Fidato

NEW ZEALAND venture INVESTMENT FUND LIMITED

NZVIF Discussion Paper

Institutional Investment in Venture Capital and Private Equity in New Zealand

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Introduction

A major issue for New Zealand's capital markets is the lack of sufficient capital to meet the needs of young high growth companies. New Zealand Venture Investment Fund (NZVIF) estimates that around $200 million of investment capital is needed each year to meet the existing demand, over double what is currently available. One of the logical sources of that capital – if existing barriers can be removed – is institutional investors.

In major Western economies, it is common practice for institutional investors to have substantial strategic allocations to venture capital and private equity. For example, endowments and foundations in the United States have an average allocation of around 50% to alternative strategies, of which 30% is invested in venture capital and private equity.[1]

In contrast, institutional participation in the New Zealand venture capital and private equity markets is modest. While several Crown financial institutions have material allocations to local venture capital and/or private equity, the vast majority of the other institutional investors have nil or very small allocations. As a consequence, family offices, trusts and high net worth investors are the primary source of capital in this asset class, providing 48% of total capital invested versus 22% in Australia.[2]

The Capital Markets Development Task Force ('CMDTF') noted in its 2009 report that the lack of institutional involvement in private equity and venture capital markets causes fund managers to forego investment in credible opportunities in New Zealand.[3] A number of recommendations were put forward by the CMDTF to address this investment gap.

Implicit in the CMDTF recommendations is recognition of the direct and causal relationship between the investment allocation decisions made by New Zealand institutional investors, and the depth of our capital markets. With the introduction of KiwiSaver, and as the domestic savings pool grows, so too does the impact of the investment decisions made by New Zealand's largest institutional investors. Ensuring institutional investors have access to a range of high quality, private and public market investment opportunities is a key part of deepening our domestic capital market.

The good news is that over the last decade there has been a significant increase in the level of investor support for New Zealand private equity investment opportunities[4]. Private equity investment per annum in New Zealand has grown from $87.1 million in 2003, to a peak of 1.2 billion in 2007, prior to the global financial crisis (GFC). Post GFC private equity investment levels have stabilised with $554 million invested in 2011. The majority of investment during the peak years was driven by large Australian private equity funds. Through the same period private equity investment by domestic private equity funds grew steadily from $44.1 million in 2003 to $223 million in 2011[5].

The level of private equity investment as a percentage of GDP, across selected countries (as highlighted in Table 1) suggests that there is sufficient capacity in the New Zealand private equity market to absorb an increased allocation to New Zealand private equity by New Zealand institutional investors.

1 *2010 NACUBO-Commonfund Study of Endowments*
2 *Capital Markets Matter, Report of the Capital Markets Development Task Force, December 2009*
3 *Ibid*
4 *New Zealand Private Equity and Venture Capital Monitor 2011*
5 *Ibid*

Table 1: Investment in private equity as a % of GDP in 2010 (selected countries)[6]

Country	PE Investment (US$ million)	GDP (US$ million)	PE/GDP
Singapore	3,473	222,699	1.6%
Australia	17,021	1,232,800	1.4%
United States	149,000	14,582,400	1.0%
United Kingdom	16,830	2,246,079	0.7%
Ireland	1,020	203,892	0.5%
Finland	777	238,801	0.3%
Germany	6,154	3,309,669	0.2%
Denmark	511	310,405	0.16%
New Zealand	212	140,256	0.15%
Japan	7,788	5,497,813	0.1%

Investment support is particularly evident where domestic fund managers have demonstrated consistent investment performance and good returns for investors, over time and across multiple investments. Research published by NZVIF on investment returns achieved from realised private equity investments between 1994 – 2010 shows that for every dollar invested 2.5 times was returned.[7]

In recent years a major source of capital for private equity investment has been New Zealand institutions. Leading the way in supporting private equity investment in New Zealand are the major sovereign funds and charitable trusts, many of which have made material investment allocations to private equity. As private equity and venture capital markets mature, large institutions with a long investment horizon and a need for portfolio diversification are likely to be the first movers. Charitable trusts also tend to be early movers, particularly if they have a preference for domestic investment opportunities. This trend of support by superannuation funds and charitable trusts is similar to that observed in North America and Europe.

Looking across the wider institutional investor landscape, however, support for private equity investment generally, and venture capital specifically, drops off sharply. Most New Zealand institutions still have very small or nil allocations to private equity. Venture capital does not figure at all. Global comparators (as highlighted in Table 2) would suggest that there is significant capacity for further private equity investment in New Zealand.

