



Metro Innovation Project  
Maximising high-growth potential:  
The case for improving early stage investment

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MAY 2009

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## FOREWORD

Just over a year ago a group of people passionate about the future of the Auckland region started to tackle the assigned task of how to improve access to early stage funding for innovative high-growth companies.

This is my first public opportunity to personally thank all members of the Working Group for the significant time and intellectual rigour they committed to this process and report. We have also been privileged to have five international experts in early stage funding add their input, viewpoints and expertise which has been extremely valuable.

With our diverse backgrounds across the innovation framework we all recognise that access to finance can be one of the greatest barriers to business development and growth, and that effectively tackling this issue would generate significant economic growth for the Auckland region and New Zealand.

This report outlines recommendations and actions to achieve this objective, and to achieve the goal we have set of: a five-fold improvement in the number of early stage high-growth companies that are being funded and a corresponding five-fold increase in the capital invested into these companies by 2015.

Significant research and consultation was undertaken in leading to the report findings and recommendations and I would urge all stakeholders, both public and private sector, to give these actions their full support.

A key insight from our work is that focus should be placed both on start-ups and existing small to medium sized firms. If the latter were to release a new product or service focused on international markets, it could turn them into a high growth potential firm.

As part of completing this report we identified that by 2018 if we just settled for organic growth in the early stage high growth company market, rather than our growth goal, there could be a loss in economic value to the Auckland regional economy of \$250 million per annum.

We believe that this is a strong reason for action.



Andy Hamilton

**On behalf of Metro Innovation Project**

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## SNAPSHOT - WHY EARLY STAGE INVESTING MATTERS TO NEW ZEALAND

### CURRENT POSITION

New Zealand is in the bottom quartile of OECD countries in regards to economic standard of living.

Currently New Zealand has approximately 750 'globally capable & competitive' firms<sup>1</sup>

### THE GOAL

To be in the top half of the OECD in regards to economic standard of living

Achieving this requires 5 companies of an equivalent size to Fonterra or 3,000 'globally capable & competitive' firms – four times the current number. Five Fonterras is unlikely and unrealistic, therefore 4 times the number of 'globally capable & competitive' firms by 2015 needs to be the goal<sup>2</sup>.

### ECONOMIC IMPACT OF EARLY STAGE INVESTMENT

Early stage investment provides the pipeline of high-quality high-growth businesses, with international research showing that angel backing will create a high likelihood of securing venture capital funding. Only 10% of venture capital backed companies have not been backed by angel investors first.

UK research shows that only 4% of start-ups seek external equity finance for growth yet in 10 years time they will provide about 50% of the employment of those firms remaining.

European research shows that high-growth companies make up 3% of all companies in Europe but create 85% of all jobs. These 'gazelles' are financed by early-stage investors, and a number are required to replace ¼ of the top companies that will die each year.

Angel-backed companies are more successful. In fact, research indicates that high-growth companies have more angels than slower-growth firms.

### EARLY STAGE INVESTMENT GOALS

To achieve a five fold improvement in the number of early stage high-growth companies that are being funded and a corresponding five-fold increase in the capital invested into these companies. This means:

- 250 high-growth early-stage companies funded annually in New Zealand, and;
- The size of the early-stage investment market to be \$250 million annually.

**If this goal is achieved then by 2018 this will produce one third, or 1,000 of the firms required for New Zealand to be in the top half of the OECD.**

### ECONOMIC COST

Organic growth, rather than the growth highlighted in this report, could mean a loss to the Auckland regional economy by 2018 in excess of \$250 million per annum and to the New Zealand economy of \$400 million per annum.

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<sup>1</sup> 350 of which are 'internationally' focused.

<sup>2</sup> With a significant shift in the mix of 'international' versus 'domestic' focused firms.

## CALL TO ACTION

Improving the level and volume of early stage funding of high-growth companies is a critical issue confronting Auckland and New Zealand. In recent years there has been good progress in improving access to early stage funding; however within the current economic climate more needs to be done.

We face a challenging time in New Zealand with our capital markets under extreme pressure and venture capital funding drying up. This is impacting on the ability of our high-growth start-ups to secure early-stage and expansion capital, and will severely hamper their attempts to grow global companies.

Early stage investment is often vital for financing of business' product development and market entry phases. Without access to this funding, many businesses may be unable to advance as quickly as the market opportunity may offer or the window-of-opportunity dictates, resulting in not only lost opportunities for individual businesses, but the loss of economic growth opportunities for the country.

There is no doubt that access to finance underpins business start-ups and growth. It is recognised internationally for the key role it plays in the innovation process, especially in commercialising research and development, lifting exports, creating jobs and stimulating economic activity. It is particularly vital for high-growth start-ups and exporting small to medium enterprises (SMEs), who are the key if we are going to transform the Auckland and New Zealand economies.

This report sets out an investment goal for 2015 of a five-fold improvement in the number of early stage high-growth companies that are being funded and a corresponding five-fold increase in the capital invested into these companies. These goals are shown in the dashboard below.

Dashboard	2007	2015	Targeted Growth
Investment Ready Rate	30%	60%	2x
No. of Early Stage Companies Funded Annually	30*	150*	5x
Size of Early Stage Investment Market	\$30m*	\$150m*	5x
High Growth Early Staged Companies:			
SMEs	18	90	5x
Start-Ups	12	60	5x
Economic Opportunity	By 2018 - \$250m per annum		

\* These figures are for the Auckland Region. Nationwide goals for 2015 are 250 Early Stage Companies funded annually and the National Early Stage Investment Market to be \$250 million annually.

These goals are achievable. However, it will require some substantial improvements on the demand side for firms seeking investment, on the supply side through the creation of more pools of capital (especially post early-stage), and a significant increase in the scale and capacity of current infrastructure such as technology parks and incubators.

**The call to action is simple and compelling.** If we settle for organic growth, rather than the growth highlighted in this report, the loss to the Auckland regional economy by 2018 could be in excess of \$250 million per annum and thereafter growing even more year on year. This is why we believe that the following key recommendations need to be actioned:

- Formation of a national angel investment association to tackle issues of advocacy, investment readiness, investor education and other appropriate issues at a national rather than regional level.
- Development of an angel investor exchange programme to jump-start New Zealand's emerging early stage investment industry. This will create the international links required for syndication, provide the ability to learn from international best practice and utilise the international angel investors to assist early stage businesses to enter global markets and secure international investment.

- Pilot a national life sciences angel network as a mechanism for increasing early stage funding in this sector, with the potential roll-out of this concept into other sectors.
- Development of a pilot programme that provides 'translators' between researchers and the private sector as a means of increasing the commercialisation rate from universities and research institutes into industry.
- Hosting of an international investment conference in Auckland to increase the exposure for early stage investment opportunities to a national and international investor market.
- Increase the scale of programmes that assist entrepreneurs to become investment ready.
- Support for the establishment of a national business plan competition, for start-ups and SMEs, designed to make more potential high-growth businesses visible within the investment marketplace. This could include development of a self-diagnosis investment readiness tool that freely enables companies to test whether they are suitable and ready for early stage funding.
- Greater support for culture changing media programmes, through dedicated central government funding, which can increase the growth ambition of New Zealand businesses.
- Delivery of a communications and education programme to increase the quantity and capability of the supply side of early stage investors, and increase start-up businesses and SMEs awareness of the benefits, sources and investment readiness requirements of early stage investment. Connected to this is the need for stronger collaboration between entrepreneurs seeking investment and investors seeking to invest.
- Implement changes to the Seed Co-Investment Fund mandate that see the 1:1 ratio of matching funding for new investments changed to 1:2 for the next three years, thus encouraging more 'new investments' while the maximum investment should be lifted to \$1m, with follow-on funding falling back to the existing 1:1 ratio.
- Increase support for key infrastructure, such as technology parks and business incubators, in order to increase their capacity to create a pipeline of investment ready companies.

## 1. THE FOCUS: where we are concentrating our efforts

This report is focused on improving access to finance for all businesses that require early stage growth funding, whether they are start-ups or existing SMEs. While it is accepted that start-ups are currently better catered for in accessing the early stage funding market, there will need to be significant growth in the numbers of both start-ups and SMEs seeking investment if the goal is to be achieved.

It is worth noting that the issues facing businesses seeking early stage investment in the Auckland market are mostly the same as those faced by businesses located in other parts of the country. Therefore it is believed that a national approach to this issue should be adopted. This report identifies that while Auckland is the biggest market for early stage funding in New Zealand, both in terms of investors and companies seeking investment, Auckland's success will be determined by other regions also being successful. Undertaking some initiatives on a national scale is therefore believed to provide greater benefit to Auckland entrepreneurs and investors.

## 2. REPORT BACKGROUND

### Metro Project Action Plan

Launched in October 2006 the Metro Project Action Plan aims to deliver on the vision of the Auckland Regional Economic Development Strategy of Auckland as *"an internationally competitive, inclusive and dynamic economy; a great place to live and conduct business; and a place buzzing with innovation, where skilled people work in world-class enterprises"*.

The Metro Plan is based around five 'platforms for action'; and brings together existing and new regional activities into one transformation economic development that reflects international best practice. These platforms for action are to:

1. Take effective and efficient action to transform Auckland's economy.
2. Develop world-class infrastructure and world-class urban centres.
3. Transform Auckland into a world-class destination.
4. Develop a skilled and responsive labour force.
5. Increase Auckland's business innovation and export strength.

### Metro Innovation Project

To deliver on the objective of increasing Auckland's business innovation and export strength, the Innovation Project has been developed. According to the OECD definition, innovation is "the implementation of a new or significantly improved product (goods or service), or process, a new marketing method, or a new organizational method in business practice, workplace organisation of external relations". The project focuses on developing and implementing initiatives that will enable Auckland to take a leadership role in transforming New Zealand's export success and global competitiveness.

The Metro Innovation Project is spearheaded by a leadership group, chaired by TZ1 executive director, and former Microsoft managing director Helen Robinson, and project-managed by regional economic development agency AucklandPlus. It comprises five workstreams, each focused on identifying, and developing, specific initiatives that will collectively further develop Auckland's business innovation and export strength:

- A. Co-ordinate innovation programmes
- B. Access to early stage funding
- C. Tell the innovation story
- D. Form industry/research partnerships
- E. Leverage international networks

### Workstream B: Access to early stage funding

The objective of workstream B, led by The ICEHOUSE CEO and Angel Association New Zealand Chair, Andy Hamilton, has been to improve access to early stage funding for innovative high-growth companies.

