Australian Private Equity &
Venture Capital Association Limited

Financial System Inquiry

Submission One

March 2014

Australian Private Equity &
Venture Capital Association Limited

31 March 2014

Mr David Murray AO
Chair, Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001

By email: fsi@fsi.gov.au

Dear Mr Murray,

The Australian Private Equity & Venture Capital Association Limited welcomes the opportunity to put forward this submission to the Financial System Inquiry that you are leading on behalf of the Government this year.

The terms of reference for this Inquiry provide you and your fellow panel members with a broad-based platform to consider a wide range of important policy issues that we believe are relevant to designing a future financial system that equips Australia to compete in the globalised marketplace for capital, innovation and business.

We look forward to continuing to actively participate in the work of your Inquiry, and to assisting in any way we can with further information as part of the next steps of the consultation process.

If you would like to discuss any aspect of our submission further, please do not hesitate to contact me or Dr Kar Mei Tang on 02 8243 7000.

Yours sincerely

Yasser El-Ansary
Chief Executive
AVCAL

ABOUT AVCAL

The Australian Private Equity & Venture Capital Association Limited (AVCAL) is the peak body representing Australia's venture capital and private equity industry. Our industry has a combined total of over $24 billion in funds under management for a wide range of domestic and offshore investors, including Australian-based industry and retail superannuation funds.

AVCAL members span across a wide spectrum of segments including venture capital (VC) and private equity (PE), as well as key advisory specialists. A comprehensive list of current members at March 2014 is set out below.

VC & PE members

Accretion Investment Management
Advent Private Capital
Allegro Funds
Anacacia Capital
Anchorage Capital Partners
ANU Connect Ventures
Archer Capital
Babson Capital Australia
Banksia Capital
Bioscience Managers
Blue Sky Private Equity Ltd
Brandon Capital Partners
Cashel House Group
Catalyst Investment Managers
CHAMP Private Equity
CHAMP Ventures
Coller Capital
Crescent Capital Partners
Equity Partners
GBS Venture Partners
Greenstone Partners Private Capital
Gresham Partners
Harbert Management Corporation
Hawkesbridge Capital
Helmsman Capital
Ironbridge Capital
Kestrel Capital
KKR Australia
Lazard Australia Private Equity
Mercury Capital
Navis Capital Partners
New South Capital
Next Capital
OneVentures
Pacific Equity Partners
Starfish Ventures
Talu Ventures
Telstra Ventures
Terra Rossa Capital
The Blackstone Group (HK)
The Carlyle Group
The Riverside Company
Torrens Capital
Wolseley Private Equity
Z5 Venture Capital

Other members

333 Management
Advancy
AIG Australia
Allen & Overy
Allens
Allier Capital
ANZ Structured and Acquisition Finance
Aon Risk Solutions
Apollan Investments
Arnold Bloch Leibler
ASF Capital
Ashurst
ATP Innovations
Australian Executor Trustees
AustralianSuper
AWE
Ayers Alliance Financial Services
Azure Capital
Bain & Company
Baker & McKenzie
Bankwest
BDO Corporate Finance
Brookvine
Cambridge Associates
Cbus
CFO Strategic
Challenger Financial Services Group
Citigroup Australia
Clayton Utz
Commonwealth Bank of Australia
Commonwealth Superannuation Corporation
Continuity Capital Partners
Cornwall Stodart, Lawyers
Corrs Chambers Westgarth
Credit Agricole CIB Australia
Credit Suisse
Crowe Horwath Corporate Finance
CtechBA
Deakin Commercial
Deloitte Corporate Finance
Department of Industry
Deutsche Bank AG
DLA Piper Australia
EC Pohl & Co
Emil Ford & Co
EY
Fawkner Capital
Fengate Capital Management
GE Capital
Gerson Lehrman Group
Gilbert + Tobin
Grant Samuel
Grant Thornton Australia
Greenhill & Co. Australia
Greenwoods & Freehills
Greville Investment HK
Hailing Holding Australia
HarbourVest Partners (Asia)
Hemsley Lawyers
Herbert Smith Freehills

HESTA
HLB Mann Judd Corporate (NSW)
Holding Redlich Lawyers
IFM Investors
Intermediate Capital Managers Australia
Investec Bank
IQX Ltd
Ironshore Australia
J.P. Morgan Australia
JANA Investment Advisers
JMD Ross Insurance Brokers
Johnson Winter & Slattery
K&L Gates
Kain Corporate + Commercial Lawyers
King & Wood Mallesons
KPMG
L.E.K. Consulting
Lander & Rogers
Macdoch Ventures
Macquarie Funds Group
Macquarie Group Services Australia
Maddocks Lawyers
Marsh
Mayne Wetherell
McCullough Robertson
McGrathNicol
Miles Advisory Partners
Mills Oakley Lawyers
Minter Ellison Lawyers
Minter Ellison Rudd Watts
Mizuho Corporate Bank
MLC Investment Management - MLC Private Equity
Monash University
MVision Private Equity Advisers
National Australia Bank
Nomura Australia
Norton Gledhill
Norton Rose Fulbright Australia
Oasis Australasia
OPTrust
Pacific Strategy Partners
Partners Group
Pennam Partners
Phillips Ormonde Fitzpatrick
Pitcher Partners
Pomona Australia
Promentor
PwC
QIC
Quay Partners
Rabobank Australia
Record Point
Risk Capital Advisors
Risk Partners
rks consultants
Rothschild Australia
Russell McVeagh
S&P Capital IQ
Shed Enterprises
Sparke Helmore
Squire Sanders
Sumitomo Mitsui Banking Corporation
Synergy Capital International
The Trust Company
Thomsons Lawyers
Uniquest
UoM Commercial Ltd
Vantage Asset Management
Westpac Banking Corporation
Wilshire Australia