Table 2: Global institutional allocation to private equity[8]

Country	2009	2012 (forecast)
United States	4.3%	6.8%
Australia	3.5%	3.5%
Europe	3.0%	3.7%
Japan	2.2%	3.5%
Global	3.1%	4.9%

6 *PE investment data sourced from individual country PE/VC association reports, GDP data – CIA world fact book*
7 *New Zealand Private Equity Returns 1994 – 2010. The performance data are gross returns (before management fees and costs) based on aggregated returns from investments into 74 companies*
8 *Russell Investments' 2010 Global Survey on Alternative Investing*

Following offshore practice, if New Zealand institutions allocated an average of 3% of their portfolios to private equity this would imply a total allocation of two billion dollars, an increase of five times the current allocation of $425 million. While not all of this would be invested domestically, even a small increase would make a difference.

A number of reasons are given for the current low levels of investment, including a lack of market pricing, poor liquidity relative to listed equities, a lack of trustee understanding of the asset class and high fees.

For venture capital specifically, the lack of investment track record is the most commonly given reason for not investing. Given that the New Zealand venture capital market is still nascent, this is not a surprise. Until the New Zealand venture capital market has experienced at least three successive investment cycles, and good returns during that time, investment support will come mainly from individual investors, family offices and government programmes.

Gaining a better understanding of how institutional investors make their allocation decisions, including their capacity for and understanding of private equity and venture capital, is a critical step in developing a robust programme of policy and industry initiatives to support the development of New Zealand's unlisted equity market in general, and private equity markets specifically.

In July 2011 NZVIF commissioned Fidato Advisory to conduct research with three aims:

- Develop a detailed description of the institutional investor landscape in New Zealand;
- Improve our understanding of the factors that drive institutional investor allocations; and
- Identify approaches that could be taken, to overcome obstacles to investment and stimulate increased investment in private equity and venture capital.

The results of the research, summarised in the following two pages, confirms much of the anecdotal information about institutions' and their advisers' perceptions of private equity and venture capital. Moreover, the research validates the recommendations made by the CMDTF in respect of the opportunity for increasing institutional investment in the asset class.

The findings of the report suggest roles for both the industry and policy-makers, in making private equity investment opportunities more accessible for institutional investors.

Key Findings of Research

- International experience and research shows that the role of private equity and venture capital (collectively referred to as 'private equity' unless otherwise stated) in institutional portfolios is related to the scale of an institution's assets, its longevity and the nature of its liabilities – their duration, predictability and controllability.
- The institutional sector in New Zealand is quite heterogeneous when it comes to the potential role of private equity and venture capital, as the sector is populated by a range of entity types that differ considerably in their characteristics, as highlighted in Table 3.

Table 3: Institutional investor entities

Institutional Type	Sector Size $	PE/VC Allocation $	PE/VC Allocation % fund
Crown Financial Institutions	$45b	$250m	0.55%
Local Authorities	$1b	$65m	6.5%
Corporate direct benefit pension schemes*	$1b	$5m	0.5%
Corporate direct contribution pension schemes**	$4b	$5m	0.125%
Philanthropic Trusts	$4b	$50m	1.25%
Endowments	$1b	$5m	0.5%
Maori Entities	$1b	$25m	2.5%
KiwiSaver Schemes***	$11b	$6m	<0.1%
Ecumenical Funds	$1b	$20m	2%
TOTAL	$69b	$431m	0.62%

* *superannuation schemes sponsored by corporations that provide for employee-members to be paid a specified benefit on retirement.*

** *managed superannuation funds in which members' contributions (regular or one-off) are aggregated, possibly with employer contributions, and invested in a portfolio selected by the member.*

*** *The seven largest schemes that account for over 80% of KiwiSaver funds under management collectively have a nil investment allocation to PE/VC.*

- Face-to-face and telephone interviews with 48 individual fiduciaries associated with institutional investors indicated that many factors have affected their views of private equity and/or their allocation decisions.
- Within certain sub-sectors (Crown financial institutions, local authorities, endowments, philanthropic trusts and ecumenical funds), the case for private equity is strong - these sub-sectors collectively represent the majority of institutional assets in New Zealand. However, the response to the investment case is mixed:
  - Crown financial institutions and the ecumenical funds (in aggregate) have made material allocations to the asset class.
  - With some notable exceptions, the majority of philanthropic trusts, local authorities and endowments have not made allocations.

