Individual angel active investors who raise capital for new ventures from their personal networks;

²¹ Infometrics, 2004. *New Zealand's Angel Capital market: the Supply Side*

- Existing incubator managers/deal brokers/small business advisors that see an opportunity to leverage off their existing access to deal flow and investment networks.

The primary reason for the lower level of development in New Zealand does not appear to be insufficient supply of finance, or lack of viable investment opportunities. Rather, there seems to be a combination of issues that are symptomatic of a market which is informal and not well co-ordinated. Specifically there is a:

- Lack of specialist skills to assess and manage technology based companies;
- Lack of liquidity of investments and concerns about a lack of second-stage or follow-on funding, which leads to a reluctance to invest;
- Lack of professional capacity to intermediate between investors and companies.

It is against this background that the Seed Co-investment Programme has been established as a mechanism for pooling experienced investors and capital into networks and structures that will facilitate investment into high growth early stage companies.

Appendix 1 provides additional background to seed and early stage investing.

Implementation of the Seed Co-investment Programme

NZVIF is charged with the execution and management of the Seed Co-investment Fund. The focus for NZVIF is to establish the programme through:

- the selection of co-investment partners,
- the detailed design of the programme under which NZVIF will co-invest with selected private sector partners (co-investment partners),
- the identification of the market issues that may hinder the successful implementation of the programme.

The model of co-investing alongside angel investor networks is a new and innovative model, with only a limited number of similar programmes established worldwide²². As NZVIF proceeds with the implementation of the Seed Co-investment Programme it is possible adjustments may need to be made to the Programme design. NZVIF will advise and work with officials as the Programme is implemented in regard to any adjustments to the design to enable the objectives of the Programme to be met.

NZVIF recognises that there is a natural tension between the Government's goal of market development through increased investment activity in high risk investments and prudent commercial investment processes which weigh up the risk and returns of these investments. This is a difficult balancing act which NZVIF has been tasked with. The inherent challenges of seed and early stage investing characterised by high rates of company failure, combined with the developmental state of the industry means the programme should be measured primarily on

²² *The Seed Co-investment Fund has been based on a similar co-investment programme operating in Scotland by Scottish Enterprise. This programme has only been in operation for three years. There is no investment performance data yet available on similar programmes.*

market development criteria rather than any direct financial returns it produces. As NZVIF has limited input in investment decisions made through programme and is restricted in its ability to follow any successful investments as well as the fact that failures will become evident before any successes, it is expected that over the short to medium term the programme will experience losses. Indeed it will not be clear for many years what the performance of the programme will ultimately be.

In this light NZVIF will focus on acting as a prudent investor, ensuring that Seed Co-investment Fund is credible in the market place as a reliable co-investor, and that best practice co-investment arrangements are implemented. Specifically NZVIF will focus on the:

- identification, evaluation and development of co-investor partnerships,
- development of best practice framework for existing and new investors, including:
 - standard engagement and investment terms
 - appropriate reward structures, for example up-front transaction fees and profit share arrangements, that reward co-investors for screening, making and adding value to investments
 - appropriate monitoring and reporting arrangements
- prudent portfolio management of the Seed Co-investment Fund by having regard to the risks and returns inherent in early stage investing and by maintaining an appropriate balance of co-investment partners and sectors.

Seed Co-investment Programme Performance Targets and Measures

Overview

As the Seed Co-investment Programme is only just being established it is too early to provide meaningful performance targets. In addition the areas that performance can be measured are limited. However a framework of indicators to measure performance from both a programme and an investment fund perspective has been established.

The performance forecasts are based on the expected investment behaviour of the selected Seed Co-investment partners. As there are a wide range of variables that can influence these forecasts, certain assumptions have been made as to the number of co-investment partners appointed, the number of investments made, the timing of these investments, the average number and size of initial and follow-on investments, and the likely divestment timeframe. These assumptions are based on feedback from potential partners and similar offshore programmes (i.e. Scotland Enterprise). Any substantial deviation from the assumptions underpinning these forecasts may result in actual performance being significantly different from these indicative forecasts.

Seed Co-investment Programme Performance

The performance of the investments made by the co-investment partners, who are fully responsible for making investment decisions, is the key determinative of the performance of the Seed Co-investment Programme. The following objectives have been established to monitor the performance of the fund.

