The Treasury

Proposed Option to Deepen New Zealand's Early Stage Capital Markets Information Release

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Office of the Minister for Economic Development

Chair, Cabinet Economic Development Committee

PREFERRED OPTION TO DEEPEN NEW ZEALAND'S EARLY STAGE CAPITAL MARKETS

Proposal

1. This paper presents a proposal to deepen New Zealand's early stage capital markets. It considers the strengths, weaknesses and risks of alternative implementation and funding options. It outlines an approach for implementing my preferred option, including how to mitigate any associated risks, secure funding, and effect legislative and operational change.

Executive Summary

2. At the last Cabinet Economic Development Committee (DEV) meeting in December 2018, you agreed that we need to deepen early stage capital markets and address the venture capital (VC) gap experienced by New Zealand firms. It was noted that we need $300 million of public money to be invested in a fund of funds model to achieve this purpose, $60 million of which already sits with New Zealand Venture Investment Fund Limited (NZVIF).

3. You agreed that I should present back to this committee a detailed proposal. This paper outlines the options I have considered.

4. The Business Advisory Council recently identified the gap in early stage capital markets and also recommended that New Zealand address this issue through our sovereign wealth fund.

5. After reflecting on the analysis, my preferred option remains to allocate $240 million of New Zealand Superannuation Fund (NZSF) contributions into a new fund administered by the Guardians of New Zealand Superannuation (the Guardians) who will then invest into NZVIF in a fund of funds model.

6. There are number of risks associated with the preferred option but I believe there are efficient ways we can mitigate those risks.

7. I proposed we legislate a new fund, with a new mandate, to service the early stage capital markets while leveraging off the expertise and reputation of the Guardians. In addition to receiving the $240 million for the new fund, the Guardians will receive the $60 million currently in NZVIF.

8. I propose we review the programme every 5 years and at the end of the proposed fund term of 15 years.

9. If Cabinet agrees with the preferred option, the next steps will include a detailed design of the funds and qualifying criteria. Minister Robertson and I will lead an engagement with the Guardians and the NZVIF, and other relevant stakeholders to develop this.

10. I propose finalising the detailed design of the fund in time for Budget 2019.

11. If agreed, this will be one of the flagship announcements of Budget 2019.

Context

12. At the DEV meeting in December 2018, you agreed that there is a gap in the early stage capital markets which inhibits the growth of our start-ups and prevents them achieving their potential within New Zealand and the World [refer DEV-18-MIN-0316]. You agreed that we need to deepen early stage capital markets and specifically that we need to address the VC gap experienced by New Zealand firms. It was noted that we need $300 million of public money to be invested to achieve this purpose.

13. I outlined options on where to source the funds and how to disperse them [refer DEV-18-SUB-0316]. You agreed that Treasury and MBIE should jointly investigate these options and that I should present back a detailed proposal which considered a range of different funding and implementation options.

14. Treasury and MBIE have undertaken a detailed analysis of the strengths and weaknesses of funding and implementation options to address this capital gap. They have developed a broad list of success criteria for the overall program, and a shorter list against which the options have been assessed. Treasury and MBIE also considered the risks brought about by different options and how these can be mitigated. [33]

15. Virtually everyone agrees that we have a problem in New Zealand with Series A and B VC rounds. This was well described in the previous Cabinet paper and was emphasised recently by the Prime Minister's Business Advisory Council, who recommended that we address this issue through our sovereign wealth fund.

16. My preferred option remains to involve the Guardians in the design and management of a new fund. While it is important to ensure the operational independence of the Guardians, the policy response is the responsibility of the Government of the day.

17. On the basis of the analysis, I present my preferred option, and why it is preferable to other funding and implementation options. I also outline how the option can be implemented and its risks mitigated. I believe my proposal is designed to guard the independence of the Guardians in respect to the NZSF.

Success criteria – what are we trying to achieve

18. MBIE and Treasury have jointly developed a framework for considering success and a list of high level performance indicators that could be used to track our progress.

19. Success will be measured at three levels: whether the ultimate socio-economic goals are being achieved, whether specific early stage capital market goals are being achieved, and whether the funds are being soundly managed.

