



## **New Zealand Venture Investment Fund Ltd**

# Statement of Intent

1 July 2007 - 30 June 2012

*"A cornerstone investor in a vibrant early stage venture capital market"*

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## **Introduction**

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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 2007 to 30 June 2012.



**C M de Boer**  
Chairman

**Date:** 27 June 2007



**P J M Taylor**  
Deputy Chairman

**Date:** 27 June 2007

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

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### ***Purpose***

To be a 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 venture capital market in New Zealand.

### ***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 funds<sup>1</sup>, 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 Programme's 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.<sup>2</sup>

The vibrant self-sustaining early stage investment market envisaged through the achievement of the NZVIF goals is an integral part of the achievement of New Zealand's economic transformation objectives. Maintaining strong working relationships with other parties involved in delivery of the innovation goals is vital to the success of both investment Programmes. This would be particularly appropriate where NZVIF's early stage investment and venture capital fund of funds experience and expertise is relevant.

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<sup>1</sup> A venture capital Fund of Funds is a fund that invests through venture capital funds as opposed to directly into 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, in partnership with private investors.

<sup>2</sup> 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 2001 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 co-invests, alongside private sector investors, on a pre-agreed investment ratio for each fund<sup>3</sup>. 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 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. Six staff provide management and administration services from an Auckland based office.

In July 2005, the New Zealand Government committed \$40 million for investment through the Seed Co-Investment Programme. NZVIF is mandated to co-invest 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 initial 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 and a further \$40 million contingent commitment subject to a review in 2009.

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<sup>3</sup> Further details on how the ratio of VIF: private capital for each fund is determined is included in Appendix 1

## **Key Roles and Responsibilities of NZVIF for 2007/08**

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The main operating objectives for 2007/08 are:

- Initiate a new VIF Venture Capital Programme investment round taking into account the revised mandate.
- Continue to identify and establish new Co-Investment partnerships with angel investor groups.

A summary of NZVIF overall roles and responsibilities for 2007/08 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.
- Best practice governance, monitoring & reporting arrangements established with fund managers/Co-Investment partners.
- Development of a standard limited partnership documentation, subject to the enactment of the Limited Partnership Bill in 07/08.

### ***Effective stakeholder management***

- Maintain effective relationships with Government.
- Acceptance by shareholding Ministers of all NZVIF reports.
- Ministerial briefings as required to ensure “no surprises”.
- Advice to shareholding Ministers on future scenarios for NZVIF fully considered.
- Continued Government confidence in NZVIF as key investment agent to facilitate further development of early stage and venture capital market.
- 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***

- Undertake and support industry development initiatives, alongside other stakeholders such as New Zealand Venture capital Association.
- Advise and report on market development and trends to Government and other stakeholders.
- Produce occasional research papers on topics relevant to the local industry.

### ***Attract early stage and venture capital investment into the 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.
- Continue the development of new investment products that will attract increased institutional investor interest.

**Maintain ongoing organisational capability to deliver on objectives**

- Ensure appropriate level of resources and systems are in place, including implementation of fund of funds administration software.
- Annual review of all management & governance policies to ensure compliance with legislative and other requirements.

**NZVIF Operating Performance**

**Table 1: NZVIF Forecast Consolidated Annual Financial Performance<sup>4</sup>**

	2007/08	2008/09	2009/10	2010/11	2011/12
<b>NZVIF Operating Results</b>					
NZVIF revenue	\$1.92 m <sup>5</sup>	\$1.89 m	\$1.89 m	\$1.89 m	\$1.89 m
Less NZVIF administration expenses	-\$2.32 m	-\$2.34 m	-\$1.89 m <sup>6</sup>	-\$1.89 m <sup>6</sup>	-\$1.89 m <sup>6</sup>
Less Product development set up costs	-\$0.30 m <sup>7</sup>	\$0	\$0	\$0	\$0
NZVIF net operating deficit	-\$0.70 m <sup>8</sup>	-\$0.45 m <sup>7</sup>	\$0	\$0	\$0
<b>NZVIF Investment Portfolio Results</b>					
Less Fees paid to investment managers	-\$2.79 m	-\$3.30 m	-\$4.00 m	-\$3.97 m	-\$4.20 m
Less Impairments in value of investments	-\$2.88 m	-\$3.26 m	-\$4.26 m	-\$4.63 m	-\$5.06 m
Add Gain on realisation of investments	0	\$1.33 m	\$5.67 m	\$8.33 m	\$12.83 m
Add Increase in the value of investments	\$1.67 m	\$1.94 m	\$2.45 m	\$2.88 m	\$3.46 m
Add Buy out proceeds received	0	0	0	0	0
NZVIF net surplus/deficit	-\$4.70 m	-\$3.74 m	-\$0.14 m	\$2.61 m	\$7.03 m
NZVIF capital drawn down from Crown (annual)	\$10.2 m - \$11.7 m	\$14.9 m - \$17.2 m	\$12.0 m - \$14.9 m	\$11.2 m - \$14.6 m	\$7.2 m - \$10.9 m
NZVIF capital drawn down from Crown (cumulative since inception)	\$49.8 m - \$51.3 m	\$65.5 m - \$67.8 m	\$78.7 m - \$81.4 m	\$91.3 m - \$94.7 m	\$100.1 m - \$103.8 m
Value of NZVIF investments <sup>9</sup>	\$35.9 m - \$37.3 m	\$48.2 m - \$50.6 m	\$61.3 m - \$64.1 m	\$76.5 m - \$80.0 m	\$92.5 m - \$96.2 m

<sup>4</sup> The NZVIF forecasts for investment are based on the VIF Venture Capital Programme and Seed Co-Investment Programme forecasts. .

