

Venture capital shrinkage needs to be reversed

If each of the major super funds invested 0.5 per cent of its portfolio in venture capital we would have an extremely healthy flow of capital.



By Katherine Woodthorpe

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Figure 1 Venture capital fundraising by financial year, 2001–10

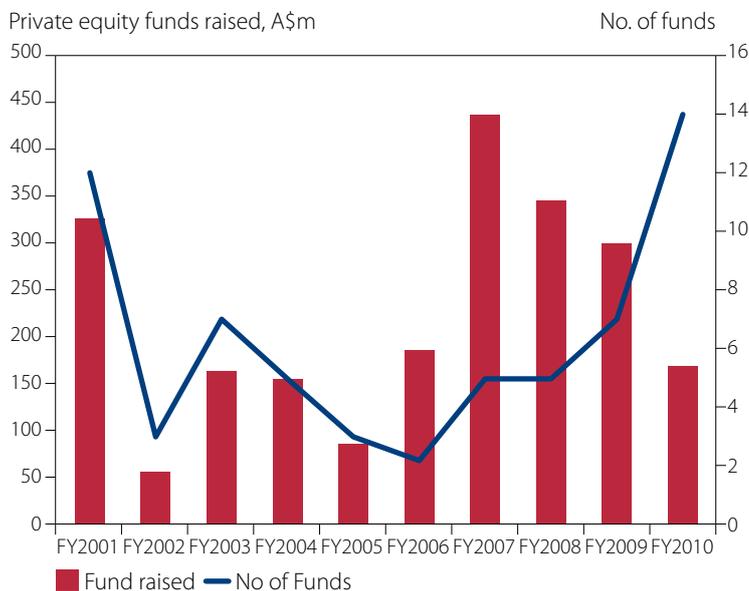
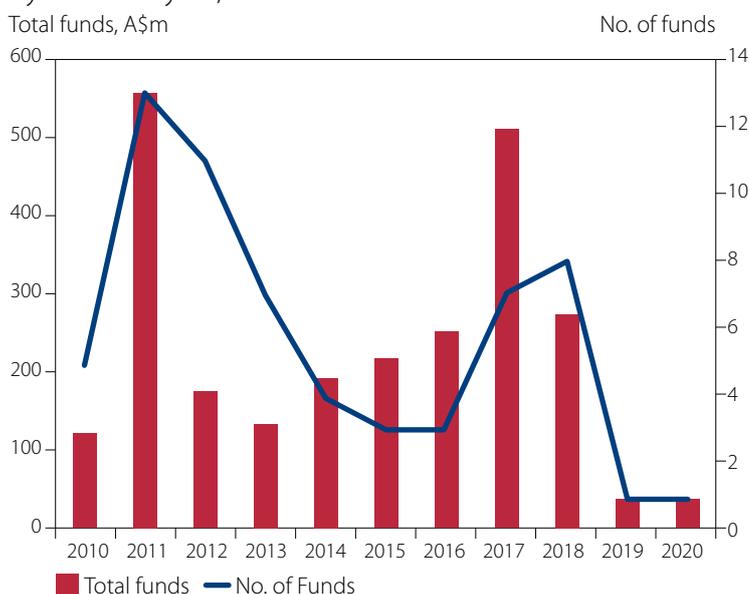


Figure 2 Estimated venture capital fund terminations by calendar year, 2010–20



The Australian Government spends upwards of \$7 billion a year on research. Obviously a large proportion is ‘blue sky’, purely to add to the knowledge base. But a very large proportion is based on the expectation that something will come out of it which enhances our lives.

It might be technology making our world cleaner, our communications faster, or life science research aiming to improve the quality of our health. We spend research dollars on making our industries more productive in order to deliver jobs in the future.

To achieve these outcomes we need to commercialise the research. Currently this is achieved through a number of different approaches, but two major routes are direct licensing of intellectual property (IP) to industry or creating spin-out companies to commercialise the products and services.

The venture capital (VC) industry worldwide, including in Australia, supports spin-out companies from public sector research agencies as well as those companies formed by entrepreneurs. Often seeking VC support is the only way to raise enough funds to commercialise a piece of IP.

What does the VC industry look like in Australia at the moment?

There are approximately 26 funds but of these probably only 10 are actively investing. They most commonly invest in life sciences (45 per cent), ICT (30 per cent) and cleantech (five per cent). There are some 250 to 300 active portfolio companies currently and the average investment range is \$4 to \$15 million. The total funds under management are about \$2.3 billion.

