Retail recovery
C3

THE DOMINION POST
BusinessDay
SECTION C
SATURDAY, MAY 15, 2010

NZX 50 3191.01 ▼ 4.80 | NZ$1= US71.37c ▼ 0.33 | NZ$1= A79.56c ▲ 0.11 | 90-DAY BILLS 2.92% ▮ STEADY | OIL US$74.04 ▼ 0.36

More capital-starved firms may be forced overseas if New Zealand's small pool of venture capital doesn't increase, reports **Catherine Harris**.

Why Kiwis should take the plunge

Cool reception: The pool of finance to help firms who have outgrown angel investment is very small, says BioVittoria's David Thorrold. Photo: FAIRFAX

THERE'S no trace of bitterness in David Thorrold's voice when he talks about the failure of his company BioVittoria's sharemarket float late last year.

Yet the likelihood that his company will probably now find the funds overseas is bittersweet.

The Hamilton-based company, which has developed a natural sweetener from fruit grown in China, tried to raise up to $20 million but failed to even make its minimum $8m.

It was not alone – all three IPOs launched at that time failed to woo investors with the post-recessionary blues.

To some, BioVittoria's issue fell into a classic venture capital gap – too big for angel investors, too small for private equity.

Mr Thorrold says the keys to raising money in New Zealand are "how much do you want to raise and what stage is the company at?".

"If you're a company that's been around for 20 years and you've got a turnover of $10m and you're looking to do a management buyout and the company is profitable, then you'll get funded to do that. There are private equity funds in New Zealand that will fund you to do that.

"But if you're a company that's $10m turnover and hoping to get to $100m in five years and you need $20m, then that's going to be difficult for you."

BioVittoria, still in its early stages, is making just US$4.5m and has yet to turn cash-positive.

"There is just not a large pool of funds that's there for companies at that level."

The health of our capital markets also worries Andrew McDouall, head of Wellington brokerage McDouall Stuart, which advised BioVittoria last year.

"The need to raise capital at the moment has never been greater. The ability to raise it has never been harder. We need it and it's just about impossible to raise."

In Mr McDouall's opinion, capital markets in New Zealand are "quite sick". Although the government is tightening regulations to improve confidence in the financial system, he also blames the New Zealand psyche.

Our low level of savings, and a Kiwi distrust of the sharemarket after the 1980s crash, have funnelled available funds away from equities into houses, finance companies and conservative investments.

"Too often people think of the sharemarket as only the secondary trading, rather than the origination of the market which was, historically and is still, fundamentally to provide a market to assist in raising capital," Mr McDouall says.

"Raising capital is what the sharemarket is all about. Trading those shares subsequently was just a means to assist in raising capital."

The credit crisis and finance company collapses have exacerbated investor demand for less risky investments. Companies, too, are looking for alternatives to the banks, and so bond rather than equity issues are flavour of the month.

"The bond issues are filling a number of gaps," Mr McDouall says.

"They tend to be used as a means of reducing bank exposure [and may allow] more flexible terms. And that's seen as pretty attractive at the moment."

Brokerages are following suit, moving more into portfolio management. But the onus on portfolios has drawbacks too.

For a start, they tend to favour less risky stocks.

"Smaller stocks have greater volatility, less liquidity. So often [brokers] don't have a mandate to invest in those kinds of stocks or they just know their investor base is looking for relatively low risk," Mr Thorrold says.

THE vast amount now under portfolio management means brokerages are less likely to take the reputational risk of helping a small company to market, Mr McDouall says.

"If somebody wanted to raise $25 million in the New Zealand market, I don't know who they'd go to, apart from us."

For small companies that do manage to list, the chances of getting all-important research coverage are also lower.

Mr McDouall believes changes in the broking industry, forced by lower trading volumes, are part of the reason – brokerages are merging, overseas owners are taking stakes, decisions are being centralised, and research teams being pruned.

He thinks the number of NZX-listed stocks researched below the top 50 can be counted on two hands.

"Previously there was a much wider number of parties both in terms of firms out there and in terms of systems which allowed capital raising for smaller companies ... People were prepared to show clients opportunities which were perhaps a bit higher risk, but left the client to make the decisions.

"Nowadays, the clients are not allowed to make decisions, in many cases. It's discretionary to the adviser. You've got discretion, you tend to be more cautious which is all good for some people but it means a lot of the opportunities for small capital raisings are not getting away."

So as everyone focuses on managing risk, Mr McDouall finds it little wonder last year's three cancelled floats – the others were Synlait and DNZ – failed to get away.

Neil Paviour-Smith, head of large brokerage Forsyth Barr, believes the float failures should be judged individually and do not reflect the state of the capital market.

But he says there are some serious matters to consider.

"I think the relevance of tax to savings and how people save is extremely relevant to capital raisings and capital market development. It's no surprise in my mind that countries like Australia have got very thriving capital markets because they have a compulsory superannuation regime that they have maintained for about 25 years."

A distaste for risk is not always confined to investors. Urs Daellenbach, Associate Professor at Victoria University's School of Management, has interviewed 15 biotech and food firms on constraints to growth, and found the firms themselves had varying risk thresholds.

One company with several heavily invested owners felt raising even $2m was too much, but that changed with a new owner and a clutch of board members from the corporate world.