Specific activity undertaken by the group, and which have provided the basis for this report include:

- Collaborating with MED to research and develop an Auckland innovation 'map' of current networks, gaps and opportunities.
- Researching options for how businesses and other organisation will access and use the innovation map.
- Identifying ways for research providers to better support innovative businesses.
- Developing tools to help businesses better plan and manage innovation.
- Identifying ways to improve commercial links between business and research providers.

The analysis of the present situation has been derived from several sources. It emerged from the Metro Innovation Project as part of the focus on improving access to early stage funding. Workshops conducted with start-up companies, investors and intermediaries identified issues that were then debated, and the context and recommendations were then extended and internationalised drawing on expertise from within New Zealand and abroad including expert advisers from Australia, UK and US (see appendix on page 25). Recommendations from the workshops and analysis of discussions led to the development of the goal for 2015.

#### Measurements Metrics

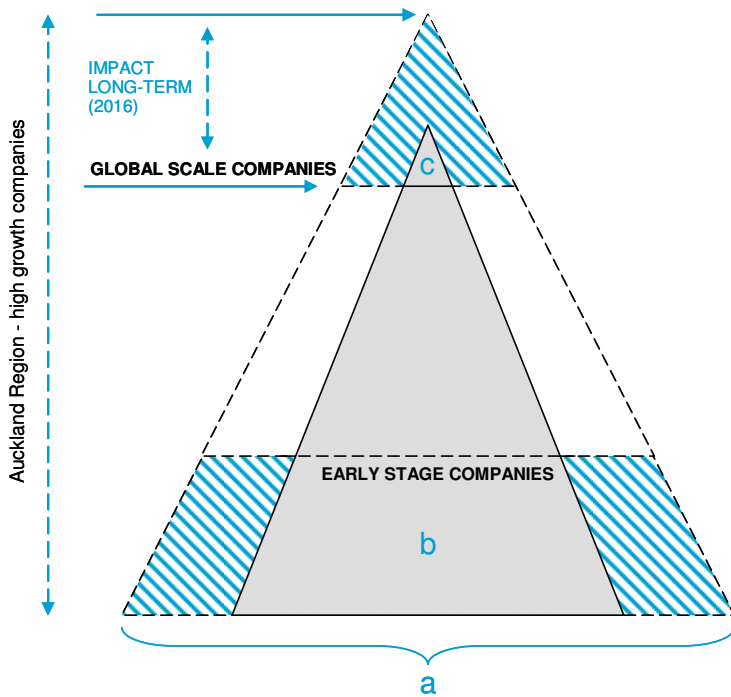
- Number of companies funded
- Volume of funding in the market – both in terms of ‘available’ capital and capital invested
- Heightened awareness
- Long term returns to investors

#### Target audience

The target audience for this report is the innovation industry in Auckland, New Zealand; Auckland territorial local authorities and economic development agencies; universities and crown research institutes; government agencies; Auckland corporates and SMEs; the investment community including angel networks and venture capital organisations; and the media.

### 3. THE GOAL: where we can be in 2015

Improving the level and volume of early-stage funding of high-growth companies is a critical issue confronting New Zealand. European research<sup>3</sup> has highlighted that for SMEs the largest barrier to innovation is access to finance and, in simple terms, we need to get more companies into our innovation system. The more companies we have at the 'base' and the faster they accelerate into international markets, the greater the impact on our economy. Currently, there are just too few actual and potential high-growth companies and even fewer that successfully receive early stage funding.



#### FOCUS

- Increase in the number of early stage high growth companies.
- Increase the number of early stage high growth companies that are investment ready – currently only 3 out of 10 meet this measure.

#### OUTCOME

- More global scale companies from the Auckland region.

Diagram 3.1: Impact of increase in Global Scale Companies. Therefore, the goal is to increase the number of early stage high-growth companies being funded in the Auckland region from 30 deals annually in 2007 to 150 annually by 2015. Achieving this vision requires a substantial leap on both the demand and the supply side.

	2007		2015	
	Auckland	New Zealand	Auckland	New Zealand
<b>Early stage high-growth deals</b>	30	50	150	250
<b>Total Investment</b>	\$30m	\$50m	\$150m	\$250m

Table 3.2: Number of investments in early stage high growth companies in Auckland and New Zealand

This goal is achievable, although it will require some substantial shifts in performance and infrastructure. With no action we believe that by 2016 the number of investments being made in early stage high-growth companies will only be 75 in the Auckland region, which represents a shortfall of 75 investments (based on the goal of 150 deals). The impact of this gap would truly appear in the years from 2018, when these companies would be starting to mature, leaving a likely lost opportunity of some 20-25 companies which would be turning over more than \$NZ10m per annum, a substantial amount of lost economic value for Auckland and New Zealand. Without even taking into account an economic multiplier effect this would mean an annual loss of \$200-250million which would accumulate year on year.

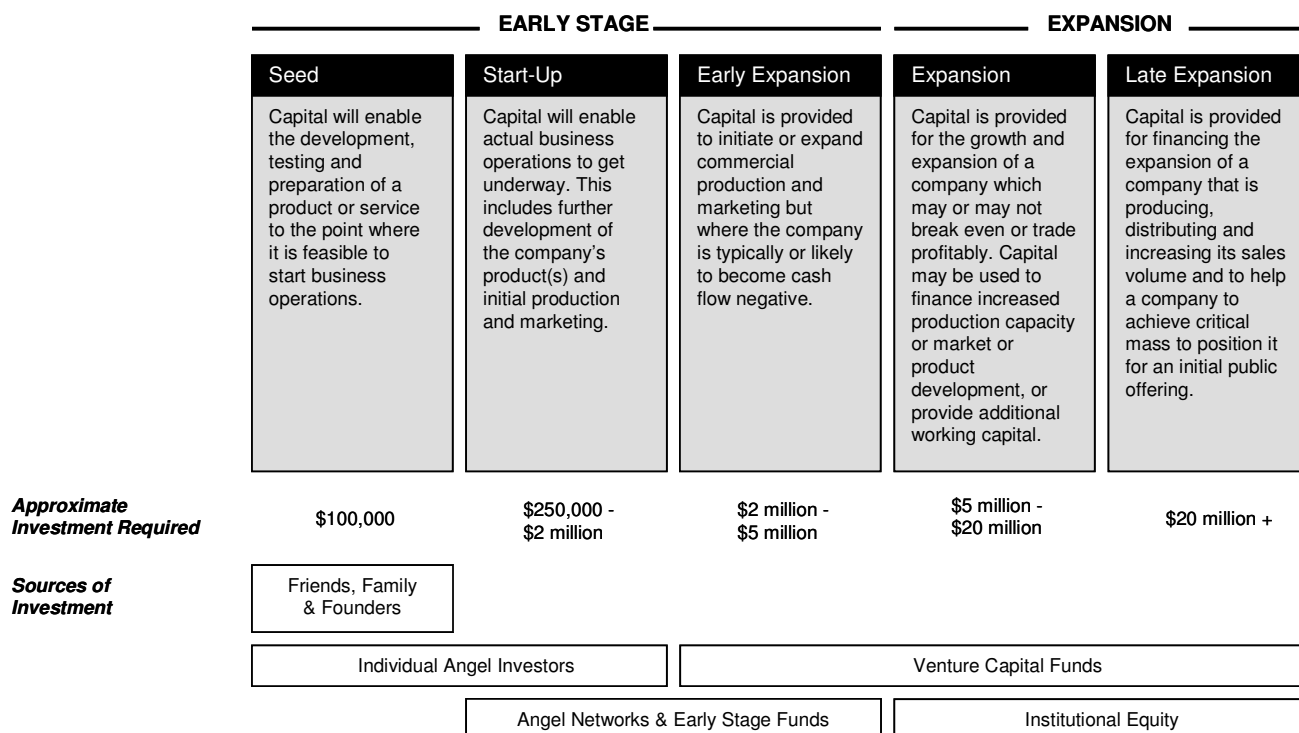
On the other hand, if we are successful in achieving this goal then it will create a significant issue with respect to follow-on funding and an increased demand for specialist talent that does not currently exist. These issues will need to be addressed.

<sup>3</sup> Observatory of European SMEs – European Commission (April 2007)

#### 4. OVERVIEW OF EARLY STAGE FUNDING

Early stage funding is a subset of the venture capital and private equity market in New Zealand. This part of the capital market constitutes around 60% of New Zealand's GDP with the remaining 40% represented by the public companies listed on the New Zealand Stock Exchange.

Different stages of a business's life cycle will generally require different types and sources of capital, as depicted in the diagram below.



At the very early stages of most businesses, funding comes from founders, friends and family, debt and sometimes from government grants and research programmes.

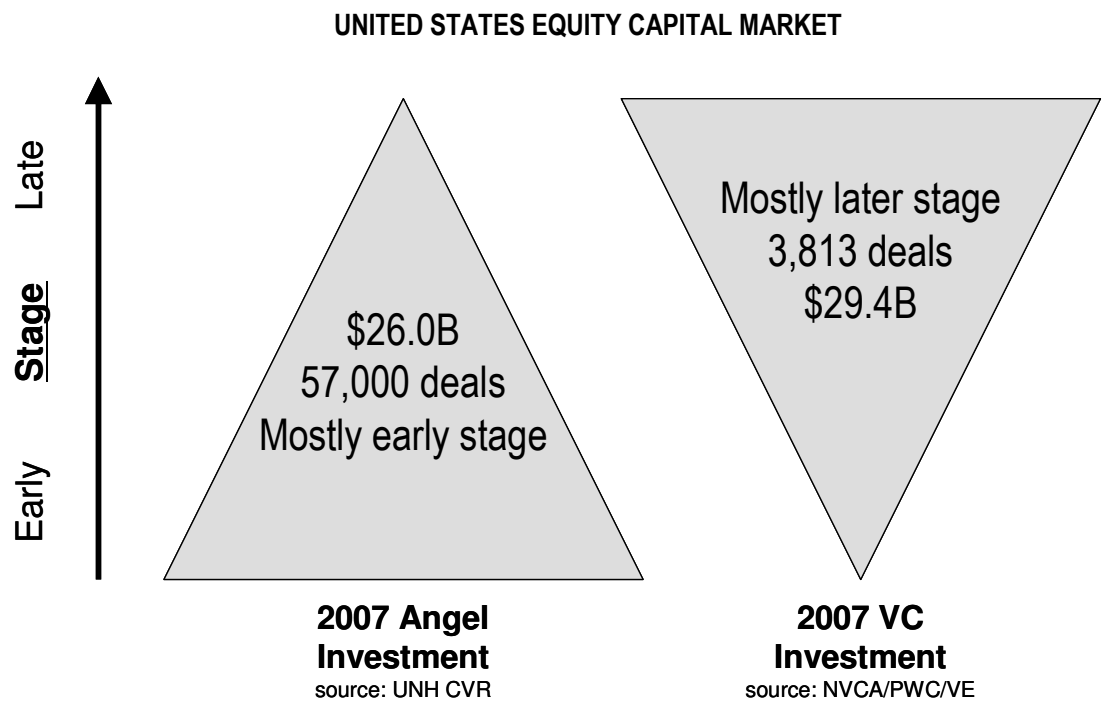
However money from founders, friends and family can only take a venture so far. For some, particularly high-growth potential start-ups, there will be a need for additional funding to achieve their market and product goals. The source of the money needed to reach these goals generally comes from the early-stage capital market, making it a critical link in the development of entrepreneurial ventures. This early stage capital is comprised of individual angels, angel groups, early-stage funds and some early-stage venture funds.

