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Level 6  
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Auckland

## **FINANCE AND EXPENDITURE SELECT COMMITTEE**

### **Submission on the Venture Capital Fund Bill**

Submission by LWCM Limited

Level 6, 2 Kitchener Street

Auckland, 1010

23 September 2019

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Thank you for the opportunity to submit on the Venture Capital Bill.

This submission is in five parts as below.

1: About the Submitter **(LWCM manages Punakaiki Fund, a \$50m VC Fund)**

2: Guiding Principles that inform our submission

3: Support of the Bill **(We do not support the bill)**

4: Feedback on specific Clauses **(seeking to improve the bill as it stands)**

5: Other feedback

Lance Wiggs from LWCM wishes to appear before the committee.

### **Section 1: About the Submitter**

**Manager of \$50m Punakaiki Fund:** This submission is made by LWCM Limited, the manager of Punakaiki Fund Limited. Each of these entities is New Zealand owned.

Punakaiki Fund is a venture capital fund approaching \$50 million in value (based on June 2019 valuation, and funds raised since then), and is one of a handful of truly active New Zealand Venture Capital Funds. Punakaiki Fund holds investments in companies with combined last 12-month revenue of over \$120 million and employing over 700 people.

**The only fund with retail investors:** Punakaiki Fund has over 830 shareholders, who are almost entirely based in New Zealand, while the handful of offshore investors are all New Zealand citizens. This compares with typical general partner/limited partner ("GP/LP") structures where there is a smaller number of investors - say 10-100 - who make larger commitments over time.

We are unique in New Zealand in raising capital using Financial Markets Authority regulated retail offers using product disclosure statements, as well as more usual offers to wholesale investors.

**No Government Support:** Punakaiki Fund has received no investment from the New Zealand government - neither directly from NZ Venture Investment Fund, nor through investment entities like New Zealand Superannuation Fund ("NZ Super") or ACC.

LWCM and Punakaiki Fund have received no formal support from NZVIF or NZTE to raise funds domestically or internationally. We note that Lance Wiggs, one of the principals of LWCM, has assisted an estimated over 200 companies to raise funds through NZTE programs, generally through mini workshops to help the companies get investment ready. Lance's work with the NZTE Investments program was recently featured on Maori TV: <https://teamaori.news/maori-businessman-seeks-dragons-den-funding-edible-hemp>

**Exclusive New Zealand Mandate:** Punakaiki Fund invests exclusively into New Zealand companies and has a particular focus on both Software as a Service and technology intensive businesses. The fund has invested over \$30 million into 20 companies ranging from seed to later stage growth, with an increasing focus on the Series A stage (\$2-3 million), where we see the greatest opportunity. The investments that form the vast majority of the value of the portfolio today are Vend, Timely, Raygun, Onceit, Mobi2Go, RedSeed, Conqa, Melon Health, Weirdly, Boardingware, Coherent Solutions, Devoli, Mindfull and Everedge IP. The companies are located across Aotearoa New Zealand.

**Successful Track Record: Revenue Increases:** Since the initial Punakaiki Fund investment into each company, the revenue from portfolio companies has increased by an average of 6.6x and a median of 3.9x. As stated above the investments had combined last 12-month revenue to June 2019 of over \$120 million, and employed over 700 people, while the revenue weighted by Punakaiki Fund's equity share was \$20.7 million.

**Successful Track Record: Investment Performance:** Our investments are performing well overall, showing returns, based on exits, dividends and internal valuation changes of 20.6% per year, as at the end of June 2019. This return includes the negative impact of 5 investments that have not performed well, including one complete write off and four extensive write-downs. (As a result of this in mid-2019 LWCM announced a tightening of mandate so that these smaller and, in one case, non-technology investments would be out of mandate in the future.) The returns also include the benefit of one exit - the sale of Linewize, a Christchurch based school internet security company, to an Australian acquirer.

**Successful Track Record: Investor Returns:** The fund commenced in April 2014 with a share price of \$10 and has raised over \$33 million through a series of retail and wholesale offers, along with share issues to acquire shares in portfolio companies. With the iNAV/share of around \$22.50 in June 2019, the investors who purchased shares in April 2014 and exercised all attached options have generated an IRR of 18.6%. This is above, for example, the expected return for venture capital of 16% set by the Yale Investment Office. A number of investors have sold their shares, and essentially all of them have made positive returns, despite share trading happening at a discount to the net asset value.

**Structural Advantages:** The structure of Punakaiki Fund is set up to be very similar to the GP/LP structure, but with crucial differences that provide advantages to founders and investors. There is a very strong Board in place, the Manager can be removed through a majority vote, there are published tier 1 IFRS accounts regular reporting and the shares in Punakaiki fund can be, and are, traded, between investors. The fund intends to list, and will have a set-up similar to Bailador, the ASX-listed Australian VC fund run by David Kirk, or Infratil, the NZX-listed infrastructure PE fund.

**Evergreen:** The advantage for portfolio companies is that, as an evergreen fund, Punakaiki Fund has no mandate to rush companies to exit (sell, often to offshore buyers). The patient investment approach allows the successful companies time to grow into substantial corporations, generating a larger number of sustainable NZ jobs, tax revenue and economic benefit for New Zealand than early exits do.

