7. REGIONAL INVESTMENT OPPORTUNITY IN VENTURE CAPITAL FUNDS

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The purpose of this report is to present to the Council an opportunity to make a long term investment in a venture capital fund which has the potential to develop the local economy and attract a significant contribution from Government.

EXECUTIVE SUMMARY

- The Council identified when it established the Capital Endowment Fund that it wished to target up to 10% of the investments from the fund into South Island based companies.
- If the Council still wishes to pursue investment opportunities in local high-growth potential companies, this could be effected by a $5 million investment, spread over several years, in the Government's Venture Investment Fund ('VIF').
- The Government sponsored Venture Capital Funds attract a 1:2 Government contribution and hence provide additional leverage for making such locally based investment.
- There are two such Venture Capital Funds currently open for investment which would establish a Christchurch based presence if sufficient local investment is received into the fund.
- The Council's Investment Policy does not specifically provide for investment in such funds but allows Council to specifically resolve on such an investment if it wishes.
- The core Capital Endowment Fund should remain invested in portfolio based investments which will produce an ongoing investment income.
- The Council could divert other special dividends into a separate Endowment Fund in order to invest in a Venture Capital Fund.
- The reason for this particular aspect of the investment strategy being raised now is that there are urgent timing issues associated with closure of the existing VIF funds at the end of September.

BACKGROUND

In 2001 the Council established a Capital Endowment Fund (CEF) from some of the funds repatriated from Orion's sale of its North Island gas networks. The Council established the fund with a series of rules which effectively ring-fenced the capital and provided for the fund to be invested and the income split in a 70:30 ratio between economic development and community and civic projects.

At the time the fund was established the Council resolved that:

"A target of up to 10% of the funds (be) invested in South Island owned or based companies consistent with prudent investment practice, the form and procedure for the investment being the subject of a report from the Director of Finance".

That resolution is the key driver for the proposal in this report. Without this resolution, it is likely that officers would have recommended a conventionally-based portfolio approach for the CEF, involving a conservative mix of diversified equities and fixed interest investments and with no specific local focus.

Capital Endowment Fund Background

In establishing the CEF, advice was taken from Frank Russell Company on how these funds should be invested and it was concluded that, as the desire of the Council was to produce an income stream for regular distribution, that an investment policy was necessary which used a portfolio based approach with a mix of equity and fixed interest investments in accordance with prudent investment policies. Seminars have been held with the Council on this issue and it is a requirement of the Council that the Director of Finance report back to the Council before a final decision was made as to how the investments were allocated. This report has not yet been made because I have been concerned about the uncertainty of the investment environment over the last 12 months, especially in respect of equity investments.

I expect to be reporting back to the Strategy and Finance Committee on the general issue of CEF investment strategy in the next two months. In the meantime the funds are currently invested in bank deposits managed as part of the Council's normal treasury function. It is likely that the recommendation will be conservatively based on an 85:15 split of fixed interest/cash to equities but this is to be the subject of a later report.

The Council also resolved in March 2001 that at least 50% of future unbudgeted special dividends received by the Council be paid into the Capital Endowment Fund. An amount of $1.7 million was credited to CEF in July 2003 in accordance with this resolution.

VENTURE CAPITAL FUND OPPORTUNITY

Two years ago, the Government established a new company, NZ Venture Investment Fund Ltd (NZVIF), whose express purpose is to manage the Government's $100 million venture capital investment programme.

In early September, in response to encouragement from CDC, Council staff were approached by the General Manager of NZVIF to ascertain the interest of the Council in investing in one of the Venture Investment Funds (VIF) funds sponsored by the company.

NZVIF's objectives are to:

- Accelerate growth of the New Zealand Venture Capital (VC) industry;
- Grow the VC skills base in New Zealand;
- Support New Zealand high tech, high growth companies; and
- Support commercialisation of kiwi technology offshore.

VIF's structure is to invest the $100 million in a 1:2 ratio with private investors through a series of professionally-managed VC funds. Total investment funds will therefore amount to $300 million. Currently there are four such funds in existence, with a fifth shortly to be launched.

The four fund managers were selected by NZVIF through an exhaustive process, using a globally-based VC consultancy, Wilshire, to perform due diligence on the short-listed applicants.

VIF has put in place good governance procedures, with monitoring bodies and VC contracts established in line with industry best practice.

NZVIF is interested in ensuring that at least one of the funds has a strong presence in the South Island and the way of ensuring this is by sourcing significant local funding .

A paper prepared by Franceska Banga, General Manager of NZVIF Ltd is attached which sets out a good summary of the purpose of VIF and the way that it operates.

A potential way of meeting the Council's expressed desire to have part of its investments in South Island companies in a structured and professional manner is to participate in the Government's VIF fund.

