

ViewPoint

(April 2008)

Innovation, Growth and the High Cash Rate

“Houston we have a problem” is a message from the sharp end to those with the power to assist. The message from manufacturers and exporters today is, “Wellington, we have a problem”.

The closing of the Feltex factories, the departure of companies like Humanware from Christchurch, Fisher & Paykel from Auckland and Dunedin, and the downsizing of our electronics industry are all on public record - all visible to those who care to look. The managers of New Zealand’s exporting companies report that competing internationally, or competing domestically with imports from low cost countries and high exchange rates, is just getting too hard. They are voting with their feet, and the skills and capabilities they demand waste away. But what of the companies that never were? How many companies have just not been started for the same reasons? These are the invisible casualties of the same economic forces, and are the issue behind this article.

The question is whether this loss overseas matters in a deeper way than the simple headline loss? One view is that these are sunset firms that will be replaced by new and innovative “high value” companies. But observation and theory both show this to be untrue. There are not nearly enough new businesses being created in New Zealand to rejuvenate economic activity.

We are knee-deep in innovation think-tanks, publicly funded incubators and state assisted venture capital funds. Although the New Zealand Venture Capital Association reports steady growth in funds invested, where are the new companies with turnovers of NZ\$50 or \$100 million dollars that we need to replace the companies that are relocating?

Overall, New Zealand businesses are well managed by smart people. Our managers move faster, work harder and have a better world-view than most of their counterparts elsewhere. So why are we seeing so few substantial new companies emerge?

In his book “Blueprint to a Billion”, David Thomson reports on research that identifies the common factors typical of US companies achieving \$1 billion in sales. This is a size where they are considered relatively stable and no longer a “small” company. (Based on GDP differences the equivalent figure in New Zealand might be in the region of NZ\$50 or 100 million dollars).

Thomson cites seven key skills that a business must demonstrate to achieve exponential growth. At the NZMEA, we see many New Zealand businesses demonstrating these skills, yet rapid growth to \$100 million dollars revenue eludes almost all of them.

To understand why this might be, consider figure 1, taken from Thomson’s book. His surprising observation is that from the onset of rapid growth (the “inflection point” in figure 1) businesses follow one of three trajectories, taking on average 4, 6 or 12 years to reach the billion dollar revenue level.

Another surprising conclusion of the research is that information technology companies are a minority among the total group of high growth companies, but it does appear that they are more heavily represented among those companies that follow the four year trajectory. We can also observe that by their nature, companies following the 6 and 12 year trajectories, while growing more slowly, are building bigger moats to protect themselves against competition.

Looking at local innovative companies, we do not see the 6 and 12 year trajectories. We do see a few shorter-term four year trajectory companies. These are clever, profitable and innovative firms; frequently IT based, but why are we missing the 6 and 12 year companies and what might that mean to our economic performance?

On the run-up to the inflection point, businesses are often self-funding, but from a year or two before the inflection point, a New Zealand business typically needs access to additional capital. Very little capital is available in New Zealand for companies seeking to follow a 6 or 12 year trajectory. Indicatively, our venture capital funds are ten year funds, wanting to stay invested for only five or six years. This fits nicely with companies on a four year rapid growth trajectory, but does not help the majority of businesses who will follow the longer trajectories.

What is it about our economy that means sensible, smart people do not invest in these businesses, whereas in other economies, similarly smart people do invest?

The answer is found in our systemically high interest rates. Early stage investments are usually considered risky and uncertain. The risk premium increases in a non-linear fashion, and so a company on a 6 or 12 year trajectory must pay much more for risk than a company on a four year trajectory. When the risk premium is added to the structurally high New Zealand interest rates, project returns demonstrably do not justify early stage investment in 6 and 12 year trajectory businesses. Of course, we would expect that the lower the interest rate, the longer the trajectories which investors would be willing to support. Anecdotally, this seems to be the case, with some businesses in Japan taking much longer to develop than here, or in the United States.

Until New Zealand interest rates are lowered, the majority of innovative companies (the 6 and 12 year trajectory companies) will not be able to grow to big companies in New Zealand. They have to leave and grow in capital markets more suited to their growth trajectories.