**Founder Centric:** LWCM has a founder centric approach, publishes diversity statistics in our annual report and is, recognising there is still a way to go, New Zealand's leader in venture capital in investing in women and Maori led companies. LWCM has led by example to help the industry shift to more founder centric investment contracts and publishes a wide variety of documents, including quarterly and annual reports, audited accounts and more on our website: <https://punakaikifund.co.nz/key-documents/>

**Experienced Team:** LWCM is founded by Lance Wiggs and Chris Humphreys, who met while trying to launch Pacific Fibre, an ambitious project to improve New Zealand's international internet connectivity. They have completed almost 100 investments together, and have a growing team of professionals, including Olo Brown, Bridget Winstone-Kight (on maternity leave), Thomas Chung and James Pope.

Lance Wiggs has a long history in the high growth ecosystem in New Zealand, as well as international experience. He assisted Trade Me from early 2004, including showing the founders and investors the value of the company, and guiding them, as advisor to the CEO, during the sale to Fairfax for \$750 million. He has assisted an estimated over two hundred companies via NZTE's Better by Design, Better by Capital and Investments programs, and was the Chair of the ICT and was a member of the Physical Science Investment Committees for Return on Science, leading the recruitment of the initial wave of students into the program. Lance's work with the NZTE Investments program was recently featured on Maori TV: <https://teaomaori.news/maori-businessman-seeks-dragons-den-funding-edible-hemp>

Chris Humphreys is based in Te Anau and is responsible for the robustness of the internal processes, including the investment processes. Full bios for Chris and Lance and more information about LWCM and Punakaiki Fund is available on the Punakaiki Fund website: <https://punakaikifund.co.nz/>

## **Section 2: Guiding Principles that inform our submission**

Punakaiki Fund was established in response to Lance's assessment well over 10 years ago that New Zealand had a yawning funding gap for excellent high growth investments. LWCM believes that if a well-crafted Bill could provide a much-needed boost to the sector with long lasting positive effects to the high growth ecosystem and wider economy.

However, we also caution that a poor Bill and Policy could create perverse incentives and do very real damage to a sector that has rapidly matured over the last five years, all with minimal government funding support to funds.

The following core principles provide the foundation for our submission:

**Fairness:** Commitment of New Zealand government's funds must be fair, which means the criteria, process and results of applying for funds are well understood, unbiased and transparent. There should be equal access to the Fund-of-funds, and the selection of the

initial funds should be based on well understood criteria and use an open and transparent process.

**Seed and grow the sector:** We see that venture capital investing is based on an apprenticeship model, where great investors learn by doing. This includes the addition of new staff to managers, first time managers starting a fund, migrants from angel funds to venture funds, and new entrants to a market such as New Zealand. The industry standard is that the first fund is relatively small, allowing larger investors observe the results, with most institutional investors avoiding first (or second) funds. We believe that **the Bill and Policy should aim to make it easier for a large number of small first venture capital funds to be created** and to ramp up investment to managers with more experience in New Zealand venture capital.

We note that Australia has succeeded in this goal, largely through adjusting the rules for investors into funds. A [spreadsheet](#) maintained by one Australian venture capital firm shows over \$5 billion in funds in that market.

**Benefits for New Zealand:** The major benefits of the Venture Capital Bill and any resulting fund should go to New Zealand entities and people, including the founders and staff of companies being invested into, the other investors in those companies, the investment managers who allocate the funds to companies, and the investors (e.g. limited partners) who are encouraged to invest alongside the New Zealand government funding.

**Activate New Zealand Investors:** The Bill should activate investment from New Zealand based private investors, from private individuals all the way to institutional investors such as retail funds, KiwiSaver funds, ACC and NZ Super Fund. A key metric of success will be the future participation of investors of all classes in the venture capital fund space. All investor types should have access to the venture capital investment asset class, regardless of their net worth, investment experience or amount available to invest

**Allocation by managers not the Fund-of-funds:** The Bill should require that funds are allocated by private venture capital fund managers, not the Fund-of-funds itself. This will build manager experience, ensure there is a funding multiplier and ensure that any Fund-of-funds is acting only in that role. It also removes conflict, if NZVIF is the manager, with the SCIF program, which does participate in Series A and B rounds.

**High speed of deployment:** The Bill should allow funding to be allocated in a way where, initially, the deployment of those funds to companies is rapid yet considered, so that the program can show early results.

**Appropriate governance, manager process and VCF Processes:** The required criteria and processes for funds to attract investment should be related to their scale. The program should ensure that, for example, a \$15 million fund is not required to meet the hurdles that a \$1 billion fund would need to meet. Smaller funds will likely have tiny and even part time teams and need to prove themselves before raising additional funds.

The Fund-of-funds itself should be subject to rigorous pre-investment scrutiny and meet all of the normal thresholds for a conviction review from NZ Super Fund.

**Long term focus:** To build a competitive and world class VC industry in New Zealand we need to grow a community of experienced local fund managers and professionals and build ongoing commitment from investors. VC investing is much different to

investing in later stage or publically listed companies as it is very hands on, requires an understanding of new technology and rapid change, and there is often a high chance of investment failure. The way to become a good VC investor is through years of investment experience and exposure to both successful and unsuccessful early stage businesses. The number of experienced VC investors in NZ is small but growing, and an apprenticeship model is needed to train the next generation of investors and incentivise them to remain in New Zealand.

**NZ Company, NZ Manager, Series A and B Focused:** The program should reflect a policy goal of getting funding to New Zealand based companies of between \$2 and \$20 million, and via New Zealand venture capital managers.