- While KiwiSaver schemes are *prima facie* able to support investment in private equity, actual investment by major schemes is non-existent to date. The illiquidity of private equity is an issue, even with member lock-in provisions, as is the effect of fund management fees on the schemes' management expense ratios.
- There appears to be a mismatch between the case for private equity and actual allocations for some entities in the corporate defined contribution subsector ('DC schemes'). In particular, the case is moderate for large and growing DC schemes, but actual investment in private equity by these schemes is very small.
- While New Zealand institutional investors' allocations to private equity have grown steadily over the last 10 years, overall they are still low, when measured against a range of international benchmarks.

Factors influencing investment

The research identified a number of factors that institutions cited as barriers to investment into private equity and venture capital.

- **Risk-return characteristics** – some interviewees in the corporate DC sub-sector view the private equity asset class as offering a risk-adjusted return that is inferior to other growth assets. These views are attributed partly to media coverage of high profile failures both locally and offshore (even though the cited failures have not involved New Zealand private equity fund managers).
- **Interaction with other assets** – a common belief amongst interviewees is that private equity is just one of a range of alternative assets that compete for allocation. In some cases, as other assets such as property have already captured this allocation, there is no opportunity to consider alternatives.
- **Relative illiquidity** – this is an inherent characteristic of the asset class and the recent global financial crisis focussed the attention of many institutional investors on the need for liquidity in their portfolios. Investors such as corporate DC and KiwiSaver schemes, which require liquidity or must rebalance their portfolios against a strategic asset allocation, are particularly sensitive to this requirement.
- **Valuations** – interviewees noted that members who leave or join a fund during the term of a private equity investment may be advantaged or disadvantaged, relative to those investors who remain in the fund for the full term. Concerns were also expressed about the accuracy of relying on valuations rather than 'mark-to-market' pricing.
- **Quality/breadth/scale of funds** – some interviewees expressed concerns about the capacity of the private equity market to satisfy the needs of institutional investors that require a program of diversified fund investments or the ability to make regular and on-going allocations to the asset class.
- **Management fees** – the relatively high cost of private equity management is seen as a significant hurdle by those entities concerned with the overall cost of fund management, such as KiwiSaver schemes. Institutions with private equity investment experience did not see this as an issue, particularly when fund managers had delivered good investment returns.
- **Familiarity with the asset class** – there is a general lack of understanding of the private equity asset class and how it operates.

- **Requisite internal skills and resources** – most organisations have limited skills or resources to consider private equity and, therefore, rely heavily on advice from asset consultants and advisors. A number of the consultants used by institutions in New Zealand do not have the capacity, expertise and in some cases willingness to undertake the research and due diligence required to support a program of private equity investment.
- **Adviser recommendation** – while most asset consultants state that they support their clients' consideration of private equity, many do not support making an allocation. Others advise that an allocation is unwarranted because diversified and multi-manager solutions are not available in ready-made form.

Venture capital specific findings

- There was a common view from the majority of interviewees that venture capital in New Zealand is not regarded as an 'institutional' investment class and is the domain of individual investors and government. The main reason for this view is the lack of observable performance to date by both venture capital-backed companies and local venture capital fund managers. Given the nascent stage of the industry and the small number of venture capital fund managers with demonstrable track record, this should not be a surprise.
- Those institutions that have an allocation to venture capital can be characterised as having a 'triple bottom line' perspective. Investing into venture capital is part of a wider decision to encourage entrepreneurial endeavour, support high growth companies, job creation and other economic development objectives.

Next Steps

The following areas have been identified, where steps can be taken to support increased institutional investment in the private equity asset class:

- Industry initiatives that focus on improving institutional investor fiduciaries' understanding of the private equity asset class.
- Targeted changes to KiwiSaver default provider regulations, particularly in respect of liquidity requirements.
- Revisiting the Capital Markets Development Taskforce recommendations in regard to improving institutional investor access to private equity, including the development of new investment products.

Building the case for institutional investor support for venture capital, for several reasons, is more challenging. Building a sustainable venture capital market cannot be undertaken by individual investors alone – but institutional investors are unlikely to support pure venture capital investment in the current market. Policy-makers need to consider the role that institutional investor support should play in building a sustainable long term venture capital industry, and whether existing programmes and incentives are sufficiently attractive, if increased institutional investor participation is desired.

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