Table 5: Forecast Seed Co-investment Programme Performance (cumulative since inception)

	2006/07	2007/08	2008/09	2009/10	2010/11
Number of partners	7	10	12	15	15
Number of early stage investments	8 -10	24 - 30	54 - 65	89 - 105	124 - 145
Capital drawn down from Crown for investment in the Seed Co-investment Fund	\$2.6 m ²³	\$6.3 m	\$12.0 m	\$19.5 m	\$27.4 m
Number of market development initiatives/ education events initiated in conjunction with industry participants (annual)	4	0	0	0	0

²³ Includes capital drawn for investment, transaction fees and working capital 'float' of \$1 million.

Table 6: Seed Co-investment Fund – Forecast Annual Investment Performance

	2006/07	2007/08	2008/09	2009/10	2010/11
Value of investments– opening position	0	\$1.50 m	\$4.25 m	\$8.00 m	\$12.37 m
New investments by Seed Co-investment Fund	\$1.50 m	\$3.50 m	\$5.50 m	\$7.12 m	\$7.50m
Impairment in the value of investments	0	\$0.75 m	\$1.75 m	\$2.75 m	\$3.56 m
Increase in the value of investments	0	0	0	0	0
Distributions received from realisation of investments	0	0	0	0	0
Value of investments at year end	\$1.50 m	\$4.25 m	\$8.00 m	\$12.37 m	\$16.31 m

Seed Co-investment Fund Forecast Assumptions

The forecasts and modelling included in this SOI are based on the following assumptions:

- \$40million fund.
- Investments to occur over 5-6 year period following the establishment of the co-investment partnership
- No distinction is made between seed and early stage investments.
- A maximum of 2-4 investments per partner per year, with a total programme investments of >150 companies over the investment period.
- It is assumed that approximately 50% of the investments will be tranching, that \$250,000 being invested over a period of 18months, with the balance investing the maximum of \$250,000.
- Transaction fees are assumed to be 5% on all deals.
- All investments are made on capital account.
- Capital draw down from the Crown on a 'just in time' basis with a \$1,000,000 working capital float in order to manage market turnaround.
- Write down are assumed to be 50% of the initial cost of the investment after 1 year.
- No successful distributions are assumed.

NZVIF Business Policies and Statutory Requirements

Operating Principles

- To operate with integrity and professionalism, in all undertakings.
- To protect the capital invested by managing all assets and liabilities on a prudent basis.
- To be a fair, equitable and effective employer.
- To meet all our statutory obligations under the Public Finance Act, Crown Entities Act and the Companies Act.
- To observe the Crown's Treaty of Waitangi obligations.
- To maintain full and accurate financial and accounting records.

Statutory Requirements

- NZVIF is established under the Companies Act 1993 and the Company, the Board, each director, and each shareholder have the rights, powers, duties and obligations set out in the Act except to the extent that they are negated or modified, in accordance with the Act, by the New Zealand Venture Investment Fund Limited Constitution.
- NZVIF acts a *good employer* where *good employer* has the same meaning as in section 118 of the Crown Entities Act 2004.
- Under the Public Audit Act 2001 the Controller and Auditor-General is to be the auditor of the Company.
- NZVIF is a Crown entity within the meaning of section 2(1) of the Public Finance Act 1989 and included on Schedules 4,5 & 6.
- NZVIF's management and financial provisions as a Crown entity are set out in the Crown Entities Act 2004.

Accounting Policies

The policies will be consistent with:

- The legal requirements of the Companies Act (as amended) and any other relevant legislation; and
- Forecasts are made in accordance with generally accepted accounting principles and are consistent with IFRS.

Dividend Policy

It is intended that funds surplus to the Company's investment and operating requirements will be distributed to the Company's shareholders. It has been agreed between the Shareholders and the Directors that the level of surplus funds will be determined by reference to:

- The Company's investment in new business opportunities.
- The sustainable financial structure for the business.
- The company's working capital requirement.
- The potential for future obligations and claims against NZVIF.
- In recommending dividends payable to the Shareholders, the Company will follow procedures generally adopted by directors of publicly listed companies.

Reporting to Shareholding Ministers

The Company will provide to shareholding Ministers an Annual Report on the achievement of the objectives and targets set out in this Statement of Intent.

