

The New Zealand Private Equity Market

An Overview for Institutional Investors

January 2017

Report prepared for the New Zealand Private Equity and Venture Capital Association Inc.



Executive Summary

This report provides an overview of the New Zealand private equity market, with specific focus on the institutional funds management industry. It examines the key features of the market relevant to institutional investors – the size of the market, investment activity, the fund manager landscape and historical returns.

New Zealand presents an attractive private equity investment opportunity for institutional investors, supported by the following features:

1. *Demand/Supply Imbalance Creates Conditions for Attractive Investments* – The demand for risk capital and capital to finance growth from New Zealand companies exceeds supply and this imbalance is likely to persist. This creates an opportunity for private equity and venture capital fund managers to generate attractive returns.
2. *Cohort of Experienced Fund Managers* – The New Zealand private equity and venture capital market has a cohort of experienced fund managers that have managed multiple institutional funds and invested across economic cycles. Fund structures are amenable to local and international investors, and taxation and legal conditions conducive to institutional investment.
3. *Private Equity Returns are Compelling* – New Zealand private equity returns are competitive with private equity returns in other developed private equity markets. A particular attraction of the New Zealand private equity market is its focus on small and mid-sized business operating in industries where New Zealand has international competitive advantages.

About New Zealand

New Zealand is a mixed market economy comprising primary industries (agriculture, forestry and fishing), manufacturing and services. Political and legal institutions are well established, open and transparent. The economy is dominated by small and mid-sized private companies and internationally-focused, with international trade comprising an important part of gross domestic product. While capital markets are relatively small, there is a robust private capital market. New Zealand is ranked well in terms of pre-conditions necessary for private equity investment.

Natural Endowments, Demographics and Political System

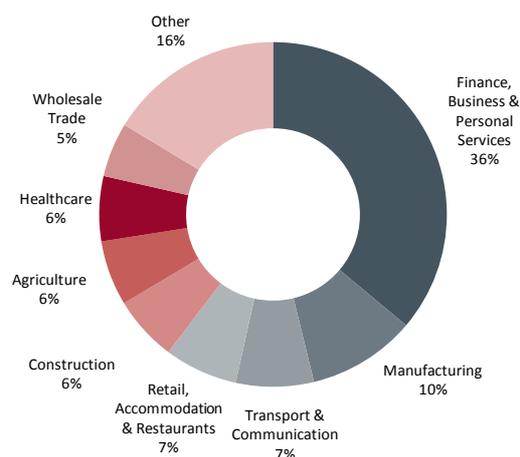
New Zealand is located on the Pacific Rim with a temperate climate. Comparable in land mass to the United Kingdom (or the Philippines), the country has 4.7 million people. The workforce is well educated, with over 75% of the population (aged 25-64) having secondary or tertiary education qualifications, above the OECD average.

The political system is a parliamentary democracy and constitutional monarchy, based on a proportional representation electoral system. Legal institutions are English common law, providing a well-defined, open and transparent business environment. In addition, the taxation system is seen as business friendly, with double tax treaties with over 30 countries.

Small Open Economy

New Zealand is a small open economy with strong trade relationships across the Asian region. Gross domestic product in 2016 was estimated to be US\$ 248 billion (current dollars), diversified across the services sector, manufacturing (in particular, light manufacturing), transport and communication, construction, the primary sector (agriculture, forestry and fishing) and healthcare. Economic activity is concentrated in Auckland (approximately 35% of gross domestic product), Wellington and Canterbury.

New Zealand Gross Domestic Product by Sector (by value, constant prices)



Source: Statistics New Zealand, 2016 data

New Zealand has international comparative advantages based on its primary production sector. This has led to globally competitive companies in food and beverage, biotechnology (agriculture, food, environmental) and cleantech, as well as specialised manufacturing (marine, food processing, agricultural equipment). Indeed, New Zealand's top three exports are dairy products (milk powder, butter, cheese), tourism, and meat. More recently New Zealand's information technology and creative industries have attracted investment attention, especially in screen production and digital animation.