20. The ultimate goal is to assist in the transformation of our economy to be more productive, sustainable and inclusive in a digital age. This requires a healthy start-up ecosystem to grow the knowledge economy. Goals therefore include:

- raising the number of start-ups that progress through successive rounds of funding and ultimately develop into successful companies
- increasing the amount of technology that gets commercialised and the level of innovation introduced into New Zealand
- retaining as many of these start-ups in New Zealand, and the proportion of New Zealand ownership, as makes sense, by avoiding the premature exit caused by weak early stage capital markets
- providing some high-level guidance for VC funds to invest into sectors which are important to New Zealand's future prosperity (for example Agritech), as identified by MBIE in the industry policy (CAB-19-MIN-0033) and the Business Advisory Council.

21. In order to achieve this, we need to have well-functioning early stage capital markets. Specific objectives include:

- increasing the amount of capital invested
- increasing the number and quality of investors
- increasing the participation of institutional investors
- increasing the number and value of early stage deals
- improved international connectivity
- creating a number of VC funds that meet a minimum scale and offer highly specialised capability and expertise.

22. Two key measures of success are the risk-adjusted returns earned by the entire VC industry and an increase in the value of high profile firms that list or exit; as these will ultimately bring more private capital into the market and make it sustainable.

23. I believe the best way to start approaching the various challenges is through addressing the capital gap by committing sovereign investment funds to it. We want to send a strong signal to the market that these funds will be soundly managed. To do this we need to ensure that we convey a solid investment reputation by designing the governance structure in a way that leverages our best institutions and investment capability.

Key success criteria for evaluating the potential options

24. For many of the broader goals, the choice of implementation and funding option will make little difference to the outcomes. In comparing the options, I narrowed the success criteria down to those that I believe are key differentiators. These include:

- reputation/capability of the implementing agency (ie. would it provide sufficient reputation and capability to generate positive market signals?)

- governance (ie. transparency, alignment of policy objectives, and ability for those governing the funds to shape or influence where and how the fund invests)

- specialisation (are individual investment decisions delegated to specialist VC managers)

- market impact (ie. will it service the identified gap in VC markets)

- complexity (ie. legislative changes, institutional setup, timeliness and costs of implementation and regulation).

25. Against these criteria I assessed five implementation options. These were the original three options I discussed in the previous Cabinet paper [refer DEV-18-SUB-0316], and two 'wider thinking' alternatives, creating a holding company, and a multi-mandate development fund.

26. I then assessed these five options against three potential funding sources to measure their 'fit' and highlight any particular risks. These included using 'new money' (making a new appropriation within the current Capital Allowance), using the Crown contributions to the Guardians and pre-assigning Crown company dividends.

27. I have also considered at a higher level a broader set of interventions ranging from various tax incentives, to changes to current legislative structures, and investor migrant rules. Some of those can be addressed in the future but are not addressed in this paper.

My Preferred option

28. My preferred option is for Government to create a second fund under the stewardship of the Guardians. That fund would be set up to invest via NZVIF in a fund of funds model (where no 'new money' is required from the capital budget).

29. The Guardians will have a governance role and assess the performance of the new fund (under the new mandate) which will have its own key performance indicators (KPIs) for market development.

30. The Guardians would be expected to work together with the NZVIF board. This is expected to deliver partnership, capability, and an uplift in reputation as a signal to the market.

31. Funding earmarked for NZSF contribution would be put into the new fund, and then transferred to NZVIF. In turn, NZVIF will co-invest into private VC funds. The detailed design process will determine how funds are disbursed and the qualifying criteria for participating private funds to be invested in.

32. I propose that the Guardians should be deeply involved in setting the mandates for the VC funds created, the terms of the VC fund management and the monitoring regime. [33]

[33]

33. The Minister of Economic Development and Minister of Finance, as shareholding Ministers, will retain direct influence and accountability over the NZVIF board alongside the Guardians' governance responsibilities. The NZVIF Board will continue to provide governance of the NZVIF.