Quarterly reports will be submitted to shareholding Ministers providing provisional financial results for NZVIF, performance against NZVIF forecasts, and performance measures as required within the Statement of Output Objectives. The Company will submit a Business Plan and Statement of Intent for discussion prior to the start of each financial year.

The Company will also provide other information relating to the affairs of the Company as requested by the shareholding Ministers.

The Crown's Investment in NZVIF

The Crown's investment in NZVIF as at June year-end as measured by Shareholder's funds, is forecast to be:

Table 7: Total Shareholders' Funds

	2006/07	2007/08	2008/09	2009/10	2010/11
Total Shareholders' Funds (\$m)	\$31.2 m - \$35.0 m	\$41.0 m - \$48.5 m	\$52.5 m - \$61.7 m	\$63.3 m - \$72.8 m	\$68.8 m - \$80.5 m

The projected year-end value of the company is the year-end value of investments made by VIF Venture Capital Funds and Seed Co-investment Fund.

Statement of Accounting Policies

Reporting Entity

NZVIF and its subsidiaries are companies registered under the Companies Act 1993.

The company and its subsidiaries comprise the NZVIF Group.

The financial statements are prepared in accordance with, the Companies Act 1993, the Financial Reporting Act 1993, and section 41 of the Public Finance Act 1989 (as if that section had not been amended by the Public Finance Amendment Act and section 198 of the Crown Entities Act 2004) and comply with generally accepted accounting principals.

Measurement Base

The principals recognised as appropriate for the measurement and reporting of financial performance, financial position results, cash flows on a historical basis except for investment are followed by the NZVIF Group.

Specific Accounting Policies

The following specific accounting policies, which materially affect the measurement of financial performance, financial position and cash flows, are consistently applied.

Basis of consolidation

Subsidiaries are entities in which the company has the capacity to determine the financing and operating policies and from which it has an entitlement to significant ownership benefits.

The consolidated financial statements include the parent company and its subsidiaries accounted for using the purchase method. All significant intercompany transactions are eliminated on consolidation. In the company's financial statements investments in subsidiaries are recognised at their costs.

Revenue Recognition

Revenue shown in the statement of financial performance comprises the amounts received and receivable by NZVIF Group for services supplied to the Crown.

Additionally, any realised and unrealised gains due to revaluation of investments at year-end are recorded as revenue in the year in which they are incurred.

Goods and Services Tax

The consolidated financial statements of the NZVIF Group incorporate the financial information of the parent company, which is prepared on a GST exclusive basis except for receivables and payables, and the financial information of the subsidiary companies, which is prepared on a GST inclusive basis as the companies are not registered for GST.

Taxation

The income tax expense charged to the statement of financial performance includes both the current years' provision and the income tax effect of timing differences calculated using the liability method.

Tax effect accounting is applied on a comprehensive basis to all timing differences. A debit balance in the deferred tax account, arising from timing differences or income tax benefits from income tax losses, is only recognised if there is virtual certainty of realisation.

Fixed Assets

Fixed assets are recorded at cost less accumulated depreciated. The cost of purchased fixed assets is the value of the consideration given to acquire the assets and the value of other directly attributable costs that have been incurred in bringing the assets to the location and condition necessary for their intended use. Where a permanent impairment in the value of a fixed asset causes the recoverable amount to fall below the net carrying value, the fixed asset is written down to the recoverable amount.

Depreciation of Fixed Assets

Depreciation is provided on a diminishing basis at rates that will write down the cost of valuation of the assets to their estimated residual values over their estimated useful lives.

The useful lives of the major classes of assets have been estimated as follows:

Computers, office equipment	2-5 years
Furniture and fittings	10 years
Leasehold improvements	Term of lease

Accounts Receivable

Accounts receivable are stated at estimated realisable value after providing against debts where collection is doubtful.

Investments

VIF Venture Capital Programme

The NZVIF Group co-invests, alongside private sector investors, in early stage (seed, start-up and early expansion) investments and these investments represent equity owned directly by NZVIF subsidiaries. These investments are made through venture capital funds (VIF Venture Capital Funds), which are managed by private sector venture capital fund managers (VIF Venture Capital Fund managers), who make the investment decisions. The NZVIF Group is not responsible for and does not exercise significant influence over these individual investment portfolio investments.