<sup>5</sup> Revenue also includes \$25,000 of interest in addition to revenue from the Crown.

<sup>6</sup> The forecast administration expense for 2009/10 to 2011/12 out years is subject to a review of the level of activity and operating revenue from the Crown

<sup>7</sup> Expenditure for 07/08 year includes an additional \$300,000 for costs associated with fund of funds product development. This activity is contingent on obtaining additional new funding (through the Vote appropriations process) and is subject to decisions regarding the continued development of a fund of funds product.

<sup>8</sup> Shortfall between forecast administrative expenses and revenue is funded from the NZVIF balance sheet through drawdown of cash reserves.

<sup>9</sup> 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.

## VIF Venture Capital Programme

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### Overview

NZVIF has invested in six VIF Venture Capital Funds following a rigorous selection process supported through independent professional due diligence and adoption of international best practice investment terms with the fund managers. It is anticipated that a further 1-2 managers will be established during 2007/08.

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

- Managers must raise matching private capital, the level of matching capital is dependent on the investment stage focus of the fund<sup>10</sup>;
- Minimum fund size to be \$30m;
- Managers invest in and support development of innovative companies;
- 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); and
- 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 2007.

**Table 2: NZVIF Capital Commitments as at 30 June 2007**

Committed Capital to VIF Venture Capital funds <sup>11</sup>	\$78 million
Capital allocated in current investment round <sup>12</sup>	\$15 million
Capital available for future rounds	\$67 million
<b>Total NZVIF Venture Capital</b>	<b>\$160 million</b>

NZVIF has made capital commitments to six VIF Venture Capital Funds amounting to \$78 million. The level of matching capital commitments received from private investors amounts to \$141 million. NZVIF has reserved a further \$15 million for the remaining participant in the 2006 venture capital round. NZVIF intends to allocate the remaining capital that has not been committed as at 30 June 2007 by undertaking further investment rounds over the next 2-4 years, subject to sufficient quality prospective fund managers being able to raise matching private capital for a viable fund size.

<sup>10</sup> Further details on how the ratio of VIF: private capital for each fund is determined is included in Appendix 1

<sup>11</sup> Committed capital is capital contractually committed by NZVIF to VIF Venture Capital Funds

<sup>12</sup> Allocated capital is capital conditionally committed subject to the fund manager raising the matching private sector capital

***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 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, CRI's and the private sector (known as 'deal flow');
- Competitive legal and tax environment; and
- 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***

While the Government intervention through NZVIF has resulted in the successful emergence of a fledgling venture capital market, the present level of investor commitment and investment activity in the New Zealand market is still very low compared with OECD comparators.

Since the inception of the programme NZVIF has been aware of the need for institutional investor participation to ensure the development of a sustainable venture capital industry. Against this background venture capital fund managers raising capital in the New Zealand market have, without exception, been unable to attract significant local institutional investor support. NZVIF has tried to address this issue in a number of

different ways over the last five years. The primary approach has been to engage with institutional investors to familiarise them with the investment opportunity and also by offering investment related services at a significant discount.

With three of the six current NZVIF venture capital funds now fully invested, a slowdown in investment activity and number of start-up companies receiving venture capital investment support is already starting to occur. The expectations regarding the establishment of future venture capital funds contained in this Statement of Intent reflect NZVIF's view of the level of activity required to maintain the current investment momentum in the market and are reliant on the fund managers raising sufficient private sector capital.

It is NZVIF's view that the existing sources of private capital will not be adequate to support new venture capital funds coming to market over the next 6-12 months even with the recent mandate changes. This is for two reasons: existing investors are close to fully committed to current venture capital funds and potential new investors are "waiting for results" before making investment commitments. NZVIF is of the view that without the development of new investment products that will attract new investors or an increase in the level of Government support for venture capital funds, NZVIF will struggle to achieve the targets contained in this Statement of Intent.

The venture capital industry is therefore at a vulnerable stage of development and in danger of stagnation unless there is an increase in new investor activity in the industry.

### ***New Product Development***

Over the past six months NZVIF has undertaken significant market and product research and engaged with a wide range of the investment community who are active in New Zealand and Australian capital markets to identify barriers and explore options for attracting investment into the New Zealand venture capital market. The key findings of this research are:

- New Zealand. An immature alternate asset environment but appetite exists for product:
  - There is appetite from both institutional investors and retail investors to access investment opportunities that will provide access to companies that are not listed on the New Zealand public markets;
  - New Zealand institutions lack the scale and resources to implement a private equity programme;
  - New Zealand institutional fund managers have a limited understanding of alternative investment, and limited resource to access investment opportunities; and
  - An investment vehicle that addresses their specific constraints is required.

