Speech by Rob Cameron at INFINZ Conference

Wednesday 16 September 2009, Rotorua

“How can we improve our capital markets for New Zealand firms?”

1 Thank you for the opportunity to speak here today. INFINZ is one of the key stakeholder groups that we have been engaging with over the past year, so it’s a pleasure to be able to update you on our work.

The taskforce is looking at a wide range of issues. As you will all know, successful markets have to work for both issuers and investors – and the taskforce is looking across the various parts of our markets from both perspectives. A key focus in our progress report in July was on how to improve investor outcomes. Today I will focus on our capital markets through the eyes of firms.

2 I’ll begin by setting out what the landscape of New Zealand firms looks like. Then we will consider the issues those firms face and identify some possible solutions. We want to deepen our public listed markets and see more New Zealand firms growing from SMEs to large firms. Both private and public capital markets can work better to help them grow.

3 First, it’s worth noting that the majority of the largest firms in New Zealand do not participate in our domestic capital markets as either public or private firms. Most are owned by government, as co-operatives or by offshore owners. In contrast, the proportion of Australia’s largest firms that are listed is much higher.

4 If we then look at those firms which are New Zealand controlled and which participate in capital markets, we see that most of the larger ones are listed, and, the vast majority of the mid-sized firms are privately owned. By definition we know less about them, but given their importance in our economy, it is vital that we make it as easy as possible for them to grow.

5 In order for both private and public markets to work well, they need three things. First, they need efficient infrastructure to facilitate transactions – for example, trading platforms such as the NZX and good settlement and clearing systems in public markets. In private markets, the infrastructure will include intermediaries and “exchange capabilities” (such as Unlisted), and regulatory settings that allow efficient and low cost intermediation and exchange. Second, there needs to be good information in the form of data and analysis available to enable risk to be identified and price to be determined. Third, there needs to be a sufficient level of capability and skills in the market to ensure that opportunities to apply and source capital for firms with growth potential are developed, transactions are well executed, and that companies are governed well. We have been looking to find ways we can improve these key aspects of both private and public markets.

6 We need to remember that firms in our private markets are heterogeneous. The vast majority of businesses in New Zealand are small “lifestyle” ones. There is no “capital market” as such associated with these types of firms, but they are usually funded by bank debt and equity from friends and family. They tend to be bought and sold outright.

But, there is also a much smaller group of small start-up firms that have the potential to grow into larger companies. For these firms, there are two routes to growth: organically, through increased earnings, or alternatively through attracting investment from angel investors, venture capital, or private capital such as wealthy individuals and family investment trusts. Data on investments from private capital sources are limited, but we know more about the
other funding sources. The Angel Association of NZ has recorded 142 investments into young companies since 2006. NZVIF had co-invested with VC funds into 48 companies by August 2009. 28 of these are exporters.

And, there are a significant number of medium-sized companies, some of which have the potential to become much larger companies. The ANZ privately owned business barometer survey 2009 indicated that around 70% of these medium-sized businesses plan on growing.

The ANZ barometer also surveyed the options business owners thought they would most likely consider to fund any future growth. Firms were asked to select their top three choices. Banks and current shareholders were the most popular choice, with only a minority of firms keen on sourcing equity from outsiders.

If that’s the landscape, what are some of the issues we see and observations we can make? Clearly not all private firms have the desire or potential to grow to become large international businesses; but, more should than currently do. For many firms, the next stage of growth is risky. It involves external equity funding to either expand into overseas markets or undertake an acquisition. Each of these is likely to require different capabilities from those the firm has relied on to date. The ANZ business barometer survey indicates that many small business owners have the perception that external equity funding involves high compliance costs as well as dilution of their control over the business. For our private markets to work well, we need to ensure that capital and talent reach those firms that can use them. And, for those that want to, that the transition to move to a public market listing is as smooth as possible.

It also seems that New Zealand institutional investors invest less into private equity than is the case in other markets. The chart shows that there is a substantial amount of investment into alternative assets by institutional investors in Europe, Australia and North America. In New Zealand, investment into this asset class, which includes private equity, is thought to be much lower. In particular we know that there is limited private equity investment amongst large KiwiSaver providers. There are likely to be a variety of reasons for this, including the scale of institutional pools in New Zealand.

So, what are some of the options to improve how private markets work?

First, we have to ensure that there are no unnecessary barriers to the intermediation of capital to small firms. Clarifying and broadening the scope of the exemptions to the Securities Act would help. We need to design a robust and efficient registration mechanism for sophisticated investors. And streamlining some of the exemptions for securities offerings which are of a small scale or to a small number of investors (e.g. employees) is important. It is not always clear currently who is a member of the public, and thus within the scope of the Act, and who is not. The possibility that an entire allotment becomes void because one member of the public was inadvertently included in a private capital raising - particularly when the rules around the scope of the Securities Act are unclear - seems a disproportionate penalty.

Second, we need to review recent changes that have broadened the scope of companies covered under the Takeovers Code. In our view, the number of firms now captured by the Code is unduly large and the cost of applying the Code requirements to small firms is high.

Finally, there is a risk that, depending on how it is implemented, the Financial Advisers Act will also introduce additional barriers to the effective functioning of private markets. Clearly, it’s important to have a strong regime around retail investment advice and the taskforce supports that. However, we are concerned that the regime has the potential to impose...
unnecessary costs on advisers who are working with firms rather than retail investors and those working to facilitate private capital raisings.