### **Section 3: Support of the Bill**

**LWCM does not support the Venture Capital Bill**, for three main reasons:

Firstly, the approach is **not inherently fair**, as the VCF will select winners rather than the government providing equal access to every fund that is eligible. The issues include:

- **A bias towards offshore funds**, as they have far easier access to large amounts of funds and experience in dealing with organisations like NZ Super Fund and its proxy NZVIF. Offshore funds already invest into New Zealand, and we see little reason for the New Zealand Government to fund them;
- **A “picking losers” bias**, where each time a fund is picked by VCF every other fund will find it harder to raise funds;
- **Concern that Punakaiki Fund will never receive VCF investment.** We are concerned that we would be unlikely to receive any funding under this program, and this will slow our progress. We see that any government support should be broad based, fair and reward historical performance versus promises, and if that cannot be achieved then it is better to do nothing; and
- **Concern that the co-funding will only apply to “new” funds raised**, and not give credit to funds raised to date. Punakaiki Fund has pushed hard to raise \$30 million in cash over the last five years from 100% private New Zealand investors, but the feedback we have received does not lead us to believe that we would get credit for this despite no government support or funding in that time.

Secondly, the approach is **complex, slow and opaque**.

- **Slowing the pace:** the funding ecosystem is on hold while this process resolves itself. Once the first funds are selected for review then other funds will lose months or years of time in their fund-raising processes;
- **Complexity:** The program appears to be becoming a lengthy, cumbersome process that sits outside of the already lengthy processes to raise funds;
- **Uncertainty:** Funds that are raising capital are uncertain on whether or not the VCF will co-invest, which will make it harder to communicate to potential investors how big the fund will actually be, and therefore its overall investment proposition; and

- **Opaque:** The Bill does not require disclosure of the contract between NZVIF and NZ Super, the review (e.g. “Conviction Review”) of NZVIF by NZ Super, the investment policies, standards and procedures established by the Guardians, and the ongoing performance of investments into funds. We see that with the amount of Government investment versus the size of the ecosystem that transparency is important to ensure a healthy ecosystem develops.

Thirdly the approach risks **creating a government owned monopoly market player, and conflicts with existing government commitments from NZVIF:**

- NZVIF-SCIF already invests in Series A and Series B rounds. Two public examples are as part of a \$3 million round led by Punakaiki Fund into Coherent Solutions and a \$10.5 million round announced by Montoux in mid-2019.
- NZVIF-SCIF has a steady stream of \$8 million a year to directly invest and has requested that this is raised to \$16 million per year. This, over 10 years, is effectively a \$40-80 million fund, and one that competes head to head with, and works alongside, venture capital funds.
- As the largest investor (e.g. on a 1-1 basis through VCF) in venture capital funds in New Zealand NZVIF (and, indirectly, NZ Super Fund) would be able to assert influence before the fund is closed and later through the Limited Partner Advisory Committees on processes, investors and mandates. This would make for inherent competition (or lack of therein) issues between funds, as, for example, they may not want to invest in two similar funds, or even for two funds to invest in competing companies.
- Under the draft policy presented to industry NZVIF, as VCF Manager, would not just select the managers, but would also direct the placement of an additional \$60 million into companies. NZVIF has a record of shifting to direct investment, with its latest annual report (2018) reporting \$7.4 million invested directly and over 200 direct investments ever made. Meanwhile just \$3.6 million was invested through the old fund of fund program in 2018. (<https://www.nzvif.co.nz/assets/publications/NZVIF-Annual-Report-2018-Final-Print.pdf>)
- Overall NZVIF would dominate the NZ high growth investment market, dictating the placement of \$300 million into other VC funds, as well as the investments by the NZVIF SCIF fund. All of these funds are co-investments, which means NZ-VIF is dictating the outcome of at least the same amount of funds again. If the VCF program works, then NZVIF would be able to assert control over most investments. We are putting a lot of eggs in one basket.
- We note that this current and future dominance most likely has a chilling effect on submissions to the Committee from funds looking to raise capital and other investors or companies who want ongoing funding from NZVIF.

### **Three approaches that could work to achieve the Venture Capital Bill objectives**

We see a strong parallel between this bill and how the previous programme for Callaghan Innovation R&D grants operated. In that programme one organisation (Callaghan Innovation) picked winners (companies who received matching grants), and



the application process was difficult, time-consuming and often expensive, while the outcomes were uncertain.

The old Callaghan Innovation system has now shifted, under the current government, to a simple and fair R&D Tax approach, which is far easier to administer from both the company and, likely, government perspective.

So, we see there are three major alternatives to the proposed Bill:

**1: Provide matching funds based on set rules:** Use a simple set of provable criteria for each fund (e.g. fund mandate, number of investors, size, fees to local managers, audited accounts, minimum experience for larger funds etc.) to automatically match New Zealand sourced funds or commitments raised on a fixed ratio. We would advocate a lower ratio for this approach of say \$1 for every \$2 or \$3 raised so that the government funds go further, and a maximum of, say, \$50 million per fund. This approach is fair, easy to administer and hard to argue that it does not support the high growth ecosystem.

We see that matching funds should only be granted against funds raised from private New Zealand investors, and certainly not to funds placed by entities owned by New Zealand or foreign governments, to avoid double dipping.

**2: Support domestic investors into funds:** This is the approach taken in Australia, where investors into funds that meet certain requirements ([ESVCLP/VCLP](#)) are able to receive certain tax benefits from that investment. These benefits include a capital gains tax holiday (not relevant in New Zealand) and the ability to claim a portion (10-20%) of the investment off against tax. While parts of the Australian approach seem unnecessarily complex the two important characteristics, when transferred to New Zealand's environment, would be to be a registered financial service provider and to meeting requirements, likely set by MBIE.