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Executive Summary

EXECUTIVE SUMMARY

This Financial System Inquiry is a once-in-a-generation opportunity to position Australia's economy for enduring prosperity for the coming decade. In the time since the last major review into our financial system in the 1990s, there is no question that the structure of the Australian economy – and indeed most global economies and markets – has changed considerably.

The Asian region is now emerging as the dominant source of global economic growth, which presents Australia with an unrivalled opportunity to be a part of helping to support the development and expansion of the economies within that marketplace. At the heart of our capacity to be a part of that growth story, however, is a critical dependency on our ability to reposition the Australian economy to succeed within the highly dynamic and highly competitive global marketplace.

We have the world's fourth largest savings pool, which is something that policymakers, regulators and Australian households should be extremely proud of. The reforms implemented over recent decades that helped to deregulate and strengthen our financial system, coupled with the introduction of the compulsory superannuation savings regime, have served our nation very well, so far.

But there is an opportunity for us to take our nation forward once again.

Investing in Australian businesses that require equity capital, at times when they need it the most, is something that the venture capital (VC) and private equity (PE) industry specialises in. Around the world, the VC and PE industry has made a strong positive contribution to helping businesses realise their potential through productivity-enhancing innovations, leading to business and economic growth and new jobs creation across many value-adding industry sectors. Over the past decade, VC and PE funds have invested over $30 billion into Australian businesses, and there is ample potential for further significant investment over the long-term.

Reform of some existing policy and regulatory frameworks is an important component of unlocking the potential for VC and PE to play a broader role in funding more Australian businesses into the future.

The Inquiry should examine how it can reweight the current imbalance that exists between short-term and long-term considerations in the process of allocating productive capital to Australian businesses. It is becoming clear now that as a result of reforms over the last few years, superannuation funds have increasingly had to direct their focus towards short-term, low-fee, high liquidity investments – in preference to other asset classes that deliver high net returns and long-term investment horizons. This imbalance must be corrected if we are to effectively address the growing gap in the supply of equity capital to the majority of Australian businesses that may not have the ability to raise capital or debt through other means.

Improving the effectiveness of Government programmes supporting research and early-stage funding, and the tax landscape for domestic and offshore investment into VC and PE, are also important components of unlocking the potential for greater equity support for small to medium-sized enterprises in Australia. Providing clarity in relation to the existing venture capital limited partnership regime, examining the merits of a new stepped long-term approach to the capital gains tax concessions, and the introduction of a new flow-through collective investment vehicle are all options that should be considered by this Inquiry.

There is no question that this Inquiry is a landmark opportunity to lay down a blueprint for reform of our financial system over the next decade. In the end, it will be up to all of us to ensure we play a part in designing our economic future: the VC and PE industry looks forward to the opportunity.

Submission to the Financial System Inquiry

1. SCOPE OF THIS INQUIRY

AVCAL is very supportive of broad-based and comprehensive review being undertaken by the Financial System Inquiry (FSI) to establish a direction for the future of Australia's financial system. It presents the nation with an important opportunity to set out a blueprint for reform of our financial system over the course of the next decade.

The efforts of the Inquiry panel in identifying options that will foster an efficient, competitive and flexible financial system, consistent with maintaining high degrees of financial stability and public confidence are fundamental to the ongoing strength of the entire Australian economy.

AVCAL was especially supportive of comments from the Financial System Inquiry's Chair, Mr David Murray AO, on 19 March 2014 as to why Australia does not "have a more dynamic venture capital market". Those comments go to the very heart of many of the arguments set out in this submission. AVCAL's members play an important role in helping to fund companies using, making and commercialising technological advances that support ongoing productivity gains across the economy.

The VC and PE industry firmly believes that it can play an important role in building a stronger financial system for Australia into the future. There is an opportunity as part of this Inquiry to ensure that key roadblocks which are considered to impede progress towards that goal are addressed.

2. DEVELOPMENTS SINCE THE WALLIS INQUIRY

At least three financial crises that were acutely significant for Australia followed the Wallis Inquiry. All were preceded by financial booms that, in hindsight, involved asset price bubbles: the Asian crisis in 1997-99, the 'tech wreck' in 2000 and after, and the global financial crisis in 2007-09.

These have driven substantial reforms to financial sector regulation around the world, which have generally focused on strengthening banking and financial systems.