- A portfolio approach is required:
  - Any allocation to venture capital from NZ institutions must be within a broader allocation to private equity as a whole; and
  - The risk return and liquidity profile of a venture capital only fund of funds is not acceptable.
- A New Zealand focused fund of funds business as part of a more sustainable private capital market:
  - The presence of a private equity fund of funds, pooling investor capital, is a key component of a developed private equity market place in New Zealand; and
  - There is wide support for NZVIF to take this role.
- New Zealand - A hot market for Australian institutional investors:
  - At present Australian private equity fund managers and institutional investors are reaping the rewards of actively investing in unlisted New Zealand equities at the expense of New Zealand institutions, investors and the New Zealand economy.

Based on the research findings, together with our observations of how other countries have addressed this same issue, NZVIF is now looking to develop suitable investment products to enable interested institutions to access a full spectrum of venture and private equity investment opportunities. As NZVIF engages with potential institutional investors regarding these investment products, issues may be raised as to whether the current structure of NZVIF is suitable for managing institutional capital. NZVIF will keep officials informed of the feedback from the market including advice on any changes to NZVIF's structure that may need to be considered by Government.

## VIF Venture Capital Programme Performance Forecasts

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### **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 time taken for raising private sector capital, 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, 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**

To date the progress of the development of the VIF Venture Capital can be characterised by:

- A total of six venture capital funds invested in by NZVIF currently operating, three still in their active investment period<sup>13</sup>.
- The Fund raising environment is challenging with the time taken to establishing a new fund now close to two years.
- Recent slowdown in the rate of investment as three of the existing venture capital funds now at the end of their active investment periods. NZVIF expects that this slowdown will persist over the next 12 months until new venture capital funds are established and start investing.
- Limited follow-on investment rounds involving third parties and as yet very few upward revaluations of portfolio companies.
- Limited realisation of investments and 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 there have been promising signs of progress by some individual portfolio companies, the ultimate financial performance of VIF venture capital funds is still unclear. At this stage based on current valuation there is an insufficient premium on the invested capital to make the buyout option a financially attractive opportunity for private sector investors. On this basis NZVIF will continue to assume that no buy

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<sup>13</sup>The active investment period is the period where a venture capital fund manager can make new investments into companies, following the end of the active investment period the manager is restricted to making follow on investments into existing portfolio companies

out options will be exercised in the period covered by the SOI. However if there is a significant distribution prior to the expiry of the buy out option or an investor perceives that the potential future value of the portfolio outweighs the costs of the buy out option, then private sector investors may elect to exercise the option. The timing for the expiry of the first four VIF venture capital funds is within the 2007/08 year.

### **VIF Venture Capital Programme Performance Forecasts**

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 measures.

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

	2007/08	2008/09	2009/10	2010/11	2011/12
Number of companies invested in through VIF VC Programme <sup>14</sup>	41 - 46	50 - 58	62 - 72	80 - 93	94 - 110
Number of seed and start up investments	28 - 32	32 - 37	38 - 45	49 - 57	54 - 63
Number of companies exporting	23 - 25	30 - 35	39 - 45	50 - 58	62 - 72
Number of deals from Crown Research Institutes & Universities	9 - 11	11 - 13	13 - 15	17 - 19	19 - 22
Number of investments by VIF VC Funds <sup>15</sup>	47 - 55	57 - 67	71 - 83	92 - 106	108 - 126
Number of VIF VC Funds invested in by NZVIF <sup>16</sup>	9	11	12	13	14
Amount committed to VIF VC Funds	\$108m	\$143m	\$163m	\$178m <sup>17</sup>	\$198m <sup>14</sup>
Number of key investment personnel	22	26	28	30	32
Cumulative amount invested through the VIF VC Programme (NZVIF & private sector)	\$142m - \$165m	\$182m - \$211m	\$234m - \$272m	\$298m - \$346m	\$374m - \$435m
Capital drawn down from Crown for investment through the VC Programme	\$45.9m - \$47.3m	\$56.1m - \$58.5m	\$62.5m - \$65.3m	\$67.8m - \$71.2m	\$69.7m - \$73.4m
Number of market development events supported	2	2	2	2	2

<sup>14</sup> 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

<sup>15</sup> 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.

<sup>16</sup> Total includes the IO Fund, in which NZVIF is no longer an investor.