Why this option is preferable

34. My preferred option is the most viable option, in my view, because it:

- is relatively straightforward to implement and does not fundamentally affect the ability of NZVIF to continue leveraging off the strong relationships they have already built

- provides a strong market impact by leveraging off the Guardians market position as a trusted investor, a potential market maker, and a provider of signals to other smaller New Zealand or large overseas funds

- leverages off the resources available to NZSF (making use of its large team of analysts and managers to do due diligence and establish high performing funds)

- encourages other key institutional investors to get involved in this space, and work closely with NZVIF. This could lead to a long-term partnership and increased interest in the VC sector

- provides a desirable tension in the system with oversight of NZVIF operation by the Guardians

- has a relatively low cost and shorter time delay compared to the option of a holding company or multi-mandate fund which would require an entirely new set up, a new team of experts or investment managers, probably a new unit or agency overlooking its operations.

35. My preference on funding options is to adjust the NZSF budget appropriation to split contributions between the two funds under NZSF ownership. I propose that we adjust the existing NZVIF appropriation so that upon realisation of the investments that NZVIF makes in new VC funds, all funds (capital and returns) are returned to the Guardians (including the $60 million currently in NZVIF). This is a fairly budget neutral solution which does not require raising new debt, lifting the Capital Allowance, or reprioritising money away from other initiatives.

Funding considerations

Opportunity cost of reduced NZSF returns

36. The current five-year returns of the Guardians $40 billion fund sits at around 13.6 per cent per annum. The returns in the VC space are far more uncertain, by nature of the businesses being invested in. The past returns to the Crown by NZVIF were low. Using NZSF contributions to fund VC might be seen as risking the potential returns on $240 million.

37. However, we must also consider.

- Past NZVIF returns have been low due to concessionary finance models, and the immature nature of the business. More recent returns of NZVIF, and returns more broadly across the sector, have been growing steadily. With the strong growth in the pipeline of opportunities receiving seed and angel funding, it is reasonable to expect that the returns of NZVIF will continue to rise.

- There is no guarantee that the return of the Guardians will remain as high as it has been.

- The returns to NZSF in this proposal will be bolstered by the $60 million currently in NZVIF, which will pass to the Guardians at the end of the term.

- The structure enables the Guardians to access smaller investments than it would otherwise make. This is because the minimum size of individual investments it makes from the current NZSF is larger than typical early stage VC investments. A $40 billion fund does not in reality make such small investments. .

38. In contrast, other options, like using new money or Crown company dividends, might seem attractive, but they also have drawbacks:

- While the cost of raising new debt is currently relatively low (for example 2.84 per cent for December 2018 bonds), there are alternative uses of the Capital Allowance to consider. It is not realistic to consider this option unless we agree to raise the Capital Allowance, Similarly, using other Crown company dividends which get paid into a common revenue pool is simply another way of using the common pool of public funds, which has many competing uses.

- Alternative projects bidding for funding might have much wider socio-economic returns than the 13.6 per cent offered by NZSF.

39. My preference remains to create the second fund.

40. The proposed amount of funding is based upon the size of the capital gap:

- Officials have estimated the total size of the Series A gap at $1.25 billion over a 5 year period, based on the existing list of seed stage start-ups in New Zealand seeking VC funding rounds, and the amount of existing domestic and international capital and deal flow.

- Officials assume a global average conversion rate where 25 per cent of seed stage start-ups secure Series A funding (as not all firms and ideas warrant funding), and a growth in opportunities of 10 per cent per year (based on reports of growth from incubators, the Technology Investment Network and others). This means the Series A gap for fundable opportunities is closer to $460 million over the period.

- If public funds were to match private funds up to a 1:1 ratio (similar to the Australian Innovation Investment Fund and others), this would mean $230 million of public funds should be able to be deployed without oversupplying the market.

- Ongoing funding of the Seed Co-investment Fund (currently at $8 million a year less any returns) is also required. This is currently funded out of NZVIFs $60 million in cash reserves.

41. The establishment of new funds with different vintages will proceed over a number of years, and money will not be all required up front. I propose that the fund is able to draw down on the money as required.

42. The $300 million would cover both the funding of my proposed solution for the VC market, as well as the Seed Co-Investment Fund.