The bulk of this early-stage investment is believed to be provided by angel investors, who in the US are estimated to be responsible for 90% of outside equity in start-up and early stage firms in the US. Internationally angel investors invest in 30-40 times more companies than the formal venture capital market, and invest three to five times more money in total.

The importance of this investment is shown by research, undertaken in the UK, that highlights that while only 4% of start-ups may seek external equity finance, in 10 years time they will provide about 50% of the employment of those firms remaining. This provides a strong argument for the importance of an efficiently functioning early-stage capital market.

**Job Creation:** As the venture grows or expands it may require significant additional capital which is where the venture capital market becomes involved. US research has shown that companies financed by venture capital added jobs at a faster pace than their non-ventured counterparts. The most recent statistics show that the 3.6 percent annual growth rate of jobs among venture capital backed companies was more than two times faster than the 1.7 percent total private sector employment growth rate between 2003 and 2006. At the same time, venture capital backed company sales grew by more than 11.8 percent, compared to an overall rise in U.S. company sales of 6.5 percent during the same period.

It should be noted that early stage investment provides the pipeline of high-quality high-growth businesses, with international research showing that 52% of angel backed companies go on to secure venture capital funding. Only 10% of venture capital backed companies have not been backed by angel investors first. As shown in the diagram below angel investment and venture capital are complementary and both need to play their key roles for the capital market to be efficient.



Fueling rapid growth, venture capital involvement often results in significant increases in company valuation. Through this increase in valuation, the venture capitalist's exit the business by either taking the venture public or by selling it to strategic partners. It is through these 'exits' that all the previous investors, including the founders, angels and others receive a payback on their investments, often to re-invest in another group of companies.

## 5. THE CHALLENGE: where we are now and what needs to change

This section sets out the current situation and considers what needs to change if the goal is to be achieved. Without bold action, the market for investment in early stage firms is likely to continue its current organic growth pattern. This is unlikely to result in transformational increases in investment activity and innovation in Auckland (see Chart 4.1) and will therefore prevent New Zealand moving more quickly into the top half of the OECD.

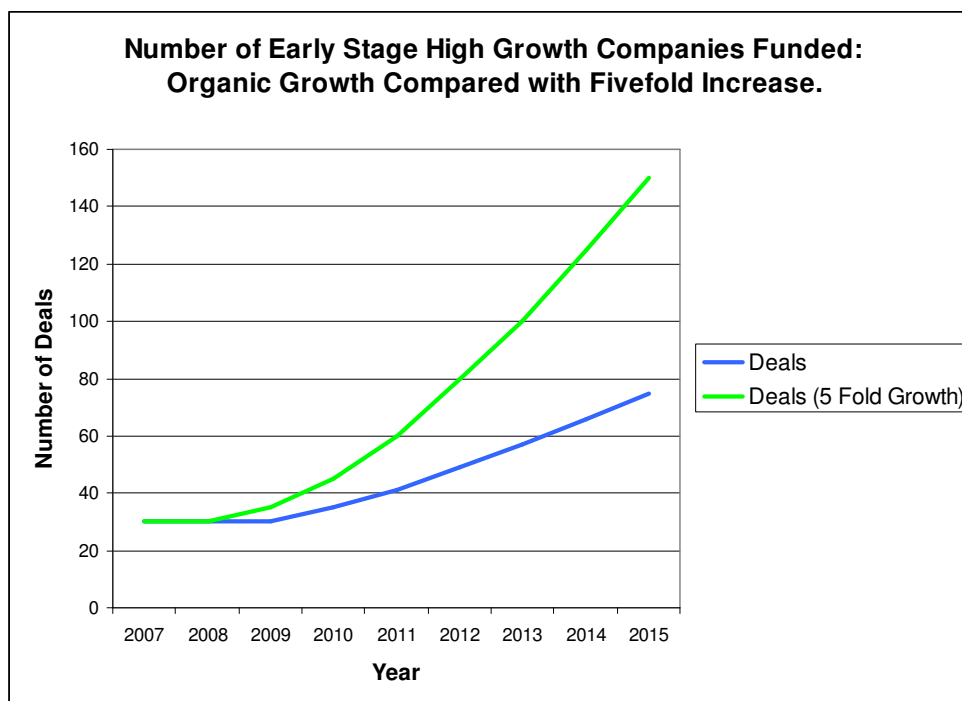


Chart 4.1: Deals comparing organic growth against five-fold increase

In order to increase the number of early stage high-growth companies being funded in the Auckland region there is a need for substantial improvements on the demand side for firms seeking investment, and on the supply side through the creation of more pools of capital. In addition there will need to be changes made to the overall early stage investment environment to develop stronger linkages, communication and interaction between the demand and supply sides of the market.

It should be noted that this report has been developed during a period of significant economic change. The current financial crisis severely affects access to finance for small and medium sized businesses, which represent 99% of companies in New Zealand and are responsible for a majority of economic growth and employment. Tightening market conditions for access to credit and late payment issues from clients are making it hard for SMEs to meet their working capital requirements. They are seeking alternative ways to source finance for the growth of their business, in particular through equity financing if they are at an early stage of their high growth potential development.

Globally early stage funders are reporting a significantly increased demand for capital which clearly demonstrates the current lack of access to traditional sources of capital. In New Zealand there currently exists a shortage of capital at all stages of a business's investment life cycle and a particular shortage for follow-on funding given the market conditions and the excellent progress that has been made in the New Zealand start-up market over the last 5 years. With the current global economic situation there are only two venture capitalists in New Zealand with funds to invest. This means that there is a critical lack of second stage funding and this is expected to be the case for the next 2-3 years.

This poses a significant problem for high-growth companies looking for the next stage of investment and their angel investors. Without this funding high-growth companies may be unable to achieve their expansion plans and advance their business as quickly as the market opportunity may offer and the window-of-opportunity dictates. It will also mean a significant shortage of 'new capital' for start-ups as the early stage investors will be preserving their capital for their existing portfolio companies.

Conversely this has meant extraordinary good deal flow for business angels who have 'new money' available with the opportunity to finance great companies at a valuation which has come down anywhere from 20 to 50% in the last months.

This trend is likely to continue in the coming months. Market intelligence from Europe and the US is showing that the companies that are seeking equity finance at the moment are not only the usual high potential start-up, but also those companies which had achieved multi-million revenues after 3 years, so-called "gazelles" who traditionally did not have to worry for their follow-on financing.

These opportunities have consequently generated an acute lack of access to finance for those who would generally be suited for angel finance, highly innovative yet risky businesses, as many early-stage investors want to stay focussed on their portfolio, making sure that they have enough money for follow-on round investments. Funding for newly formed early stage businesses will not come easy in the next 2-3 years, and while entrepreneurs will focus on their cash flow they will often need additional funding for their growth in that time period. Redundancies or layoffs are also likely to create a new generation of entrepreneurs and start-ups, increasing the need for additional start up and early stage risk capital.

This is creating some important challenges for early stage investors but also opportunities which policy makers can help to tackle and leverage.

In short, New Zealand has made significant progress in the early stage angel investment market since 2000, with over 100 companies angel investment backed since 2006. However, with the current economic conditions the market has stopped. There is little if any venture capital available and the angels' resources are severely limited. A highly likely outcome is an industry at risk of failure with the impact on these high growth potential companies significant.

### **5.1 Demand Side Challenges**

The major demand side theme that has emerged is that there is a lack of companies who are investment ready.

When you drill down into this market, it is apparent that there are two segments with differing characteristics: start-ups which are high-growth focused from day one, and existing SMEs who have the potential to be high-growth if they focus their activities on a new product or service that has international potential. Start-ups are generally more active in seeking investment but may face issues in terms of information about the market, capabilities within their team and the quality of their business proposals. On the other hand most SMEs are not even contemplating attracting early stage funding and firstly need to be made aware of the benefits of this investment. This latter characteristic masks a significant management capability issue existing in these companies.

Any shortage in early stage funding can to some extent reflect the fact that there is a lack of good quality investment opportunities, the challenge therefore is to stimulate demand by both start-ups and SMEs and generate increased deal flow.

Demand side challenges and issues:

- The process of sourcing funding is confusing and time consuming with no central place or focal point for businesses or investors.
- The time it takes to raise funding, once businesses find the potential investors is long and arduous.
- Getting early involvement and money from angels and venture capitalists is a strong driver for the future success of companies.
- There is a perception that only a small percentage of SMEs are looking for investment. Many try to grow organically, and this is unlikely, in most cases, to lead to being high-growth.
- Many businesses are not prepared to give up a share of the business or value the business at an unrealistic level.
- While there is a stronger pipeline of start-ups seeking investment compared with SMEs, only three in 10 of the start-ups seeking funding in 2007 were investment ready. This significantly reduces the chance to grow the number of deals when seven are effectively 'lost' at the first stage.
- While there are investment ready services available, there is a clear difference in skill level across the region and duplication across differing organisations offering investment ready services. There is a strong argument for a more effective co-ordination and consolidation in the provision of investment ready services, including the need to build the capacity and capability for the Auckland Region to provide this.
- The management teams of early stage companies are struggling to execute the ambitious growth plans that they have set for themselves.