However, these numbers belie some fundamental problems with the industry here and overseas. These include problems with fundraising, difficulty in exiting in poor markets and withdrawal of government support.

As Figures 1 and 2 show, funds raised in Australia have declined steadily since 2007 in dollar terms, although the number of funds has increased, demonstrating a rise in the

number of smaller and less economically viable funds. At the same time, several VC funds are coming to the end of their contractual lifetime and unless a significant number and value of funds are raised in the near future, the industry will shrink severely over the next few years.

There is a commensurate reduction in investments made. Figure 3 shows that although the number of investments appears to remain steady this is mostly reflecting an increase in follow-on funding for existing investments and the underlying number of new investments has declined sharply.

This exacerbates the already strong discrepancy between the level of innovation activity in Australia compared to the local capacity to fund its commercialisation.

We are rightly proud of the outcomes of our investment into R&D in Australia but a substantial number successful overseas companies, not Australians, have reaped that benefit, such as Suntech, commercialising solar cells based on research from UNSW.

The problems in venture capital are not unique to Australia (Figure 4) but are exacerbated by the relative newness and size of our industry. In the US, the National Venture Capital Association estimates that the number of funds has shrunk by as much as 50 per cent. In Israel, so often held up as an example that we should emulate, the venture industry has shrunk so much, and is viewed with such opprobrium, that it no longer has a VC industry association but has become the High Tech Industry Association.

Specific issues facing Australian VC are the reduction and imminent termination of government support for the industry, coupled with a withdrawal of Australian superannuation funds from any illiquid assets.

Government support for the industry, primarily through the Innovation Investment Fund (IIF) program, has helped the industry develop from an almost non-existent base 15 years ago. The review of the IIF program showed that the returns to investors from co-investing with the Government in VC funds under the scheme, have been worthwhile and the total cost to the Government relatively low compared to the outcomes of growing companies (www.innovation.gov.au/Innovation/Policy/Documents/IIFEquityProgrammeAssessment.pdf).

However, this program has only one more tranche of funds before it ends later this year and there is no appetite from the Government to extend it in any form. The Australian Private Equity and Venture Capital Association Ltd (AVCAL) spent a year working with the super indus-

Figure 3 Number of venture capital investments by quarter FY05 - FY10 Q2

No. of funds

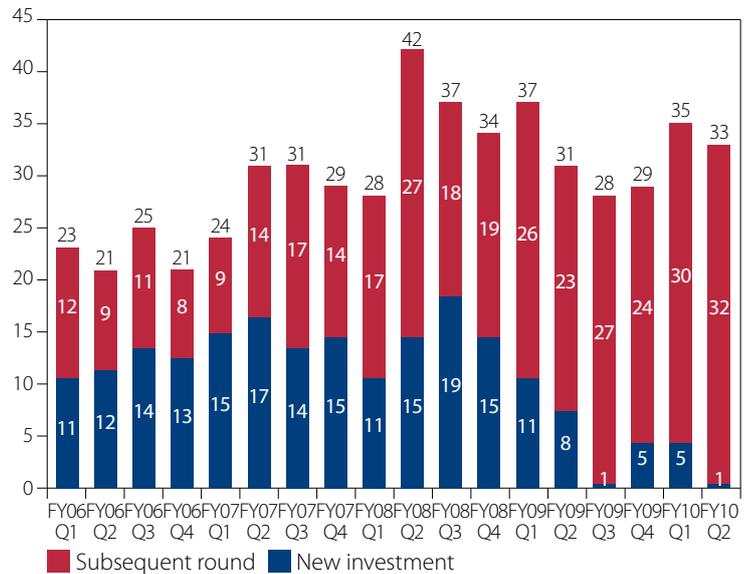
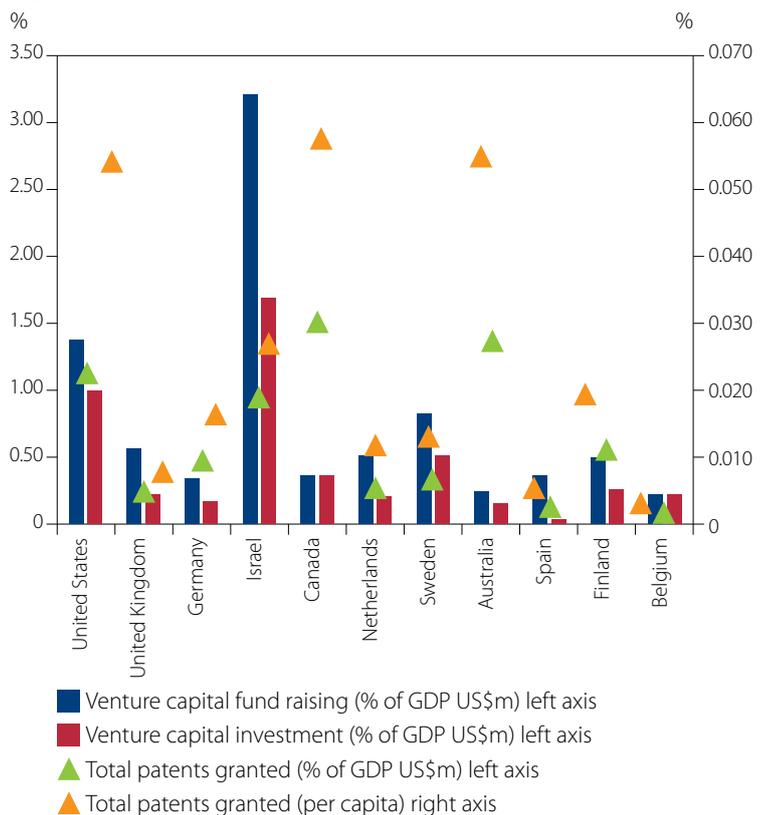