The risks to the preferred option and how to mitigate them

43. There are number of risks both real and perceived associated with my preferred option.

Solution takes too long

44. Regardless of the solution chosen, the first risk that should be emphasised is that of doing too little or doing it too late. While there are important consequences resulting from the choice of the implementation and funding options that must be duly considered, if we take too long to decide on the most appropriate option, we risk losing the momentum we have built in developing a pipeline of opportunities, and potentially a whole cohort of start-ups.

45. My preferred option involves necessary legislative changes, which might ordinarily take up to 15 months but I believe that this can be expedited.

Guardians reluctance to invest via NZVIF, and mixed policy objectives

46. A risk to my proposed option is the Guardians reluctance to invest in VC and their past public stance on the matter[1]. Their lack of investment in the past is partly due to the perceived low risk-adjusted returns in the market segment and their view that the ecosystem is still immature, and partly due to the small size of the each investment relative to the size of the NZSF. They have not built VC investment capability. They are also concerned about the potential impact on their ability to meet their mandated obligations with the NZSF, and the wider impact this might have on their investment reputation. In respect of this last point, I note other sovereign funds do invest in VC.

47. The Guardians will face two different investment criteria for the investment goals of the two funds. This risks a dilution of the board member attention on driving the performance of the larger NZSF.

48. There are ways to mitigate these risks:

    - The first way is to amend the New Zealand Superannuation and Retirement Income 2001 Act (NZSRI Act) to enable a second policy mandate for the new fund. This new mandate will be entirely separate, and not affect the delivery of the key goals of the NZSF mandate.

[1] Guardians currently invest only a small amount in the domestic VC market (mostly at the expansion stage or Private Equity firms).

- If we also separate out where the money comes from (and is returned to) and make the new fund independent from NZSF, then the returns of the new fund will have no bearing on NZSF obligations beyond the time and effort of the Guardians. Money could be returned to the Crown, and not to the NZSF.

- This, however, poses the question of how much management time we want from the Guardians. I believe we can achieve this by utilising the governance skills of the Guardians but leave the management to NZVIF (subject to the right to remove NZVIF as manager should the need arise for non-performance), utilising specialist VC fund managers.

- An alternative option would be to provide entirely 'new money', with has no connection with the NZSF contributions. However, 'new money' would require Cabinet agreement to increase debt due to an oversubscribed Capital Allowance, and there may be both delays and trade-offs with other key Government initiatives not receiving funding.

[25]

An alternative option

51. An alternative implementation option would be to use the $60 million available from NZVIF as an interim step for a new fund, and signal work will commence as a matter of priority on identifying how to grow the fund, including working with NZSF. NZSF have indicated their willingness to contribute to the design work.

52. NZVIF, with the support of NZSF, would restart work on its fund of funds option, and look for new and potential private VC fund managers to raise a fund, while the policy work is being carried out. The Guardians could be requested to partner with them.

53. This would also enable more time to develop the separate fund concept and identify whether altering NZSF contributions is the best funding source. The work could also include an assessment of the impact on the future sustainability of NZSF and its ability to meet their commitments, where a portion of their earmarked contributions have been used to funding VC.

54. Funding of the Seed Co-Investment Fund (currently $8 million a year less any returns) will need to be considered as this is currently funded out of the $60 million in NZVIF accounts.

55. This option has drawbacks, as it:

- sends a relatively weak signal to the market of the Government's commitment to solving the VC gap, and creates uncertainty as to the scale and timing of any planned intervention
- does not commit the NZSF, as New Zealand's most respected institutional investor, to the market. This further reduces the signal to the market.
- makes it less likely that top quality VC fund managers will be attracted to manage the funds created, which would be sub-scale
- risks simply continuing the status quo and fails to appreciate the urgency of the capital gap. This raises the risk that promising start-ups are unable to raise sufficient capital and miss their brief window of opportunity, as they are unable to grow aggressively and compete in a highly competitive and rapidly evolving global marketplace
- risks the incentive for investment managers to consider the New Zealand market, or look to raise private VC funds at scale, as there is less public funds to match with private capital.

