AVCAL
Australian Private Equity &
Venture Capital Association Limited

28 November 2013

Consultation on Government programmes being reviewed by the National Commission of Audit

The Australian Private Equity and Venture Capital Association Limited (AVCAL) represents the venture capital (VC) and private equity (PE) industry in Australia, with approximately $24b in funds under management. VC and PE are key sources of capital investment for Australian companies of all sizes, to enable their growth and realise their potential. Over the last ten years, the PE and VC industry has invested $31b in private businesses, on behalf of investors such as superannuation funds, financial institutions and public sector funds.

AVCAL welcomes the opportunity to respond to the National Commission of Audit's consultation on the effectiveness and efficiency of existing Government programmes and related expenditures.

While AVCAL is supportive of efforts to identify efficiencies and cost savings to help restore the government's fiscal position, we feel it is important that the Commission of Audit maintains a long-term perspective of the economic value-add of specific expenditure programmes that will help to drive the nation's prosperity into the future. In the venture capital sector, AVCAL can identify two key programmes that have a vitally important role in supporting innovation investment across a wide variety of sectors in our economy.

The Innovation Investment Fund (IIF) programme and the 2013 McKeon Review's recommendation for a Translational Biotech Fund (TBF) should remain a key part of the government's overall policy agenda of supporting investment in the venture capital industries in Australia. Some of the reasons why these funds are important to our nation's future prosperity are set out below.

1. *Investment Innovation Fund (IIF)*

The IIF was originally a Howard Government initiative to develop the pool of Australian VC fund managers and to develop high-growth Australian companies to become globally competitive by commercialising the outcomes of Australia's strong research capability. The objectives of the programme are to:

- Develop fund managers with experience in the early stage VC industry by addressing capital and management constraints;
- Encourage the development of new companies that are commercialising research and development;

- Establish, in the medium-term, a ‘revolving’ or self-funding scheme; and
- Develop a self-sustaining, early stage VC industry in Australia.

The programme is intended to attract private sector investment into VC in Australia. It does this by awarding licenses to private sector fund managers (VCs) who, as part of the licensing process are required to raise capital from private sources to match the capital provided by the Government. The Government and private sector capital is pooled in a co-investment fund managed by the licensed VC manager who has responsibility for identifying and investing in the most promising early-stage companies.

The recipients of the last tranche of funding under the IIF were announced in April 2013. Just prior to that, in February 2013, the then Government announced a new $350m investment round that would run for a number of years starting from 2014.

It is important to recognise that the IIF represents an investment vehicle where the Government can obtain a return on the funds invested. This feature helps to reinforce why expenditure under this program should be viewed quite separately from other recurring expenditure programs where no such direct return on investment can be readily identified.

AVCAL’s view is that the Government should send a strong signal of its commitment to backing Australian innovation by maintaining the previously-announced commitment to a new $350m investment round commencing from 2014. All profit, capital and interest returned to the Government from current IIF investments should be recycled into an ongoing programme to help establish a self-sustaining and consistent cycle of targeted investment into high-growth early stage, innovative businesses in Australia. Some of the reasons why we believe this is so important to the nation’s future economic landscape are set out below:

1.1. Bridging the funding gap

The IIF programme forms an important part of the Australian VC investor base. Since 1998 and over three rounds, 16 licensed funds have raised over $640m and supported over 100 innovative companies in their early stages. Over the same period, non-IIF VC funds have raised $2.7b, including over $300m from other Government co-investment programmes which are no longer open for new applications.

There is a broad range of unique challenges in relation to attracting investment in small but innovative companies.

The businesses that receive IIF funding typically have high growth potential, but require investment capital by sophisticated investors such as VCs as they are too young and too risky to access other conventional forms of business financing. However, fundraising in the VC sector has been particularly challenging since the recent global economic downturn, and it is likely that the prevailing environment will continue for some time. It is for this reason that appropriate public policy settings should be maintained in order to support a marketplace

that is not capable on its own of delivering the desired outcome from an economic perspective.

Total VC funds raised in the five years from FY2009 to FY2013 amounted to only 65% of the amount raised in the preceding five years. Similarly, the 2013 Australian Innovation System Report shows that VC availability has steadily deteriorated since 2006.[1]

In addition, the average VC fund size has nearly halved from $60m in calendar years 2003-07 to $33m in 2008-12. The shortage of larger, later-stage VC funds means that it is difficult for start-ups to obtain follow-on VC investment as they grow, thus stymieing their expansion opportunities and affecting the funds' ability to participate in the later stage expansion growth.

In 2010, an independent analysis commissioned by the Department of Innovation, Industry, Science and Research (DIISR) examined the effectiveness of the IIF programme in delivering on its objectives.[2] This analysis found that the programme delivers an important policy outcome in the marketplace by helping to bridge the funding gap that exists for early-stage start-ups, an outcome that cannot be addressed by private investors. It also found that the IIF provides clear benefits to many young businesses that would otherwise go unfunded, and has important flow-on effects for start-ups that receive IIF backing.