WHY CONSIDER A VIF FUND INVESTMENT

This report is prepared on the assumption that the Council intended the local investment element of the CEF to be targeted to companies with high-growth potential in order to maximise the economic benefit to the region. This report will use the term venture capital ('VC') to describe the investment in such entities.

The Council's requirement for an element of local investment however, raises a tension between, on the one hand, the need to preserve and enhance the capital and income of the CEF for the long term and, on the other, to provide a stimulus to the local economy through targeted investment in potentially high-growth companies. These are two entirely different objectives, and need to be recognised as such.

Given the desire for local investment, the Council must decide on the most appropriate way of achieving this.

Most observers would probably agree that it is not the place for the Council to attempt to "pick winners" – we have neither the resources nor the expertise to undertake this role effectively. It was for this reason that the Canterbury Economic Development Fund was established to ensure that the distribution of interest from CEF was handled in an independent way.

A more structured method of investment is therefore required if outright investments of capital are to be made. The Government's VIF fund, described in more detail further on in this report, is one such solution. CDC are actively encouraging enough local investors to support one of the VIF so that one is based in Christchurch.

CHARACTERISTICS OF LOCAL VENTURE CAPITAL ('VC') INVESTMENT

The following characteristics are commonly associated with VC:

1. Most start-up companies do not achieve ultimate commercial success. Some disappear completely, and the investors lose all their money. Others struggle along and may preserve the investors' capital, but little more. Others provide a return on capital, but probably not enough to justify the effort and risk associated with them. A few achieve outstanding success and make "super" investment returns.

2. Start-up companies (whether eventually successful or not) consume or "burn" cash in their formative years and hence do not generate income for their investors for some time.

3. Frequently, start-up companies do not just require capital – they require hands-on expertise and access to overseas networks. Perhaps counter-intuitively, start-ups can in fact be held back by inappropriate investors who have the capital but not the other attributes.

4. The New Zealand VC market is relatively immature. However, overseas experience suggests that properly-constructed VC portfolios can often generate returns over and above 'normal' equity returns, with the returns from the few successful VC investments outweighing the losses or sub-optimal returns from the others.

5. Successful start-up companies can have a significant beneficial impact on the region, attracting export sales, providing local employment and significant multiplier effects. Further comment is provided on this later in the report.

In view of the above, it is clear that, while there are potential regional benefits from the Council allocating a small part of the CEF to make local investments, there are also some significant risk management issues to deal with. There are some issues relating to the Council's investment policy and the appropriate source of funds which are dealt with later in this report.

VIF FUND MANAGERS

The current funds established in New Zealand are:

- Endeavour I-Cap (investment focus – advanced electronics, software, chemical and biotech);
- IGlobe Treasury (biotech, creative industries, IT, environmental);
- TMT Ventures (telecommunications, media, technology); and
- No. 8 Ventures (software, IT).

A fifth fund – a joint venture between Orion and Infratil has been disestablished, following a change in business focus by Orion towards its core network operations. The cessation of the fund has left the South Island VC market under-represented, and consequently the first two of the above funds are now actively seeking investors in this region. This is being strongly encouraged by NZVIF.

A new fund is about to be established. However, its investment focus will be solely biotech, and hence is likely to be less attractive to the Council than the more generalist funds noted above.

Of the four existing funds, TMT Ventures has already raised its share of the available capital and No. 8 Ventures is unlikely to have much, if any, focus on the South Island.

Therefore, if the Council were to consider a VIF investment, the two best options would be Endeavour i-Cap and/or iGlobe Treasury. Both are keen to attract South Island investors. Staff have had initial discussions with representatives from both of these funds in order to obtain more information.

Endeavour and I-Globe have many similar characteristics, but also some points of difference. It is not proposed to exhaustively review the merits of each in this report – assuming the Council is prepared to consider an investment in the VIF fund, it is recommended that staff be authorised to evaluate the preferred fund manager, using external advice where necessary.

REGIONAL INVESTMENT

Clearly, from a Council perspective, and ignoring for the moment the potential impact on the CEF, a key issue is the extent to which either of these funds will invest locally and hence help develop the regional economy.

Both fund managers make the point that they cannot guarantee that all new investments will be Canterbury-based. Every VC proposal has to be evaluated on its merits. However, if there is sufficient local investment from bodies such as the Council, both funds have indicated that they would establish a permanent representative in Christchurch. This would ensure that all local possibilities are searched out and fully evaluated – something that may not happen if there is insufficient local investment in the VIF funds.

A key aspect of VC investment is that the fund managers have a very “hands-on” approach to the investments, providing the start-up companies with expert advice and wide range of contacts. They typically would spend time at each start-up company at least once a week. The fund managers therefore add significantly more value than simply providing capital.