56. My preference remains to create the second fund under the Guardians.

How the preferred option will be implemented

57. To progress my preferred option, while also mitigating some of the risks identified earlier, I propose we perform the following in the next three to six months.

Legislate for the new NZSF fund

58. A change to the NZSRI Act is required to establish a new fund and to extend the role of the Guardians to the second fund.

59. This would leave the remainder of the NZSRI Act intact.

60. The change of legislation could consider whether the scope of new mandates should be limited. During the drafting of this legislation we will need to consider the role of the NZVIF Board, and the shareholding Ministers and overall governance of the Funds.

61. A Bill of this type would ordinarily take six months to introduce, and a further nine months to be enacted. However, Ministers may choose to expedite this process. If this is not realistically able to be introduced at Budget time, the appropriation and announcement could be made with the legislation to follow.

The design of the new mandate and development KPIs

62. A new mandate to be designed to invest in early stage capital markets.

63. The detailed design of the programme will stipulate the details of the new mandate, what KPIs it will have, and how those will be assessed.

Ensure the Guardians and NZVIF boards work together effectively

64. The Minister of Finance and I will engage with the Guardians and NZVIF boards to work through the accountability between boards and governance structure[2].

Develop a communication plan with NZVIF

65. I will work with NZVIF to develop a communication programme to ensure NZVIF's staff understand the new value proposition and objectives of NZVIF, while also ensuring the correct signal is sent to the market.

Engagement on the detailed design

66. I will also be engaging with the Guardians and NZVIF to develop a detailed design of the new funds NZVIF will co-invest in, including the sectors they should focus on, the number and size of the funds, any condition on emission requirements or local representation, and the qualifying criteria the Guardians would have for the funds receiving investments.

Commit to a set of milestones, the term of the fund, and when the review process should take place.

67. I propose that the programme be reviewed after 5 years and again after the full term, which I propose to be 15 years.

68. All funds invested via NZVIF will then be returned to the Guardians.

Next Steps

69. If Cabinet agrees with the preferred option, the Minister of Finance and I will:

- consult with key stakeholders on the detailed design of the funds and qualifying criteria
- begin to effect the legislative changes: amending the NZSRI Act, the role of the Guardians and creating the mandate for the new fund
- effect other changes to the governance structure of both NZSF and NZVIF to support this.

70. The Minister of Finance and I will work with NZVIF, the Guardians and other relevant stakeholders to develop the detailed design.

Consultation

71. The Treasury supports the alternative option presented in this paper. This would allow immediate action whilst providing time for further engagement with the Guardians of

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[2] The letter of expectations to the Guardians could be used to set out an expectation of effective partnership with NZVIF to develop New Zealand's capital markets to accommodate institutional investment.

New Zealand Superannuation and NZVIF to inform a solution, consistent with the preferred option, and help to manage potential risks with implementation.

72. Using $60 million from NZVIF’s capital reserves for Budget 2019, and announcing the intention to develop the Venture Capital market to the full amount presented in this Cabinet paper preserves optionality for the source of future funding. Depending on the roles played by the Guardians and NZVIF, this could still utilise superannuation contributions or a future capital allowance.

73. The Department of the Prime Minister and Cabinet has been informed.

74. I have had initial consultations with NZVIF and NZSF.

75. Once agreed by Cabinet, the Minister of Finance and I, and officials from Treasury and MBIE, will begin consulting with stakeholders in the VC market on the detailed design. The detailed design will be finalised in May 2019.

Financial Implications

76. If my preferred option is agreed to by Cabinet, then the main financial implication is transferring $240 million earmarked for the Guardians into this new fund, which will then be transferred to NZVIF’s fund of funds together with the $60 million of NZVIF’s available assets, to make up $300 million total. There is no new money required in this proposal; this is a budget neutral solution. This $240 million is 0.6 per cent of the $40 billion in NZSF and 3 per cent of the $7.7 billion addition contribution earmarked between 2018 and 2022.

Legislative Implications

77. Implementation of the preferred option would require changes to the NZSRI Act, to enable the Guardians to administer additional funds. There is a unique provision in the NZSRI Act (section 73) requiring the Minister of Finance to notify the House of the consultation process used to formulate the amendment.