All investments will be early stage investments at the time of the initial investment. The VIF Venture Capital Fund Managers are contractually required to value investments on an annual basis. The valuation of these investments will be undertaken by the VIF Venture Capital Fund Managers using accepted venture capital industry guidelines. Venture capital industry guidelines recommend that early stage investments should be valued at cost until they cease to be regarded as early stage unless:

- A significant transaction involving an independent third party at arms-length values the investment at a materially different value, or
- a provision for impairment is considered necessary if the performance of the investment is significantly below the expectations on which the investment was based, leading to a diminution in value.

If the investments are no longer considered to be early stage by the VIF Venture Capital Fund Manager then the investment should be valued according to one of the bases set out below:

- Cost (less any provision for impairment required)
- Third party transaction
- Earnings multiple
- Net assets

Dividend income is accounted for when received.

Seed Co-investment Fund Programme

The NZVIF Group co-invests, alongside private sector investors, in seed and start-up stage investments and these investments represent equity owned directly through a 100% owned subsidiary. NZVIF will be a passive investor and will not make the initial investment decision or take a seat on investee company Boards; these roles will be undertaken by NZVIF's co-investment partner. However NZVIF will reserve certain shareholder rights and may make subsequent investment decisions in certain circumstances.

All investments will be early stage investments at the time of the initial investment and the valuation of these investments will be undertaken by NZVIF using accepted industry guidelines for early stage investments. Venture capital industry guidelines recommend that early stage investments should be valued at cost until they cease to be regarded as early stage unless:

- a significant transaction involving an independent third party at arms-length values the investment at a materially different value, or
- a provision for impairment is considered necessary if the performance of the investment is significantly below the expectations on which the investment was based, leading to a diminution in value.

Impairment

If the recoverable amount of an investment is less than its carrying amount, the item is written down to its recoverable amount. The write down of an investment recorded at cost is recognised as an expense in the statement of financial performance.

The carrying amount of an investment, which has previously been written down to its recoverable amount, will be increased to its current recoverable amount if there has been a change in the estimates used to determine the amount of the write down. The increased carrying amount of the investment will not exceed the carrying amount that would have been determined if the write down to its recoverable amount had not occurred. Reversals of impairment write downs are recognised as income in the statement of financial performance.

Leased Assets

Operating lease payments represent the pattern of benefits derived from the leased assets and accordingly are charged to the statement of financial performance in the periods in which they are incurred.

Foreign Currencies

Transactions in foreign currencies are converted at the New Zealand rate of exchange ruling at the date of the transaction. At balance date foreign monetary assets and liabilities are translated at the closing rate and exchange variations arising from these translations are reported at the forward rates specified in those contracts.

At balance date foreign monetary assets and liabilities are translated at the closing rate and exchange variations arising from these translations are recognised in the statement of financial performance.

Financial Instruments

Financial instruments recognised in the statement of financial position include cash balances, receivables, payables, investments including advances, and term borrowings.

The financial instruments are stated at market value and any gain or loss is recognised in the statement of financial performance

Employee Entitlements

Provision is made for annual leave entitlements estimated to be payable to employees on the basis of statutory and contractual requirements.

Statement of Cash Flows

The following are the definitions of the terms used in the statement of cash flows:

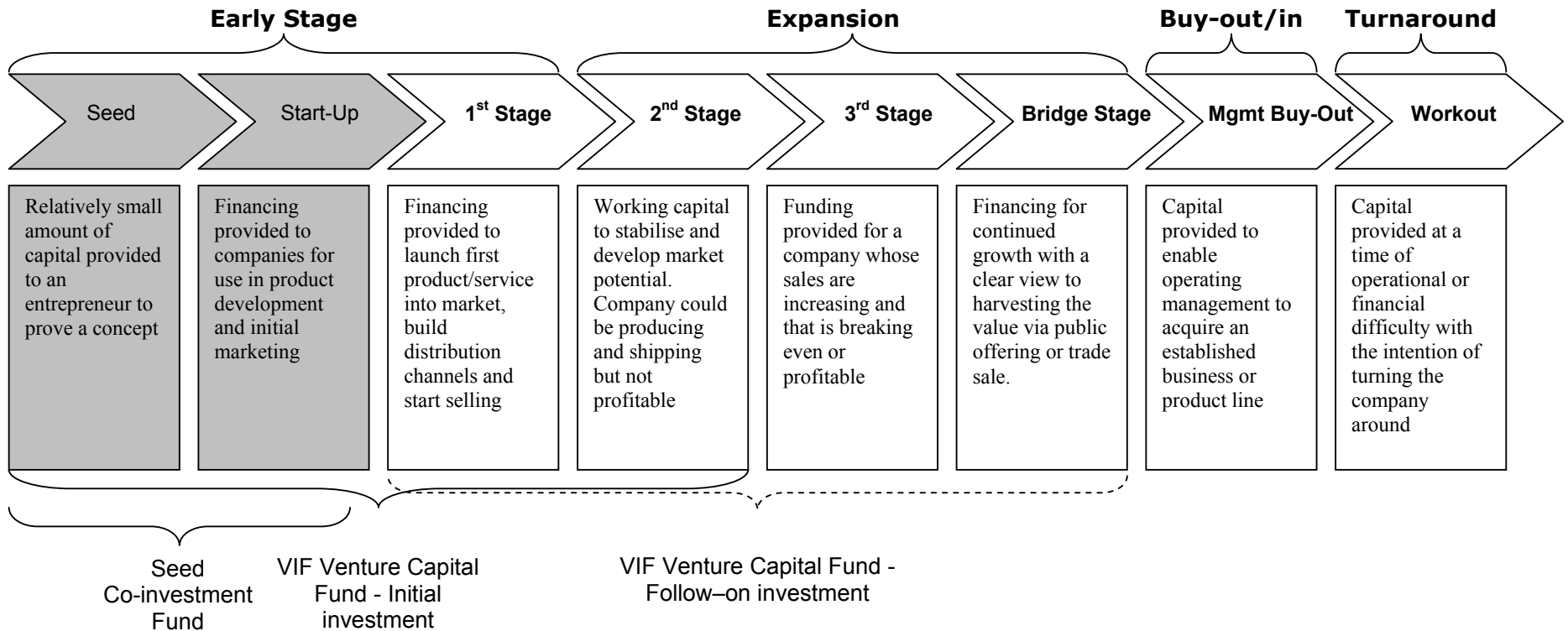
- Cash is considered to be cash on hand, current accounts in banks and overnight bank deposits, net of bank overdrafts.
- Investing activities are those relating to the acquisition, holding and disposal of fixed assets and investments. Investments can include securities not falling within the definition of cash.
- Financing activities are those activities, which result in changes in the size and composition of the capital structure of NZVIF. This includes both equity and debt not falling within the definition of cash. Dividends paid in relation to the capital structure are included in financing activities.
- Operating activities include all transactions and other events that are not investing or financial activities.

Appendix 1 – Further Explanatory Information

Characteristics of Venture Capital Funds

Venture Capital/Private Equity Continuum

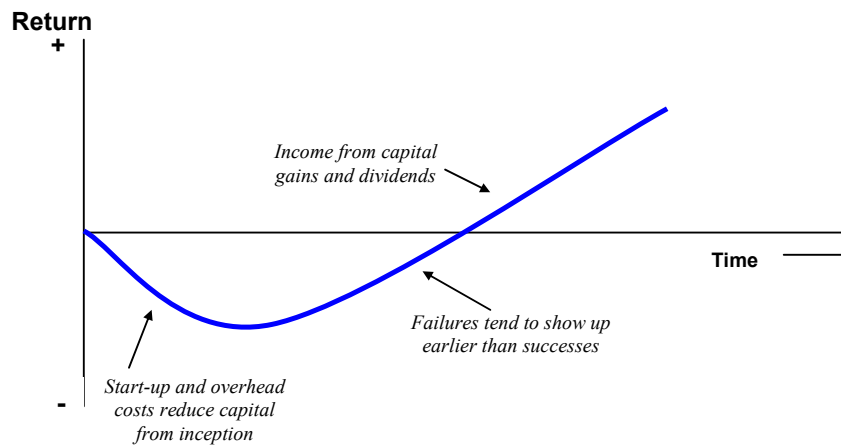
NZVIF invests alongside private investors through venture capital funds into companies that are early stage companies, i.e. seed, start up or early expansion stage of development. The following diagram provides an overview of the venture capital/private equity investment continuum.