<sup>17</sup> Assumes an additional \$40 million allocated to the VIF VC Programme following review of the Programme in 2009

**Aggregate VIF Venture Capital Fund Performance**

The combined investment performance of the VIF Venture Capital Funds is the key driver of NZVIF's fund of funds 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**

	2007/08	2008/09	2009/10	2010/11	2011/12
Value of investments made by VIF VC Funds – opening position (forecast)	\$29.2m	\$32.8m - \$34.3m	\$40.4 - \$42.8m	\$47.9m - \$50.8m	\$57.4m - \$60.8m
New investments by VIF VC Fund managers	\$6.5m - \$7.9m	\$10.7m - \$13.0m	\$12.9m - \$15.7m	\$15.2m - \$18.6m	\$17.0m - \$20.8m
Net impairment in the value of investments	\$2.7m	\$2.6m	\$3.1m	\$3.1m	\$3.5m
Increase in the value of investments	\$1.7m	\$1.9m	\$2.4m	\$2.9m	\$3.5m
Distributions received from realisation of investments	\$2.0m	\$4.5m	\$11.7m	\$15.3m	\$21.0m
Buy out proceeds received	0	0	0	0	0
Value of investments held by VIF VC Funds at year end <sup>18</sup>	\$32.8m - \$34.3m	\$40.4 - \$42.8m	\$47.9m - \$50.8m	\$57.4m - \$60.8m	\$68.0m - \$71.8m

<sup>18</sup> Value of investments represents the holding value of NZVIF Venture Capital investment portfolio and is net of reported and forecast impairments and cost of realised 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:

- Six VIF VC Funds operating in 2006/07, with two further funds established in 2007/08, two more in 2008/09 and one each in 2009/10, 2010/11 and 2011/12.
- Assumes that the current contingent capital allocation of \$40 million is committed by Government following review of the Venture Capital Programme in 2009.
- 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/Start up: \$1 - 2 million invested in tranches over 2 years
  - Early Expansion: \$3 – 5 million invested in tranches over 3 years
  - Expansion/Late Expansion: \$5 million invested in tranches over 3 years
  - Follow on investment: \$3 - 5 million, subject to portfolio limit
- VIF Venture Capital Fund managers co-invest together on 25% of early expansion, expansion and late expansion investments.
- Follow-on investment is expected to be made after the end of the active investment period (first 5 years of a fund's life). It is assumed fund managers will on average reserve between 20 - 30% of a fund's capital for follow-on investment.
- NZVIF invests on a pre-agreed ratio with private sector investors; the level of matching capital is dependent on the investment stage focus of the fund.
- Forecast distributions resulting from the realisation of investments are offset against VIF VC fund manager capital calls. This will impact on the level of capital drawn from the Crown and the value of the NZVIF investment portfolio. NZVIF assumes no realisation of investments in the first five years of a VIF Venture Capital Fund's life.
- 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 VC Programme where the level of impairments to date average 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 and all expansion companies exporting at time of 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, refer Appendix 1 for further explanation.
- VIF VC Fund operating costs based on average management fees of 2.5% (of capital commitment) p.a., other fund costs of \$30,000 (per fund) per annum and an average establishment cost per fund to NZVIF of \$75,000 (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 Fund

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### **Overview**

The Seed Co-Investment Fund (Seed Fund) is a Government investment programme aimed at providing seed funding for early stage businesses with strong potential for growth. The Seed Fund has \$40 million of funding available for Co-Investment alongside selected private investor groups. There is an upper funding cap of \$250,000 per initial investment with a requirement for at least 50:50 matching funding from private investors. The Seed Fund is able to invest up to 15% of its total capital (\$6,000,000) in follow-on funding and is able to invest an additional \$250,000 of follow-on funding per investment. The maximum amount that any private investor group may access for Co-Investment is \$4 million. The Government's objective for the Seed Fund is primarily market development by focusing on increasing the seed and early stage investment activity (primarily the angel investor community) within New Zealand and providing investment into companies that are:

- 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.

The Seed Fund's core market development goals remain 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; and
- Catalyse investment that would not have occurred without the programme.

### **Current State of the New Zealand Informal Early Stage Investment Market**

In 2004, as part of its broader work programme on access to finance, the Ministry of Economic Development commissioned Infometrics to review the extent of the angel capital market in New Zealand. This study highlighted that whilst there was strong evidence that there was an active angel investor market in New Zealand, several key challenges existed. These include ensuring that skilled active potential investors could find attractive investment opportunities and that these investments are made according to best practice angel investment principles. This report identified the need to support the establishment of business angel networks. Such networks benefit investors by enabling them to share information and allowing easier investment syndication thus sharing the costs and risks of investment. They also benefit firms by reducing the costs of searching for potential investors and improving the likelihood of finding investors with the right skills and experience for the needs of the business.

Via the Seed Fund, NZVIF has been tasked with developing the angel capital market by investing in identified business angel networks or Co-Investment partners. Specifically NZVIF has been tasked with:

- Designing an investment programme through which NZVIF will co-invest with selected private sector partners (Co-Investment partners),
- The selection of Co-Investment partners;
- Making investments in early-stage companies in New Zealand, alongside the approved Co-Investment partners;
- The identification of the market development issues that may hinder the successful implementation of the programme.