78. The expectation set in legislation is that co-signers to Part 2 of the Act (Labour and National) and the Guardians Board would be consulted for any proposed change. If Cabinet did not want to this to occur before Budget night, legislation would not be introduced until after that date.

79. These legislative amendments would not change the Guardians’ existing mandate for NZSF.

Publicity and Proactive Release

80. This could be one of the flagship announcements of Budget 2019.

81. The Budget announcement could be used to underline the Government’s support for the development of early stage capital markets while maintaining optionality on the specific roles of the Guardians and NZVIF in supporting this objective

82. This proposal is budget and market sensitive. Any engagement or publicity will be coordinated through my office.

83. I do not intend to make an announcement on these issues, or proactively release the Cabinet paper under the Official Information Act 1982, in advance of Budget 2019. This material will be released following Budget 2019.

Recommendations

The Minister for Economic Development recommends that the Committee:

1. **Note** that the Cabinet Economic Development Committee has agreed that there is a capital gap experienced by New Zealand firms and we need to address this issue.

2. **Note** that the Treasury and MBIE have undertaken a detailed analysis of the strengths and weaknesses of funding and implementation options to address this capital gap.

3. **Note** the preferred and alternative funding and implementation options, and their trade-offs relative to my preferred option.

4. **Agree** to use $240 million (being 3 per cent) of the $7.7 billion earmarked for the New Zealand Superannuation Fund between 2018 and 2022 (with the $240 million being 0.6 per cent of the total $40 billion funds under management), together with $60 million from New Zealand Venture Investment Fund Limited's available assets, to make $300 million available for new Government investment into venture capital funds.

5. **Agree** to amend the New Zealand Superannuation and Retirement Income Act 2001 to enable a 'New Fund' (separate to the New Zealand Superannuation Fund) to be set up and allow the Guardians of New Zealand Superannuation to administer this new fund.

6. **Agree** that $240 million is transferred to the 'New Fund' to be administered by the Guardians, and that it invests in venture capital via New Zealand Venture Investment Fund Limited's fund of funds.

7. **Note** ongoing funding of the Seed Co-investment Fund (currently at $8 million a year less any returns) is also required.

8. **Note** that creation of a new fund administered by the Guardians of New Zealand Superannuation does not require changes to the original New Zealand Superannuation Fund mandate.

9. **Agree** that a review of the programme is conducted at five years and at the end of the term (fifteen years) to assess the performance and make recommendations for any changes to the structure and design of the programme.

10. **Agree** that at the end of the term (fifteen years) all funds (including both the principal and returns) are returned from New Zealand Venture Investment Fund Limited back to the Guardians of New Zealand Superannuation.

11. **Note** that the preferred option does not require any new money to be found in the Budget 2019.

12. **Note** that the details of the specific role for the Guardians of New Zealand Superannuation and the New Zealand Venture Investment Fund Limited board will require clarification but is expected to deliver partnership, capability and an uplift in reputation as a signal to the market.

13. **Note** the risks associated with the preferred option and proposed mitigation of those risks.

14. **Note** that the detailed design of the funds, their mandates, governance structure and qualifying criteria will be finalised in May 2019.

15. **Agree** that the Minister for Economic Development and Minister of Finance lead the detailed design process and implement the new fund.

16. **Agree** that the Minister for Economic Development and Minister of Finance engage with key stakeholders, including New Zealand Venture Investment Fund Limited and the Guardians of New Zealand Superannuation on different design options.

17. **Note** that these proposals are budget and market sensitive and any engagement or publicity relating to it will be coordinated through the Minister for Economic Development.

18. **Note** an alternative option is to use $60 million available from New Zealand Venture Investment Fund Limited as an interim step for a new fund, while signalling work will commence as a matter of priority on identifying how to grow the fund, including working with New Zealand Superannuation, but such an approach would lack scale.

19. **Invite** the Minister of Finance to issue drafting instructions to the Parliamentary Counsel Office to give effect to the recommendations.

20. **Authorise** the Minister of Finance and the Minister for Economic Development to make decisions on any minor or technical matters that may arise during the drafting process.

Authorised for lodgement

Hon David Parker

Minister for Economic Development