As both a capital exporter and importer, as well as a participant in global markets, the need for Australian financial sector regulations to accommodate and be harmonised with regulations in the rest of the world (both within the 'old' developed world and within the 'new world' including China) has intensified. Australia has played a major role in leading international cooperation in this area.

With the Asian region emerging as a dominant source of global economic growth, Australia's financial system needs to have a strong regulatory framework that has well-established investor protections and legal safeguards, but yet has the freedom to successfully innovate, operate and navigate its way domestically, regionally and internationally to align with our national interest.

The FSI will have to take into account several major structural developments and changes since the Wallis Committee of Inquiry, some of them unanticipated (at least in scale) but now well-recognised. These include:

- The strong growth of superannuation savings and relatively high concentration of these savings in a single asset class (listed equities), as well as the deepening focus on low-cost and liquid investments in superannuation plans which has not been counterbalanced with enabling policies to achieve the best long-term outcomes for superannuants;
- The rapid and significant growth of China and other Asian countries leading to increased exports, a doubling in Australia's

terms of trade and the dramatic expansion in Australia's mining capacity in the past decade; but going forward also a projected significant decline in mining sector capital expenditures in the years ahead;

- The advances in technology which have created new opportunities and efficiencies across most forms of economic activity, but which have also made obsolete many traditional sectoral and national boundaries as defined in the legal and tax frameworks governing the financial system;

- The increasing dependency by almost every Australian on the fundamental structure and stability of our financial system, partly driven by the ageing population and the consequent need for appropriate levels of retirement savings, accumulation of financial and real estate wealth and use of leverage; and

- The increasing dominance of banking as a supplier of funding to business and households, the increasing concentration within the banking system and the introduction of an effective explicit government guarantee for most authorised deposit-taking institutions (ADI), which when taken together, has arguably facilitated the major banks extending their systemic importance within the financial system and the economy.

These developments create a complex foundation for how we envisage the pathways to sustainable prosperity for Australians. Complicating the task is the fact that nothing stands still.

In addition, less often debated are the developments that might have been expected since the Wallis Inquiry but have fallen short of their potential, or have yet to emerge. These include:

- The decline in the 1980s and 1990s of productivity growth, despite the wide reach of advances such as information technology;

- A slowing in the realisation of economies of scale and associated reduction in costs in the provision of financial services, which has kept interest margins higher than necessary and dampened the after-cost returns on funds under management in superannuation;

- A costly retreat both globally and locally in the expansion of investments into asset classes that typically carry a longer-term horizon, with shorter reporting cycles and increased peer benchmarking resulting in increasingly narrow short-term investment horizons for traditional long-term institutional investors; and

- The slow progress towards developing a deeper and more complete financial system that caters for all Australians. The gaps that have become more obvious over time include products that address retirement incomes and longevity risk (typically annuities), alternatives to bank financing for bigger businesses (such as corporate bonds) and sources of funding for smaller and more innovative businesses and growth businesses (typically involving VC and PE investment).

3. FOUNDATIONS FOR OUR FUTURE FINANCIAL SYSTEM

Better intermediation of long-term investment

A healthy financial system that is able to serve Australia's needs has to be flexible and resilient. The challenge faced by the FSI is to find ways to accommodate the changes and developments already seen, identify gaps, anticipate likely general trends ahead, and create a vision of a financial system that will meet Australians' needs well into the future.

Addressing the factors that have caused the gaps – which in some cases arise as an unintended consequence of previous reforms or developments that were appropriate at the time – will help the financial system develop into what will be best for purpose in the next decade.

AVCAL believes that the financial system can be better positioned to meet Australia's evolving needs and contribute more to fund and nurture business development and innovation, thereby playing a role to help support the growth and expansion of the Australian economy in the long-term.

This can be achieved by all – including especially the finance sector – adopting longer-term horizons in investment decisions and supportive measures being taken by government and regulators.

In framing this initial submission, AVCAL is mindful of the fact that financial stability reforms being implemented in other developed markets around the world have largely been directed towards repairing weaknesses in the regulation of banking and capital markets where the causes of the most recent economic crisis can be found.

Australia by contrast can seize this opportunity to refocus on how the financial system can better facilitate long-term investment: a potentially significant competitive advantage for funding Australia's future.

Bridging the capital gap for Australian businesses

VC and PE in Australia occupy an important role in the financial system as a source of equity capital at different stages of the company lifecycle, ranging from start-ups to SMEs to larger businesses.

It helps bridge the gap between the demand and supply of capital for companies that need funding beyond what individual investors and banks can (or will) provide, and yet are not quite ready for a stock market listing. Figure 1 sets out the role that VC and PE can play in the lifecycle of business development.

VC and PE, together, play a vital role in activating the link between innovation and productivity. The fundamental investment model is based on the idea of backing ideas and businesses where VC or PE can add sustainable value over the long-term.