The J Curve

The projected financial results of NZVIF are expected to be governed by the underlying portfolio of venture capital funds that NZVIF has invested. The typical life cycle of a venture capital fund that invests in early stage companies comprises a period of initial investment activity, usually up to the end of year five, followed by periods of growth and realisation of investments. Returns on venture capital funds tend to follow a “J-curve” effect, where the initial years show a decline in net asset value, as start-up costs, management fees and impairments in the value of investments deplete capital before any gains are realised in years 5-10 of the fund’s life.

The following chart depicts a typical cash flow profile of a venture capital fund and is known as the “J-curve”.



Returns on venture capital funds tend to follow a "J curve" effect, where the initial years show a decline in net asset value, as start up costs and management fees deplete capital and before any gains are realized in the 5-10 years of the fund’s existence.

Management Expense

The forecast management expenses of VIF Venture Capital Funds comprise three components; management fees, fund costs and establishment costs. The forecasts of these costs are based on the industry best practice and the information supplied to NZVIF by the prospective VIF Venture Capital Fund managers. The management fee paid to Fund managers to build and manage the portfolio, is set at a level that is sufficient to meet the operating expenses of the fund manager, and typically falls in the range of 2-3% p.a. of the Committed Capital of the Fund. The incentive for the manager to build a successful portfolio comes from the manager’s entitlement to share in the profits of the VIF Venture Capital Fund, not through the management fee. Appropriate alignment of these incentives is important in ensuring a well-managed venture capital portfolio. The non-management related expenses are typically costs involved in administering the VIF Venture Capital

Fund (eg audit and legal fees), and are borne by the VIF Venture Capital Fund (paid out of the investors' Capital Commitments). Establishment costs are a one off cost to the Investors resulting from the establishment of the VIF Venture Capital Fund (eg legal fees).

Management expenses are fully recovered by Investors before any profits of the VIF Venture Capital Fund are distributed. NZVIF expects to recover these expenses either through exercise of the buy out option or by sharing in distributions from the realisation of the VIF Venture Capital Fund's investments.

Co-investment by VIF Venture Capital Fund managers

Co-investment between VIF Venture Capital Fund managers has been encouraged by NZVIF as a positive development of the New Zealand venture capital industry as it increases the amount of risk capital that investee companies have access to in the New Zealand market and provides investee company management with access to range of capital sources, management expertise and networks. Co-investment by venture capital fund managers, which is a normal feature of a developed venture capital market, allows the VIF Venture Capital Fund managers to share their risk, and access experience and expertise of other investors.

Buy Out Option

The buy out option is intended to provide potential Investors with an incentive to invest in a VIF Venture Capital Fund. It allows private sector Investors to share with the Government the risks of investing in early stage companies whilst providing the opportunity to receive a greater share in the future profits of the VIF Venture Capital Fund. The private sector Investors may choose to exercise the buy out, either partially or in full, up to the end of year five of the life of the Fund, subject to a minimum parcel size.

The exercise price of the buyout will be calculated as to provide for NZVIF the return of its capital invested less any distributions plus a rate of return on that capital equal to the yield on the 5-year Government bond rate. The 5-year Government bond rate has been used as it matches the duration of the buy out period. It is anticipated that the private sector Investors will choose to exercise the option at the optimal point. In the case where significant distributions have been made and/or the underlying value of the investment portfolio is at a significant premium to the expected buy out price at year 5, then it is likely that the Investors will exercise the option. Where the buy out option is not exercised in full, NZVIF will share the risk and return of the investment with the other Investors.

Although the exercise of any of the buy out options may influence the forecasts contained in this document, VIF is not able to predict with any certainty the likelihood of the buy out option being exercised. The range of possible scenarios surrounding the circumstances under which Investors would choose to exercise the option is so varied it is not meaningful for VIF to attempt to make such predictions. As at 30 June 2006 the VIF Venture Capital Programme has not demonstrated a premium on the invested capital and there have been no substantial realised or unrealised gains. Therefore at this stage it would seem unlikely private sector investors will elect to exercise the buy out option prior to the expiry of the buy out option.