From initial discussions with VIF representatives and fund managers, it would seem that $5 million would be the minimum necessary investment by the Council in order to ensure local representation. The Council’s resolution referred to a maximum of 10% of the CEF and if this was the outer benchmark the amount could not exceed $7.5 million. The staff recommendation would be $5 million.

FINANCIAL ASPECTS

Each investor in VIF signs a detailed standard contract with the fund manager. While the details vary, some of the standard key financial arrangements include:

- A contribution by the Government of $1 for every $2 raised privately;
- The fund managers invest on a portfolio basis to spread risk, with a maximum investment of 15% of the fund in any one company;
- Investors must make an up-front initial commitment of capital;
- No more than 30% of the committed capital can be called upon in each of the first three years;
- After five years the investors have the right to buy out the Government’s initial capital (plus interest);
- The fund managers receive a management fee of between 2% to 3% per annum;
- In general terms, profits over and above the initial capital invested are split 20% to the fund manager and 80% to the investors;
- Proceeds from exits (eg. trade sales, IPOs) are returned to investors – they cannot be re-invested;
- All funds are closed after 10 years and the capital distributed.

The following table summarises private equity (PE) and venture capital (VC) performance for the 10 years to December 2001 in the US, UK, Australia and Europe (the latter two have not distinguished between private equity and venture capital for the purposes of these statistics).

For 10 years to Dec 2001		
US	PE 20.2% pa	VC 28.4% pa
UK	PE 17.4% pa	VC 13.4% pa
Australia	PE 12.9% pa	
Europe	PE 15.5% pa	

GOVERNANCE ASPECTS

The fund managers provide regular reports to the investors, describing activities undertaken as well as financial detail. Each fund manager is also independently audited.

Reporting requirements are summarised in the table below:

Annual Report	Six-Month Report
• Audited Financial Statements of the Fund. • Portfolio Summary Report, including assessment of the status and value of each investment, and investment activity over the previous quarter. • Fund Costs Report – report of the costs borne by the fund for the last six months and in aggregate over the full year. • Training Plan – report outlining progress in respect of training personnel and a copy of the training plan for the following year. • Economic Data –data on Investee Companies including: Sales (domestic and export), Number of employees (local and overseas), Taxes paid.	• Unaudited Financial Statements. • Portfolio Summary Report, including assessment of the status and value of each investment, and investment activity over the previous quarter. • Fund Costs Report – report of the costs borne by the fund for the last six months.
Calendar Quarter Report	**Periodic Reports**
• Portfolio Summary Report, including assessment of the status and value of each investment, and investment activity over the previous quarter.	1. Investment Details 2. Details of each Investee Company at time of investment 3. Legal Proceedings 4. Public Announcements

An advisory committee oversees each fund, and monitors the funds manager's compliance with the various stipulations in the contract (eg. investment criteria, approval of any changes in key personnel, conflicts of interest, ineligible target companies, valuation guidelines etc).

Membership of the advisory committee comprises the General Manager of VIF and representatives of the key investors.

In addition, there is broad oversight of all the funds by NZVIF, a Crown-owned company with experienced directors.

TIMING ISSUES

Timing is a critical issue. The funds are due to be closed to new investors by 30 September (in the interests of the existing investors, it is difficult to extend deadlines). However, the NZVIF General Manager is seeking approval from her Board to extend the deadline to 31 October, providing they receive reasonably firm expressions of intent from potential new investors by 30 September.

We understand that there are some other potential South Island investors who are in a similar situation.

The purpose of this report is therefore to seek from the Council approval in principle, prior to 30 September, to a limited entry into the VIF fund, through Endeavour and/or i-Global, subject to completion of due diligence procedures prior to approval by the Council at its 23 October meeting.

The maximum recommended commitment is $5 million, which, if invested through the CEF, would represent just over 6% of the current balance of the CEF. This amount will be leveraged by a contribution from the Government of $2.5 million and additional investment from some South Island investors who may be waiting for the Council to take a lead on this issue.

THE COUNCIL'S INVESTMENT POLICY

The Council's investment policy is set out on pages 197 to 207 of the 2004 Financial Plan. The policy makes special provision for the Capital Endowment Fund. The policy provides flexibility for investment in professionally managed portfolios of investments over a wide range of investment categories but does not specify Venture Capital funds. There is, however, provision in the policy for the Council to resolve to make other investments if it is minded to do so and therefore some investment of funds in Venture Capital can be accommodated within the policy by resolution of the Council.

It is appropriate to point out to the Council that venture capital funds are at the riskier end of the investment spectrum and as such returns are not assured. However, if the Council wishes to invest locally this method of investing in new ventures is a much sounder method of achieving this than Council itself trying to pick winners as the funds are managed by experienced venture capitalists and the fund they manage is spread around a range of businesses.