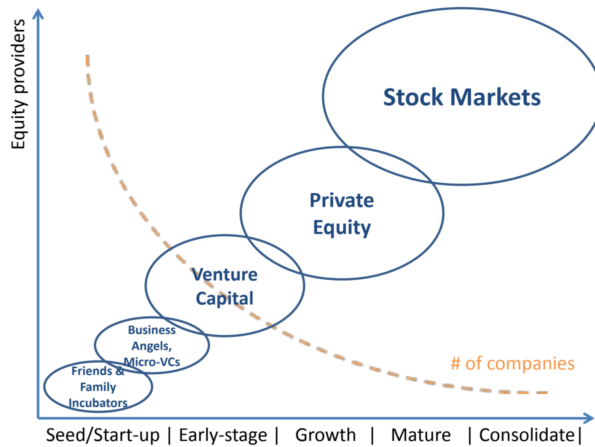
The industry provides capital and business expertise which can make a vital difference to whether or not innovation-enhancing start-ups get off the ground, and whether SMEs succeed or fail.

With the mining sector entering a slower capital investment phase, Australia will be relying more and more on the efficient deployment and allocation of capital in the financial system to drive productivity in the non-mining sectors of our economy.

This is the type of longer-term focus that aims to convert capital investment into enhanced productivity gains, job creation and business growth.

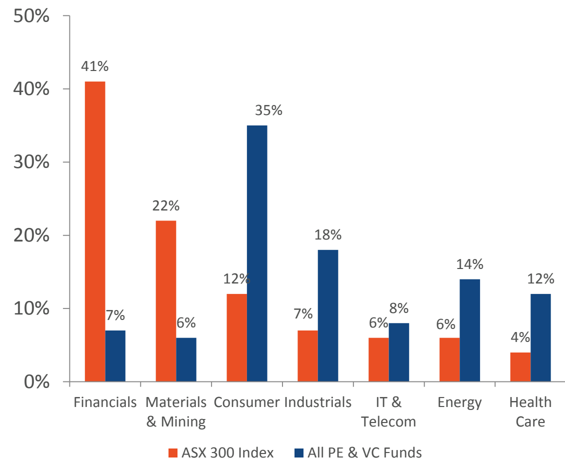
VC is particularly important for bringing innovation to the market. It specifically targets the funding of technologies that make smart industries bigger and big industries smarter. PE, in turn, is particularly important for funding capital expenditure, and improving productivity

Figure 1: External equity capital providers in a financial system



Source: AVCAL

Figure 2: Sectoral distribution of PE & VC investee companies in Australia vs ASX300 companies, by market value



Source: Cambridge Associates, as of 31 Dec 2012

as companies grow larger and more complex, which helps create new value-adding jobs and further expansion opportunities both domestically and internationally.

Both VC and PE seek to create and support businesses that can expand to access global export markets. They intersect when the company moves up the innovation value chain from a high-risk start-up into a more mature business with a steady income stream.

Over the past ten years, VC and PE funds have invested over $30 billion in Australian businesses across a diverse range of industry sectors in the economy.

These investments have been spread out across industry sectors that are generally less well represented on the ASX (Figure 2), and are predominantly in small to medium-sized businesses with superior long-term growth prospects.

Today, VC and PE-backed companies can be found right across the country, including in key pockets of regional Australia (Figure 3).

Funding future growth and productivity

Although the size of the Australian VC and PE industry ($24 billion in funds under management) is modest in relation to the broader investment management industry (around $2.3 trillion), it plays a disproportionately significant role in catalysing growth and productivity in the businesses in which they invest.[1]

VC financing, for example, has been successful in generating substantial economic benefits by translating home-grown innovation to market-leading technologies.

Many successful Australian companies such as Cochlear and ResMed got their start with VC backing in their early stages of development.

Today, it can be demonstrated that for every dollar of assets owned, VC-backed companies innovate at a much greater rate than most other companies, and punch well above their weight in other areas as well.

[1] AVCAL, ABS 5655.0 (Dec 2013).

Figure 3: Geographical distribution of PE-backed companies in Australia

Source: AVCAL, as at 30 June 2013.

For example:

- Companies that have received VC backing in their early stages have total assets amounting to just 0.3% of GDP, but account for 10% of all business R&D expenditure in Australia.[2]
- There are only 500 companies in Australia that have received VC backing before, compared to 24,000 in the US. However, two of the 20 US FDA-approved drugs identified as "first-in-class" in 2012 came from Australian VC portfolios.
- Of the top 50 healthcare and biotech stocks on the ASX, one-third are VC-backed.
- Success stories include SEEK.COM.AU, which, 14 years after AMWIN Innovation Fund's original investment, is now worth over $3.6b and is the largest online jobs-listing business in the world.[3]

The need for more efficient allocation of productive capital is not confined to early stage companies, but also extends to more established small to medium sized Australian businesses that are simply looking to grow further.

Other than through bank loans, other typical sources of funding expansion would be from retained earnings or external sources such as private equity.

PE plays a vital role in funding this growth. Research recently completed for AVCAL by Deloitte Access Economics shows that businesses backed by PE investment have, on average, revenue growth of 11% p.a. and

[2] Cumming & Johan (2012).

[3] As of 6 May 2013.

workforce growth of 28% p.a. in the first five years after the initial investment.