- Many companies do not have the skills/management capability to enable their company to become investment ready, and there are minimal opportunities for them to self-diagnose or test their company's investment readiness.
- There is some knowledge in the advisor or intermediary market on investment readiness, but it is limited and in the hands of too few. This is a function of weakness on the demand side from entrepreneurs who are not demanding support and where they are, their ability to pay is limited.
- More spin-outs from universities, research institutes and technical colleges are required but until there is increased investment in the 'soft skills' to transfer knowledge and greater "alignment", the scale will not change.
- Companies need a better understanding of products which are appropriate for the global market. There would appear to be a latent opportunity to create more high-growth companies by enabling the existing SMEs to launch new products/services that are focused on international markets.
- Certain sectors have greater difficulty raising finance due to the dynamics of the industry, the level of funding required or the lack of knowledge of the sector by those on the funding side. For example the Seed Co-Investment Fund maximum ceiling of \$250,000. At this level it is far too low for life science companies, and should be increased to \$1,000,000 with up to \$500,000 being allowed to be invested each time.

## 5.2 Supply Side Challenges

There are particular challenges for early stage companies in accessing finance. Investors are often hard to find particularly as venture capitalists seldom invest in start-ups and early stage SMEs, where business models are not proven and customers are few, and where there is no ability to provide guarantees for debt equity. This highlights the importance of government grants, early stage investment funds, angel networks and individual angels in increasing the capital pools available.

The New Zealand early stage market is still immature by world standards, though there has been an increasing interest in the area of early stage investing, particularly given the aggregation of wealth that has been created since the early 1990s. However, even with the current 'organic growth' rate of early stage investments, there must be more funding committed to the market otherwise there will be shortages of funding which will be ever more exacerbated in the area of follow-on funding. The impact of this will be a significant slow down in the number of early stage high growth firms receiving first time funding and the failure of a significant number of the 100 companies that have been funded over the last three years.

Supply side challenges and issues:

- Corporate organisations, particularly banking organisations, are on the whole not engaged in this market. There would appear to be an issue of risk aversion when compared with the UK and American banking models for supporting early stage companies.
- The sustainability of existing angel networks is questionable as they are surviving on the 'love and attention' of angel investor members, who generally provide their time free of charge to the network organisation.
- Investor skills and experience are often restricted, and there are limited opportunities of scale to build the capability. This is even more obvious in particular segments or industries, such as life sciences.
- There are very few experienced investors who have led companies from 'investment to exit'.
- The Auckland market for early stage investment is controlled by a small number of investment organisations and individuals.
- There is currently a lack of expansion capital available, particularly with the limited supply of venture capital funding. Growth will be needed in venture capital and angel syndication to fill the gap, including syndication with international partners which can provide assistance on market entry into international markets.
- The financial returns for the venture capital model in New Zealand are as yet unproven.
- There are only limited formal linkages to international investment venture capital or angels who might invest in New Zealand early stage companies, and there are limited examples of actual investment by international firms.

### 5.3 Environment Challenges

In addition to the challenges specific to either the supply or demand side, there are also issues with regard to the overall environment for early stage funding and the interactions and linkages between the businesses and the investors.

Overall early stage funding challenges:

- The current early stage funding market is generally competitive rather than collaborative.
- There is limited access to the profiles of opportunities that are seeking investment and also limited information on those that actually achieved investment. Investment in technology frameworks for collaboration of investors and applicants would deliver significant benefits.
- Stronger communication/linkages in the innovation system for companies, research and development institutions and investors need to be encouraged and developed.
- More investment and activity is required in supporting and driving the innovation ecosystem, particularly in the interfaces between the various participants.
- There is limited promotion of investment successes which could encourage new investors and new businesses in to the market.
- The potential of Auckland to be a business hub for New Zealand needs to be discussed with other regions of New Zealand and partnerships created to deliver on the potential.

## 6. INCREASING THE DEMAND FOR INVESTMENT FUNDING

A common theme emerging is the lack of companies that are investment-ready. While there is a clear sense that the demand for investment funding for early stage high-growth companies should and could be increased, ultimately the quality of projects is just as important as ensuring that there is a good pipeline of deals from a quantitative perspective.

If demand side issues could be solved, working backwards from the goal of 150 investments in 2015 in the Auckland region, this would mean that based on international conversion rates there would be approximately 450 firms that were investment-ready, coming from 750 firms seeking investment. This is in contrast to the 2007 and 2008 experience in the Auckland region of ICE Angels which is one of the more active groups in the region. Of ICE Angels enquires only 30 per cent was deemed to be investment-ready, and of these companies only 13 per cent were funded, the overall split from initial enquiry to investment currently being 5 per cent.

By 2015 we envisage a doubling of the investment-ready rate from 30 per cent to 60 per cent, and the overall rate of enquiry to investment lifting four-fold from 5 per cent to 20 per cent which would line up with international experience.

This is set out Table 6.1, which also shows the forecasted split between start-ups and SMEs.

Initial enquiries from companies	→ 60%	Applications for funding (investment-ready)	→ 33%	Deals funded (20% of enquiries)
<b>750</b> (450 SMEs & 300 Start-ups)		<b>450</b> (270 SMEs & 180 Start-ups)		<b>150</b> (90 SMEs & 60 Start-up)

Table 6.1: Composition of firms seeking funding in 2015

The ability to increase the pipeline of investment-ready companies will be directly affected by the infrastructural capacity that will be determined by the number of incubators, science parks and other organisations that are supporting the creation of high-growth potential start-ups and the activities to encourage and motivate high growth potential SMEs to take the step up. Table 6.2 details the split between these venues for high growth companies, both actual numbers from 2007 and forecasted for 2015 in regards to the number of companies that actually receive investment.

	2007			2015		
	Start-ups	SMEs	Total	Target		
				Start-ups	SMEs	Total
Incubators & technology parks	6	2	8	24	20	44
Escalator	2	6	8	6	24	30
Economic development agencies	2	2	4	1	17	18
Universities and research institutes	3	-	3	15	-	15
Corporate organisations	1	-	1	5	-	5
Other including informal/garage	4	2	6	9	29	38
<b>Total</b>	<b>18</b>	<b>12</b>	<b>30</b>	<b>60</b>	<b>90</b>	<b>150</b>

Table 6.2: Demand for investment in 2015 in the Auckland region

### **Key Demand Side Challenges**

- Need to increase the quantity and quality of start-ups and SMEs seeking investment.
- Need to improve the 'investment-readiness' of these businesses.
- Need to provide opportunities for businesses to test their investment-readiness.
- Need to improve entrepreneurs' understanding of the early stage funding market and investors' needs.
- Need to develop the skills and management capability of early stage companies.
- Need to improve capability and reduce duplication in the provision of investment ready services.
- Need to generate a greater number of spin-outs from universities and research institutes.
- Need to deliver individualised solutions for specific sectors that face unique issues in accessing funding.

### **6.1 Current Demand Side Initiatives**

A number of demand side initiatives are currently being undertaken to address the challenges identified.

- Incubators provide entrepreneurs and start-ups with the expertise, networks, tools and environment they need to make their ventures successful. With incubation, a venture's chances of raising capital is greatly enhanced as the incubator staff and advisors will often provide the expertise needed to get the businesses investment-ready and tend to be directly aligned to regional angel networks. There are currently three incubators in the Auckland region housing approximately 36 start-up companies.
- Technology parks are normally designed to co-locate new and established knowledge-based companies working on 'smart' technologies. They will generally leverage local science and technology resources by providing an effective interface, or even a shared research environment, between universities and/or research institutions and private industry. Technology parks may have strong links to an incubator as a feeder of small, rapid growth firms into the larger park environment and perhaps to assist in providing a number of specific services on site to support start-ups and early-stage companies. There are currently three new tech park concepts being developed in the Auckland region which would positively impact on both the quality and quantity of businesses seeking investment if they came to fruition.
- Universities and research institutions in New Zealand can provide a source of spin-outs that commercialise the institutions research or intellectual property. These institutions all tend to have commercialisation units and teams though there are still barriers to getting products to markets both in terms of finding the capability to commercialise the product and the ability to secure investors. The University of Auckland's involvement in the AUD\$30 million Trans Tasman Fund for early stage commercialisation of intellectual property should increase the rate at which they are able to commercialise ideas, thereby resulting in new spin out companies within the Auckland region.
- New Zealand Trade and Enterprise's Escalator service provides training and brokering services designed to assist innovative firms to raise capital. Since being founded in 2003, Escalator has helped over 90 qualifying New Zealand businesses raise over \$58 million and provided over 200 businesses with deal preparation expertise. In a typical year Escalator receives around 350 applications, provides specialist advice to 200 businesses, prepares 62 firms for potential deals and aims to raise \$20 million from the private sector. While a review in 2005 by the Ministry for Economic Development found that the programme was successfully assisting innovative firms to become investment ready and raise capital it does not have the capacity to be the only provider of investment ready services and nor should this be the case.
- New Zealand Trade & Enterprise's Enterprise Training Programme delivers training services to SME owners and start-up entrepreneurs. The services are designed to improve management capability to enable businesses to more effectively and efficiently manage their business. An investment-ready training component is provided to help business people learn about the type of finance they require to expand, diversify or commercialise a new concept and how they can access equity funding from investors. While clients of this service could often staircase to the Escalator programme, it would appear that there is not a strong link here.

- Angel networks and angel investors will often work with companies to get them investment ready. This early involvement by potential investors in projects can help them develop into sound business propositions. Early involvement can also ensure that unviable projects do not proceed, thereby saving all concerned time, effort and money. The early involvement of investors can also help to speed up investment returns.

## 6.2 Critical Demand Side Success Factors

The current initiatives being taken on the demand side are addressing some of the issues but the following gaps still exist and need to be better addressed.

### Capacity of current pipeline

The ability to 'increase the pipeline' of investment-ready companies is directly influenced by the infrastructural capacity and number of incubators, science parks and other organisations that support the creation of high-growth SMEs and start-ups. Auckland-based start-ups will be derived from incubators and technology parks, investment ready schemes like Escalator, regional economic development agencies, universities and research institutes, corporate organisations and a variety of other sources including the informal market.

At present these organisations do not have the capacity to enhance the pipeline of start-ups that will achieve the numbers of the goal. The infrastructural investments made by the prime business developers such as incubators and tech parks and also the prime IP holders, universities and research institutes, are critical to increasing the number of high-growth businesses. There are well advanced plans for new technology parks to be created within the region and these will need to be publicly, and possibly financially, supported by local and central government in addition to direct encouragement for the expansion of current infrastructure such as incubators. The advantage that these organisations provide is that they tend to identify, nurture and accelerate IP-based businesses with high-growth potential and provide ongoing assistance to lift their organisational capability. This will assist in increasing the number of good quality investment opportunities.

