AVCAL
Australian Private Equity &
Venture Capital Association Limited

5 May 2014

URGENT
The Hon Joe Hockey MP
Federal Treasurer
PO Box 6022
House of Representatives
Parliament House
CANBERRA ACT 2600

Dear Treasurer,

2014-15 Federal Budget – Importance of backing Australian innovation

As you know, the Australian Private Equity & Venture Capital Association Limited (AVCAL) represents the venture capital (VC) and private equity (PE) industry in Australia.

VC and PE are key sources of capital investment for Australian companies of all sizes. For every dollar of assets owned, VC-backed companies innovate at a much greater rate than other companies. In Australia, VC-backed firms make up only 0.01% of our economy's aggregate GDP, but they account for 10% of all business R&D expenditure in Australia. They also spend, on average, 200 times more on R&D per employee than other businesses.[1]

AVCAL is very concerned about some of the specific recommendations made by the National Commission of Audit in relation to key innovation programmes such as the Innovation Investment Fund (IIF) and Commercialisation Australia. The Commission of Audit recommended that these industry support programs – along with many others – should be abolished, in an attempt to cut back on fiscal expenditure within the federal budget.

Having seen these recommendations, we thought that it was very important we write to you urgently to set out our views, to assist in your final deliberations ahead of the upcoming 2014-15 federal budget.

Systemic market failure in funding early-stage companies

In its report, the Commission of Audit stated that it was appropriate to abolish industry support programmes, such as the IIF, because "specific grant programmes in addition to [the Research and Development tax concession] have the potential to skew investment decisions" (p.171, Phase 1 report). The Commission also argues that "… the venture capital sector receives government support through existing tax concessions" (p.36, Appendix Volume 2).

[1] AVCAL, *The Economic Impact of VC in Australia*, 2013.

The report completely overlooks the fact that the current VC tax settings cannot, of themselves, foster a vibrant innovation ecosystem if the fundamental market failure faced by the industry is not first addressed.

The reality is that the main barrier to the successful commercialisation of *home grown* innovation is the lack of funding to a market segment that is inherently unattractive to most private investors because of the high risk profile associated with the asset class.

The establishment of the IIF was predicated on the failure of markets to provide capital for investment in early stage ventures.[2] The programme was designed to make investment in Australian VC more attractive because private investors would generally not otherwise invest in the segment in the absence of a Government partnership.

A comprehensive analysis of the IIF, conducted in 2010, explains that "The IIF programme has accurately addressed market gaps in the provision of smaller amounts of equity capital to genuinely early stage and high risk young businesses primarily in new technology sectors. This is a very challenging segment of the capital market for investors. As a consequence, it remains largely unattractive to private sector, institutional providers of venture capital. Government is perforce obliged to be the investor of last resort in order to protect and enhance the economy's innovative infrastructure. This limited supply of early stage 'classic' venture capital to high potential but also highly uncertain and speculative new enterprises remains an international not just an Australian problem".[3]

This funding gap has not abated over the years. In fact, the gap has widened in recent years, following the market impact of the recent global financial crisis, which is operating in tandem with significant structural changes to significantly constrain the flow of institutional capital to small business. As a result, very little new institutional capital has been invested in Australian VC funds in the last five years with the exception of Government-backed funds such as the IIF, IIF Follow-on Funds (IIFF) and the Renewable Energy Venture Capital (REVC) programme.

The fundraising statistics, compiled by AVCAL across the industry, demonstrate the urgency of addressing this funding gap: total VC funds raised in Australia in the five years from FY2009 to FY2013 amounted to only 65% of the amount raised in the preceding five years. Similarly, the Government's own 2013 Australian Innovation System Report shows that VC availability has deteriorated steadily since 2006.[4]

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 go further up the funding escalator as they grow. This lack of funding not only stymies the start-ups' expansion opportunities, but the small size of VC funds means that they are also unable to participate in these companies' later stage expansion growth.

Government plays a vital role in addressing this market failure because – particularly for smaller VC markets such as Australia – the partnership provided via Government support is critical to drawing-in private sector investment. Other economies such as the United States, Singapore, Canada and New Zealand recognise this, and their governments have in recent years taken decisive steps to address this through further bolstering their innovation policies despite facing fiscal positions that could be argued to be more problematic than our own.

The IIF programme has unambiguously brought long-term benefits to the Australian economy

The Commission of Audit concludes that 'business as usual' is simply not an option in the context of Australia's economic and fiscal future. AVCAL agrees with that proposition.

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[2] Department of Innovation, Industry, Science and Research, *Innovation Investment Fund Program Progress Report*, Sept 2011.
[3] Murray, G., Cowling, M., and Liu, W., *IIF Equity Programme Assessment*, 2010.
[4] Department of Industry, *Australian Innovation System Report,* 2013.

However, AVCAL does not agree with the Commission when it states that "While there are definite private benefits to Australian companies from the commercialisation of their intellectual property, the public benefits from commercialisation and support through the Innovation Investment Fund are less clear" (p.36, Appendix Volume 2).

The fact of the matter is that there is a comprehensive body of evidence that directly disproves the Commission of Audit's conclusions.