The average PE-backed business in Australia has annual turnover of $195 million; pays $42 million in wages, to 827 full-time equivalent employees; and contributes $77 million in direct value added to the nation's economy.

The economic analysis concluded that capital investments by PE funds help to support a total of more than 500,000 jobs and contribute over 4% to Australia's national economic output every year.

On these numbers, the contribution made by PE-backed businesses is considerable. This means that PE-backed businesses, on a collective basis, employ a larger workforce than either the automotive or banking industries.

In addition, PE-backed firms generate more revenue (an estimated $64 billion p.a.) than either the coal mining or the general insurance industries in Australia.

The evidence, both from Australia and from around the world, unequivocally supports the fact that VC and PE investment plays a vital and important role within a robust financial system. This plays out not just through the intermediation of savings to productive investments, but also through the transformative effects of their investment model on businesses to create market leaders of the future.

4. CURRENT CHALLENGES AND OPPORTUNITIES

Impact of policies and reforms

Previous financial system inquiries, including the Campbell Report in 1981 and Wallis Report in 1997, were catalysts for major economic reforms and financial system development in Australia. But since the time of those reviews, considerable and significant change has occurred.

For instance, the growth of the superannuation savings pool has been a key driver for the expansion of the VC and PE sector, which has led to significant benefits for the economy in terms of job creation, productivity-linked technological innovations, and overall economic growth.

The expanded market for PE and VC has also been helped by the macroeconomic stability that has been seen in Australia, which has been well supported by the opening up of the domestic economy to international capital and the associated increase in depth of Australia's banking and financial markets.

While policy reforms put in place throughout the 1980s and 1990s are just now starting to be identified as the major building blocks that underpin the strength of our current financial system, there does appear to be an emerging structural challenge confronting our economy looking out into the future.

In the context of the superannuation savings pool, an unintended consequence of the ongoing consolidation and up-scaling of superannuation funds, coupled with recent policy and regulatory changes is driving an increased (and problematic) focus on highly liquid, low-cost investment products.

In recent years, this has seen a reduction in funds allocated to less liquid, longer term investments in Australian businesses. This has significantly affected allocations to long-term investments through intermediaries such as VC and PE, and a number of others (Table 1).

Table 1: Superannuation funds held in Australian equities vs Australian PE and VC (FY04-13)

Financial Year	Total super fund assets under management (AUDm)	Total super funds held in Australian equities (AUDm)	% held in Australian equities	Total super funds committed to Australian PE and VC (AUDm)	% committed to Australian PE and VC
2003-04	611,290	239,014	39%	4,346	0.7%
2004-05	709,036	281,691	40%	4,996	0.7%
2005-06	860,123	352,674	41%	6,337	0.7%
2006-07	1,129,631	476,461	42%	8,520	0.8%
2007-08	1,099,453	452,948	41%	9,700	0.9%
2008-09	1,026,178	401,688	39%	9,861	1.0%
2009-10	1,151,092	463,555	40%	10,429	0.9%
2010-11	1,288,704	541,400	42%	9,352	0.7%
2011-12	1,341,930	523,867	39%	9,452	0.7%
2012-13	1,560,000	618,020	40%	9,578	0.6%

Sources: ABS 5655.0, 5678.0.

Future funding opportunities

Australia has, it is estimated, around 30,000 businesses which fall within the PE ‘investment range’ (ie. businesses that have growth potential and which are likely to require significant capital injections to realise that potential).[4]

Many of those businesses will, at some point in the medium-term, seek investors for a variety of reasons such as succession planning, expansion capital, and turnaround financing.

PE funds are currently invested in fewer than 350 businesses in Australia: meaning that they presently have the funding capacity to financially back less than 2% of the total ‘investable pool’ of up to 30,000 businesses.

In Australia, PE accounts for only 5% of all mergers and acquisition activity and private placements. In the US and UK markets, the comparative is around 14%.[5]

Australia also lags behind global averages in terms of its VC activity. VC investments represent, on average, 0.03% of GDP internationally, but in Australia it only constitutes 0.02% of GDP. Countries such as Israel (0.4%) and US (0.17%) greatly exceed the OECD average by a significant margin.[6]

It can therefore be observed that the full economic benefits of a dynamic VC and PE industry remain largely unfulfilled here in Australia.

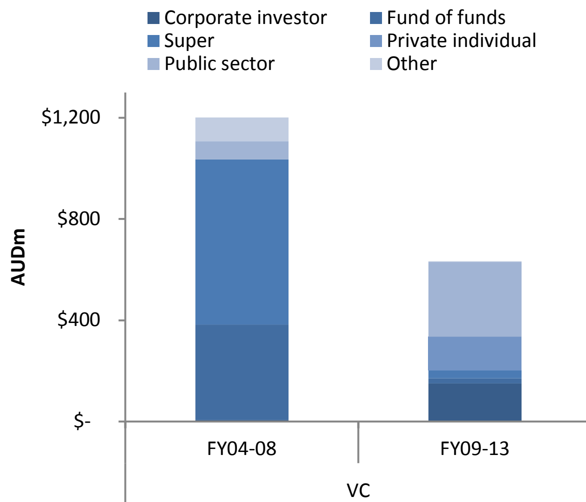
Funding for VC and PE has become much more challenging over recent years (Figure 4 and Figure 5). Total fundraising for FY2013 was under $900 million, down from the $3.3 billion in FY2012.