The Seed Fund is now entering its second year of operation and with good progress made in some key areas, most notably in the appointment of four Co-Investment partners and five initial investments made into early stage companies. The angel investment community in New Zealand remains small and in its very early stages of development. Significant challenges still exist. These include:

- The base of active angel investors on whom the business angel networks and the Seed Fund rely to lead investments and to take an active role in the ongoing development of the investee company remains small and is not currently at a sustainable level. Angel investing is highly risky and while the establishment of the Seed Fund has gone some way towards attracting new investors the question remains as to whether additional incentives are required, to ensure that a structured angel capital market centred around established business angel networks in New Zealand can sustain itself and grow.
- The existing business angel networks at this stage are not financially viable and are largely being funded via sponsorships, business incubators or high net worth individuals. There exists a risk that if a self sustaining business model is not developed for these networks it will be difficult to attract and retain the professional teams required to run these networks.
- Early stage investing is highly risky and key to lessening these risks is the need to develop a community of early stage investors and advisers who are able to share best practice, information and capital. This requires a high level of cooperation between participants in the marketplace. There exists an ongoing challenge to coordinate both private sector and government agencies in their efforts to develop a sustainable angel capital market.

The development of the Seed Fund has had a catalyzing impact on the angel capital market in New Zealand. However the programme is still at a very early stage and more work needs to be done to ensure that the market continues to develop. In order to address the challenges identified above, NZVIF's core focus will remain on growing the number of investment partners and investments for the Seed Fund. Specifically NZVIF will focus on:

- Reviewing potential Co-Investment partners and actively seeking other potential networks.
- Reviewing and processing investment opportunities that are submitted for investment by Co-Investment partners
- Engaging with the angel community to develop best practice frameworks for existing and new co-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; and

- the development of best practice guides for angel investing in New Zealand.
- Working with the angel community to identify common areas of interest to ensure the on-going development of the angel capital market, i.e. business models which will ensure the viability of business networks, additional incentives which may attract additional investors into the market.

### **Future Developments - Seed Fund**

While good progress is being made at all levels there remain a number of significant broader issues which will need to be addressed to ensure the long term viability of the market and the Seed Fund. The main challenge for NZVIF remains attracting sufficient matching private capital and lead investors to invest the \$40m that has been committed to the Seed Fund. The likelihood of investor fatigue (where active investors are constrained in their ability to make new investments because their existing portfolio of investments means they have limited available time and/or capital) looks increasing possible within the next 2-3 years as the existing active investors become less involved.

In dealing with these issues a number of potential solutions are open to NZVIF. Specifically NZVIF must assist the investor community to:

- identify sufficient numbers of active investors that are willing and able to act as lead investors<sup>19</sup>;
- deepen the capital pools available to be accessed by the business angel networks so that they are not so reliant on the lead investors to provide the majority of the investment capital<sup>20</sup>; and
- take an active role in marketing to, educating and training investors and their advisors, to ensure that they are able to invest according to best practice guidelines.

Having recognised this challenge, NZVIF is now exploring initiatives that are designed to specifically address these issues.

- *Initiative One – Find and Educate the Investors.* These include developing education and training initiatives with the wider investment community with the view to actively find and train active and passive investors. The goal of this programme of work would be to identify and train the 70-100 required lead investors together with many more passive investors needed to ensure that the Seed Fund capital is fully invested.
- *Initiative Two – Find ways of deepening the capital pools* – A key method of allowing investors to invest effectively in the angel capital markets is for business angel networks to establish a passive or side car fund. This provides investors with an ability to invest in a wide range of companies and also provides diversification in their portfolios. A benefit of this fund is that it introduces new passive angel investors to the business angel networks and ultimately provides a conduit of future active angel investors.

Due to the size of the New Zealand market the ability of one network to raise such a fund which is of sufficient scale to be economic (\$4-5m) is limited. A passive fund of sufficient scale may go some way to alleviate the issues raised above by providing a mechanism for

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<sup>19</sup> Initial analysis suggest this will be in the vicinity of 70 – 100 individuals

<sup>20</sup> Initial analysis suggest this will be in the vicinity of 800 – 1000 individuals

members of the angel community to pool their resources. Based on the premise that scale is required, NZVIF is investigating the feasibility of assisting the development of a passive fund by providing the administrative functions for the fund.

## Seed Co-Investment Fund Performance Forecasts

### Overview

NZVIF has developed a framework of indicators that can be used to assess the performance of the Seed Fund. The indicative 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. Any substantial deviation from the assumptions underpinning these forecasts may result in actual performance being significantly different from these indicative forecasts.

### Seed Co-Investment Fund Performance

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

**Table 5: Indicative Seed Co-Investment Fund Performance (cumulative since inception)**

	2007/08	2008/09	2009/10	2010/11	2011/12
Number of partners <sup>21</sup>	8	10	12	15	15
Number of early stage investments	26 - 30	51 - 55	79 - 83	104 - 108	126 - 130
Capital drawn down from Crown for investment in the Seed Co-Investment Fund	\$3.95m	\$9.35m	\$16.15m	\$23.47m	\$30.43m
Number of market development initiatives/ education events initiated in conjunction with industry participants (annual)	5	5	5	5	5

<sup>21</sup> The number of partners is cumulative and may include partnerships that have ceased or are no longer actively investing.

