“HOW WE INVEST” WHITE PAPER

NZ EXPANSION CAPITAL

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Te Kaitiaki Tahua Penihana Kaumātua o Aotearoa

PREFACE

The Guardians of New Zealand Superannuation uses a number of active investment strategies to add value to the New Zealand Superannuation Fund ("the Fund"). Expansion capital, which exploits some of the Fund's key endowments, is a key active investment strategy for the Fund in its domestic market, New Zealand.

This paper explains how we define expansion capital in a New Zealand context, how we access it, and how it aligns with our endowments and investment beliefs. It also explains the performance of the strategy to date.

For further information see the 'Investing in New Zealand' section of our website. A list of current Fund investment managers is maintained at: https://www.nzsuperfund.co.nz/how-we-invest-investment-managers/our-managers.

Matt Whineray
Chief Investment Officer

FOR MORE WHITE PAPERS SEE:
www.nzsuperfund.co.nz/publications/papers-reports-reviews

OUR INVESTMENT BELIEFS

Investment beliefs are a consistent way of thinking about financial markets in the context of a specific investor. Our investment beliefs are described on our website and aligned to our endowments as an investor, such as our sovereign status. In our view, it is important to clearly document our investment beliefs because it helps us remain disciplined and provides the courage to stay the course when most needed.

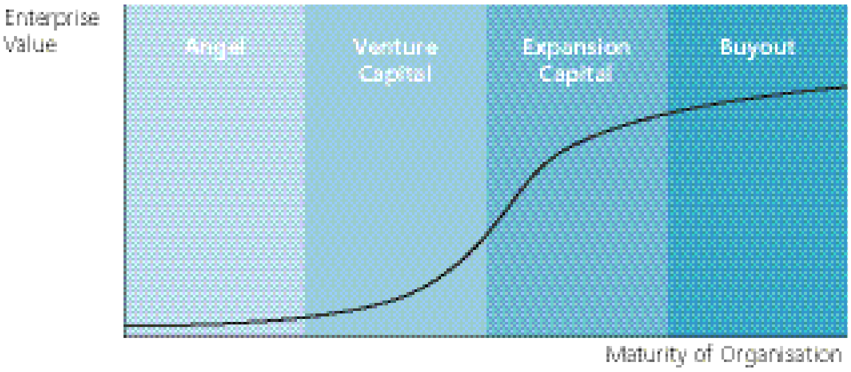
One of our investment beliefs is that "some markets or strategies have characteristics that are conducive to a manager's ability to generate active returns. These characteristics tend to evolve slowly over time…". NZ expansion capital is an investment opportunity that we believe has characteristics conducive for generating active returns. We therefore believe it is an attractive investment opportunity for the Fund's portfolio.

WHAT IS NEW ZEALAND EXPANSION CAPITAL?

We define expansion capital as the provision of capital to small, fast-growing private companies. It includes growth equity (the provision of new capital to support organic growth) as well as small and medium enterprise buyout (the acquisition of a minority or majority stake from an existing shareholder).

All expansion capital portfolio companies have proven products and established business models that would benefit from additional capital, or a refreshed strategy to accelerate their growth. This distinguishes them from venture capital portfolio companies which still have technology and commercialisation risk i.e. they need to provide evidence that there is sufficient demand for their product.

Graph 1 – Illustration of the Different Stages of Growth Capital



Expansion capital portfolio companies are typically founder-owned with no prior institutional investment. They have proven business models but their stage of maturity may vary, with buyout companies tending to be cash-flow positive. Expansion capital companies are typically growing rapidly, with organic revenue growth usually in excess of 10% per annum.

These companies' need for capital has generally outgrown the ability of the venture capital or debt markets to adequately fund their growth but they are typically not yet mature enough to list on a stock exchange. Most of these companies are also not yet large enough to be attractive investments for offshore private equity investors, who typically focus on portfolio companies that have enterprise values of NZ$100 million or more.

We believe there are approximately 5,000 companies in New Zealand that fit within our definition of expansion capital i.e. enterprise value between NZ$5 million and NZ$100 million with revenue between NZ$5 million and NZ$50 million. Investment cheque size can be anywhere between NZ$5m and NZ$50m.

WHY IS NEW ZEALAND EXPANSION CAPITAL AN ATTRACTIVE INVESTMENT OPPORTUNITY?

There are three key drivers of the investment opportunity:

1. The **supply** of available capital is constrained through a combination of low levels of private equity activity in New Zealand versus comparable markets, lack of appropriate debt products (e.g. mezzanine financing), and a listed market that is undercapitalised relative to larger developed markets. New Zealand market capitalisation as a percentage of GDP is 50% versus more than 100% for Australia and the United Kingdom;
2. Although New Zealand private equity managers raised more than NZ$1 billion in 2016, we believe **demand** for capital to support growth still materially exceeds supply. We estimate there are approximately NZ$150-250 million in transactions, supplying ~20 companies, or less than 0.3% of the ~35,000 small and medium size enterprises in New Zealand; and
3. Low levels of institutional capital penetration in New Zealand and sparse broker / intermediary coverage creates **asset level mispricing** because of poor liquidity and price discovery tools. These are features of both the public and private markets in New Zealand.