While giving high net worth investors extra benefits may not be palatable, we note that the Australian approach, complex as it is, appears to be vastly more successful than a fund approach as proposed here.

**3: Do nothing, and close down all investment from NZ VIF to all stages of companies.** We see a case for the market forces working without government intervention, and a high possibility of the intervention having unintended consequences. We are concerned about the speed of both this bill and the policy development, the implications of which for last for the next decade and beyond.

#### **Section 4: Feedback on specific Clauses**

We provide feedback on specific clauses in the Bill below. This feedback assumes that the Bill does move forward and seeks to minimise the negative impacts and increase the possibilities of successful outcomes for founders, high growth companies and investors.

#### ***Explanatory note - General Policy Statement***

**Early-stage capital markets in New Zealand. Page 2, Paragraph 4:** The ability/intention of the VCF to invest alongside private VC funds is noted, but page 19,

*Schedule 1, Part 1, Clause 2 (1) states that “NZVIF to undertake investment of the **whole** of the money of VCF using a fund of funds model...”. The fund of funds model is not defined, but the usual definition of a fund of funds would not allow for direct investments or co-investments.*

***Early-stage capital markets in New Zealand. Page 2, Paragraph 6 (last):*** Refers to private VC funds raising a certain minimum amount before receiving investment from the VCF. A minimum is required, but the amount is not specified. We see that the minimum should be very low (say \$5 million or even less) to encourage first funds from new managers.

***Venture Capital Fund Bill. Page 3, Paragraph 6 (last), bullet point 1:*** Refers to a “substantial proportion of the VCF’s capital will be made available to New Zealand entities through venture capital funds with a New Zealand connection”, however under the current draft Policy document, only a minimum of 56% and a maximum of 70% will be invested in this way, significantly less than what we would consider “substantial”.

We also note that only 42% would be necessarily placed through those mechanisms to Series A and B investments, defined as those from \$2 to \$20 million.

We note as well that individual investments from funds could be substantially less than \$2 million, and the draft Policy provides only that the total investment round is over \$2 million. We do not see we need more small investors - we need investors that can provide \$2-20m investments on their own.

### ***Venture Capital Fund Bill***

*Clause 24:* The Purpose of the Venture Capital Fund (VCF) does not include a mandate to improve the domestic venture capital ecosystem through amplifying the contribution from local investors, and this creates a cascade of issues that risk or do create inherent bias against domestic investors and domestic funds.

We see that the Purpose of the VCF should add four elements:

Firstly, there should be an additional purpose to increase investment from New Zealand (e.g. limited partner) investors into New Zealand targeted VC funds. This is a large gap that has been addressed well in Australia and it is not evident that they need additional funding to form VC funds that can invest into New Zealand;

Secondly there should be additional Purpose to increase the number of and scale of funds managed by New Zealand connected and New Zealand owned managers;

Thirdly there should be an additional purpose for increasing diversity of recipients of investments into funds and companies, particularly for Māori owned businesses and businesses founded by women, both of which are significantly under-represented in the New Zealand ecosystem. We see that if this goal is not explicitly stated then the VCF risks the development of systematic bias in investments; and

Finally, we would like to see a purpose to ensure an open, transparent and level playing field for funds seeking to raise capital from the VCF. We see that reporting of the investments made, performance by fund and overall and general openness are crucial to building trust and confidence in the ecosystem.



**Clause 35, (2) (b) and (d):** The wording “wholly or substantially” is used in reference to investments in New Zealand entities (the portfolio companies that take investment) – (b), and in reference to funds with a New Zealand connection – (d). We believe that specific targets should be referenced as the amount being received by NZ entities is the key to the success of the Bill.

**Clause 35:** We do not believe the balance between legislation and the Policy statement is set up for ongoing success. The draft Policy Statement, for example, allows for:

1. a minimum of only 42% of funds would be placed into series A and B investments via New Zealand fund managers,
2. A surprisingly loose definition of “a fund with a New Zealand connection” (Clause 35 (2)(e), so that offshore funds setting up a local subsidiary but using offshore decision makers and offshore investors would be treated exactly the same as New Zealand managers backed by 100% New Zealand investors;
3. Almost 30% of funds could be invested out of mandate - to either seed, Series C+ or into foreign companies;
4. \$60 million would be directly invested by VCF, which is \$12 million per year, adding to the \$8 million (\$16 million requested) that NZVIF already invests through SCIF.
5. And more. We attach our **Submission on the Draft Policy Statement on the Venture Capital Fund Act 2019** as part of this response. This can be made public as we have redacted sensitive text.

We would like this clause to be more prescriptive, including, for example:

1. a minimum share of the funds that will be applied via New Zealand fund managers to the mandate of series A and B New Zealand company investments. We suggest 80% of the \$300 million should be committed to New Zealand managers over five years;
2. a definition of “New Zealand funds”. This could include a minimum amount of New Zealand investment in the fund, and thresholds for ownership of and allocation of management and performance fees from managers. While we do require offshore funds to be active here, the Bill and Policy as currently written risk the domestic fund manager ecosystem being taken over by New Zealand government funded Australian and other country’s funds entering the market. These offshore managers are well funded, continuously courted by NZTE to invest into domestic companies, and do not need additional support to continue to grow their investments here.
3. a requirement that all investment is through fund managers, and not direct; and
4. requirement for public reporting of investment and results attached to any VCF investment.