**Table 6: Seed Co-Investment Fund – Indicative Annual Investment Performance**

	2007/08	2008/09	2009/10	2010/11	2011/12
Value of investments – opening position	\$1.00m	\$3.73m	\$8.49m	\$14.10m	\$19.94m
New investments by Seed Co-Investment Fund	\$2.95m	\$5.40m	\$6.80m	\$7.33m	\$6.95m
Impairment in the value of investments	\$0.22m	\$0.65m	\$1.18m	\$1.49m	\$1.60m
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	\$3.73m	\$8.48m	\$14.11m	\$19.94m	\$25.29m

**Seed Co-Investment Fund Forecast Assumptions**

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

- \$40 million fund.
- Investments to occur over a 5-6 year period following the establishment of the Co-Investment partnership
- No distinction is made between seed and early stage investments.
- An average of 2-4 investments per partner per year, with total programme investments of >150 companies over the life of the Seed Fund.
- All transactional fees paid are included as part of the investment made by NZVIF.
- Capital drawn down from the Crown on a 'just in time' basis.
- Impairments in value of investments are assumed to be ~25% of the initial cost of the investment after 1 year.
- No successful distributions are assumed over the planning period.

## **NZVIF Business Policies and Statutory Requirements**

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### ***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 company within the meaning of section 7(1) of the Crown Entities Act 2004 and included on Schedule 2 of this Act.
- 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 has been agreed between the Shareholders and the Directors that the distribution of surplus funds to the Company's shareholders 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**

	<b>2007/08</b>	<b>2008/09</b>	<b>2009/10</b>	<b>2010/11</b>	<b>2011/12</b>
Total Shareholders' Funds (\$m)	\$41.7 m	\$54.2 m	\$67.5 m	\$83.0 m	\$99.0 m

The net worth of NZVIF will increase as capital funds are drawn to co-invest with the private sector in early stage ventures. Changes in net worth result from the net effects of profit (after tax), changes in the value of NZVIF investments, dividends paid and capital injections or withdrawals.

## **Statement of Accounting Policies**

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### ***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 (in respect of financial years ending before 1 July 2006, these statements are prepared as if that section had not been amended by the Public Finance Amendment Act) and comply with generally accepted accounting principles.

### ***Measurement Base***

The principles 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 depreciation. 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:

Computer equipment	33% - 60%
Office equipment	11.4% - 60%
Website	33%

**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 primarily early stage venture capital 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.

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 not 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**

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 NZVIF 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:

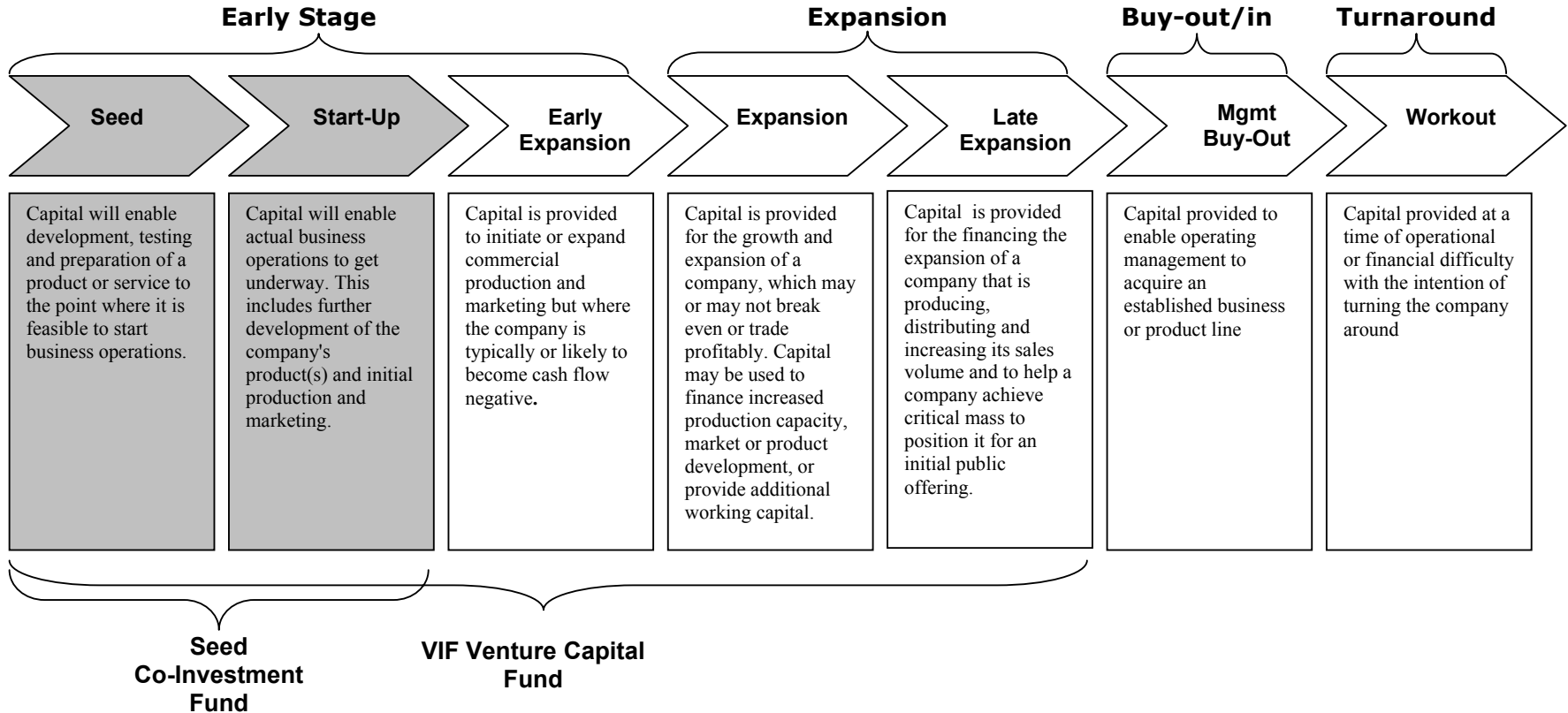
- Cash is considered to be cash on hand, current accounts in banks and overnight bank deposits, net of bank overdrafts.
- Investing activities are those relating to the acquisition, holding and disposal of fixed assets and investments. Investments can include securities not falling within the definition 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