There are both structural and cyclical factors behind the difficulty in attracting sufficient funding allocation into VC and PE. Notwithstanding those factors, AVCAL believes that there is an emerging gap in productive capital investment into Australian businesses if steps to arrest the decline in funding are not addressed.

[4] Based on S&P Capital IQ data on Australian companies with Total Revenues between $10m to $3b, as of 1 Mar 2014. This number excludes the following sectors: Oil & Gas, Metals & Mining, Forest Products, Real Estate & Construction, Primary Food Products, Tobacco and Banks.
[5] AVCAL/S&P Capital IQ Market Observations FY2013.

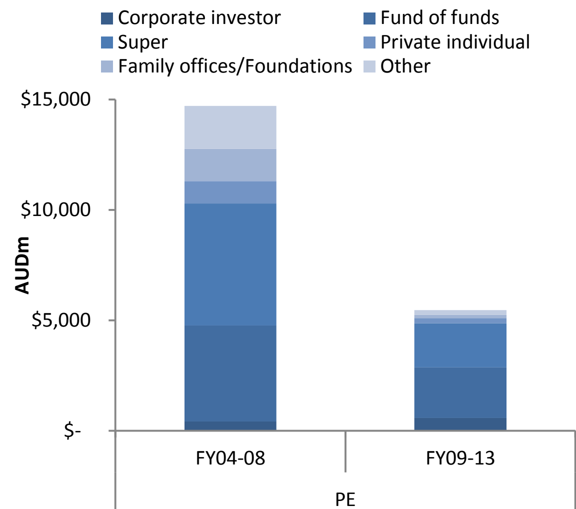
[6] OECD, 2012 data.

Figure 4: VC funds raised FY04-08 vs FY09-13



Source: AVCAL

Figure 5: PE funds raised FY04-08 vs FY09-13



Source: AVCAL

5. POLICY REFORMS THAT SHOULD BE CONSIDERED

In AVCAL's view, some features of the financial system that would underpin the funding of Australia's future economic needs include:

- a dynamic VC and PE industry;
- a deeper corporate bond market;
- a ready funding market for quality infrastructure assets; and
- the full panoply of instruments required for a deep and flexible annuities market.

Some of the major roadblocks preventing Australia from having a more dynamic VC and PE industry include:

- Disincentives to long-term investment;
- Superannuation asset allocation and liquidity support;
- Effectiveness of Government programmes; and
- Incentives and impediments in tax policy settings.

While this submission focuses on the role of VC and PE, the other points such as improving the potential for a deeper corporate bond market, and ensuring that reforms can be made to facilitate increased funding for infrastructure and the availability of annuities have AVCAL's full support.

Disincentives to long-term investment

There is little debate that a financial system that is fit for Australia's future should benefit the nation by providing products and services that boost productivity and welfare.

It has been observed that:

- The tendency to short-termism that has gained increasing priority financial markets and the investment community over recent years has had a detrimental effect on the potential for the VC and PE industry to continue funding capital investment into Australian businesses; and

- An unintended outcome of changes made over the course of recent years to superannuation policy settings is serving as a further restriction on the flow of superannuation fund investment into VC and PE vehicles, which is ultimately detrimental to superannuation fund members.

A number of studies have investigated the causes and rising costs of short-term investment horizons.[7]

Some jurisdictions have also initiated reviews to identify measures to encourage the adoption and pursuit of longer-term investment horizons.[8]

As the Myners Report found in the UK over a decade ago, “private equity … is in an important sense simply one victim – albeit an extreme one – of these deeper weaknesses in the investment process”.

These weaknesses, which are leading to a growing gap in the supply of longer-term finance to Australian businesses, are issues that the FSI should examine as part of making recommendations about reforms that both reinforce the key principles of a pro-market philosophy, as well as encouraging the adoption of a longer-term investment horizon across the financial sector.

AVCAL believes that a range of key policy and regulatory changes can be made to the existing financial system environment to address the current imbalance between short- and long-term investments.

Better alignment of the long-term interests of superannuation fund members with the long-term funding required for innovation and growth capital for Australian businesses across a number of industry sectors is paramount.

As numerous economic studies have concluded over time, creating a more dynamic Australian economy depends on our ability to support innovation, and to back businesses that can create competitive positions in the globalised marketplace.

VC is very often the critical step in commercialising technological innovations and creating new jobs within a dynamic knowledge-based Australian economy of the future.

However, without the right environment that facilitates and nurtures a strong and vibrant VC and PE industry, many innovators will be forced to relocate to markets where more attractive policy and regulatory settings exist.

VC and PE make a particular contribution to innovation and competition in the mid and smaller segment of the financial system, both to the smaller fund managers and the smaller (including regional) investee companies that might well be overlooked by Australia’s banking system.