There are only two ways to fix this. Reduce interest rates, or reduce the risk premium. Better innovation management and Government assistance for R&D are both paths to reducing the risk premium, but the primary focus needs to be on interest rates.

Since its inception, the NZMEA have been advocating policies to reduce interest rates. This is not a job that can be left to the Reserve Bank alone, as they must manage monetary policy within the broader framework of Government policy. Government must take the lead, and we advocate that the Government assist the Reserve Bank by doing the following to reduce pressure on interest rates:

- Limit government and local body spending.
- Ensure a balanced and non-distortionary approach to the taxing of capital, income and profits.
- Focus any incentives on productive investment rather than speculative and inherently inflationary investment.
- Ensure that trade and climate change policy advantage rather than disadvantage New Zealand businesses.
- Use superannuation and savings approach to implement monetary policy.

As a nation, if we aspire to once again beat the OECD averages, in education or health care or average living standard, they all must be paid for by higher incomes.

These aspirations will never be realised unless we can create wealth above the average rate for the OECD, and we cannot do that unless we can grow not just one or two, but many, innovative businesses of all types. For that to happen, we need policies that ensure New Zealand interest rates to be near, or lower, than the OECD average.

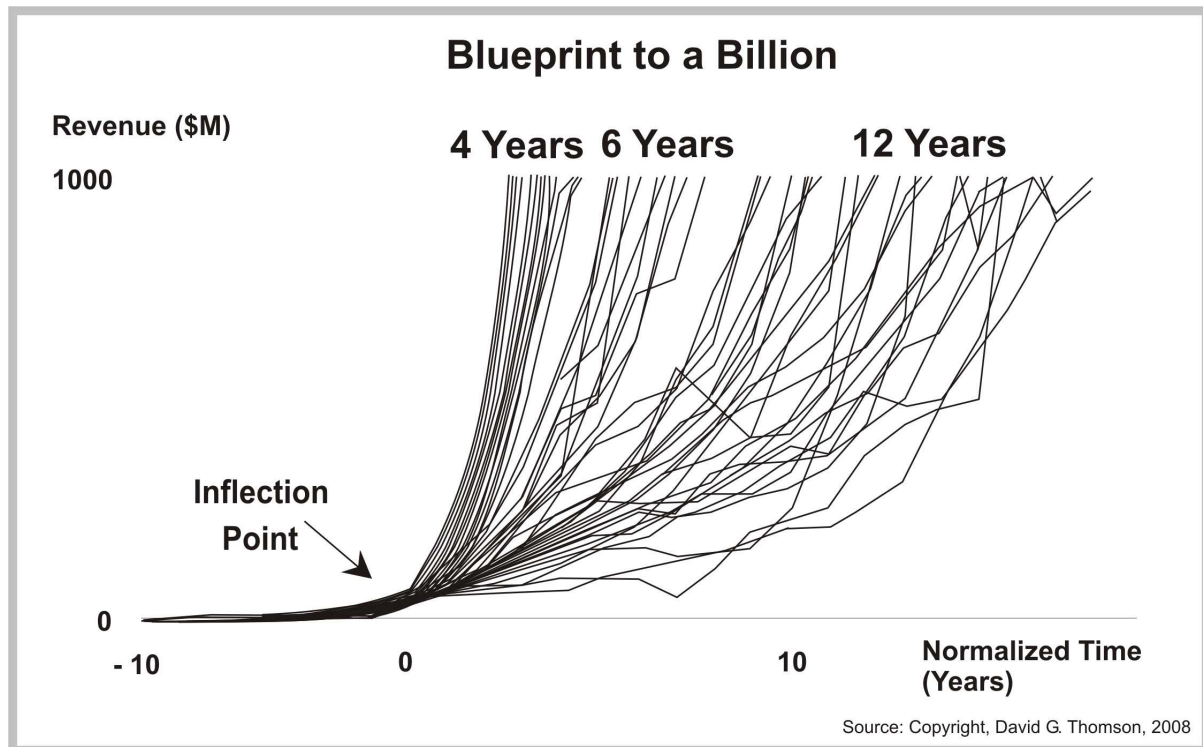


Figure 1