**Clause 39:** This may not be consistent with the draft policy statement which requires NZ Super to appoint NZVIF to manage the fund of funds, particularly with respect to NZVIF making direct investments.

#### **Transparency: Clause 41 and Clause 42:**

VCF investment vehicles (as opposed to the VCF itself) are not required to prepare annual reports under the draft Bill. Although it is unlikely that there will be more than one VCF investment vehicle, if there is, we would expect separate reports for each (whether in a separate annual report or disaggregated in the VCF annual report).

We see that the Guardians and VCF should publish detailed quarterly and annual reports, including statistics on each fund's commitments, investments and performance. In general, we see that any government funding should have conditions of public data sharing attached, so that the performance of the VCF and each investment is open and transparent.

We note that NZVIF's own reporting is opaque and appears to have become less transparent in recent years. NZVIF has company level data which would be incredibly valuable to the industry that is unable to be shared, and we would like the Bill to fix this for future government funding.

Under the Limited Partnerships Act there is no requirement to disclose investors. Punakaiki Fund, meanwhile, has a company structure where disclosure is required. The Committee may consider whether it is arguable that any time government funds are being invested into a fund then the standard of disclosure should be elevated to that of Companies.

We also see that there should be a requirement to publish the documents/procedures created by the Guardians for VCF. Proactively publishing these will mean that the criteria for selecting funds is more clearly understood, helping to achieve fairness.

As mentioned in Clause 56 we also see that government funds should come with strings - in this case a prescribed list of reporting that will be required from the underlying funds, and that will be made public.

The New Zealand entity status of underlying funds should also be monitored and reported.

**Clause 43 (a):** Given the requirement in Schedule 1 for the Guardians to appoint NZVIF the manager, the selection criteria of this subsection do not appear to be required. The criteria that the Investment manager will be evaluated against should be defined in the policy statement.

**Clause 43 (b):** This should be clarified as pertaining to interim investment only. The Guardians should not be investing the VCF directly.

**Clause 43 (c):** Again, this should be defined in the Policy Statement.

**Clause 43 (j):** We believe that this should be consulted on and the valuation methodology published.

**Clause 44 (1):** The terms and conditions (and criteria) should be consistent with the terms, conditions and criteria for other investments by the Guardians, and not just "that the Guardians think fit".

**Clause 44 (2):** This suggests that the VCF could be split between different investors/managers and implies that NZVIF may not be the only manager appointed by NZ Super to manage the fund of funds. The policy statement should specify the following:

- That any manager appointed by NZ Super should be disclosed including the terms of the appointment and any fees to be paid to the manager.

- The selection criteria for a manager to be appointed to manage any part of VCF. NZVIF should be held to the same standard as any other manager that is appointed.
- The consequences of an appointed manager failing to meet the terms of the agreement including under what circumstances the appointment can be terminated.
- If the fund of funds manager is removed, will NZ Super be responsible for making investments into underlying funds and making co-investments? What would be the terms of this arrangement?

**Clause 56:** We believe that the Annual Report should be required to report the following information:

- Commitments and disbursements made by VCF into each fund during the year, along with the amount (and country of origin) of private capital committed and disbursed into each underlying fund;
- Investments made by each underlying fund during the year;
- Performance of underlying funds' investments including portfolio company revenues, fees, valuations and returns to investors;
- Diversity statistics from the fund manager and underlying investments; and
- Management and performance fees paid to underlying fund managers.

## **Section 5: Other**

### **Risk of a chilling effect on the submissions process**

We reiterate that the current and future dominance of NZVIF may have a chilling effect on submissions to the Committee. At LWCM we decided to relay our concerns to the Committee but will continue to endeavour to work positively with NZVIF and MBIE. Our abiding fear is that the VCF Fund and this Bill will create a number of mainly offshore funded competitors while making it harder for LWCM to raise more funds for Punakaiki Fund.

### **Risk of poor investment results for NZ Super Fund**

While the Guardians are the natural owner of the VCF fund of funds, NZ Super Fund has no visible asset allocation to the venture capital asset class. While forcing the Guardians to allocate capital to the venture capital sector will help the sector get funding, we note that investing in first funds (including experienced funds transferring to a new market) is likely to produce poor results, and that other Sovereign or endowment funds almost always look experienced managers with good prior results before investing. Venture capital returns do tend to skew to the very best funds, so the returns for NZ Super may not be very good. This may increase their scepticism of the venture capital asset class and the domestic opportunity, backfiring if the intention is to free up more assets.

### **The compressed consultation does not allow for appropriate industry collaboration**

The timing of the VCF Bill and policy statement submission processes is very compressed, and at LWCM we have struggled to do this justice. We are concerned that the industry, especially active funds, has little capacity to give the feedback required.

The accelerated legislation and policy process has not provisioned for industry feedback to a revised version of the policy and makes for a very limited time to feed back on the legislation. Given the two pieces of work are moving in parallel we see that the speed and structure of the approach may lead to unintended poor policy and legislation outcomes.

As mentioned by many in the workshop we request that MBIE provide the NZ venture capital industry an opportunity to review the revised policy after it has been redrafted.

A handwritten signature in black ink, appearing to be 'In Lr'.

## **Appendix 1:**

*We have included a redacted version of our submission to MBIE on the Draft Policy Statement on the Venture Capital Fund Act 2019. Many of the submission points are also relevant to the Venture Capital Fund Bill.*

### **1. Do you agree with the proposed definitions? If not, please explain why.**

**New Zealand Connection:** We do not believe that having a single senior investment professional resident within New Zealand is sufficient in order for a venture capital fund or manager to have a strong enough connection to New Zealand for the purposes of the policy.