It is important for Auckland that this investment in infrastructure occurs on a national basis. For our 2015 goals to be realised, it is expected that around one third of the investment deals done in the Auckland region will involve businesses from outside of Auckland. The concern is where these deals will come from in New Zealand as national infrastructure is not currently creating close to the 150 investment-ready businesses needed from outside the Auckland region.

### Encouragement of businesses into the investment marketplace

In New Zealand there is often a lack of growth ambition amongst many SMEs. For SMEs, a key issue is the 'cultural shift' required in terms of capability and attitude if more SMEs are to become high growth. For SMEs, the issue seems primarily to be how to increase the pool of people that want to increase their level of activity to the next level and become international companies. The key difficulty is that there are not enough people who *want* to do this.

There is significant upside given the number of SMEs in the Auckland and New Zealand markets: if some SMEs shifted their thinking, immediate impact could be achieved from the supply side. This will require an education process to enable the SME to have a better understanding of what products are appropriate for the global market, and a communication process to lift the aspirational and attitudinal capability of SMEs through promoting the benefits of investment. A major driver of the cultural change required to increase the number of companies seeking investment is the use of media. There are an increasing number of programmes in which entrepreneurs present ideas to investors, or compete to enter global markets. In order to draw these businesses in to the marketplace there will be a need for 'honey pot' initiatives.

### Level of investment readiness

In 2007 we estimate 30 per cent of companies seeking investment were 'investment-ready', and only 5 per cent secured investment. If we are to lift this to the international benchmarked goal of 20 per cent then there needs to be a significant improvement in the capability of the teams and an increase in support services to assist the businesses. This is an area of low hanging fruit which could be focused on to achieve an immediate improvement.

For start-ups, the recommendation is for a business model that permits intervention at the investment-ready phase for maximum impact: more companies that are investment-ready should mean more deals. Positive or negative conditions such as increasing competition and a contracting economy could challenge the existing comfort zone, resulting in some becoming even more risk-averse, but may encourage others to adapt to the new conditions eg through customer-led change, encouraging further collaboration, reinvestment, the development of new products and so forth. At this point, there is a need to provide business capability support, as well as a pre-screening process to increase awareness of investment

opportunities. Ensuring that the right quality of management exists, through training or the introduction of new skills and new people, is a critical part of investment readiness.

According to Canadian research<sup>4</sup> many of the angels surveyed referred to the extremely high rejection ratio of investment proposals is largely caused by the entrepreneurs' unrealistic valuations of their companies and their lack of product and market knowledge. This assessment is commonly shared and is the reason why a number of international angel associations are involved in the provision of information and education for entrepreneurs, so they better understand angel capital and are prepared for attracting it. As part of this there is a need for investors to be encouraged to relay their investment knowledge to entrepreneurs seeking investment so they have a better understanding of the needs of investors and investment proposals are more likely to be investment-ready.

Business angel networks can also play a key role in the education process as they bring angel investors and entrepreneurs together. This can make the process for obtaining equity capital more transparent, entrepreneurs may better understand investor's needs, and better matching between entrepreneurs and investors can occur. There is a strong belief that entrepreneurs receive the best education by doing and so there is a need for educational initiatives that allow this. Software like the 'Running the Gauntlet' programme, developed by Library House and the East of England Development Agency, which allows companies to self-diagnose or test their readiness and pitching/business plan competitions are initiatives that can achieve this.

#### Information for entrepreneurs

Many start-ups and SMEs lack information and knowledge about the marketplace. They are unaware of the sources of early stage funding, including grants, and often do not know who to approach for more information or how to seek investment. At present there is no central resource in the market that provides entrepreneurs with this information and development of a portal to address this issue would be of benefit at a national level.

#### Recognition that specific sectors face specific barriers

It is important to recognise that specific sectors can face specific issues in regards to accessing early stage funding. Life science companies tend to need greater levels of early stage funding than many other businesses due to the high cost of getting a product to market. This means that national syndication is important in this market as it allows access to larger funds and to specific industry expertise.

Investors also tend to invest in sectors and propositions that they understand. In sectors like life sciences there is a shortage of investors in any one angel network who understand the technologies. This means that a few investors get tasked with undertaking all the due diligence required. In this case there are potential benefits from developing linkages between networks or investors, or even a standalone angel network, to bring all these specialists together.

While life sciences face an obvious industry need, the marine sector is another industry where a sector specific solution for investment in this sector could be created. Another possibility to explore may be in the context of the proposed Auckland Innovation Centre where it could become appropriate to launch an angel network for advanced materials in due course.

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<sup>4</sup> An Overview of Angel Investors in Canada – Bank for International Settlements (December 2005)

## 7. INCREASING THE SUPPLY OF INVESTMENT FUNDING

There has been a noticeable shift in early stage funding over the past five years and there is likely to be a further shift in the coming years. In 2003, the venture capital base was strong while the availability of earlier stage funding such as angel funding was limited. In 2008, it reversed with a reasonable supply of early stage funding existing for investment-ready companies and a shortage of venture capital.

Notwithstanding, based only on the current 'organic growth' rate in the number of early stage investments, there must be more funding committed to the market otherwise there will be significant shortages for early stage and for follow-on funding. If the goal outlined in this report is to be achieved, the need for subsequent/expansion funding will be even more significant. With the current venture capital funding gap likely to persist for the next three to four years, while the existing funds manage their investments to exit and provide the hoped for sufficient returns to raise further funds, the level of angel activity will need to be increased in order to maintain this momentum.

This will require more focus on angel/seed funding, passive funds and syndication among angel groups. There is also likely to be a shift toward university/crown research institute spinouts being funded as the focus on seeking returns from the IP investment by government is increased.

The current pool of capital that is available for investment in early stage companies is shown in table 7.1. A forecast of the situation in 2015 has also been provided. It should be noted that this is capital available, rather than investments made, and covers the entire New Zealand market due to difficulties in ring-fencing investment available within any single region. Table 7.1 shows that in 2007, only 10 per cent of the available capital (approximately \$50million) was committed to investments in early stage high companies while we are predicting this will lift to about 23 per cent (approximately \$250million) by 2015.

Source	2007		2015	
	Number	Total	Number	Total
Informal	N/A	\$250m	N/A	\$300m
Angel	6 @ \$10m	\$80m	15 @ \$15m	\$225m
Captive (seed)	6 @ \$10m	\$60m	10 @ \$15m	\$150m
Universities	1 @ \$30m	\$30m	3 @ \$30m	\$90m
Corporate	3 @ \$5m	\$15m	6 @ \$5m	\$30m
Venture Capital	2 @ \$20m	\$40m	6 @ \$50m	\$300m
<b>Total<sup>5</sup></b>		<b>\$475m</b>		<b>\$1,095m</b>

Table 7.1: Investment funding available for investment in New Zealand

### Key Supply Side Challenges

- Need to strengthen the sustainability of existing angel networks.
- Need to increase the capital pools available and the number of investors.
- Need for greater levels of expansion capital.
- Need to build the capability of investors.
- Need to engage corporates and banks in the market.
- Need to more actively promote investment opportunities and investment successes.
- Need to increase the level of national and international syndication.
- Need to increase venture capital activity and prove the financial returns of the model.

<sup>5</sup> Not included in market estimate. However, in 2007, it is estimated \$10-25m was 'international funds' and it is projected that in 2015 it will be \$100m plus.

## 7.1 Current Supply Side Initiatives

A number of supply side initiatives are currently being undertaken to address the challenges identified.

- Government grants are available in a variety of forms, primarily through New Zealand Trade and Enterprise (NZTE) and the Foundation for Research, Science and Technology, which can prove an effective way of assisting in financing start-ups and SMEs. These are generally co-funding grants and are available for innovative research and development, capability building and market development. It is reasonable to conclude however that consolidation of the various funds could have a positive impact.
- Seed Co-Investment Funding is managed by The New Zealand Venture Investment Fund Ltd (NZVIF), and is an equity investment fund aimed at businesses at the seed and start-up stage of development that have strong potential for high growth. Started in 2005, this fund provides \$40million of matched seed funding to support the further development of early stage investment markets through a co-investment fund alongside selected Seed Co-Investment Partners. \$18 million has been committed through the programme to date by both the fund and matching contributions.
- The number of angel groups and early-stage funds continues to grow. The development and formation of new groups throughout the country does increase awareness about early stage investment and should increase the number of potential investors. However, there are issues around the differing levels of capability within the angel networks and the sustainability of the networks.
- New funds entering the market such as Pacific Channel, Cure Kids & the University of Auckland's involvement in the AUD\$30 million Trans Tasman Fund.

## 7.2 Critical Supply Side Success Factors

The current initiatives being taken on the supply side are addressing some of the issues but the following gaps still exist and need to be better addressed.

### Number and size of capital pools

In order to grow the pool of capital available, and meet the need for larger investments and a greater number of investments, it is vital that new investors enter the market. Even on the current 'organic growth' rate of early stage investments, there must be more funding committed to the market or there will be significant shortages for follow-on funding. If the goal of this report is to be achieved, even more subsequent or expanded funding will be required. For example, the New Zealand early stage investment market for the years 2006, 2007 and 2008 has been approximately \$20M per annum invested in just under 100 companies. These 100 companies' capital expectations for the years 2009 to 2011 are 4 times what has been invested previously, highlighting a serious problem that is looming.

New investors need to be attracted and this is best achieved through the promotion of successful investments and better education of the benefits of investing. For angel networks this is vital as international best practice shows that the 'membership churn' within angel groups in mature markets is approximately 20 per cent per annum and larger numbers of investors will help ensure sustainability of networks. Further, it is international experience that in angel networks the 20/80 rule applies where 20 percent of the network does most of the work and has the experience necessary to assist the early stage companies. In Auckland, there is a significant issue of 'burn out' from this active 20 per cent. As part of this process, research will need to be completed to show the Internal Rates of Return (IRRs) from any existing investments. Attractive returns will be required to encourage the existing and new investors to support future funds.

There is a need for three to four new angel networks and early stage funds in the Auckland region (including any sector specific networks such as life science), new venture capital funds with bigger pools of capital and more significant seed funds. The establishment of passive funds for persons who are interested in the early-stage industry but who do not have time to devote would appear to be an attractive option. The New Zealand Venture Investment Fund has lead the development of this concept and will shortly launch the Halo Fund in partnership with the private sector.