1.2. Commercialising Australian innovation for economic growth

Government sponsorship of the IIF programme has been successful in generating substantial economic benefits by translating home-grown innovation to market-leading technologies. Many successful Australian companies got their start in business through IIF investment by the Government, including, for example:

- SEEK, which returned 6.5 times AMWIN Innovation Fund's original investment in 1999 which was part of the company's first institutional capital raising. Fourteen years later, SEEK is worth 1,440 times that initial investment – approximately $3.6b – and is today the largest online jobs-listing company in the world with a market capitalisation over twice the size of Fairfax Media.[3]
- Pharmaxis, a GBS Venture Partners IIF investment. Its first commercial product, Aridol® (a lung function test kit to help doctors diagnose and manage asthma medication levels) is now approved for sale in Australia, US and other major markets. Its current key product in development, Bronchitol® was listed on the Australian Pharmaceutical Benefits Scheme for the treatment of cystic fibrosis in 2012.
- BTF Pty Ltd, which was backed by Four Hats Capital's IIF fund to successfully commercialise the BioBall®, a major innovation in bacterial testing now used by the food, water and pharmaceutical industries around the world.

---

[1] Table 2.4, Australian Innovation System Report (2013), Department of Industry.
[2] Murray GC, Cowling MC and Liu, W (2010) *An Independent Econometric Analysis of the "Innovation Investment Fund" Programme (IIF) of the Australian Commonwealth Government: Findings and Implications.* Canberra, DIISR.
[3] As of 6 May 2013.

One recent analysis has found that "the Australian IIF programme where government investment is done at the institutional level as limited partners … appears to be a successful model for engineering a successful VC market that generates substantial economic benefits in terms of innovation and economic growth. These effects are observed even after the worldwide financial crisis with data measurement up to 2012."[4]

The analysis suggests that an expansion of VC and IIF investments would facilitate more productive innovation and economic growth in Australia relative to the expansion of other sources of capital, particularly in view of the comparative dearth of VC investments in Australia relative to other countries.

1.3. Impact on the fiscal balance

The administered capital provided through the IIF involves the acquisition of financial assets, with no impact on the fiscal balance of the Government. In return, the Government receives an equity share in these investments. Returns from the Government's investment are recycled into the existing Revolving Fund, and re-committed to future VC funds.

As these funds are committed for a 10-year term and returns do not generally start flowing until the later stages of the funds' lives, a policy approach that is framed around a long-term outlook is vital. Intermittent commitments by Governments will not fully realise the objectives of a programme such as the IIF. Often, the highest-potential innovations are competing for investors during periods of capital scarcity. In AVCAL's view consistency in Government policy in this area, and certainty for the VC industry, are essential ingredients in helping to realise the programme's policy objectives both now and into the future.

2. McKeon Review recommendation for a $250m Translational Biotech Fund

In February 2013 the McKeon Review ("the Review") recommended that the Government should establish a Translational Biotech Fund for early-stage development, with $125m in equity capital provided by the Australian Government and matched by the private sector on a one-to-one basis. The TBF was intended to support research commercialisation by bridging the "valley of death" at the early clinical stage for phase 1 and 2 clinical trials and testing of devices. Similar to the IIF, the Government's contribution to the TBF would be in the form of an equity injection, with no impact on the underlying cash or fiscal balance.

In AVCAL's view, we believe it is important that this recommendation remain on the Government's policy agenda, to ensure that the goals of the McKeon Review are achieved and to provide another catalyst to help Australia strengthen areas of innovation investment which – evidence has clearly proven – can deliver a competitive advantage in the global marketplace.

[4] Cumming, D and S Johan (2013), *Venture's Economic Impact in Australia*, Journal of Technology Transfer, forthcoming.

From an overall federal revenue base of around $400b p.a., our analysis reveals that the Government currently spends around $9b p.a. (or the equivalent of 2.25%) on science, research and innovation, and estimates are that less than 1.5% of the $9b goes towards research translation into commercial outcomes.

This represents a fundamental flaw in our current policy prioritisation and goes some way to explaining why Australia currently lags so far behind our global counterparts in collaborative innovation.[5] Long-term policy support for forward-thinking initiatives such as the IIF and TBF will greatly help in fostering an environment that nurtures the development of Australian innovation beyond the confines of universities, laboratories and research centres. That is why it is vitally important that the Commission of Audit support the ongoing funding of these programs, which into the future, should in fact attract greater levels of Government support than is the case today.

If you would like to clarify any points raised in this submission, please do not hesitate to contact me or Dr Kar Mei Tang on 02 8273 7000.

Yours sincerely,

Yasser El-Ansary
Chief Executive
AVCAL

[5] Australia currently ranks second last out of 26 OECD countries as measured by the percentage of Australian businesses engaging in international collaborative innovation, and 12th out of the 26 OECD countries on domestic collaboration on innovation. Source: Australian Innovation System Report 2013.