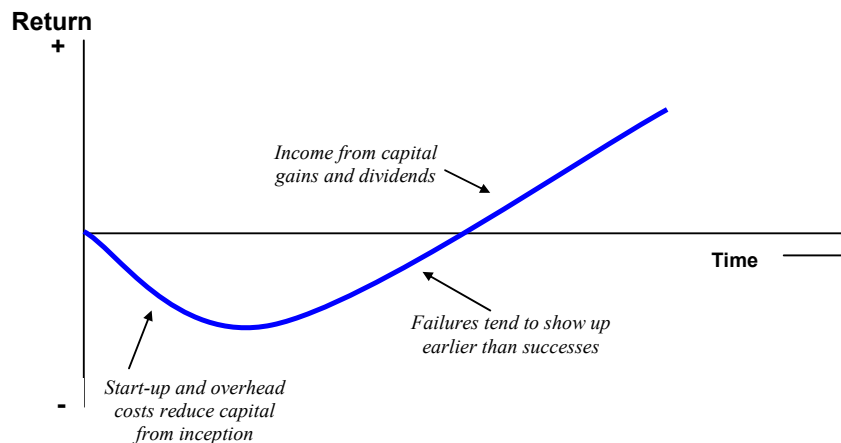
NZVIF invests alongside private investors through venture capital funds into companies that are at the early (seed, start up or early expansion) or expansion (expansion, late expansion) stage of development. The following diagram provides an overview of the venture capital/private equity investment continuum.



### **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”.



### **Ratio of VIF: Private Capital**

NZVIF invests into venture capital funds on a matching capital basis with other private sector investors. For VIF VC Funds invested into prior to the mandate change in 2006, this is on a 1:2 basis. Following the mandate change NZVIF now invests into venture capital funds on a pre-agreed ratio based on the funds investment focus (by stage of development). NZVIF determines the ratio based on the fund manager’s stated investment strategy. The ratio for each stage of development which contributes to the overall fund ratio are as follows:

- Seed/Start up on a 1:1 ratio
- Early expansion on a 1:2 ratio
- Expansion on a 1:4 ratio
- Late expansion on a 1:5 ratio

**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 industry best practice and the information supplied to NZVIF by the 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 fee 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 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 so 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, NZVIF 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 NZVIF to attempt to make such predictions. As at 30 June 2007 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 NZVIF 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 in accordance with 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 valuation<sup>22</sup>, 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 held by the VIF Venture Capital Funds. 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.

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<sup>22</sup> *If New Zealand guidelines do not exist*

**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.

**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 to a 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 sources 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 sources 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 businesses they more typically prefer larger deals both to minimise due diligence costs and also to maximise their ability to efficiently manage their investment portfolio<sup>23</sup>.

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 typically have three roles in the companies that they invest in; mentor to senior management, governance and investor. Making one to two investments every couple of years, they typically seek strong returns on investment but many undertake the investments for other 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 increase resulting in larger and larger deals. This formalisation process has taken a number of formats including:

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<sup>23</sup> Note small deals take as much time as big deals and VC's often don't have resource to manage a large number of small deals.

- 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 alongside 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
  - 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 – source deals for members to make a personal investment. Managers typically do a lot of the heavy lifting until an active investor takes the lead.