SOURCES OF FUNDING

Core Capital Endowment Fund

Discussions have been held with the Council's professional advisers for the CEF, Frank Russell Company, regarding this proposal. They have pointed out that the objectives for the CEF were to:

- Maintain the real value of the capital of the fund with regard to inflation
- Maximise the value of the fund and therefore the amount that can be distributed from the fund over the long term, subject to prudent portfolio risk
- Maintain a degree of consistency in the amounts that can be withdrawn on an annual basis.

There is also a requirement in the Investment policy for an appropriate level of portfolio risk to be determined and accepted by the Council in consultation with professional advisors. Frank Russell consider that as returns on venture capital are unproven and in any case are in the form of capital gain at the end of the investment period (10 years) that venture capital does not meet the specific needs of the CEF.

In view of these issues it has therefore been concluded that the core capital of the CEF ($75 million) should be left intact and invested as originally intended, However, an alternative associated source would be possible as set out below.

Special Dividends

As noted earlier in this report the Council resolved in 2001 that at least 50% of future unbudgeted special dividends should be allocated to the Capital Endowment Fund. In July this year CCHL paid a special dividend to the Council and $1.7 million was added to CEF in accordance with this resolution. This is not part of the core CEF and could be partitioned off and invested under separate criteria approved by the Council in accordance with the Investment Policy.

VIF rules provide that funding will be drawn-down over a number of years, rather than immediately, with no more than 30% of the investor's commitment in one year. If the source of funding for a VIF investment were to be a partitioned part of CEF funded by special dividends then the initial funding of $1.7 million received a few months ago would be sufficient for the current year. CCHL expects to be able to provide additional special dividends over future years and it is reasonable to expect that the remainder of the investment would be to hand in time.

This report is therefore recommending that if the Council wishes to invest $5 million in a VIF fund that it do so as an investment of a separately partitioned part of the CEF sourced from special dividends received subsequent to the initial fund establishment.

Selecting a Fund

If the Council decides that it wishes to proceed to invest in a VIF fund then it will be necessary to evaluate which fund to use or how much to allocate to each. This will require an evaluation of the merits of the two funds which are currently open. An indication of the Council's intentions must be given to NZVIF by 30 September to justify them agreeing to extend the closing date for the two funds to the end of October.

The next Council meeting following this Committee will be on 23 October. It would be appropriate for a sub-committee to be established in conjunction with representation from the CDC to meet with each fund and form a view to recommend to the Council as to which fund should be selected for investment.

CONCLUSION

If the Council wishes to invest locally, the VIF fund would seem to offer a structured and effective method of achieving this objective while at the same time achieving a degree of security through spreading risk over a portfolio of investments. The VIF fund provides the Council with a "ready made" VC vehicle for investment, with industry best practice contracts in place and industry standard reporting and governance arrangements already established.

While recognising that a fund manager cannot guarantee to make solely local investments, it will at least ensure that local start-ups will be fully evaluated by VC experts and that those who meet the criteria will receive significant investment and practical assistance. The leverage of the 1:2 Government funding is also an attractive factor.

Rather than making the investments in the VIF from the CEF, an alternative and more transparent solution would be to source the funding instead from special dividends from the Council's trading operations. This would have the advantage of making a clear distinction between the economic development objectives of local capital investment on the one hand, and the need to preserve the capital and income-generating ability of the CEF.

Currently the Council has a policy that at least 50% of all future special dividends are added to the CEF. If the Council decides to make an investment of $5 million in a VIF fund then it should earmark the $1.7 million received in July 2003 together with the next $3.3 million of such special dividends and partition these funds into a separate part of the capital endowment fund for investment into a selected VIF investment.

Staff Recommendation: That, if the Committee decides it wishes to recommend to the Council that it invest in a Venture Capital Fund in order to achieve the Council's goal of local investment, it resolve as follows:

1. That NZ Venture Investment Fund Limited be advised that the Strategy and Finance Committee will be recommending to the Council, at its meeting on 23 October, that an investment of $5 million be made in one of the two VIF funds currently open for subscription.

2. That a subcommittee comprising the Chair and Deputy Chair of the committee and the Chairperson of CDC and appropriate staff evaluate the two funds available and make a recommendation to the Council on 23 October where and how the funds should be placed.

3. That it be recommended to the Council:

   (a) That an investment of $5 million be made into venture capital funds established under the auspices of the New Zealand Venture Investment Fund.

   (b) That Capital Endowment Fund 2 be established and $1.7 million be transferred to this fund from the special dividend received by Council in July 2003.

   (c) That future special dividends of not less than $3.3 million be allocated to Capital Endowment Fund 2 as a first priority.

   (d) That in terms of clauses 3.4.2 and 4 of the Council's Investment Policy the Council approve of the investment in Venture Capital Funds from Capital Endowment Fund 2.

Chair's Recommendation: That the above recommendation be adopted.