ACCESS TO CAPITAL MARKETS FOR SMALL NEW ZEALAND EXPORTERS: IS THERE A MARKET FAILURE?

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Abstract

This paper considers whether New Zealand's capital markets enable export businesses to grow effectively. We find that there are significant constraints facing smaller New Zealand exporters in raising capital for growth that are specific to the New Zealand environment, and are not faced by international firms. These constraints include thin domestic markets for venture capital and private equity, in the sense of a limited number of market participants, and high costs of accessing international capital markets, including the need to relocate their business to the investor's country of origin or the firm's target market.

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Introduction and Background

A common view held in the New Zealand business community is that our capital markets do not allow viable local businesses to access sufficient capital for growth. This paper examines the issue of access to capital for New Zealand firms looking to grow their business in overseas markets. We test whether the performance of New Zealand's capital markets is constraining business growth, and we suggest policy measures that might help to resolve any problems that are identified.

We begin by setting out a framework for interpreting the results of this research. We examine what would constitute a failure of New Zealand's capital markets. We then describe the research methodology used to test whether New Zealand's capital markets are functioning well to enable viable New Zealand export businesses to grow.

What constitutes a failure of New Zealand's capital markets?

The first challenge in evaluating the performance of New Zealand's capital markets is to define what would constitute a market failure. Clearly, an inability to raise capital is not in itself conclusive evidence of a market failure. Difficulty in raising capital would also result from a well-functioning market if investment proposals were not well conceived, or if businesses had risks that were not adequately reflected in projected returns.

In this report, we define market failure as being present when a New Zealand firm is unable to raise capital, or finds that the difficulties or delays in raising capital constrain growth where a similar venture would proceed unimpeded overseas. This establishes a benchmark for New Zealand's capital markets to operate as well as markets overseas. This benchmark can be linked with a sensible policy objective of providing local businesses with equal opportunities to expand compared to their foreign competitors, to ensure that New Zealand maintains a competitive and vibrant business environment.

When evaluating the performance of New Zealand's capital markets, we also acknowledge that raising capital depends on expectations for returns held by business owners and prospective investors. For example, it is important not to discount the risk that Government programmes aimed at promoting access to finance may in fact distort capital markets by raising business expectations on the terms for providing capital.

How do we assess the ability of New Zealand enterprises to access capital?

In this research we have conducted a series of interviews with New Zealand businesses to obtain first-hand perspectives on the process of raising capital for export growth. A list of the questions asked in the interviews is provided as Attachment 1. These interviews do not provide a basis for quantitative analysis of capital access issues, but instead focus on obtaining unique insights into the most challenging aspects of raising capital, and how the process could be improved to unlock business potential.

Interviewees were selected across a broad range of sectors to test whether firms operating in different sectors of the New Zealand economy face unique challenges in raising capital. Large exporters were excluded, with interviewees all employing less than 50 staff. Our sample includes recent start-ups as well as established local businesses, and deliberately includes both firms attempting to sell products overseas that are

already successfully sold in New Zealand, and ventures involving new products for international markets.

Specific examples from the interviews are used throughout this report to support the conclusions drawn. Where information provided in the interviews may be commercially sensitive, the interviewee is not named to protect commercial confidence.

Different Capital Sources for Growth

It is common to speak generally about capital as if all sources of capital are equal. In fact, different capital sources each have unique characteristics and challenges, which are described in this section.

What different capital sources can be used to grow a business?

Most firms initially rely on their retained earnings to fund organic growth. However, organic growth is usually tightly constrained, forcing firms to look for external sources of capital. Table 1 provides a brief description of the main sources of external capital, the risk appetite of the party providing the capital and a comment on perceived availability of each capital source.

[Table 1 here]

Which sources of capital are the most viable for growing an export business?

We asked New Zealand businesses what their experience has been raising capital from the sources listed in Table 1.

We specifically wanted to find out which capital sources are the most viable for funding expected export business growth, and which sources are not considered viable or attractive for this purpose.

Relatively few export ventures reported an ability to raise debt for growth. Even businesses that have positive cash flows experience difficulties raising debt, with banks requiring ranking security on property (preferably real estate). Many firms had talked to commercial banks, but generally found no willingness to lend to the business without the security of personal guarantees or property mortgages.

Several interviewees noted that venture capital was not a productive avenue for raising capital for their business. The reason is that the venture capital market in New Zealand is perceived as particularly thin and risk averse. Many businesses had heard of the Government initiative to match venture capital funding through the New Zealand Venture Investment Fund, although views on the effectiveness of NZVIF were mixed. Interviewees also noted that because of the fixed costs associated with due diligence, venture capital funds only seem to be interested in larger investments (more than $5 million). For most New Zealand start-up companies this investment is too large, meaning that venture capital funds tend to focus on more advanced (and possibly lower risk) companies.