Distributions

The forecasts contained in this document assume that there have been no distributions to Investors from the realisation of investments by the fund manager in the first five years of a funds life. This is prudent, as a typical early stage venture capital fund will not begin to realise any returns from its investments until later in the life of a VIF Venture Capital Fund's existence. Refer to the explanation above of the profile of a typical venture capital fund and the J-curve.

Therefore NZVIF is forecasting realisation of investments and distributions to investors from 2007/08 onwards. The distribution profile is based on empirical data available from international academic studies, data from the Australian IIF programme as well as information provided by VIF Venture Capital Fund managers regarding future expectations for their portfolios.

Valuation and Impairment

All forecast investments by the VIF Venture Capital Funds are valued at cost in accordance with the standard industry practice. These investments will be in early stage private companies and are required to be valued in accordance with the guidelines issued by the NZVCA, or the Australian Venture Capital Association Ltd (AVCAL) or another accepted standard of valuation²⁴, for the valuation of early stage investments. AVCAL currently recommend that early stage investments are valued at cost until they cease to be early stage, with the following exceptions:

- a) if the manager assesses the performance of an investment is significantly below expectations, leading to a diminution of value (impairment), then the investment should be valued at cost less any impairment.
- b) if there is a significant third party transaction (at arms length) that values the investment differently, then the value of the investment should be adjusted to reflect this.

The forecasts include a provision for impairment in the value of the investments by the VIF Venture Capital. The level of the forecast impairments, 15% of annual investment, is based on the experience of the VIF Venture Capital Programme over the past four years. Where any revaluation of investments occurs the forecasts contained in this document may be influenced.

Best Practice Investing

The contractual arrangements between the VIF Venture Capital Fund managers and investors (including NZVIF) are aligned with international venture capital industry best practice standards with respect to key commercial terms and how the venture capital fund manager operates. This includes having appropriate investor governance arrangements (in the form of an Investor Advisory Committee), a clearly defined investment mandate and procedures for dealing with conflicts of interest, to ensure that the investment decisions made by the VIF Venture Capital Fund managers are in the best interest of all the investors in the VIF Venture Capital Funds.

²⁴ If New Zealand guidelines do not exist

Characteristics of Seed and Early Stage (Angel Investing)

Angel investing or early stage investing is the process of the provision of capital by private and professional investors to entrepreneurs with a concept, or young company that has the potential to grow rapidly into a significant contributor to the local and global economies. This capital is most usually introduced into the company once founders, friends and family have been exhausted as source of start up capital. Angel investing fits at the earliest stage of a company's funding requirements as outlined below:

Angel investors typically fund the gap between the founder's idea, prototype and business plan stage through to when other source of capital such as venture capital or bank lending become available to the company. This stage is often reached after the company has been successful in a local market, and the product or service is robust and ready for a global launch. Many entrepreneurs encounter difficulties raising capital to support their business plan because they overlook the 'angel space' and attempt to raise capital either from venture capitalists at a stage when they have not yet laid the strong foundations of a business, or alternatively the banking community that is more used to balance sheet lending. In addition whilst some venture capital funds will invest in early stage business they more typically prefer larger deals both to minimise due diligence costs and also to maximise their ability to efficiently manage their investment portfolio²⁵.

Angel investors are typically wealthy individuals who have successfully built and then exited their own company/companies. They are often strongly entrepreneurial and risk takers. They will play varied roles in the companies that they invest in (from active executive or governance roles (most usual) to passive investors). Making one to two investments every couple of years, they typically seek strong returns on investment but many undertake the investments for 'soft emotional reasons' such as a desire to stay involved and/or give something back to the business entrepreneurial community.

Angel Investment Groups

More recently angel investing has become more professional in its approach. A clear offshore trend is the formalisation of angel groups in response to a market need for early stage capital and the opportunity to fund companies as the venture capital fund sizes increases resulting in larger and larger deals. This formalisation process has taken a number of formats including;

- Angel funds / Sidecar funds – pool money and invest in deals based on votes/ investment committees/defined criteria decision. Often side by side arrangement investing alongside active investor who has taken a lead in a particular investment. The fund rides or invests along side an angel group that have been vetted and invested in by the membership. Three broad models
 - funds that invest automatically based on definition of the fund (i.e. 10 angels in investment \$350,000, investor must have board seat)
 - funds that invest based on judgements of an independent manager
 - funds invest automatically but with manager override in certain circumstance (hybrid)
- Member led – the members share the load of leadership, administration and managing deal flow and make investment decisions. Members do the "heavy lifting" in managing deal flow, due diligence, negotiating the deal
 - Manager led – tee up deals for members to make a personal investment. Managers typically do a lot of the heavily lifting until an active investor takes the lead.