Multiple independent evaluations of the IIF programme since its inception in 1997 clearly show that the programme delivers significant public benefits to the community, and successive reviews of the IIF programme commissioned by the Government have supported the continuation of the programme. For example:

- The first evaluation of the IIF programme in 2005 found that the basic rationale for Government intervention in the early stage sector was supported, and that the programme "facilitated investment in start-up, early stage and high tech firms as well as the provision of monitoring and value-added advice to investees".[5]

- A second evaluation in 2010 found that the rationale for the three rounds of financing for the IIF programme remains valid. The report stated that, "The evidence shows that the IIF programme has been critical in channelling additional equity capital to pre-start (seed and pre-seed) and start-up firms… The IIF programme was significantly more likely to provide initial and follow-on funding to capital constrained businesses than the two compared, private sector equity providers. On average, IIF funds provide 1.6x more funding rounds than private sector investors. This public provision helps create a credible funding 'escalator' and allows supported businesses access to investment capital to smooth their transition from start-up to early-stage development. In this sense, government is filling a market gap and there is likely to be little displacement of private sector investment activity in key early stage sectors, e.g. biotechnology. The IIF intervention is accurately targeted and creates value".[6]

- A third and more recent independent 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."[7]

The consistency of the conclusions reached in each of these major evaluations makes a very compelling argument in support of continuation of the existing IIF programme. It is difficult therefore for AVCAL to reconcile the Commission of Audit's conclusions in respect of the IIF, when viewed in the context of this analysis.

Examples of success stories from the IIF include:

- **AMWIN fund**: This was one of the first funds licensed under the IIF. Since its commencement in 1998, AMWIN has provided investors with a 1,047% internal rate of return, with international independent research firm Preqin rating it the top performing venture fund in the world.[8]

[5] Cumming, D., *Government policy towards entrepreneurial finance: Innovation Investment Funds*, 2005.
[6] Murray, G., Cowling, M., and Liu, W., *IIF Equity Programme Assessment*, 2010.
[7] Cumming, D. and S. Johan, *Venture's Economic Impact in Australia*, Journal of Technology Transfer, forthcoming, 2013.
[8] AusIndustry, *AMWIN Innovation Fund rated as world's best VC fund*, Customer Story, Jan 2014.

- **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.[9]

- **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 in 2012 to give cystic fibrosis sufferers faster relief from some of its many symptoms such as coughing fits and reduced lung capacity.[10] The company now employs over 100 people across its research, clinical development, regulatory and commercialisation disciplines. Its HQ and manufacturing operations are located in Sydney, with offices in the US, Europe and Asia Pacific.

Programmes such as the IIF represent a vital investment in Australia's future economic prosperity

From an overall federal revenue base of around $400 billion per annum, the Government currently spends around $9 billion per annum (or the equivalent of 2.25%) on science, research and innovation, and estimates are that less than 1.5% of the $9 billion goes towards fostering the commercialisation of our research.

The flaw in Australia's current policy prioritisation is that it does not invest enough in bringing its innovation to market. A recent PwC study has flagged VC as being one of the 'game changers' in contributing to Australia's innovation system: a position that has been echoed in many forums in recent years.[11] It also highlighted the fact that the US spends over four times (per capita) what Australia spends through VC investment. Even Canada has a VC industry nearly four times the size of Australia's, which is being driven by local pension funds and high net worth individuals.

This chronic under-investment goes some way to explaining why Australia currently lags behind our global counterparts in collaborative innovation, as identified in the 2013 Australian Innovation System Report.[12] VC availability in Australia now ranks below our regional counterparts in Hong Kong, Singapore, Malaysia, Taiwan, China, Indonesia and New Zealand.[13]

This is why AVCAL is firmly opposed to the abolition of vitally important programmes such as the IIF.

Long-term policy support for forward-thinking initiatives such as the IIF and Commercialisation Australia play a key role in helping to foster an environment that nurtures the development of Australian innovation beyond the confines of universities, laboratories and research centres.

A further important point of distinction in respect of the IIF is that the administered capital provided under the programme leads to the acquisition of a financial asset for the Government, with no impact on the underlying fiscal balance of the federal budget. In return for the IIF funding provided, the Government receives an equity share in the investments made. Returns from the Government's investment are recycled into the existing Revolving Fund,

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[9] As of 6 May 2013.
[10] See "New drug gives longer life to cystic fibrosis sufferers" (Daily Telegraph, 6 May 2009), and "Vital drugs made cheaper" (The Sunday Age, 24 June 2012).
[11] PwC, *Expanding Australia's economy through digital innovation*, April 2014.
[12] 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.
[13] World Economic Forum, *Global Information Technology Report*. 2014.

and re-committed to future VC funds. The mechanics of the IIF therefore represent a highly commercial Government and private sector approach to providing the necessary support to correct a market failure that would otherwise exist.

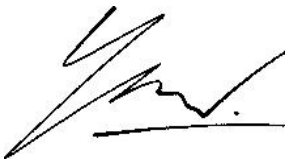
As these funds are committed for a 10-year term and returns do not generally start flowing until later stages of the life of the fund, a long-term approach to policy in this area is necessary.

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.

For all of the reasons set out above, AVCAL encourages the Government to dismiss the Commission of Audit's recommendations in relation to the abolition of the IIF and Commercialisation Australia programmes. While there should always be a focus on looking at ways in which Government expenditure can be reduced or made more economically efficient, it would be unwise in the extreme to abandon outright all support for innovation for Australian businesses under these programmes.

If you would like to discuss any aspect of this submission further, please do not hesitate to contact me directly.

Yours sincerely,



Yasser El-Ansary
Chief Executive
AVCAL

cc: Senator the Hon Mathias Cormann
Minister for Finance and Acting Assistant Treasurer

The Hon Ian Macfarlane MP
Minister for Industry

Mr Nigel Ray
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