While angel investment has been used by many of the interviewees, perceptions on the value of angel capital are mixed. Some respondents value the corporate governance disciplines that angel investors introduce, and have appreciated an independent, objective opinion on their business. Other interviewees noted that the angel investor community in New Zealand is not effective in providing this independent voice because New Zealand angel investors are too busy with their own business endeavours. One respondent contrasted this to angel investment communities overseas, where the individuals involved are “full time angels” that contribute both their money and their smarts to maximise the value of their investment. For most businesses, angel investors are only useful in raising initial seed capital, and further growth calls for capital that exceeds the amount likely available from New Zealand angel investors.

A few respondents noted that a public listing seemed less attractive as a way to raise capital or exit from an investment than other channels, such as trade sales and raising private capital. This reflects a perception that the fixed costs of listing (issuing a prospectus, complying with listing rules etc) may not be outweighed by the benefits, particularly in New Zealand where investors are seen as favouring traditional stocks to smaller, high-growth firms.

Few firms had considered capital sources such as subordinated debt or more “exotic” financial instruments like debt factoring. This seems to reflect a lack of interest in fully investigating all capital sources—which is perhaps not surprising, given the other management tasks undertaken in small New Zealand businesses with limited resources.

Capital Raising Process

Accessing capital is clearly only one aspect of growing a successful business. In this section, we consider how the process of raising capital fits in to the overall process of developing a successful business.

How does the process of raising capital play out when developing a business?

Every business is different, with different capital requirements and commercial strategies, and generalisations on a standard capital raising process are fraught with difficulty. Some ventures may only need to raise capital once, with future growth funded entirely from cash generated early in the company’s life. Other firms may have several rounds of capital raising to keep management focused on proving a particular business model and to limit investor risks.

Despite the unique process for raising capital followed by each business, many of the firms interviewed for this research recounted a capital raising process that shares several features. Figure 1 provides an illustrative example of capital raising requirements based on these shared experiences. This process includes three “rounds” of capital raising, with the amount raised growing on each occasion with the cost of the activities to be completed. The most likely capital sources for each round of capital raising are highlighted, although

there is scope to use any capital source at any time, provided that investors can be convinced of the value of the investment.

[Figure 1 here]

What are the main challenges in the *process* of raising capital?

It is important not to be misled by the perceived formulaic and linear nature of the capital raising process shown in Figure 1. In fact, the process of raising capital is far from straightforward and several interviewees listed the ability to raise capital as the major constraint on their business' growth.

The first point to note is that the capital raising process can consume a significant amount of management and board time. Senior staff need to be involved in the process in order to present the company credibly to investors, and to develop the documentation that supports the funding pitch (including business plans, financial forecasts and investor presentations). Perversely, management time spent on capital raising can work against the probability of business success in the event that management effort is required in other areas to prove the business model.

To overcome the imposition on management time, some businesses give responsibility for capital structure to a non-management representative, such a as non-executive director. This requires the current owners to trust the ability of the non-executive to effectively represent their interests, and may not be an option available to very small businesses. Other companies interviewed in this research received assistance from professional advisers in the capital raising process. This experience seems most valuable in presenting materials professionally and clearly, but requires the adviser to learn a great deal about the firm's value proposition and strategy to be most effective.

A further challenge in the capital raising process is that delays are common. Investors will invariably recognise a value in waiting before committing their capital, while management will invariably need the capital as soon as possible. The effect of these non-aligned interests is that companies frequently need to alter their expenditure levels to avoid running out of cash prior to receiving a new injection of capital. This may not always be optimal from a business perspective, for example where a marketing campaign that relies on consistent brand visibility needs to be temporarily suspended.

A third challenge in the capital raising process is to identify investors. Most businesses found that investors were not hard to identify in New Zealand, where the investor community is relatively small and professional networks commonly intersect. However, several businesses have found it difficult to identify the right investor—that is, an investor with sector expertise, a shared passion for the business, a good strategic fit, and closely aligned values.

Major Challenges to Accessing Capital

In addition to questions of process, raising capital also involves a number of substantive challenges. In this section we discuss three challenges that featured prominently in the research interviews—ensuring that the investment pitch is sound, that the right management team is in place, and that the business obtains the right mix of domestic and international capital.