In addition to regulatory changes, improvements can be made to increase the flow of good opportunities and their commercialisation. Government has wide-ranging initiatives in this area – as the major funder of research and in supporting the commercialisation of that research. A key theme for us is that as a small country, we need to build scale in our commercialisation activities and leverage off best practice. It seems likely that finding ways in which CRI and university commercialisation functions can be consolidated would improve our ability to build capability and best practice in this area, and would more efficiently access capital for these activities. We also note that government has a number of agencies involved. Again, building scale seems sensible, and in our view should be based around arms length, commercial models.

As well as developing the flow of investment opportunities, we need to remove any obstacles to investors into the market. Business angels who bring both skills and capital to firms play a critical role in the economy. Government already facilitates angel networks and should continue to do so. We also need to ensure that we remove any barriers to investment in private equity by institutional investors, such as managed funds. With the introduction of KiwiSaver, local pools of funds are accumulating. While not wanting to skew their investment mandates, we do need to ensure that managers who wish to are able to access this asset class. Currently, the liquidity requirements and the investment mandates of default funds bias these schemes against investments into private equity. That is unfortunate from both the perspective of investors looking for the full range of opportunities and for New Zealand businesses looking for sources of funding.

Finally, we need to ensure that private firms have attractive exit opportunities – including to public markets.

Turning to public markets, it’s clear that they are not as large or vibrant as we would like to see.

From investors’ perspective, there are limited choices available for them on local markets in sectors such as banking, energy and utilities, and agriculture. The under representation of these sectors is also be one of the reasons for the comparative lack of growth in our public markets. The ASX in Australia has grown substantially more than the NZX, but much of this growth is due to their mining and financial sector companies. Excluding these companies, the NZX and ASX have had similar growth in market capitalisation since 2000.

Interestingly, though, despite turnover being relatively low, the price discovery mechanism on our market works well. For similar-sized companies, the bid-ask spreads for the larger New Zealand companies are generally tighter on the NZX than they are on the ASX. The market serves these companies reasonably well.

It’s also sometimes argued that the small size of our market is due to the fact that the Australians steal them all. In fact that’s not the case. The rate of exits from our market is similar to that in other markets. Instead, we have a “birth rate” problem and we don’t see listed companies growing as fast as we would like.

How can we improve things? Given the relatively small size of many of our companies, we need to make the transition from private company to public company as low as possible for those that wish to make that transition. One part of that is by developing stepping stones to public markets, such as unregistered exchanges. At the moment, unregistered exchanges, such as Unlisted, operate under threat of being required to become registered exchanges. They need regulatory certainty in order to develop. And there seems
to be no obvious reason why a registered exchange should not be able to own and operate an unregistered exchange as a stepping stone to the registered market.

Its possible to imagine an unregistered exchange looking to develop an opt-in regulatory regime where companies agree to abide by particular conduct and disclosure rules, the exchange enforces those, and the companies are able to brand themselves on that basis – and lower their cost of capital. There's no particular reason why one size should fit all, and we need to develop a regulatory regime that recognises this.

Alongside such initiatives, we need to ensure that the market is seen as an attractive investment opportunity. The recent ANZ-Retirement Commission Financial Knowledge survey indicated that many New Zealanders have a poor understanding of share investing. Only 25% of participants understood that, over the long term, shares are generally considered to have the best return. This seems to have translated into very small numbers of people investing into shares here compared to other countries. We've been working on improving investor confidence and have formed recommendations to make information more readily available, improving governance standards, and ensuring that any new regulations are effective through rigorous enforcement.

14 Finally, we are looking at ways in which we can increase participation in New Zealand's listed equities market by sectors and industries which are not currently represented. Clearly, the New Zealand economy is overweight in agriculture. That should be reflected on our public markets. We need to find ways to make our markets more attractive to agricultural cooperatives – by creating mechanisms that work to meet their specific requirements. That should go beyond just debt and equity participation to include derivative products which would allow farmers and others to hedge their exposure to price volatility. There is also a potential role for government - to examine ways in which organisations it currently owns (such as SOE's) might participate in our public market without compromising control objectives. We also need to ensure that our public markets are seen as an attractive exit opportunity for foreign-controlled firms operating here. For example, when Australian private equity firms look to divest themselves of New Zealand companies in coming years, an IPO onto the NZX should be seen as an attractive option.

15 Today I've highlighted part of the work we are doing in the taskforce. Clearly though, there are a wide range of other areas that we are involved in and actively developing proposals on. We are continuing to work on how we can improve outcomes for investors – in particular, developing our thoughts and recommendations in the managed funds area. We've also undertaken work on New Zealand's settlement and clearing infrastructure, tax settings and rules and regulations as well as exploring international opportunities for our financial services sector. We're now working hard to bring the various pieces of our work together for our final report in December.

To close, let me just reiterate how important it is for New Zealand to get our capital markets working better for our firms. I think that we have a unique opportunity now, following the global financial crisis, to think through how we want our capital markets to work for New Zealand. Given the need for firms, including banks, to de-leverage following the crisis, ensuring that our capital markets work well is now more important that it has been.

I would also like to thank those of you who have contributed in some way to the work of the taskforce. We have worked hard at consulting with industry and we welcome ideas and submissions on what recommendations we should be making.

Thank you for your time.