International trade is an important component of economic activity. New Zealand’s top five trading partners account for approximately 65% of traded goods (exports and imports).

New Zealand International Trade – Top Five Trading Partners 2014 (by value)

Exports	%	Imports	%
Australia	19	Australia	17
China	19	European Union	17
European Union	11	China	14
U.S.A.	10	U.S.A.	11
Japan	5	Singapore	5
Total	64	Total	64

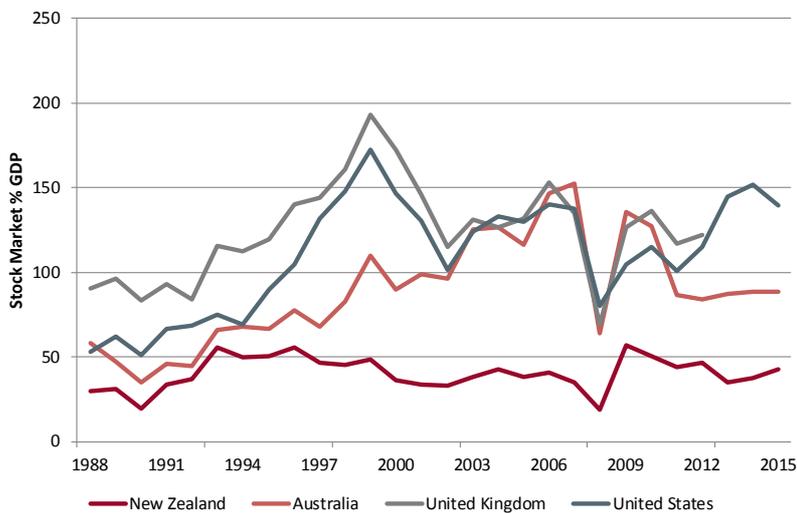
Source: Statistics New Zealand, *New Zealand in Profile 2015*

Three of the top five trading partners are located in the Asian region and New Zealand has free trade agreements with all major trading partners including Australia, China and ASEAN.

Private Companies

The private company sector plays an important role in the economy. Indeed, the business sector is largely comprised of unlisted companies. The New Zealand domestic stock market capitalisation is below 50% of gross domestic product, while other developed economies have experienced significant growth in public equity markets since the 1990s.

Stock Market Capitalisation (% GDP)



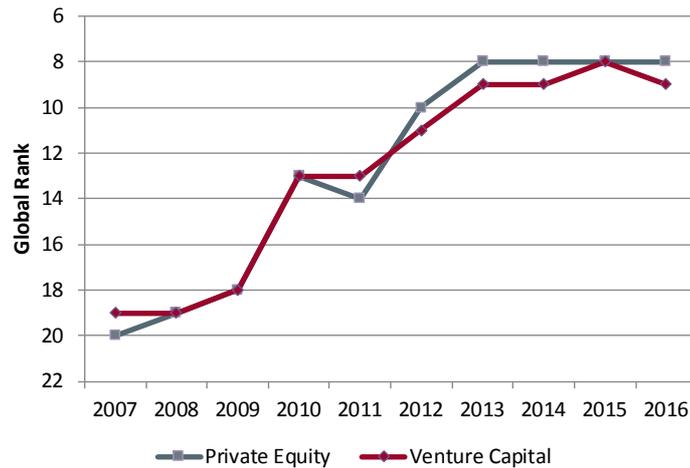
Source: World Bank World Databank, World Development Indicators (U.K. data only available to 2012)

Statistics New Zealand reports that there are over 11,000 small and mid-sized companies in New Zealand with between 20 and 100 employees – a large majority of these companies are private.

Strong Preconditions for Private Equity

The economic, legal and social environment in New Zealand provides strong preconditions for private equity investment. New Zealand is ranked the 8th most attractive market for private equity globally (out of 125 countries), comparable to European markets such as Germany, Switzerland, Denmark and Norway.¹ Furthermore, New Zealand's private equity and venture capital markets attractiveness ranking has strengthened over the last ten years.