In addition, it should be noted that the contribution of PE and VC to the economy comes not only through fostering growth but also through turning around or reallocating resources from failing firms. The FSI should consider, for instance, the implications of the lack of a US-style Chapter 11-type framework in Australia (as opposed to the Voluntary Administration regime) on PE managers' capacity to turn around distressed companies.

Without the support VC and PE, many companies would not be able to progress from start-up to thriving businesses, or to expand further, or rescued from financial distress, without the resources offered by VC and PE backing.

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[7] Haldane & Davies, Bank of England (2011), IRRC and Mercer (2010), and Pocock (2013)). Substantive analyses on the issue have also been conducted by the OECD (in 2013) Task Force on Institutional Investors and Long-Term Financing, as well as the 2008 voluntary development of the ‘Santiago Principles for Generally Agreed Practices and Principles’ for Sovereign Wealth Fund investment behaviour.

[8] For example, the Myners Report (Institutional Investment in the United Kingdom: A Review, March 2001) and the Kay Report (The Kay Review of UK Equity Markets and Long-Term Decision Making, July 2012).

Superannuation asset allocation and liquidity support

The domestic superannuation industry today is worth $1.75 trillion and is expected to rise to around $6 trillion by 2037.

Currently, only a fraction of these funds are deployed to some of the most productive but underfunded segments of the Australian economy: namely, small businesses and innovative high-growth companies. These are the industries that will drive Australia's future economic prosperity and long-term competitiveness, while at the same time potentially delivering superior returns to their investors.

In Australia, super funds are estimated to have $17.6 billion allocated to PE (constituting only 1.2% of total superannuation assets), half of which ($9.6 billion) is invested in Australia. This level of investment is significantly lower compared the US and UK, where some funds invest as much as 50% of their total asset pool into PE.

The evidence from mature pension PE programmes demonstrates the value in taking a long-term view of the asset class. For instance, the California Public Employees' Retirement System (CalPERS) – the US's largest public pension fund – had 11% of its assets in PE in 2013, and as of June 2013 CalPERS' PE programme had generated US$25 billion in profits since 1990 for its 1.6 million members.

The drivers of the low asset allocation to VC and PE in Australia are attributable in part to specific policy and regulatory settings that have created a bias towards low-cost, highly liquid asset classes. For instance:

- The requirement to provide 30-day portability incentivises many trustees to allocate only a small proportion of funds to relatively illiquid asset classes such as infrastructure, and VC and PE;
- MySuper default funds, intended to "deliver a better deal for all default fund members, including through improving the simplicity, transparency and comparability of superannuation products", in practice has the effect of driving excessive focus on high liquidity and low fees, limiting the range of assets invested in, at the expense of longer-term returns. It has been observed that MySuper products largely compete on the basis of low fees rather than overall net returns, with reduced diversity of asset allocation mixes. A 2012 report by Rice Warner Actuaries shows that most default funds tend to converge to a mix of 70-80% in equities and 20-30% in debt assets.[9] This type of asset allocation and focus on 'race-to-the-bottom' and lowest cost outcomes will, over time, limit the funding of innovation and investment in long-term asset classes that are capital intensive and high value-adding.

An unintended outcome of changes made over the course of recent years to superannuation policy settings is serving as a further restriction on the flow of superannuation fund investment into VC and PE vehicles, which is ultimately detrimental to superannuation fund members.

AVCAL is very supportive of work being done to examine the merits of a form of liquidity 'back-stop', such as access to a committed liquidity facility for qualifying superannuation funds, possibly provided by the Reserve Bank of Australia, which could provide a partial solution to the liquidity focus of superannuation funds under the current policy and regulatory settings.

A Government-backed liquidity facility could allow qualifying superannuation funds to hold higher asset allocations of less liquid, longer-term assets, which are better matched to the duration of the investment horizon of superannuation fund members saving for their retirement.[10]

Additionally, there is an opportunity to consider how the self-managed superannuation funds (SMSFs) sector can benefit from a greater

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[9] The Rice Warner (2012) report also states that "Allocations do provide a form of diversification but they are monitored against peers rather than overall fund performance".
[10] See, for example, the discussion in Deloitte Access Economics' report *Maximising Superannuation Capital* (2013), and Infrastructure Australia's *Review of Infrastructure Debt Capital Market Financing* (February 2014).

degree of investment into VC and PE as part of a balanced portfolio of asset holdings for the long-term. By their very nature, SMSFs offer their trustees a greater degree of flexibility than larger APRA-regulated funds in choice of investment. It may be the case that freeing up barriers to entry by a wider spectrum of SMSFs to investment into VC and PE will help bridge the funding gap that currently exists in the marketplace.

Improving the effectiveness of Government programmes

Over time there have been many government assistance programmes which provide a form of support to the VC industry. At a general level, many of the programmes are now dated and are in need of some form of modernisation.

Programmes supporting VC investment have served the purpose of maintaining a modest pipeline of activity in the face of a significant decline in VC fundraising.