²⁵ Note small deals take as much time as big deals and VC's often don't have resource to manager a large number of small deals.

Annex 1 – Statement of Service Performance

A sum of \$1.89 million has been appropriated for the management and governance of NZVIF. This includes the administration and monitoring of the VIF Venture Capital Programme and the Seed Co-investment Fund Programme. NZVIF is expected to deliver on the following performance measures and standards.

Performance Measures	2006/2007 Performance Standards
Governance	Good governance of the Company is provided in accordance with its Constitution, Statement of Intent and the expectations of shareholding Ministers.
Administration	Sound administrative practices are implemented to support the Company's core business.
Selection of Investment Managers	<ul style="list-style-type: none"> ▪ Utilise best practice selection methodology and due diligence processes to select Investment Managers. ▪ Establish new seed and venture capital investment partnerships, taking a commercially prudent approach.
Manage the Investment Programmes	<ul style="list-style-type: none"> ▪ Fund management conforms to current industry 'best practice' for a venture capital "fund of funds" and early stage angel co-investment portfolio. ▪ Administer and maintain up to date records of all capital draw downs, distributions and buy-out transactions. ▪ Collect data on Investment Programmes to support NZVIF reporting on the impact of the NZVIF Venture Capital and Seed Co-investment Fund Programmes. Such data to be agreed between NZVIF Ltd and MED by 1 September 2006.
Monitor the Performance of Investment Managers	<ul style="list-style-type: none"> ▪ Maintain monitoring and governance processes that conform to industry 'best practice'²⁶ and provide a high level of assurance about Investment Managers' compliance with investment charters. ▪ Maintain robust internal procedures to ensure that the investment mandate as set out in investment charters and legal documentation is consistent with the intent of Cabinet decisions and shareholding Minister approvals. ▪ Actively monitor Venture Capital Fund managers and Seed Co-investment Fund partners in relation to: <ul style="list-style-type: none"> - NZVIF investment criteria for the respective Investment Programmes; - procedures for managing conflicts of interest; - industry best practice reporting¹; and - key person requirements. ▪ Take appropriate remedial action when necessary to ensure investment managers comply with the respective NZVIF mandate.
Promotion and Support of the Developing New Zealand Seed and Early Stage Venture Capital Industries	<ul style="list-style-type: none"> ▪ Undertake effective promotion activities in conjunction with the New Zealand Venture Capital Association and other private sector participants, to help build the industry. ▪ Continue to work alongside the New Zealand Venture Capital Association and significant early stage investor networks, on selected initiatives that will assist in developing the New Zealand seed and early stage²⁷ venture capital industries. ▪ Undertake a programme of targeted visits to institutional investors to promote the NZ venture capital industry.
Input on Government Seed and Early Stage Venture Capital Policies	As required, provide input on policy development and new legislation that is likely to have an impact on the future development of the New Zealand seed and early stage venture capital industries: <ul style="list-style-type: none"> ▪ Tax treatment of venture capital investments. ▪ Limited Liability Partnership Structures. ▪ New Government investment initiatives to support growth of the New Zealand seed and early stage venture capital industries.
Provision of Advice to the Minister as Required	<ul style="list-style-type: none"> ▪ The advice will be delivered within 15 Business Days of the formal request, unless otherwise agreed, and will be of a standard acceptable to the Minister.
Provision of an Annual 'Progress and Achievements Report'	<ul style="list-style-type: none"> ▪ Report to include an assessment of the effectiveness and impact of the NZVIF Seed Co-investment Fund and NZVIF Venture Capital Programmes to date and advice on future policy directions and initiatives to ensure ongoing effectiveness of the programmes, to deliver against the Government's policy goals. ▪ Acceptance of the report confirms the Minister's satisfaction.

²⁶ Where 'best practice' measures are not available, currently accepted measures will be used.

²⁷ Where early stage venture capital includes seed, start up and early expansion stage