New Zealand Private Equity & Venture Capital Market Attractiveness 2007-2016



Source: Groh, Liechtenstein and Lieser (2016). Inverted scale

Once rankings are adjusted for New Zealand's relatively small capital markets, the country is placed in the top 5% globally in key features such as investor protection and governance, taxation, human and social environment (education, human capital).

¹ See Groh, A., Liechtenstein, H., Lieser, K. and Biesinger, M. (2016) *The Venture Capital and Private Equity Country Attractiveness Index 2016*, IESE Business School, University of Navarra.

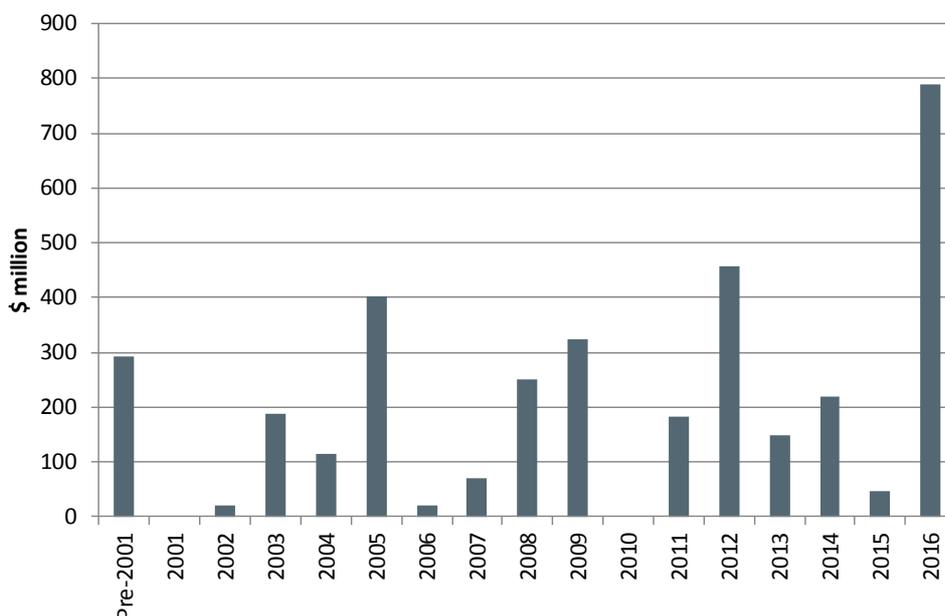
The Private Equity Market

The New Zealand economy provides attractive investment opportunities for private equity. Foremost, as discussed above, the economy is dominated by private companies which raise capital outside established stock markets. Second, small and medium sized enterprises are important players in many sectors of the economy – notably, light manufacturing, agribusiness, consumer retail, services, healthcare, and leisure. Many of these companies were established in the second half of the twentieth century and are now facing succession issues, or are positioned for expansion into adjacent markets in Australia and Asia. The most efficient way (typically) for an institutional investor to invest in these private equity opportunities is through local private equity fund managers. In this section we examine the key features of the New Zealand private equity market relevant to institutional investors – the size of the market (funds raised and number of firms), investment activity, the fund manager landscape, and historical performance.

Market Size

Institutional investment in New Zealand private equity and venture capital fund managers began in earnest in the early 2000s.² To be sure, private equity investment had flourished in New Zealand prior to this decade, but the institutional market was relatively small.³ The early success of private equity transactions, increasing domestic institutional interest in alternative assets and “stimulus” from the government sponsored New Zealand Investment Fund (NZVIF) coincided in the early 2000s to create conditions for unprecedented growth in assets under management.

Private Equity and Venture Capital Funds Raised 1993-2016



Source: NZVCA; LECG; firm websites

Between 2002 and 2016 New Zealand based fund managers raised in excess of \$3.2 billion in over three dozen private equity and venture capital funds. In several years, fund raising exceeded \$300 million per annum through multiple funds raised, providing adequate scale for an institutional investor seeking to deploy capital.