### Education and information for investors

Education is important for the early-stage funding industry as it builds investor confidence, increases investment activity and can result in more successful ventures. Seminars and workshops have proven effective in upskilling angel investors. This is important as the greater the expertise and knowledge of the investors, the higher the likelihood of a successful investment. Obviously the higher the percentage of successful investments is, then the greater the number of investors that will want to become active in the market.

Nationwide delivery of angel education occurred in the past on a minor and low scale basis utilising internationally recognised programmes such as the 'Power of Angel Investing' delivered by the Kauffman Foundation in association with organisations such as Incubators New Zealand and The ICEHOUSE. National organisation or development of any educational programmes would provide time and cost savings for individual networks and allow investors to access a quality programme. Development of a curriculum and training programme is best managed nationally by the proposed angel association.

Angel networks also play a key role in the education process. By joining a formal network new investors are able to access the knowledge of experienced investors and possibly take a more passive approach to initial investments. The variety of experiences by angels in many different vertical markets can be of enormous value when an angel is considering investing in a business that is unfamiliar. This process can also enable education to play a key role in encouraging and developing lead investors which is important in order to increase numbers of deals and the levels of syndication.

The provision of information is also a key component in encouraging new angel investors and the publishing of guides such as New Zealand Venture Investment Fund's 'Best Practices for Angel Investing' and 'Young Company Finance' should continue to be undertaken but strengthened.

#### Promotion of investment opportunities and successes

There is currently limited access available for investors to the profiles of opportunities that are seeking investment. Exposure of opportunities to a larger pool of investors will increase the percentage of companies seeking investment that actually receive early stage funding. Investment in technology frameworks to deliver this collaboration between investors and applicants would deliver significant benefits.

In addition there also needs to be greater promotion of investment successes and the benefits of early stage investing which could encourage new investors into the market. Once again this should be undertaken nationally, as there is a need to grow the number of investors nationally in order to achieve desired syndication levels, and a national association would be able to achieve greater media exposure and profile than can be achieved by any one network or region.

#### Level of national and international syndication

Syndication is important in New Zealand as it provides a mechanism for addressing the equity gap caused by the lack of early stage capital available and venture capitalists concentrating on later-stage investments. While angels in New Zealand have typically invested \$20,000 to \$250,000 per business, and are usually involved in two to three investments, syndicating with other angels would allow Kiwi angels to mitigate risk and collectively invest up to \$1million per deal. Syndication can also provide the ability to invest in new industries that have higher capital or investor knowledge requirements and provide the ability to access other regional and/or off-shore funds.

By 2015, we estimate that 35 per cent of all investments made or one in three deals will be syndicated between funds/angel networks in New Zealand and a further 10 per cent or 15 deals from the Auckland region will be internationally syndicated. To achieve this will require relationships to be developed between investor networks and funds, more experienced lead investors and the challenges around tax treatment for international angel investment to be resolved. Developing the relationships and advocacy role will need to be undertaken at a national level. Technology can also play a role here in enabling the sharing of deals, and ultimately to encourage syndication and this should be actively pursued. Ideally syndication levels would be up around a rate of 75 per cent nationally and 40 per cent internationally, but it is acknowledged that it necessary to start somewhere.

#### Venture capital activity and returns

As venture capital becomes more and more focussed on expansion phase funding there is an exit problem for the early stage funders. Linkages between early-stage funders and venture capitals need to be strengthened to encourage increased follow-on funding from venture capital. There is also a need for institutional investment in the venture capital market to be looked at as a very long-term game, ie 15 years, and for it to be more attractive to get funds up and running. Like other funds there is a need for clear evidence of above average and internationally competitive rates of return for investors in the early stage and venture capital markets in New Zealand.

#### Commercialisation of Research

In overseas markets, the commercialisation of university and research institute innovations is a significant factor in helping to develop start-ups and high-growth potential firms. Early stage investors will only invest in research innovations if they

think that they can be successfully brought to market. However, for this to work, angel investors investing in and working closely with commercialisation arms need to be technologically savvy, or in other words, understand the implications involved in successfully commercialising research innovations, which are often highly risky and IP based. There is currently a shortage of these people and there is a limited commercial model to pay for the services. The establishment of specialist industry-based angel networks or sub-networks and the development of national networking between angel investors with this knowledge could provide one solution.

Another solution that would assist in generating university and research institute spin-offs is the involvement of 'translators' who can act as the conduit between companies, funders and research providers and explain the technologies involved and the market potential. The European Commission found that cooperation between universities, research institutes and financiers was singled out in Europe as a crucial factor in increasing the amount of financing available for the commercialisation of research.<sup>6</sup> More investment and activity is required in supporting and driving the innovation ecosystem, particularly between the various participants.

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<sup>6</sup> European Commission (2002). Benchmarking business angels.

## 8. RECOMMENDATIONS

To increase the level of early stage funding in Auckland and New Zealand there is a need to:

- Grow the size and number of capital pools
- Grow the number of investors
- Increase the capacity of infrastructure
- Improve the capability of entrepreneurs
- Improve the capability of investors
- Improve coordination among the market players on the demand and supply side.

The following recommendations outline how this can be achieved.

### 8.1 Formation of a National Angel Association (Established July 2008)

A number of the activities required in order to grow the demand and supply side for early stage funding are better tackled at a national rather than regional level. Auckland would be represented on this body through the memberships of locally based angel networks and early stage fund organisations. The national body would then take responsibility for:

- Developing an industry strategy and industry benchmarks for success
- Promoting collaboration among angel groups, encouraging greater syndication between New Zealand groups and cross-border with global groups in order to increase the capital pool and expertise available
- Educating entrepreneurs, new angel investors and angel groups to improve capability
- Promoting the benefits of angel investment to the entrepreneurial community and potential new investors
- Improving information in the marketplace to more easily facilitate investment
- Encouraging the exchange of best practice between members
- Working with research institutes/universities to facilitate an increase in the number of angel backed deals
- Conducting research, compiling statistics and publishing industry information to help demonstrate industry trends, economic impact and benefits of angel investment
- Advocating for changes in the investment environment that will increase early stage investment.

This initiative was identified during the research and consultation phases of this report and has subsequently been established in July 2008 through seed funding from AucklandPlus and the New Zealand Venture Investment Fund. The association is currently funded through membership fees and sponsorship although there is a need for additional funding if the activities suggested in this report are to occur. There are also specific sponsorship branding opportunities that Auckland should explore, particularly around the national conference that is proposed.

### 8.2 Development of an International Angel Investor Exchange programme

Incorporating three key components, this programme would develop the international links which are required for syndication, learn from international best practice and utilise the international angel investors to assist early stage businesses to enter global markets or secure international angel investment. The three proposed components are:

- A visiting angel investor programme, based along similar lines to the visiting professor models utilised by universities world-wide. This would provide funding to cover airfares and living costs in order for leading international angel investors to base themselves in New Zealand for three-six months.
- New Zealand angel investor international conference attendance programme which would fund New Zealand angels, on a 50/50 basis, to attend major international angel conferences to develop relationships for the purpose of subsequent syndication and market entry of New Zealand firms into these markets.
- International angel network partnerships, designed to further encourage and support angel network to network partnerships. Development of these partnerships would be expected to be established based on personal relationships and through established channels such as sister city programmes.

These initiatives would have a significant multiplier effect on the capability and connections in the New Zealand market.

### **8.3 Feasibility study into the need for a Life Science Angel Network (Phase 1 Feasibility Study complete April 09)**

The life science sector faces two barriers to early stage funding: 1. the need for greater levels of funding than other sectors due to the high cost of getting a product to market and 2. a shortage of investors who understand the technology. As a result of this and initial consultation with players within the life science market has been recommended that a nationwide feasibility study be undertaken for a life science angel network.

It is expected that if a network is established that it would meet the need for seed and early-stage funding for life science companies by identifying promising investment opportunities and bringing together members who add sector-specific experience, broad networks, and financial backing. The key need within any network is for talented people who can undertake the due diligence and assess the market opportunity, then lead the investment, which other networks in New Zealand and internationally can syndicate on. In order to get the critical mass required of sector-experienced angel investors it is believed that the network would need to be national with international members added subsequently.

This initiative was identified during the research and consultation phases of this report and the feasibility study has been initiated by AucklandPlus and was completed in April 2009. It is recommended that discussion on improving access to investment for other sectors such as marine and advanced materials are considered in due course.

### **8.4 Pilot programme to translate between Researchers and Private Sector**

This initiative would address the demand side issue of increasing the number of investment propositions out of universities and crown research institutes. It is envisaged that at least five 'translators' are initially funded for a year, on a part-time basis, to work with the researchers to assist in commercialisation and investment readiness. They would work with tertiary providers, tech parks and incubators and act as a conduit between the research providers, companies and funders. The key for this initiative will be accessing talent that has sector specific expertise and understands the science and research environment. There are linkages with other parts of the Metro Innovation Project, particularly in the digital content sector or with the feasibility work being undertaken around a life sciences network. Either of these could be a good starting point for this initiative.

It is believed that the model could be adapted from The ICEHOUSE's 'Entrepreneur in Residence' programme and that an organisation, with access to this type of talent, will need to coordinate the programme. It is expected that an initial pilot will require approximately \$500,000 funding. If successful the initiative would increase the number of start-ups, increase engagement by private sector with research providers and increase investment in research spin-outs. It is believed that this pilot could be expanded nationally at a later date if successful.

It should be noted that there are other systematic issues that need to be addressed that would also assist in meeting this objective. This includes underlying issues with the crown research institute business model and the need for up-skilling of many university and commercialisation offices and staff.

### **8.5 Hosting of an International Early Stage Investment Conference in New Zealand**

It is recommended that a major international early stage investment event be held in Auckland to increase the exposure for early stage investment opportunities to a national and international market. This event would also provide a forum for educational opportunities to improve the capability and professionalism of both investors and businesses seeking investment. It is probably advisable that this conference be held once the market has grown and strengthened – possibly in 2011 to coincide with the Rugby World Cup.

### **8.6 Increase the scale of programmes that assist entrepreneurs to become investment ready**

There already exists a number of programmes such as the Incubator Support Programme and Escalator which are having an impact on the management capability of entrepreneurial firms. The issue of investment readiness needs to be raised at a national level and a significant increase in support of these programmes together with consolidation for scale purposes would lead to an immediate impact given there is no ramp up requirement for a new initiative. This may require advocacy to policy makers, by local and regional government (and the proposed national angel association), on importance of investment readiness.