Establishing a Sound Business Model

Most businesses interviewed for this research reported a good understanding of what goes into a good business plan—senior personnel with business expertise and a track record of success, a strong value proposition, and an understanding of the target market.

The challenge is to use the business plan to obtain firm investor commitments to provide capital. A winning business plan needs to address all those reasons an investor might say no, and present a compelling case that the capital will be used to add value over a given time horizon.

In this environment, obtaining firm commitments from investors can take longer and require a more intensive effort from senior management than many businesses anticipate. Previous research identifies that small and medium sized enterprises in New Zealand lack investment ready capability, which is not surprising given the other demands on management time dealing with more day-to-day operational tasks. The businesses in this research that were most successful in raising capital identified that additional resources were needed to convince investors to participate in the company.

One element of a sound business model that may not be well-understood by New Zealand businesses is investment exit. Several firms interviewed for this research had given little thought to how the business might be eventually sold. Exit possibilities should be presented to potential investors at the outset to highlight how the value of the investment (in addition to dividend payments) might be realised, including details on likely exit timeframes and potential buyers.

Putting Effective Governance Arrangements in Place

A second important challenge in raising capital is to put effective governance arrangements in place that ensure good decision-making. Many companies start out with very simple governance arrangements, with the Board of Directors consisting solely of the firm's management team. Independent governance is often introduced as a condition to raising capital from other investors, with new investors getting a seat on the Board.

The presence of non-executive directors can help to inject some independent testing of management strategies, and provides an important monitoring capability for investors. A measure of independent governance also provides reassurance to potential new investors in the company that management is used to

having their ideas challenged, and can work effectively within a corporate decision-making framework. This can be challenging for entrepreneurs that have put significant "sweat equity" into developing the business concept and the strategy for growth.

Investor-appointed Board members can also provide value by broadening the firm's understanding of market opportunities and facilitating beneficial relationships with other related companies. For example, one firm interviewed for this research noted that the independent directors appointed following a capital injection from a major venture capital fund provided additional channels to market and new supplier relationships that would not have otherwise been possible.

The real challenge for New Zealand businesses is finding directors that are able to add value in this way. Most directors in New Zealand have professional backgrounds, and do not have experience with high-risk business ventures. Although these individuals understand financial issues and risk management, their skills may not be well-suited to maximising the value of dynamic, high growth companies. One interviewee noted that in his experience, most New Zealand directors are not able to perceive opportunity costs well, which leads to a counterproductive level of risk aversion.

Choosing between Domestic and Offshore Capital Sources

Several businesses interviewed for this research found that even with a sound business model and effective governance arrangements, they could not successfully raise the capital they needed for growth in New Zealand. Although not always their preferred course of action, these businesses have sought to raise required capital from off-shore investors.

In this section we consider the reasons that New Zealand businesses are looking overseas for investors to support their growth ambitions, and the implications of bringing off-shore investors on board. We find that off-shore investors can add value to New Zealand business that may not be provided by investors based at home, but that a difficult condition attached to this value is that off-shore investors generally want the business relocated to their country of origin or the firm's main target market.

Value created by bringing off-shore investors on-board

The primary value in accessing capital from overseas sources is to ensure that businesses continue to operate despite a failure to raise funds in New Zealand. At least three of the firms interviewed for this research reported that overseas investment into their business was essential due to a failure to raise sufficient funding through New Zealand's capital markets.

This suggests that New Zealand's capital markets are not reaching the benchmark of operating as well as capital markets overseas.

Several businesses reported that they only started to look off-shore for investors once the opportunities in New Zealand had been largely exhausted. However, once their attention turned to the prospect of obtaining off-shore investment, several interviewees reported that the value of broadening their investment base became apparent. In particular, businesses noted that off-shore investment can add value through:

- **Global connectivity**—Overseas equity providers also invest in other related firms, and can exploit these direct relationships for marketing purposes, supply channels and to tap into networks that will help the business succeed
- **Sector expertise—**Particularly in areas that are not well established in New Zealand, such as the technology sector, overseas investors know the major issues facing the company and know the right questions to ask
- **Opportunities for exit—**Off-shore investors have close ties within global investor networks that are much larger than the networks of New Zealand investors. Because all investors are interested in receiving the highest return possible on their investment, off-shore investors will use their networks to scope out the best opportunities for selling the business
- **PR value and credibility**—Many large overseas investors have successfully grown businesses before, and therefore have a level of credibility in the marketplace that is not true of New Zealand investors. There can be an inherent value of having a well-regarded investor supporting the business.