"Suddenly it became more about 'Yes, we're pushing this forward in new areas and we can see new revenue streams hopefully developing', and they saw it as a really good thing, rather than 'We're putting all our eggs in this basket'."

Other firms opted to grow organically or went overseas to raise capital, sometimes because the overseas lender understood the risks involved in a particular field better than banks or venture capitalists here.

> **'Sometimes one of the issues raising capital is . . . that they don't know how to articulate their vision or plan.'**
>
> ROB CAMERON, CAPITAL MARKET DEVELOPMENT TASKFORCE CHAIRMAN

"Maybe that says something about the New Zealand market, that many of these companies did have to bring in large overseas investors."

Successive governments have not sat idly by. The Venture Investment Fund, or VIF, has increasingly sought to partner with other venture capitalists, and the current Government commissioned the Capital Market Development Taskforce to report on the best ways forward.

Mr McDouall believes the taskforce was "a wasted opportunity" because it did not address wider issues such as savings, industry changes or corporate and investment tax.

But the chairman of the taskforce, investment banker Rob Cameron, disagrees. Mr Cameron – whose firm successfully helped Xero and, more recently, Ecoya, to list – says the taskforce made a number of tax recommendations, but wanted to look at the capital markets as a system rather than "magic bullets".

He agrees there are "quite big gaps" around commercialising early stage companies and a need for the Government to "play in that area".

But he believes the key is to have good "stepping stones" between all the markets, including the private market where a lot of SME capital raising still goes on.

"If you're looking at SMEs you have to look at all the various areas from which they can get capital, which is private markets, unregistered markets, and the publicly listed market.

"Certainly for some smaller growing companies, accessing small amounts from the public listed markets isn't going to work. The way I think about it is less about the amount of capital they want to raise then the costs imposed on them."

ONE OF the taskforce's recommendations was to remove the regulatory axe that hung over the unregistered market, and allow the NZX to operate there.

"In most other capital markets, the listed player is able to participate in those sorts of register-exempt markets and almost develop them as feeders through to the publicly listed market."

The overall solution, he says, is to make the public market more attractive and reverse the "low birth rate" of listings.

This is why the taskforce called for partial listings of state-owned enterprises and coaxing other big players such as council-owned subsidiaries, agricultural firms and the local subsidies of foreign-owned banks.

But sometimes, Mr Cameron says, a company's problem is not so much a lack of capital but a lack of "capability" – investor-inspiring governance skills for moving to a new market or producing a good business plan.

"Sometimes one of the issues raising capital is exactly that: that they don't know how to articulate their vision or plan."

Are our capital markets sick? Mr Cameron says no.

"I think there have been some significant steps already ... Have a look at how we've gone through the global financial crisis and we've figured pretty well. Our debt capital markets have held up remarkably well, but our equity markets have performed pretty well also."

But he says there's still an urgent need to carry out the recommendations such as with regard to the SOEs.

"I don't think New Zealand's got a choice around doing some of these things ... New Zealand is the odd one out by not doing this and the choice that governments make not to do that has a bigger impact on our investor choices and our capital market than probably any capital market in the OECD."

BioVittoria has been talking to investors in China and the United States and hopes to make an announcement within a couple of months, which means the company's headquarters may have to go overseas.

Mr Thorrold says it is an age-old problem for fledgling firms here, referring to touchscreen company NextWindow which has just been purchased by a Canadian company.

"One of the reasons that investors sell to overseas companies at a relatively early stage is they know it continues to be a challenge to find funds in New Zealand to build the business."

WAY AHEAD

Options for the Government to help small companies raise capital.

- Increase investor choice and bolster the stock exchange by partially listing SOEs.
- Further support the VIF Fund. Replace some business grants with equity or debt stakes.
- Free up the unregistered market. Make funds for commercialisation at CRIs and universities more effective – less duplication of resources and skills.

Source: The Capital Market Development Taskforce

Bringing home the importance of raising capital here

Catherine Harris

WHEN it comes to raising capital, Wellington-based Neville Jordan has first hand experience.

He was the first New Zealander to successfully float his microwave telecommunications company, MAS Technology, on the United States-based Nasdaq stock exchange.

Today he spends much of his time as executive chairman of private equity fund Endeavour Capital, which has $100 million under management.

Mr Jordan says many firms at the "expansion stage" are suffering from a lack of enough capital, companies which usually have revenues of $10m to $20m and typically $5m to $10m.

"In order to get companies listed, there needs to be some, I call it small-scale, private equity investment to bring the fledgling companies through and there is a big hole there right now."

He says a lack of institutional support for small businesses here has forced him to seek support overseas.

"I leave for the Middle East on Sunday and then there is a GM going to the US in about three weeks time to try and raise money," he said.

Mr Jordan knows the risk is not that the funding will cost more but that the companies will follow the money overseas.

"And then it's not just the companies that go, but they take with them the many years of Government investment in science and technology through the universities and CRIs and so on ... that's the sad fact."

However, he sees encouraging signs on the horizon.

The Venture Investment Fund, VIF, which "I have a very high regard for", has put $20m into his latest fund and new legislation 18 months ago has brought venture capital legislation into line with overseas.

The capital markets taskforce and a focus on getting intellectual property out of CRIs into companies is also positive.

"If I was sitting in Government I'd be saying now it's time for the private sector to perform," Mr Jordan said.

URS Daellenbach