As observed in Section 4, however, there has been very little new investment in early stage Australian businesses relative to other OECD markets. Also, due to the lack of scale in domestic VC funds, much of that investment has been concentrated on seed and very early stage rounds, with very limited capacity to fund later-stage venture rounds.

In addition, it can be argued that there exist a number of small scale support schemes which require are often complex to manage and difficult to extract the full benefits from.

We suggest the FSI examine the merits of reforms that would seek to simplify and modernise the current range of government assistance programmes to improve their overall effectiveness in delivering their policy objectives.

Some immediate options could include consolidating the less effective ancillary support programmes to significantly augment the current scale of the Innovation Investment Fund (IIF), and the potential for introducing a tertiary education-styled ‘HECS’ innovation grant scheme, where companies receiving innovation grants return the capital assistance they receive once they achieve a certain scale of size and profitability. The repaid capital could assist in freeing up funding for deployment to new emerging start-up businesses.

Other areas worth exploring include better targeting government research funding to projects with high innovation content and commercialisation potential, and requiring government-funded research with commercialisable outcomes to be spun-off into a commercial environment that maximises the likelihood of realising the full potential of locally-developed ideas and technology.

In addition, there may be scope to review the rules surrounding Government procurement policies to drive more local content participation by Australian-based firms, to increase the probability of successful development of local technologies.[11]

Improving the tax landscape

Most institutional investors with long-term horizons, such as sovereign wealth funds and pension funds, will not consider investing in external managed funds that are below a certain size threshold relative to their total assets under management.

As a result, Australian VC and PE funds – as with other managed funds – will need to progressively scale up their successive fundraisings in order to meet the investment criteria of their institutional investor base.

However, one of the main factors that erode the attractiveness, and international competitiveness, of Australian fund managers relate to taxation arrangements applying to collective investment vehicles (CIVs).

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[11] For example, US legislation requires federal agencies that contract out more than $100 million annually in R&D for technologies to set aside 2.5% for small businesses under its Small Business Innovation and Research Program (SBIR), resulting in annual expenditures of $2-3 billion going to innovative small businesses. The Department of Defense and National Institutes of Health are among the largest users of the programme, which has been credited with being very successful in driving innovation as a consequence.

There has been long-standing uncertainty and inconsistency over the tax rules that apply to CIV investors, both offshore and domestic. Several of the recent inquiries, most notably the Johnson Report (2009), have recommended improvements to the tax regime applying to offshore investors investing through Australian funds managers, endorsing flow-through tax treatment of investment income.

The outcomes of the Government's review of these recommendations are important because the CIV of choice domestically, apart from venture capital limited partnerships (VCLPs), remains a managed investment scheme taking the legal form of a trust.

Currently some features of the VCLP and Managed Investment Trust (MIT) tax framework put Australia's funds management sector at a competitive disadvantage, including ongoing uncertainty in the treatment of some classes of investors. This makes attracting investments into Australia challenging for local fund managers, particularly those that manage funds for offshore clients (who have greater certainty of flow-through tax treatment through other international CIVs of choice, such as limited partnerships and limited liability companies).

AVCAL believes that it is vitally important that deemed capital account treatment for eligible domestic partners in VCLPs is provided as a matter of priority. A consistent and unambiguous VCLP tax regime will encourage private domestic investors to invest in unlisted Australian businesses with high growth potential through VC and PE funds.

In addition, it can be argued that the current structure of Australia's capital gains tax (CGT) regime distorts the activities and capital investment allocations of households as well as superannuation funds. The impact of the existing policy in this area can perhaps be attributable to the fact that the CGT discount is available in a single step, after holding an eligible asset for only 12 months.

The FSI should examine the merits of a change in CGT policy that is aligned with incentives to hold eligible assets for a longer-term horizon. It may be appropriate to consider a CGT discount regime that rewards long-term asset holding by providing a stepped reduction in tax based on the period of holding. A smaller CGT discount could be offered for the holding of an asset for a relatively short holding period, and a larger CGT discount offered for a long holding period. A zero CGT rate could even apply for the holding of an asset for greater than 10 or 15 years for example.

From a longer term perspective, existing complexities within our tax system need to be eliminated and monetary thresholds and restrictions should be updated to ensure alignment with modern business practices and scale.

Simple, and well-understood limited partnership or limited liability company vehicles should be introduced in order to eliminate the significant compliance costs associated with the administration and management of existing complex vehicles. There is evidence to support the fact that these types of complexities are having the effect of deterring potential investment into Australia, in preference for other jurisdictions that have simpler and more widely understood compliance frameworks. For the VC and PE industry, the introduction of a globally-recognised flow through investment vehicle such as a limited partnership or limited liability company will certainly help to make investing into Australia a more attractive proposition for offshore investors than is presently the case.

In addition, the FSI should seek to ensure tax neutrality in its recommendations to reduce unintended distortions in the flow of investments. Notwithstanding the complexities of tax treaties and assistance schemes, no investor should obtain more advantageous tax treatment in respect of their offshore investments than they do for equivalent investments in Australia.

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