The definition of “New Zealand Connection” defines the difference between Foreign and New Zealand funds, however that definition allows for 100% foreign investor owned and managed funds to, for example, set up a small branch in New Zealand and present as New Zealand funds. Foreign funds already benefit from structural advantages in their domestic market. These include tax advantages for Limited Partners and other investors, vibrant investment fund communities that have established relationships with VC firms and a larger population of deal flow, investors and other funds in their market. They have better access to their local institutional investors and will be more likely to be granted early access to the VCF program as they are used to dealing with LPs like NZ Super. However, it is already relatively easy for them to set up a smaller fund in New Zealand, as, indeed, one fund is already doing without any support from the New Zealand government or material support from local investors.

Our concern is that the VCF legislation and policy as currently structured will likely have the unintended consequence of creating a “domestic” range of funds that are predominantly owned and operated by offshore entities.

The history of the investment banking industry in New Zealand tells us that offshore owners, despite intentions, tend to be fair weather friends, and when conditions turn, they are likely to scale down involvement or exit the market.

We are also concerned that they will import certain biases, and that they will not understand, or materially seek to understand Maori Owned businesses or businesses owned by other diverse founders.

While we agree that offshore funds should be supported to set up shop in New Zealand, we also see that the New Zealand based funds with predominantly New Zealand based investors should be recognized as a separate class of fund and to have goals and benefits specifically targeted to those funds.

**New Zealand Fund:** This term would define funds that are truly New Zealand grown and not an outpost of an offshore fund. Our suggestions are that there is a test of ownership of both the fund and the manager, where the only meaningful test of manager ownership is the allocation of management fees and carry. We suggest that funds where 80% of investment is from New Zealand investors (NZ Underlying Funds), and 80% of the management fee and the 80% of the carry (or equivalent) goes to New Zealand citizens or people with a resident visa. We see this definition is critical to ensure a true domestic funding community is developed.

**New Zealand Connected (Fund):** This term should be amended to add to the current definition minimum thresholds (say 30-50%) for all or two out of three of investor location, management fees and management carry.

For the New Zealand Connected definition we see that there should be requirements for a certain share of investment committee members to be based in New Zealand, to encourage the development of industry expertise within New Zealand.

The VCF will not have succeeded until the industry has local investors of all types making substantial commitments and returns from the New Zealand markets and local funds owned by local managers who controlling a substantial share of the market.

We also see there should be, for New Zealand Connected Funds, a required minimum portion of the manager of a venture capital fund to be owned by, or the benefits flow to, New Zealanders. In successful venture capital investing, profits flow not only to fund investors, but also to fund managers. These profits may then flow overseas when the manager has foreign owners. We prefer that much of the manager profits are retained within New Zealand and draw a parallel to the Objectives, which discusses concern related to the premature “sell-off of innovation to offshore interests” and “the substantial potential gains that investors can make in successful start-up businesses also being made overseas”.

Alternatively, the definition of New Zealand Connected could be amended to the suggested New Zealand Fund definition.

As the Policy seeks to develop New Zealand’s venture capital markets over time, including its participants, the Policy should encourage greater skill development within New Zealand venture capital environment, both at a senior and a junior level. This can be achieved by increasing the allocation to NZ Funds and tightening the requirements for the NZ Connected funds over time. We would expect this to result in a greater training and mentoring of junior New Zealand-based staff and senior investment professionals “spinning out” and creating their own venture capital management firms.

**Co-investment:** This term should be removed as co-investment should not be part of the VCF program.

**Fund-of-funds:** We do not believe that VCF should allocate capital to Co-investment with Underlying funds. The definition of Fund-of-funds should be amended to remove the reference to Co-investments, and explicitly state that the Fund-of-funds will only be allocating capital via funds.

**Seed Capital:** This definition could be amended to state “up to \$2 million” rather than the range of \$100,000 to \$2 million.

We see that any capital that is not allocated to investments between \$2 and \$20 million should not attract any funding from VCF. If a fund, for example, allocates 20% of their fund to seed investments, then only 80% of the fund should be eligible for co-investment, and VCF would have clawback rights if this ratio is exceeded.

**Series A and B Capital:** We see that the funding gap in New Zealand is from investors who are alone able to meet the \$2-20m investment range. We already see groups of investors reaching that level, but the investment provided is “angel” and not venture capital and comes with a number of issues.



We would like this definition amended to make it clear that Series A and B Capital is capital where the investment by a fund to a company exceeds \$2 million, and where the round size is up to \$20 million. The unintended consequence of the current definition is that groups of funds might invest trivial amounts in a round (e.g. \$200,000 each) and call it a Series A investment, where the market failure is in the larger checks being written quickly and with conviction.

**Series C and C+ Capital:** The definition of Series C and C+ Capital are all capital raisings which are not Seed or Series A or B capital raisings. Based on the definition of Seed Capital (NZ\$100,000 to NZ\$2 million), Series C and C+ Capital means any capital raising either less than NZ\$100,000 or more than NZ\$20 million. This definition should be modified to be only greater than NZ\$20 million.

We see that any capital that is not allocated to investments between \$2 and \$20 million should not attract any funding from VCF. If a fund, for example, allocates 20% of their fund to Series C or higher investments, then only 80% of the fund should be eligible for co-investment, and VCF would have clawback rights if this ratio is exceeded.