² We adopt the term private equity to denote fund managers specialising in investments in majority (buyout) and minority (expansion or growth) equity positions in established companies. Venture capital fund managers invest in start-up and early stage companies.

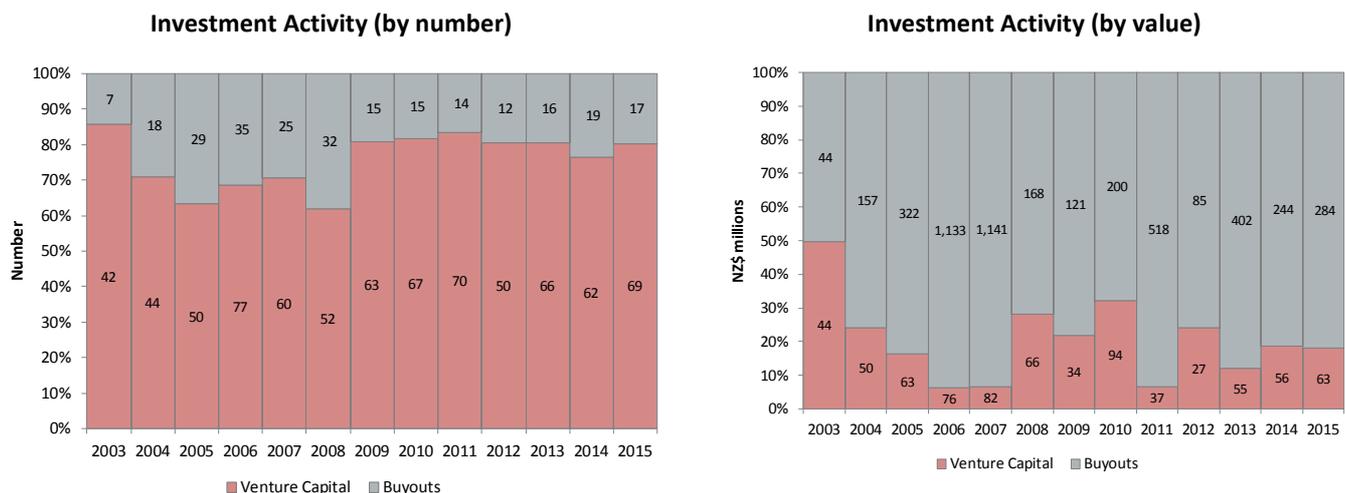
³ The New Zealand institutional private equity market has its genesis in the Greenstone Fund (1993), a government-private sector fund established to invest in private companies. The fund was managed by Pencarrow Private Equity Limited. Direct Capital was established in 1994 and raised its first private equity fund targeting private companies.

2016 was a watershed year with over \$700 million raised by private equity and venture capital firms. The number of funds raised has been relatively evenly distributed between private equity and venture capital firms, although private equity funds have been more successful at raising multiple funds. Indeed, the three most active private equity firms have raised four private equity funds (on average), and have almost 20 years investment experience. Institutional investment in the venture capital market has received strong government-private sector support through the New Zealand Venture Investment Fund program.

Investment Activity

The private equity and venture capital industry has posted robust investment activity since the early 2000s, as a result of increases in the number of private equity fund managers and the “demonstration effect” of successful private equity transactions on investor appetite for excess returns. Private owners have been increasingly willing to engage with private equity as a viable provider of capital.

Private equity and venture capital investment activity in New Zealand is around 80 transactions per year (by median) with equity investment of approximately \$300 million per year (median). There are typically 50-70 venture capital transactions per year and 15-25 private equity transactions. By value, private equity comprises the largest component of investment activity.