Figure 4 An untapped resource for innovation



try and others to develop proposals to fill this looming gap but they have been rejected.

The Australian superannuation industry has been a modest investor in VC over the past 10 years but that in-

Letters to the Editor

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vestment is now waning as the Figures show. The reasons for this are many. A key one is the lack of consistent returns from VC, which is not surprising given the newness of the industry. Another structural problem is that as super funds increase in size and coupled with an ongoing trend of mergers in the super industry, they are finding it less attractive to make relatively small investments. Between these two issues the industry has almost completely withdrawn from investing in venture.

What can we do about it?

One thing is that as super fund members we should make sure our trustees know that we are not happy with this investment approach. If each of the major super funds invested 0.5 per cent of its portfolio in VC we would have an extremely healthy flow of capital. It's not exactly a high risk strategy for the super funds.

As an example, how many university researchers would be aware that Unisuper does not invest in VC? Would they be pleased to know that their super fund has no interest in supporting the work that they do and enabling R&D to be commercialised into companies delivering an economic value to the country?

In fact Unisuper did have a Private Equity (PE) and VC

portfolio until recently. It sold the portfolio on 31 March and the following quarter the portfolio gained 20 per cent. So we can't really rely on the trustees to make good decisions.

A second is to lobby government to continue to support the VC industry and also to mandate that super funds invest in VC. The excuse that they shouldn't interfere is weak when you consider that the super industry exists by government mandate, taking out nine per cent of our salaries every year and has a beneficial tax regime.

So don't let our venture capital funds disappear or we will have a much-reduced capital base to support the commercialisation of Australian research. ◀

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searchers and company, there should be flexibility to allow them to spend the money in a shorter time frame, achieving a 'fast and furious' research agenda.

The second change for the better would be to reduce the complexity of the legal agreements. This complexity greatly slows down the knowledge transfer process and in some cases kills the deal for the wrong reasons. The standout reason for excessive complexity is risk avoidance, applied mostly to IP concerns but also to financial fears.

Most agreements for access to technology are written by lawyers for whom protecting their client from risk is the single most important imperative. Access to technology could be dramatically simplified if management – on both sides – ensured that the legal agreements were written with commercial outcomes as the priority rather than risk-avoidance.

Everybody acknowledges this but very few have the courage to pursue it. It isn't easy – managing the external legal and accounting professionals who work for you is one of the toughest tasks in management.

I can give you an example of "quick and effective". Shortly after I started Axon Instruments I had the opportunity to in-license some software from the California Institute of Technology.

In one visit from my offices in San Francisco to Caltech in Pasadena I met the inventor, met the in-house general counsel and agreed on the terms of a licence agreement. Within two weeks it was all signed up. It could not have been easier and this relation-

ship underpinned 20 years of continuous growth for this particular software product.

The secret to this rapid closure was that both sides were willing to show some trust in each other.

I re-emphasise my two main points:

- first, when it comes to helping innovative start-ups, I see an important role for government grants, some of which should not require matching funds – following the example of the SBIR grants in the US; and
- second, start-ups need more than just money and patents – they need the funding and intellectual property transfer processes to be facilitated so that they are easy and fast. Universities, funding agencies and the companies themselves need to rely on risk minimisation rather than risk elimination. ◀

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