**Underlying Funds:** We would like this definition to be expanded as below into “NZ underlying funds” and “Foreign Underlying Funds, as below.

We would also like this definition to exclude certain categories of funds (for matching purposes), including funds that are provided by any government entity - domestic (double dipping) or foreign (foreign funds) and funds that are not provided in cash form (e.g. share swaps).

We would like this definition to make it explicit that the type of investor is not material, just the location. It should also make clear that the timing of fundraising is not material, giving credit to funds that have already raised funds from private investors, and allowing investment in established funds that have not fully closed, could reopen or are evergreen. We see this is critical to getting funds working and to address bias against funds, like our own, that raised funds when NZVIF was not active.

**We see that the following New Definitions are required:**

**LP/Investor:** This definition should ensure that all investors into funds are treated equally - i.e. that funds from institutional investors are treated no differently than funds from retail or wholesale investors.

**New Zealand based LP/investor:** This defines the source of the capital for funds, which is defined by the residency of the ultimate owner of the funds.

**NZ underlying funds:** Where the LP/investors are NZ residents, along with the changes in definition to underlying funds above.

**Foreign underlying funds:** Where the LP/investors are foreign residents etc. Less credit should be given to funds from foreign sources.

**Capability and connections:** We heard this term used in passing at the workshop and would like it to be articulated in the policy. It appeared to be an important criterion for fund selection, and we would like to ensure that domestic funds are able to respond to this.

**Viable Fund:** We heard this term used in passing at the workshop and would like it to be articulated in the policy. If the fund of funds is only going to invest in “viable funds” then the term is clearly highly important. In our own experience we note that even tiny funds can be viable, as long as the principals are not full time, and that micro-funds may be (and currently is) the best way to identify the best fund managers.

***2. Is the overall drafting of the Policy Statement objectives and definitions clear and consistent?***

**Add an objective to explicitly promote investment from New Zealand investors (i.e. Limited Partners or other investors)**

The Purpose of the Venture Capital Fund (VCF) does not include a mandate to improve the domestic venture capital ecosystem through amplifying the contribution from local investors, and this creates a cascade of issues that risk or do create inherent bias against domestic investors and domestic funds.

The Objectives of the policy statement should add three elements:

Firstly, there should be an objective to increase investment from New Zealand (e.g. limited partner) investors into New Zealand targets VC funds. This is an obvious gap that was identified at the workshop, and mirrors a gap identified by the retail sector for investment into private companies in New Zealand

Secondly there should be an objective to increase the number of and scale of funds managed by New Zealand connected and New Zealand owned managers, with, say, defined targets for 2, 5 and 10 years.

Finally, there should be objectives and measures for investment into Maori and women owned businesses, as well as funds allocated to fund managers with Maori and women principals. Ignoring this risks the development of systematic bias in investments.

***3. Do you agree with the proposed policies as set out in the Policy Statement? If not, please explain why.***

**Policy 1: Investment Model**

We can accept the Investment Model but do not agree with the definition of Fund-of-funds and recommend that it is amended as discussed in response to Question 1.

[REDACTED]

[REDACTED]

We would prefer an approach that is more formulaic, and harder to game, much like the system in Australia where certain parameters grant certain advantages. If, for example, a domestic fund raises a certain amount of funds, from a minimum number of investors, with a Series A and B mandate then, subject to reasonableness tests, they should receive co-funding. This approach would be far easier to administer and remove uncertainty for funds. It will also remove the prospect of the government being blamed for picking winners (or not). We note the parallels between the previous and current system of Callaghan Innovation R&D grants.

## **Policy 2: NZ Fund Investments**

The policy proposes that a minimum of 70% of the Net Committed Capital is made available for investment into funds with a “New Zealand connection”.

We see the allocation of funds should be 20% foreign, 40% “New Zealand connected” (with foreign control and/or investors, and 40%-100% “New Zealand Funds (locally controlled and local investors). As explained elsewhere access to capital is not the issue for foreign funds, and we would prefer an even lower percentage of foreign, if not zero. We also see that the percentage should decline over time as successful foreign funds become more local.

## **Policy 2: NZ Fund investments**

As covered under the definition section we strongly see that either an additional definition for true NZ funds is required, or the NZ Connection definition is tightened considerably.

We note that as written only 42% of the \$300m would be allocated to New Zealand managers and Series A and B investments, which could be argued is failing the policy objectives. The amount of funds allocated to both NZ funds and Series A and B should be significantly higher, so that at least 80% of the \$300m is allocated by NZ Funds to Series A and B.

## **Policy 3: Foreign Fund investments**

We note that high quality Foreign Funds from well-functioning foreign markets are not likely to be capital constrained. The ability to secure additional funding from the Venture Capital Fund should not be motivational for these Foreign Funds to come to New Zealand and invest in New Zealand Entities.

These Foreign Funds will come to New Zealand to invest because of the high-quality investment opportunities that are present here versus the opportunities that are available in their domestic markets. The availability of Venture Capital Fund funding to Foreign Funds may result in poorer quality Foreign Funds that have difficulty raising capital in their domestic markets coming to New Zealand due to the availability of capital from the Venture Capital Fund.

There is an unintended consequence. Higher quality (and thus better funded) Foreign Funds are likely to invest in New Zealand Entities due to the investment opportunities available in New Zealand rather than the availability of additional capital. Lower quality Foreign Funds are likely to be more driven by the availability of capital. Thus, this policy will attract lower quality funds.