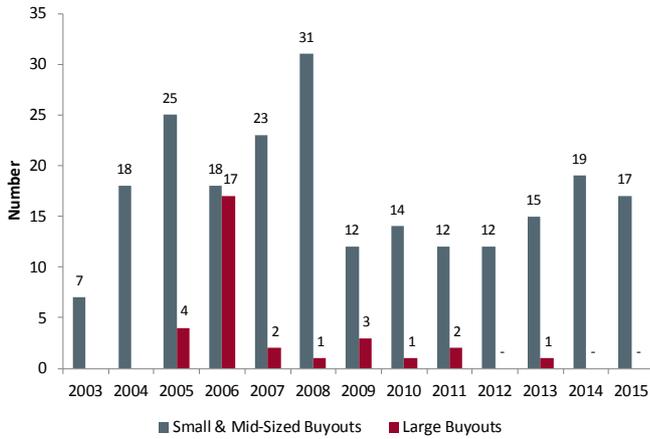
Source: NZVCA

In addition to institutional venture capital investment activity, start-up and early stage companies raise finance from an active angel investor market comprising around \$60 million in 2015.⁴

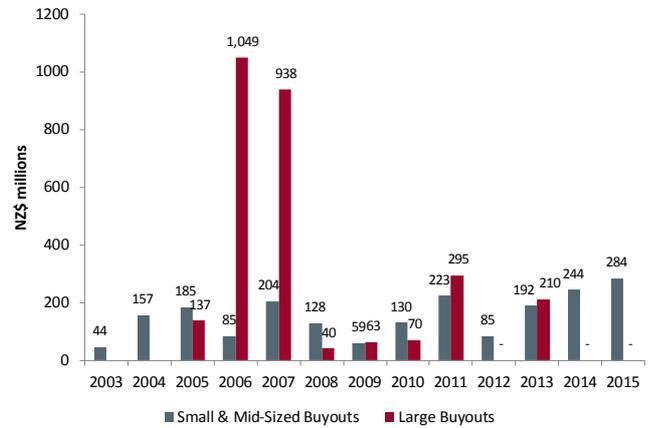
Private equity investment activity is predominantly in small and mid-sized companies with enterprises values less than \$150 million. Analysis of investment activity by enterprise size (by number and value) shows that small and mid-sized transactions are at least 90% of all deals by number and at least 75% by value (excluding the two years 2006 and 2007).

⁴ The New Zealand Angel Association and the New Zealand Venture Investment Fund’s Seed Co-Investment Fund program are important players in this part of the venture capital market. For further details, see *Startup. Young Company Finance Report* (various issues).

Private Equity Investment Activity (by number)



Private Equity Investment Activity (by value)