## 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	2007/2008 Performance Standards
<b>Governance</b>	Good governance of the Company is provided in accordance with its Constitution, Statement of Intent and the expectations of shareholding Ministers.
<b>Administration</b>	Sound administrative practices are implemented to support the Company's core business.
<b>Selection of Investment Managers</b>	<ul style="list-style-type: none"> <li>▪ Utilise best practice selection methodology and due diligence processes to select investment managers.</li> <li>▪ Establish new early stage and venture capital investment partnerships, taking a commercially prudent approach.</li> </ul>
<b>Manage the Investment Programmes</b>	<ul style="list-style-type: none"> <li>▪ Fund management conforms to current industry 'best practice' for a venture capital "fund of funds" and early stage angel Co-Investment portfolio.</li> <li>▪ Administer and maintain up to date records of all capital draw downs, distributions and buy-out transactions.</li> <li>▪ Collect data on investment programmes to support NZVIF reporting on the impact of the NZVIF Venture Capital and Seed Co-Investment Fund Programmes.</li> </ul>
<b>Monitor the Performance of Investment Managers</b>	<ul style="list-style-type: none"> <li>▪ Maintain monitoring and governance processes that conform to industry 'best practice'<sup>24</sup> and provide a high level of assurance about investment managers' compliance with investment charters.</li> <li>▪ 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.</li> <li>▪ Actively monitor Venture Capital Fund managers and Seed Co-Investment Fund partners in relation to: <ul style="list-style-type: none"> <li>- NZVIF investment criteria;</li> <li>- procedures for managing conflicts of interest;</li> <li>- industry best practice reporting; and</li> <li>- key person requirements.</li> </ul> </li> <li>▪ Take appropriate remedial action when necessary to ensure investment managers comply with the VIF mandate.</li> </ul>
<b>Promotion and Support of the Developing New Zealand Venture Capital and Early Stage Industries</b>	<ul style="list-style-type: none"> <li>▪ Undertake effective promotion activities in conjunction with the New Zealand Venture Capital Association and other private sector participants, to help build the industry.</li> <li>▪ 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 venture capital and early stage industries.</li> <li>▪ Undertake a programme of targeted visits to institutional investors to promote the NZ venture capital industry.</li> </ul>
<b>Input on Government Venture Capital and Early Stage Policies</b>	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 venture capital and early stage industries: <ul style="list-style-type: none"> <li>▪ Tax treatment of venture capital investments.</li> <li>▪ Limited Liability Partnership Structures.</li> <li>▪ New Government investment initiatives to support growth of the New Zealand venture capital and early stage industries.</li> </ul>
<b>Provision of Advice to the Minister as Required</b>	<ul style="list-style-type: none"> <li>▪ 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.</li> </ul>
<b>Provision of an Annual 'Strategic Overview Memorandum'</b>	<ul style="list-style-type: none"> <li>▪ Memorandum to include advice and perspectives on future market development issues and policy directions and initiatives to ensure ongoing effectiveness of the programmes, to deliver against the Government's policy goals.</li> <li>▪ Acceptance of the memorandum confirms the Minister's satisfaction.</li> </ul>

<sup>24</sup> Where 'best practice' measures are not available, currently accepted measures will be used.

## Annex 2 – Forecast Financial Statements

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### Forecast Statement of Financial Performance for the year ended 30 June 2008

Revenue	3,601,895
	<hr/>
Administrative expense	3,601,895
Product Development set up costs	2,327,115
Management Fees and fund costs	300,000
Impairments in value of investments	2,791,713
	<hr/>
Total operating expense	2,887,173
Income tax expense	8,306,000
	<hr/>
Net surplus/(deficit)	-4,704,105.50
	<hr/>

### Forecast Statement of Movement in Equity for the year ended 30 June 2008

Equity - beginning of year	35,528,820
Net surplus/(deficit)	-4,704,106
	<hr/>
Increase in share capital	10,953,379
Equity - year end	41,778,093
	<hr/>

**Forecast Statement of Financial Position as at 30 June 2008**

Equity	\$41,778,093
<hr/>	
Represented by	
<b>Current Assets</b>	
Bank	\$4,532,751
Receivables and prepayments	\$246,610
	<hr/>
	\$4,779,361
<b>Non-current assets</b>	
Property, plant, equipment	\$110,000
Investments	\$37,262,346
	<hr/>
	\$37,372,346
Total assets	\$42,151,707
<b>Current Liabilities</b>	
Payables and accruals	\$373,614
Total liabilities	\$373,614
	<hr/>
Net assets	\$41,778,093
	<hr/>

### Forecast Statement of Cash Flows for the year ended 30 June 2008

#### *Cash flows from operations*

Cash provided from:	
Crown - Fees	\$1,890,000
Interest & other income	\$25,000
	<hr/>
	\$1,915,000
Cash applied to:	
suppliers	-\$1,585,340
employees	-\$658,701
management fees	-\$2,791,713
	<hr/>
	-\$5,035,754
<b>Net cash flows from operations</b>	<b>-\$3,120,754</b>

#### *Cash flows from investing*

Cash provided from:	
Sale of investments	\$2,000,000
	<hr/>
	\$2,000,000
Cash applied to:	
purchase property plant equip	-\$30,000
purchase investments	-\$10,161,667
	<hr/>
	-\$10,191,667
<b>Net cash flows from investing</b>	<b>-\$8,191,667</b>

#### *Cash flows from financing*

Cash provided from:	
increase in share capital	\$10,953,379
<b>Net cash flows from financing</b>	<b>\$10,953,379</b>
<b>Net increase/decrease cash</b>	<b>-\$359,042</b>
Plus opening cash	\$4,891,793
<b>Closing cash balance</b>	<b>\$4,532,751</b>