### **8.7 Support for the establishment of a National Business Plan Competition**

That financial support is provided for the development of a national business plan competition designed to draw a greater number of Auckland and New Zealand SME businesses into the market place. This will be important for enlarging the pipeline but requires a significant 'honey pot' prize that attracts people into the process of idea/business development. The process of participating in the competition is viewed as the key outcome. It will need to be determined whether this

competition is designed for both start-ups and SMEs or just SMEs, though the initial recommendation is that the focus should be heavily SME.

This competition could be designed to have an educational component to start the 'investment-readiness' process and use a self-diagnosis tool at the front end. A key component of the investment readiness process is education by doing. A self-assessment tool, like 'The Gauntlet' in the UK, can allow companies to test whether they are suitable and ready for early stage funding. This can positively impact on the number of companies that seek investment and who seek professional assistance. Any tool developed would need to be freely available and could be modelled of the Management Focus assessment kit undertaken by the Ministry of Economic Development.

### **8.8 Greater support for culture changing media programmes**

A major driver of the cultural change required to increase the number of companies seeking to grow is the use of media and particularly TV. A need has been identified through the Metro project process for local and regional government to strongly advocate to central government for increased funding of media programmes that can significantly impact on increasing the growth ambition of New Zealand businesses. This could be achieved through dedicated funding as part of NZTE's Enterprise Culture and Skills Fund or through NZ On Air.

### **8.9 Delivery of a national communications and education programme**

A key activity required is increased communication about what is happening in the market. The three key participants involved in undertaking this activity are the Angel Association New Zealand, New Zealand Venture Investment Fund and Escalator. This communications and education programme would be undertaken to increase the supply side of angel investors and early stage funders, and increase awareness among start-up businesses and SMEs of the benefits, sources and investment readiness requirements of early stage investment.

Specific activities would include:

- Continued publication of the Young Company Finance Newsletter with increased distribution through professional networks and channels designed to present the results to the wider public. This could include distribution through mainstream media such as daily newspapers.
- Technology solutions being implemented, including an industry web portal and deal collaboration software, by all Auckland and New Zealand early stage funding providers. There is a definite need for one portal for New Zealand that connects the demand and supply sides, which also in time provides the opportunity for connection to preferred international partners.
- Ensure better coordination of activities and events, and increased connectivity between the demand and supply sides. These should include regular entrepreneurs-meeting-investors events and could be specific to the network, the region or the country.
- Consideration of a pipeline approach to the identification of high potential SMEs in the Auckland region that could be nurtured and developed on a case by case basis to become high growth.

### **8.10 Changes to the Seed Co-Investment Fund Criteria**

The establishment of the New Zealand Venture Investment Fund, and in particular the Seed Co-Investment Fund, has proven extremely successful and continuation of their operations is recommended with some enhancements to its mandate. Given the current market conditions and significant demand for follow-on funding it is recommended that the 1:1 ratio of matching funding for new investments is changed to 1:2 for the next three years, thus encouraging more 'new investments' while the maximum investment should be lifted to \$1m, with follow-on funding falling back to the existing 1:1. The cap of \$8 million per Seed Co-Investment Fund partner should also be increased as existing partners reach this entitlement.

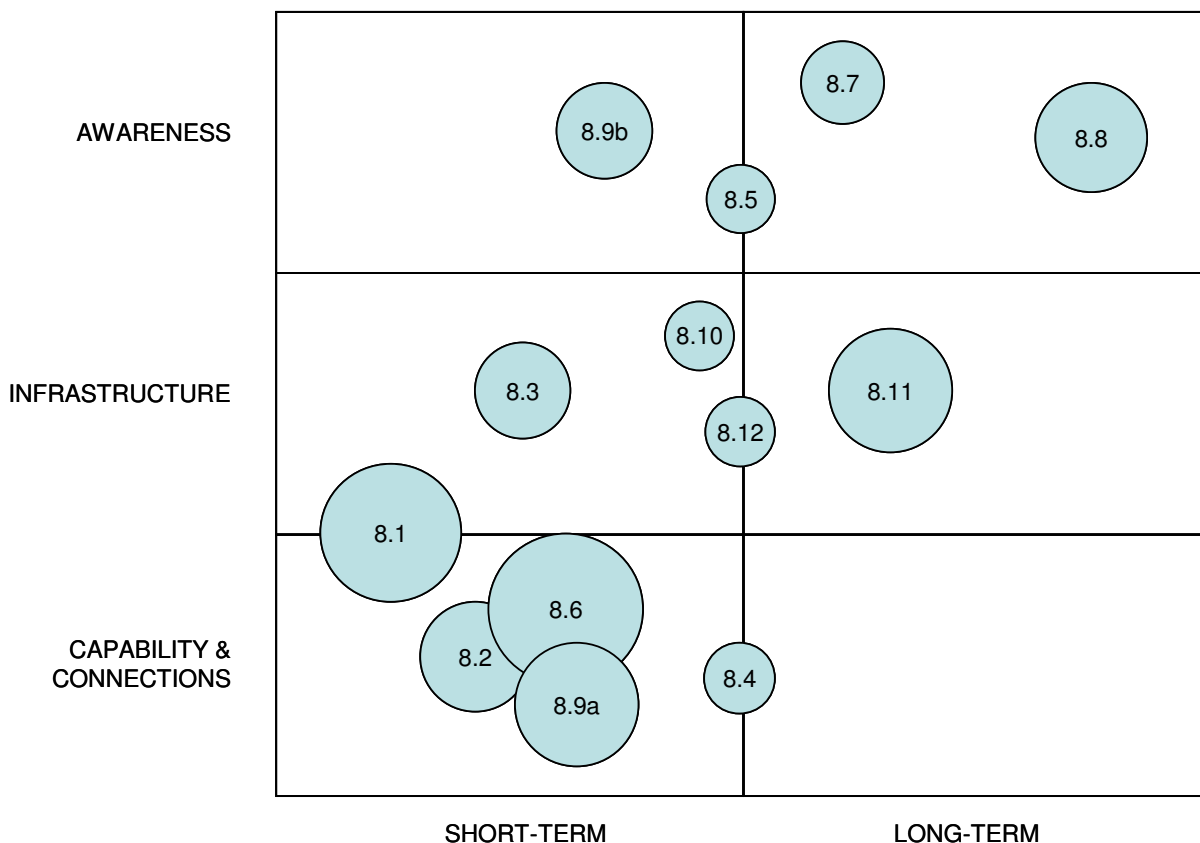
### **8.11 Increased Support for Tech Park and Incubator Development**

In order to achieve the goals identified earlier there is a need to increase the pipeline of investment-ready companies. Two of the key infrastructure components to achieve this are technology parks and business incubators but at present these organisations do not have the capacity to create the pipeline required. There needs to be regional support for tech park development (need two- three tech parks in Auckland with capacity of a minimum of 100 start-up companies) and an increase in scale of the incubator community from 36 start-up companies to over 100 start-up companies.

### 8.12 Encourage the Creation of New Passive and Co-Investment Funds

The funding of early stage companies will always be limited by the size of capital pool available for investment. There is a need for new pools of early stage funds in the Auckland Region and passive funds can be a mechanism for people who are interested in the early-stage investing but who do not have time to devote to angel investment or as a first step to encouraging new angel investors in to the market. The New Zealand Venture Investment Fund is currently launching the Halo Passive Fund and central government needs to encourage and/or seed the development of further investment funds.

Set out below are the recommendations in the context of time and potential impact with the size of the circle recognising the size of their impact.



*Disclaimer: It is expected that other outputs and initiatives within the Metro Innovation Project will touch on the issue of early stage funding in relation to their specific sectors (for example the digital sector). Recommendations on those findings may need to be considered by those that contributed to the development of this report at a later stage).*

Recommendation	Detail	Issues Addressed	Responsibility	Market Segment	Projected Cost
Encourage the formation of a national angel association. (Achieved July 2008))	<ul style="list-style-type: none"> <li>▪ Nationwide communications and education of entrepreneurs and investors.</li> <li>▪ Advocacy for changes to regulations and investment environment.</li> <li>▪ Development of industry statistics including measurement of investment returns</li> <li>▪ Improved networking opportunities.</li> <li>▪ Sharing of best practice.</li> <li>▪ Information dissemination.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need for more angel investors and larger pool of capital.</li> <li>▪ Need for greater levels of syndication.</li> <li>▪ Need to educate and increase capability of investors.</li> <li>▪ Need to improve connectivity between demand and supply sides.</li> <li>▪ Need to improve awareness of benefits of investment.</li> <li>▪ Need to increase capacity of current pipeline.</li> </ul>	<p>Angel Association NZ</p> <p>Ongoing funding required.</p> <p>Possible consolidation with Incubators NZ, Angel Association NZ &amp; NZVC&amp;PE Association</p>	Supply side (primarily)	\$150,000 - \$200,000 pa
Develop an international angel investor exchange programme.	<ul style="list-style-type: none"> <li>▪ Visiting investor programme.</li> <li>▪ Co-funding international angel conference attendance.</li> <li>▪ Creation of partnerships with international angel networks.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need for greater levels of international syndication and investment.</li> <li>▪ Need to educate and increase capability of investors in New Zealand.</li> </ul>	Angel Association	Supply side	\$200,000 pa
Conduct feasibility into the need for a life sciences angel network. (Achieved April 2009)	<ul style="list-style-type: none"> <li>▪ Feasibility on national angel network.</li> <li>▪ Potential process for marine and advanced materials sectors.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need for greater levels of funding to get product to market.</li> <li>▪ Need for more investors who understand the technology.</li> </ul>	AucklandPlus for validation.	Supply side and demand side (start-ups)	Implementation \$300,000 - \$400,000 pa
Pilot programme to translate between researchers and private sector.	<ul style="list-style-type: none"> <li>▪ Multiple translators assist with commercialisation.</li> <li>▪ Assist in explaining technologies to potential investors.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need to increase investment propositions from universities/crown research institutes.</li> <li>▪ Need to increase investors with knowledge of technology.</li> </ul>	RFP or existing provider.	Supply side and demand side (Start-ups)	\$500,000 pa