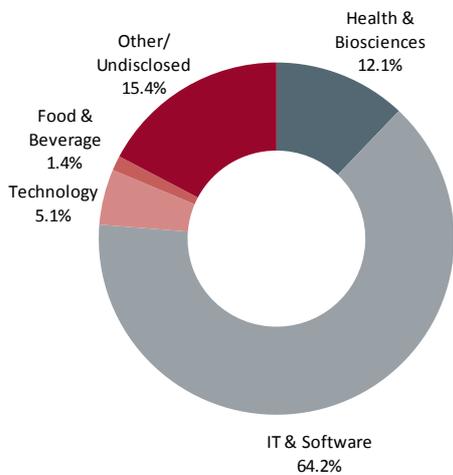


Source: NZVCA

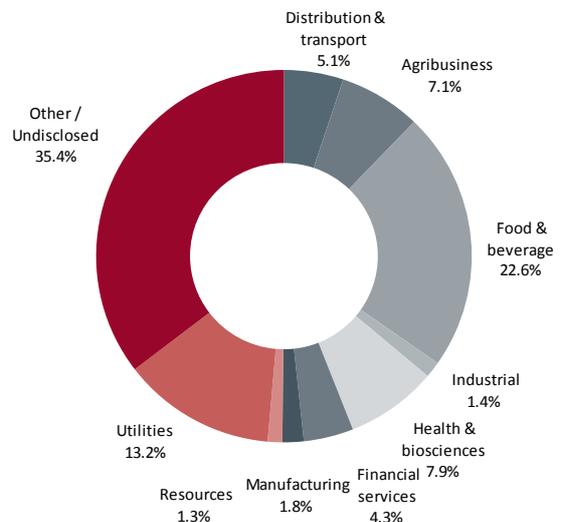
This feature of the market is important for institutional investors. Small and mid-sized companies are the largest part of the New Zealand economy and capital raising for these companies is typically less intermediated than for larger companies. The industry has not been immune to larger buyouts where the use of financial leverage was important in securing the transaction and generating returns. The global boom in buyout activity in 2006 and 2007 found its way to New Zealand in the guise of several high profile transactions – for example, New Zealand Yellow Pages, MediaWorks, and Independent Liquor Group. Investment activity increased markedly between 2005 and 2006 – the participants in these transactions were global buyout firms or larger regional/Australian players (rather than local managers) purchasing large capitalisation businesses.

A sector breakdown of venture capital and private equity investment for the five years 2011-2015 shows that investors gain exposure to core areas of the New Zealand economy including distribution and transportation, agribusiness, food and beverages, healthcare, utilities (including energy) and the industrials and manufacturing sectors. Investment in start-up and early stage companies (through venture capital) is concentrated in the health and biosciences, information technology, services and technology sectors.

Venture Capital Investment by Sector 2011-2015



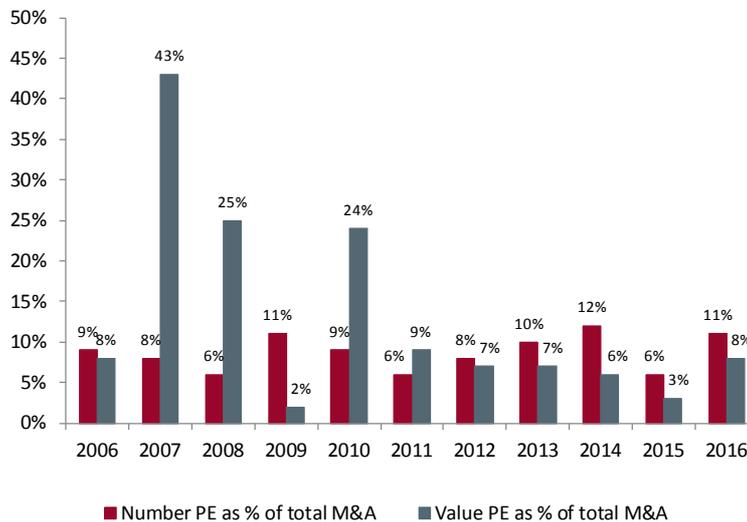
Private Equity Investment by Sector 2011-2015



Source: NZVCA

Private equity has developed over the last 15 years to be an important player in the New Zealand M&A and private placement market.

Private Equity as a Percentage of M&A Activity



Source: AVCAL/S&P Capital IQ Market Observations 2016

Private equity transactions have typically accounted for 5% to 10% of M&A activity by number and value (median 9% by number and 8% by value).

Fund Manager Landscape

The New Zealand private equity and venture capital market is serviced by approximately 15 local fund managers. In addition, Australian and larger regional/global firms are opportunistic investors with a focus on larger market capitalisation businesses.

A fund manager map for the New Zealand market, categorised by the location of the fund manager and their investment focus (as determined by their investment strategy's target enterprise size), is presented below.

New Zealand private equity fund managers are concentrated in the small and mid-cap space consistent with the structure of the economy. In addition, there is a robust start-up and early stage growth sector serviced by venture capital firms. New Zealand based fund managers are the main participants in these sectors of the market, and have demonstrated consistent transaction capabilities.

Some Australian, regional (Pan-Asian) and global private equity fund managers have also canvassed private equity investment opportunities in New Zealand. Our market map lists firms which have completed at least one transaction in New Zealand in the last ten years. Large cap private equity transactions are more likely to be completed by non-New Zealand private equity fund managers – typically from Australia. However, as we noted previously such transactions are relatively uncommon.