Trade-offs involved with off-shore ownership

Given the benefits that can be unlocked by overseas investors, we might expect more New Zealand businesses to raise capital from off-shore sources. However, a major consideration for many New Zealand businesses is that off-shore investors generally want their target companies to relocate to their country of origin, particularly when the investor is based in the firm's target market.

There are several reasons why off-shore investors insist on relocating the business. The first is so that management and sales teams are close to their target markets. Simply put, many offshore investors perceive no value in having a firm based in New Zealand if their customers are based in the United States or Europe. Investors may also want to be able to exercise a degree of control and monitoring that is not possible at a great distance.

Perhaps the most significant reason for relocating New Zealand businesses in the eyes of off-shore investors is to maximise opportunities for exit. Selling a business is easier, and likely to generate higher returns, if the business is accessible to potential investors. This is not simply a matter of perception. There are substantial fixed costs in conducting buyer due diligence, and investors will be reluctant to expend additional money and effort to investigate a purchase based elsewhere. In

contrast, if the business is located near potential buyers then management can be on hand as required to resolve queries and showcase the firm's competencies and progress.

Policy Proposals to Improve Access to Capital

The difficulties experienced by New Zealand export businesses in raising domestic capital indicate that policy changes may be required to improve the conditions for enabling business growth. Policy proposals should be directed towards addressing specific problems which prevent local businesses from enjoying the same opportunities that overseas firms have to expand, while also allowing businesses to remain in New Zealand. In some cases, the barriers may be insurmountable, and an attempt to intervene in the market to offset such a barrier could work against the objective of ensuring that New Zealand maintains a competitive and vibrant business environment. Hence, any policy interventions need to be cautious and informed by market realities.

In this section we consider three possible policy responses to the market failure identified in this paper. We first consider whether policy can facilitate a deeper capital market in New Zealand that would allow firms to raise needed capital domestically. We then consider ways that policy can respond to the problem of New Zealand firms moving overseas, while retaining the benefits of off-shore investment in our companies. Finally, we discuss other measures that have been proposed to tap into the New Zealand investor community living overseas.

Measures to deepen New Zealand's capital markets

This research has identified a concern for policy makers that New Zealand does not have enough domestic investors with specialised skills and the right risk appetite looking to place in capital in business opportunities. The New Zealand Government has recently considered how domestic capital markets might be improved as part of the Capital Markets Development Task Force.

Many of the issues discussed in Task Force Report were raised in interviews with New Zealand businesses. In particular, one of the key recommendations of the Task Force was that tax and regulatory biases between different types of investment (for example, property versus financial assets) be eliminated.

Interviewees confirmed that a bias exists towards property investment due to tax treatment and depreciation that has adverse impacts on the availability of capital for business growth. Removing tax advantages for property investors will at least indirectly help to deepen New Zealand's capital markets—as more liquidity flows into other forms of investment the incentives to gear up skills and personnel and chase investment opportunities will become stronger.

Several businesses also noted the potential for the New Zealand Superannuation Fund ("the Super Fund") and managed Kiwisaver funds to deepen the availability of capital for New Zealand businesses. The Task Force report encourages continued Government support for initiatives of the Super Fund to investigate opportunities to invest in New Zealand companies to help build capability and scale in domestic capital markets.

Measures to avoid the systematic relocation of New Zealand businesses

The second area where policy changes could improve access to capital is through measures directed at the relocation of New Zealand businesses following capital contributions from off-shore investors.

To overcome the desire of off-shore investors to relocate New Zealand companies, investors need to perceive some value in companies remaining in New Zealand. A small proportion of businesses are able to demonstrate an inherent value to remaining in New Zealand, for example due to a need to maintain close links with South East Asia or leveraging New Zealand's positive environmental reputation. However, the experience of businesses interviewed in this research suggests that something more is required to broaden the capacity of firms to credibly make a case for remaining in New Zealand (and enabling a greater share of the economic benefits of corporate success to remain in New Zealand).

A further value to remaining in New Zealand is to stay within a sector "cluster", where companies benefit from close proximity to each other through sharing of ideas, technologies and a pool of labour. Such clusters—as in the case of the software sector in Israel or business process sector in India—allow domestic businesses to attract international investors without relocating.

For the most part, "clusters" are not deliberately created through policy. However, some interventions may facilitate the development of clusters when the right conditions are in place. One interviewee highlighted that the two conditions for an effective cluster may be strong domestic competition and demanding customers. An obvious possibility for a New Zealand business cluster exists in the agricultural sector—where both of these conditions appear to hold. Policies to support and grow such clusters may help to overcome the "conveyor belt" effect of New Zealand companies moving overseas.