We believe the attractiveness of the expansion capital investment opportunity is likely to be reasonably persistent over time, due to the slow moving nature of these investment opportunity drivers.

Our experience supports this. We have been investing in NZ expansion capital since 2005 (Direct Capital Fund III) and have committed more than NZ$450 million[1]. Over this time we have generated an Internal Rate of Return (IRR) of 14.7% net of fees or a 1.5x Multiple of Invested Capital (MOIC), which is 0.7% over our expected return at the outset of the investment. The comparable Public Market Equivalent (PME) generated a return of 10.7% over the same period[2].

WHY DO WE INVEST THROUGH EXTERNAL INVESTMENT MANAGERS?

Our operating model is based on a commitment to active (rather than passive) investment management *only* where we have a strong expectation of meaningful risk-adjusted returns net of costs. Given the under-representation and low daily average volumes traded on the NZX of companies similar to those in our NZ expansion capital cohort (described above), accessing this investment opportunity via the listed equity market is not feasible, either in a passive or active form.

Table 1 – Comparison of NZ expansion capital companies to NZX listed companies

Metric	NZ Expansion Capital	NZX Mid Cap Index	NZX Small Cap Index
Number of companies	~5,000	38	66
Enterprise value (range)	NZ$5m to NZ$100m	NZ$270m to NZ$16bn	NZ$1.4m to NZ$1.2bn
Daily average volume traded	n/a	NZ$480m	NZ$12m
Annual capital invested	NZ$150-250m	n/a	n/a

We have increasingly developed in-house investment capability through our NZ Direct Investment team. However, this investment activity is focused on much larger investments, such as Datacom and Kiwibank, where we can leverage our endowments as a NZ sovereign fund with a very long term investment horizon to access attractive investment opportunities. By comparison, the relative size of each NZ expansion capital investment is small versus our overall portfolio, at approximately NZ$35 billion, making it difficult for us to cost-effectively invest directly into NZ expansion capital portfolio companies.

1 Commitments include a flexible component for some mandates

2 The mPME IRR evaluates what New Zealand Superannuation Fund's return would have been if the dollars invested in private funds had been invested in a public market index. The mPME calculation assumes that a public index's shares are purchased and sold according to the cash flow stream of the private portfolio, with distributions calculated in the same proportion as the private portfolio's. The NZ expansion capital mPME calculations are based on a 65%/35% blend of the NZX Small Cap and NZX Mid Cap 30 indices

Our operating model is also focused on having greater influence over the allocation of our capital to different investment risks *over time*. For example, the ability to dial up and down our risk allocation to specific investment opportunities as their attractiveness waxes and wanes is important to us as opportunistic investors, hence the recent emphasis on flexible mandates onshore and offshore. As global investors we have played a role in bringing international best practice into the local capital markets, in particular through Limited Partnership Agreements that incorporate International Limited Partnership Agreement (ILPA) principles.

Currently we are invested with five NZ expansion capital managers and have invested across nine funds. Although our preference is for fewer, deeper investment manager relationships, our appetite for NZ expansion capital materially exceeds the capacity of one manager. We therefore mandated three managers in 2016.

Table 2 – Summary of NZSF Investments in NZ Expansion Capital Managers (at 30 June 17)

Fund	Inception Date	NZSF Maximum Commitment (NZ$m)	Companies Funded	Status
Direct Capital Partners III, L.P.	04/05	$20m	13	Post-investment period
AMP Pencarrow JV	06/05	$23.75m	6	Fully realised
Direct Capital Partners IV, L.P.	05/09	$50m	8	Post-investment period
Waterman Fund 2, L.P.	04/10	$30m	6	Post-investment period
Pencarrow IV Investment Fund, L.P.	11/11	$30m	6	Post-investment period
Pioneer Capital Fund II, L.P.	12/12	$40m	6	Post-investment period
Movac Fund, IV L.P.	11/16	$50m[3]	1[4]	Investing
Direct Capital Partners V, L.P.	12/16	$90m[3]	0[4]	Investing
Pioneer Capital Partners III, L.P.	12/16	$120m[3]	1	Investing
Total		$453.75m[3]	47	

SUMMARY

We define the NZ expansion capital investment opportunity as high growth private companies that have an enterprise value between NZ$5 million and NZ$100 million. We believe investment returns are attractive because there is insufficient capital available to support the demand for growth equity from this cohort of companies. The slow-changing nature of the key drivers of the opportunity support our belief that NZ expansion capital will likely be attractive for institutional investors for the next several years. We invest via external investment managers because the size of the individual investments is significantly below where we are targeting our internal direct investment activity. The performance of NZ expansion capital has exceeded our expectations to date.

3 Commitment includes a flexible component

4 Three acquisitions added post balance date