Institutional investors need to be aware of nuances in the New Zealand private equity fund manager landscape. The small and mid-cap market represents the overwhelming majority of private equity transactions each year. This market is serviced predominantly by local private equity fund managers. Institutional investors will only achieve meaningful exposure to New Zealand private companies by investing with New Zealand based fund managers.

New Zealand Private Equity and Venture Capital Manager Map

Enterprise Size

Large cap
(EV > \$150 m)

New Zealand-Based Firms

Australia-Based Firms*

Regional/Global Firms*

Small & mid-cap
(EV < \$150 m)

Start-ups/Early stage growth
(EV < \$15 m)

Enterprise Size	New Zealand-Based Firms	Australia-Based Firms*	Regional/Global Firms*
Large cap (EV > \$150 m)	---	Archer Capital CHAMP Ironbridge Capital Quadrant Private Equity Pacific Equity Partners	Affinity Equity Partners Blackstone Unitas Capital
Small & mid-cap (EV < \$150 m)	Direct Capital Knox Investment Partners Maui Capital Oriens Capital Pencarrow Private Equity Pioneer Capital Waterman Capital	Allegro Private Equity Anchorage Capital Catalyst Investment Managers CHAMP Ventures Crescent Capital Equity Partners Mercury Capital Next Capital Wolseley Private Equity	Denham Capital Fortissimo Capital Riverside Asia
Start-ups/Early stage growth (EV < \$15 m)	BioPacific Ventures Global from Day One GRC Sinogreen iGlobe Treasury Movac	Brandon Capital CM Capital GBS Bioventures Square Peg Capital	Domain Associates Khosla Ventures Matrix Capital Point Nine Capital Sequoia Capital Valar Ventures

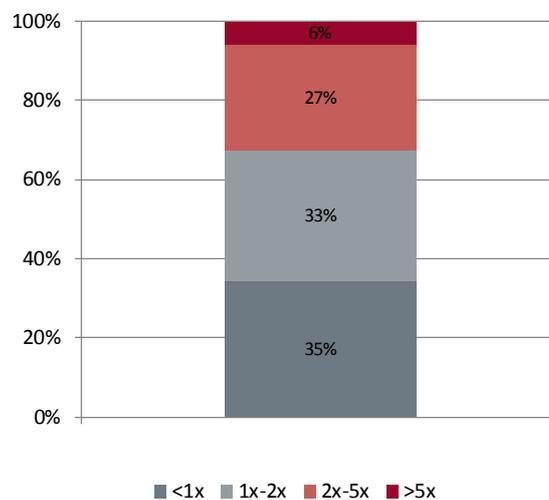
* Fund managers that have completed at least one New Zealand deal in the last 10 years

New Zealand Private Equity Returns

Institutional investors can draw upon several recent studies to assess the performance characteristics of New Zealand private equity. These studies show that realised private equity returns to New Zealand transactions are attractive. A Cambridge Associates study of 131 private equity investments in New Zealand since 2000 found that median (average) returns to New Zealand private equity deals were 22.0% per annum (33.7% per annum), with aggregate return on investment of 2.1 times cost.⁵

The distribution of realised private equity returns (52 investments) in the Cambridge Associates sample shows that two-thirds of transactions have delivered returns above investment cost, with approximately 33% returning greater than 2 times cost.