A further view emerging from the interviews with New Zealand businesses is that policies to broaden partnerships with overseas investor communities would help to build international understanding and confidence in the value of New Zealand-based business.

Conclusions

The first conclusion from this research is that there are very real barriers to raising capital in New Zealand to grow an export business, and the capital that is

available tends to flow towards investments with a lower risk profile—banks lend to businesses that provide personal guarantees and property as security, while venture capital funds generally seek businesses that already have positive cash flows. This appears to differ from the situation in other countries, such as United States or Australia, suggesting that New Zealand does not meet the benchmark of having capital markets that operate as well as markets overseas.

The effect of our thin capital markets is that locally based export businesses may not have opportunities to expand that are comparable with their overseas competitors, which poses risks to maintaining a competitive and vibrant business environment in New Zealand. Our thin capital markets could lead to a "conveyor belt" effect where successful New Zealand firms are required to relocate off-shore—particularly to the United States where investors and consumers reside.

In reality, New Zealand firms will seek capital in overseas markets even if domestic capital is available. Off-shore investors can add significant value due to their highly specialise sector expertise and business networks, and ability to maximise the value of exit opportunities.

The view emerging from this research suggests that sensible policies should therefore be directed a deepening New Zealand's capital markets, while at the same time giving off-shore investors good reasons for leaving the business in New Zealand. Proposed changes to tax and investment incentives could help to level the playing field between business and property investment, and initiatives such as the New Zealand Superannuation Fund could also help deepen our capital markets. There is also some evidence to suggest that off-shore investors can be convinced of the value of having businesses remain in New Zealand, where our country has an international reputation for excellence or a natural competitive advantage—such as in the agribusiness and agritech sectors.

Attachment 1: List of Research Interview Questions

Background

Company name

Relevant sector

Business model

Location of offices

Location of affiliates

Years in operation

Staff numbers

Annual turnover (revenue)

Ownership

Management structure and expertise

Governance—board composition, independence, expertise

Export operations

Proportion of the company's turnover relating to products or services provided outside New Zealand (i.e. size of the export business relative to the total business)

Main export markets targeted

Characterisation of underlying strategy for export business:

- Sell the same product internationally as is offered in New Zealand?
- Innovate for international markets based on competencies established in New Zealand market

Record of export business growth:

- Over the history of the firm?
- Over the past 12 months?

Expectations for growth in export markets:

- Over next 12 months?
- Over next 5 years?

Most challenging issues facing export business

Experiences with capital raising

Firm's history of raising capital (debt and equity):

Seed funding

Capital for further growth / achieving scale

Has the growth of the firm (and in particular the firm's export business) been constrained due to a lack of available capital?

What are the most viable capital sources for funding expected growth in export business, and why?

What methods of raising capital are not viable or attractive for funding expected growth in export business, and why?

What are the most important features of your business and governance arrangements for raising additional capital from:

- Equity investors (angel investors, venture capital funds, overseas investors, private equity funds)?
- Debt providers (banks and providers of subordinated debt)?
- Grant funding providers?

What options exist for making capital more readily available for New Zealand businesses looking to grow their business in overseas markets?

Table 1: Overview of Capital Sources

Capital Source	Description	Risk Appetite in New Zealand	Availability
Senior debt	▪ Capital provided on basis of fixed return to lender ▪ Lender has priority in the event of business failure	Very Low	▪ Generally not available without guarantee over real property
Subordinated debt	▪ Debt with lower priority than senior debt in the event of business failure ▪ Examples include convertible notes and mezzanine debt	Low	▪ Does not appear to be widely used by small export companies in New Zealand
Private equity (PE)	▪ Capital provided in exchange for shareholding in company ▪ Target mature investments that are able to generate positive cash flows	Moderate	▪ Some PE firms are active in New Zealand ▪ Most do not invest in cash flow negative, start-up companies
Venture capital (VC)	▪ Capital provided in exchange for shareholding in company ▪ Target start-up companies that are beginning to generate positive cash flows	Moderate (lower than for VC in other countries)	▪ Limited number of funds in New Zealand, large number overseas ▪ Can leverage Government NZVIF
Angel investment (including "friends and family")	▪ Capital provided in exchange for shareholding in company ▪ Target very early stage investments that may be cash flow negative	High	▪ Small network in New Zealand that syndicates ▪ Huge network overseas, particularly in the United States
Other	▪ Grant funding ▪ Public listing (IPO)	N/A	▪ NZTE grants are widely used ▪ IPOs are not common in New Zealand

Figure 1: Illustrative Capital Raising Process