Another unintended consequence is for Australian Funds that already allocate 20% to NZ, where they may opportunistically seek additional capital from the Venture Capital Fund to increase funds under management, but this may not lead to a material increase in deployment of capital in New Zealand Entities. (e.g. a \$200m Foreign Fund may designate 20% of its funds for investing in New Zealand Entities (\$40m), apply to the Venture Capital Fund for funding and receive \$20m. It is now a \$220m fund. Its 20% allocation to investing in New Zealand entities has now slightly increased to \$44m - i.e. a \$20m investment from the Venture Investment Fund has resulted in only \$4m of additional investment into New Zealand Entities).

We also note that profits from Foreign Funds flow not only largely to foreign investors, but also entirely to Foreign Fund managers. This exporting of Foreign Fund manager profits is not beneficial to New Zealand when compared to investing in funds with a New Zealand Connection where most or all these profits are retained within New Zealand.

*We see that investment from foreign funds should be lowered or eliminated, and that consideration be given to lowering the ratio of VCF funding to underlying capital.*

#### **Policy 4: Co-investment with Underlying Funds**

Based on the proposed policies, \$60 million would be allocated to co-investments (\$42 million co-invested alongside NZ Connection funds and \$18 million co-invested alongside Foreign funds).

We do not believe that the fund should have any allocation to Co-investments alongside Underlying or Foreign Funds. We note the strong consensus for this at the industry workshop in Auckland and draw attention to the below:

- A \$60 million allocation to Co-investments, combined with NZSCIF's existing \$80-\$160 million fund (\$8-16m per year over 10 years) would make the NZVIF/NZSCIF by far the largest pool of early-stage investment capital in the New Zealand market. NZ VC funds should not be competing with NZVIF and NZ government for investments.
- Under the Policy Statement, any capital allocated to Underlying Funds requires at least a matching investment from external investors and therefore has a multiplier effect. The Co-investment allocation has no fund matching requirement. \$60 million allocated to Co-investments represents a 20% reduction in external funding being required compared to a scenario where the \$60 million is allocated to Underlying Funds which require matched external investment.
- The size of the fund is \$300 million less the cost of administering the fund. Any amount spent on administration will not be available for investment into Underlying Funds and companies with a need for capital. The cost of administration of VCF can be materially reduced if NZVIF adheres to the strict mandate of selecting Underlying Funds to invest in and does not employ an investment team for making Co-investment decisions.
- There is a clear conflict of interest between NZVIF and NZSCIF, which could both be participating in Series A investments, and NZVIF as a Fund of funds manager. NZVIF Would likely be in direct competition with the Underlying Funds which are being selected by NZVIF. This could lead to distortions in market pricing and returns, or affect the Fund-of-funds ability to make unbiased decisions about which Underlying Funds to invest in.
- Side-car investment vehicles are typically structured to allow large LP's/Investors to pay lower performance and/or management fees in exchange for providing a cornerstone investment. It is our understanding that VCF will not be negotiating lower fees for their investment into Underlying Funds as VC Funds depend on reasonable fees to fund operations and remain viable. If VCF investments into Underlying Funds will be paying

the same fees as other LP's/Investors, then there is no need for Side-car investments and the capital should be allocated into the Underlying Fund directly.

### **Policy 6: Timing**

We see that the timing of commitments should be front-loaded so that companies receive funding earlier. We would like clear expectations to be set for the amount of funds to be committed and disbursed in the first 2 and 5 years.

### **Policy 7: Secondary Period**

We would prefer that this is addressed at the time, so that there is a formal review before rollover.

### **Policy 8: Return of Capital**

No comment

### **Policy 9: Economic Strategy**

We were unable to comment on this but agree that the NZ Government should not be investing directly or indirectly in high emissions industries, and that lowering emissions is critical.

### **Other Policies:**

**Statistics:** We see it is reasonable to require that any entity accepting government funding agree to publication (i.e. on a public website) of basic information including their investments (amounts by company), holding value and returns, and overall metrics such as TVPI, DPI and IRR. They should also report other metrics such as total company revenue, equity weighted revenue and employment.

These would ideally be on a quarterly but certainly on an annual basis.

The fund of funds manager would aggregate these in detail and overall to provide an effective mechanism to track results.

### ***4. Do you think the policies will achieve the objectives of the Venture Capital Fund as set out in the objectives section of the Policy Statement? If not, please explain why.***

As it stands, we do not believe the VCF objectives will be met by the policy, and even see that the results could be negative for the ecosystem. This is due to the inherent advantage that offshore funds will have in becoming recipients of the funding, the chilling effect of the funding on funds that do not attract funding and the inherent conflict that NZVIF as the manager presents. We are concerned that it will not develop a

truly New Zealand funding ecosystem, which will exacerbate the existing industry against Maori owned businesses, and likely diverse founders per se.

**5. Do you have any other comments?**

**5.1 Timing and review for this process**

The timing of this and the VCF Bill submission processes is very compressed, and at LWCM we have struggled to do this justice. We are concerned that the industry, especially active funds, has little capacity to give the feedback required.

The accelerated legislation and policy process has not provisioned for industry feedback to a revised version of the policy and makes for a very limited time to feed back on the legislation. Given the two pieces of work are moving in parallel we see that the speed and structure of the approach may lead to unintended poor policy and legislation outcomes.

As mentioned by many in the workshop we request that MBIE provide the NZ venture capital industry an opportunity to review the revised policy after it has been redrafted.

[REDACTED]

[REDACTED]

Lance Wiggs  
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*LWCM Limited (LWCM) is the manager of Punakaiki Fund Limited*