New Zealand Private Equity Returns – Multiple of Money Invested



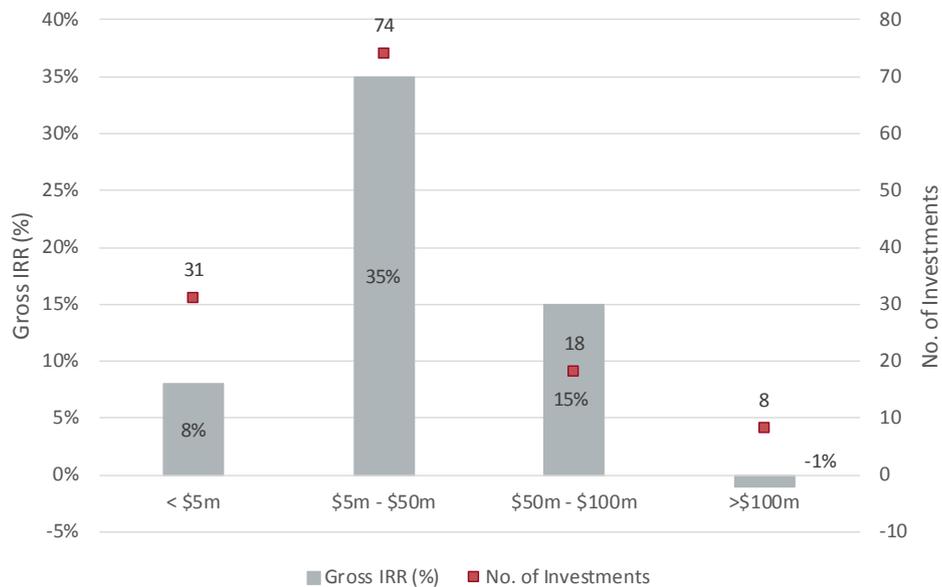
Source: Cambridge Associates (2016)

The percentage of investments which did not deliver a full return of investment cost (35%) is not unusual for private equity, and in line with other developed private equity markets.

⁵ An earlier study by Cumming, Johan, Fleming and Takeuchi (2010) found that the median investment return for New Zealand private equity transactions was 24% per annum, with a median ROI of 2.7 times cost (investments between 1989 and 2009). These returns compared well to other established markets in the Asia-Pacific region. See Cumming, D., Fleming, G., Johan, S. & Takeuchi, M. (2010) "Legal Protection, Corruption and Private Equity Returns in Asia" *Journal of Business Ethics*, vol. 95(2), pp. 173-193.

Cambridge Associates have also analysed New Zealand private equity returns by size of investment. Private equity investments between \$5 million and \$50 million in invested capital have delivered the highest returns, with an aggregate gross IRR of 35% per annum (74 investments)(see graph below).

New Zealand Private Equity Returns by Size (Invested Capital)



Source: Cambridge Associates (2016)

Investments with \$50 million to \$100 million in invested capital (18 investments) delivered an aggregate gross IRR of 15% per annum. The Cambridge Associates study suggests that investors should be cognizant of investment size (and by implication, enterprise size) and private equity fund size when seeking superior returns from New Zealand private equity.

The Investment Opportunity

Private equity provides institutional investors the opportunity to generate attractive risk-adjusted returns by investing in less efficient parts of capital markets.

New Zealand presents an attractive private equity investment opportunity for institutional investors, supported by the following features:

Demand/Supply Imbalance Creates Conditions for Attractive Investments

The demand for risk capital and capital to finance growth from New Zealand companies exceeds supply and this imbalance is likely to persist. This creates an opportunity for private equity and venture capital fund managers to generate attractive returns.

Cohort of Experienced Fund Managers

The New Zealand private equity and venture capital market has a cohort of experienced fund managers that have managed multiple institutional funds and invested across economic cycles. Fund structures are amenable to local and international investors, and taxation and legal conditions conducive to institutional investment.

Private Equity Returns are Compelling

New Zealand private equity returns are competitive with private equity returns in other developed private equity markets. A particular attraction of the New Zealand private equity market is its focus on small and mid-sized business operating in industries where New Zealand has international competitive advantages.

More Information

For more information on the New Zealand venture capital and private equity market:

New Zealand Private Equity and Venture Capital Association

www.nzvca.co.nz

New Zealand Venture Investment Fund Limited

www.nzvif.co.nz

Investment in New Zealand

www.nzte.govt.nz/en/invest/

Continuity Capital Partners Pty Limited

www.continuitycp.com

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