Recommendation	Detail	Issues Addressed	Responsibility	Market Segment	Projected Cost
Host an international investment conference in New Zealand.	<ul style="list-style-type: none"> <li>▪ Conference with both national and international investors.</li> <li>▪ Educational forum for investors and entrepreneurs.</li> <li>▪ Investment matching component.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need to increase the level of investment readiness.</li> <li>▪ Need to educate and increase capability of investors.</li> <li>▪ Need promoting of opportunities for investment to international networks</li> </ul>	Angel Association and Investment NZ	Supply side and demand side (start-ups & SMEs)	\$150-250,000
Increase the scale of programmes that assist entrepreneurs become investment ready	<ul style="list-style-type: none"> <li>▪ Increase funding and reach of investment ready programmes, with a clear focus on increasing the number of 'capable investment intermediaries.</li> <li>▪ Increase funding of Incubators in the region to enable a greater scale of offering.</li> <li>▪ Tie any funding to a focus on SMEs and consolidation of providers in market to achieve scale and efficiency.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Provide an immediate impact on the investment ready rate of 30%.</li> <li>▪ Focus in the area of SMEs as they are a key area for the future.</li> </ul>	NZTE	SMEs	\$400,000 pa
Support the establishment of a national business plan competition.	<ul style="list-style-type: none"> <li>▪ National competition with prizes that encourage entry.</li> <li>▪ Process involved in competition is the most important part.</li> <li>▪ Process could have educational component with self-diagnosis tool. This is important as we believe that the tool will only work if tied to a process.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need to encourage businesses into the investment market place.</li> <li>▪ Need to increase the level of investment readiness.</li> <li>▪ Need for education by doing.</li> <li>▪ Need to increase the level of investment readiness.</li> </ul>	RFP	Demand side (start-ups & SMEs)	\$500,000 pa

Recommendation	Detail	Issues Addressed	Responsibility	Market Segment	Projected Cost
Delivery of a national communications and education programme.	<ul style="list-style-type: none"> <li>▪ Deliver national education for investors based on international best practice.</li> <li>▪ Undertake communications programme to increase awareness of the benefits of early stage investment and increase numbers of investors and businesses.</li> <li>▪ Continue the publication of Young Company Finance which provides communication of deals done, profiles and industry statistics.</li> <li>▪ Implement technology solutions, an industry portal and deal collaboration software, to encourage awareness and connectivity.</li> <li>▪ Ensure better coordination of activities and events.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need to educate and increase capability of investors.</li> <li>▪ Need to improve awareness of benefits of investment.</li> <li>▪ Need to promote investment successes.</li> <li>▪ Need to demonstrate evidence of return on investment.</li> <li>▪ Need to increase connectivity between demand and supply sides.</li> <li>▪ Need to increase entrepreneurs' knowledge about the marketplace.</li> <li>▪ Improved access to opportunities.</li> </ul>	Angel Association, New Zealand Venture Investment Fund and Escalator.	Supply side and demand side (SMEs and startups)	<p>\$100,000 pa</p> <p>\$30,000 seed funding.</p>
Advocate for greater support for SME culture changing media.	<ul style="list-style-type: none"> <li>▪ Advocacy for dedicated funding for business culture changing media.</li> <li>▪ Dedicated funding could be part of NZ On Air or NZTE's Enterprise Culture and Skills Fund.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need to encourage businesses into growing their companies into export businesses.</li> </ul>	AucklandPlus	Demand side (SMEs)	<p>-</p> <p>(Funding would need to be \$250,000 - \$500,000)</p>
Continuation of the VIF and SCIF with increases in investment levels.	<ul style="list-style-type: none"> <li>▪ Recommend change in matching levels and, investment maximum lifted to \$1m with cap per SCIF partner lifted to \$8million.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need to increase size of capital pools available.</li> <li>▪ Need to increase size of funds in certain sectors.</li> </ul>	New Zealand Venture Investment Fund	Supply side and demand side (SMEs and startups)	-

Recommendation	Detail	Issues Addressed	Responsibility	Market Segment	Projected Cost
Support for tech park and incubator development.	<ul style="list-style-type: none"> <li>▪ Need for two-three new tech parks in Auckland.</li> <li>▪ Need to increase scale of incubation to 100 companies.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need to increase capacity of current pipeline. If we are to achieve the number of start-ups required then it requires an increase in infrastructure funding.</li> </ul>	MED & NZTE	Demand side (start-ups)	Capital pool for increased investment of incubators.
Encourage the development of new passive and seed funds.	<ul style="list-style-type: none"> <li>▪ NZVIF launch the Halo Fund.</li> <li>▪ Advocate that government support new seed funds.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need for larger pools of capital.</li> <li>▪ Need to attract new investors.</li> </ul>	New Zealand Venture Investment Fund and Angel Association of New Zealand.	Supply side	-

## APPENDIX: INTERNATIONAL ADVISORS

### International Advisers

#### ***Anthony Clarke - Chair London Angels, President European Business Angel Association***

Anthony Clarke is Managing Director of GLE Growth Capital specialising in providing early-stage equity finance for high growth businesses. GLE Growth Capital includes the London Business Angels Network and its sister angel co-investment fund London Seed Capital. Anthony is also Managing Director of the UK's first Enterprise Capital Fund, the £30 million Seraphim Capital Fund, and of GLE Limited. He is also President of the European Business Angels Network (EBAN) and Chairman of the British Business Angel Association (BBAA). Anthony also holds a position on the Board of Catalyst (Council for Advancement of Science and Industry for London).

#### ***John Morris - Past Chair, Tech Coast Angels, California***

John Morris is Managing Director of GKM Ventures and is the immediate past Chairman of the Tech Coast Angels, the largest angel investor organisation in the country investing in startups and early-stage companies. John is also the past president and a co-founder of TCA's Los Angeles network. John is also the President of the Western Region's Association of Small Business Investment Companies. During his career in venture capital, John has been a director for a number of private and public companies. He presently is the co-chair of Entretch and a director for the Los Angeles Venture Association. He is a co-founder and past president of the Forum for Corporate Directors in Orange county. Currently John is a director for Syntricity, Accordent Technologies, BrightQube and a board observer for Sodahead. John is a frequent panel speaker on venture capital and angel investing. Finally, John is a faculty advisor in the Global Access Program at UCLA's Anderson Business School.

#### ***John McTaggart - Chair, Australian Association of Angel Investors, Brisbane***

John has extensive experience across many industries, including export of animal products, food processing, industrial fasteners, Formwork, manufacturing of building equipment and computer hardware and software. John is currently the executive chairman of Brisbane Angels Pty Ltd and the managing director of Jontra Holdings Pty Ltd, J L Mactaggart Holdings Pty Ltd, Associated Construction Equipment Pty Ltd and director of Australian BioRefining Pty Ltd. Listed company directorship include Technology One Limited. John is also the president of Australian Association of Angel Investors limited and a founding committee member of the World Business Angels Association. John, through J L Mactaggart Holdings Pty Ltd and Jontra Holdings Pty Ltd, has provided venture capital to many companies including co-founding and all the capital requirements until listing for Technology One Limited.

#### ***Marianne Hudson - Executive Director, Angel Capital Association, US***

Marianne Hudson is Director, Entrepreneurship at the Ewing Marion Kauffman Foundation. She oversees many of the Foundation's entrepreneurial education, mentoring and networking programs designed to ensure that more entrepreneurs develop sustainable, innovative businesses. She serves as Executive Director of the Angel Capital Association, a professional organisation of North American angel investing groups focused on networking, research and sharing best practices. They currently have 165 member angel groups and another 22 organization as affiliates throughout North America. These angel groups fund approximately 700 new companies each year, and have an on-going portfolio of more than 5,000 entrepreneurial companies throughout the United States and Canada.

#### ***William Payne - Past Board Member, Angel Capital Association, US; Tech Coast Angels; Vegas Valley Angels; Montana Angels***

Bill Payne currently assists the Ewing Marion Kauffman Foundation to advance entrepreneurship in America and improve the education of children and youth. In his role (since 1995) with the Kauffman Foundation, Bill has worked on educational programmes for entrepreneurs and their investors, including [www.eVenturing.com](http://www.eVenturing.com) and the Power of Angel Investing seminar series. Bill Payne is an active angel investor, board member, and advisor to Entrepreneurs and has over 120 combined years of board service for private companies and not-for-profit organisations. He currently serves as advisor to several start-up companies and is an involved member of the Frontier Angel Fund, Tech Coast Angels (San Diego), Vegas Valley Angels and Aztec Venture Network. For over three decades, Bill Payne has successfully founded or invested in 37 start-up companies and was previously a board member of the Angel Capital Association.

## APPENDIX: DEFINITION OF TERMS

**Angel:** An angel investor is a name used for investors who invest capital directly into small and medium sized businesses, but contrary to common belief, they are not philanthropists. There are numerous types of angel investors with varied motivation for investing in small and medium sized businesses. All seek significant and viable returns from the businesses they invest in (<http://www.bizangels.co.nz/Portal.asp>).

**Early Stage/Start-up:** The business is in the process of being set up or may have been in business for a short time. Such firms have not yet sold their product commercially and have little or no track record. Funding is required to initiate commercial manufacturing and/or sales. (<http://www.nzvca.co.nz/GlossaryOfTerms.aspx>).

**Early Stage:** Companies carrying out product development and initial marketing, manufacturing and sales activities. (<http://www.nzvif.co.nz/documents/Angel%20Guide.pdf>).

Early stage capital investment is for those investors that do not want the risk of the seed and start up business. Quite often the product or service development has finished and the company is making sales but profitability is marginal. (<http://www.escalator.co.nz/content/Resources/Investment%20Ready%20Guide%20-%20Main/1218/Chapter%206%20-%20Investment%20stages%20and%20funding%20sources.pdf>).

**Informal:** The informal capital market covers a wide range of investors, from founders, families and friends through to business angels. It is generally distinguished from the formal capital market by the fact that the investment is done by individuals directly rather than via a specific entity (normally a company, such as a venture capital fund) ([http://www.med.govt.nz/templates/MultipageDocumentPage\\_1049.aspx](http://www.med.govt.nz/templates/MultipageDocumentPage_1049.aspx)).

**Seed/captive:** Money used for the initial investment in a project or startup company, for proof-of-concept, market research, or initial product development, also called seed financing or seed money ([http://www.investorwords.com/4453/seed\\_capital.html](http://www.investorwords.com/4453/seed_capital.html)).

**Syndication:** The joint purchase of shares by two or more venture capital organisations or the joint underwriting of an offering by two or more investment banks (<http://www.nzvca.co.nz/GlossaryOfTerms.aspx>).

**Venture capital (VC):** Independently managed, dedicated pools of capital that focus on equity or equity-linked investments in privately held, high-growth companies. Many venture capital funds, however, occasionally make other types of private equity investments. Outside the United States, this phrase is often used as a synonym for private equity (<http://www.nzvca.co.nz/GlossaryOfTerms.aspx>).



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