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Australian Government

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Financial System Inquiry
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By email: fsi@fsi.gov.au

Dear Mr Murray

Financial System Inquiry

I am writing to respond to the Financial System Inquiry, on behalf of Innovation Australia.

Innovation Australia provides the following comments principally to Terms of Reference 1.3 and 3.3, in this initial submission, but notes the relevance to other Terms of Reference focussed on regulation, the role of government, and impact on innovation and industry generally.

We have focussed specifically on the significant issue of market failure in early stage and development capital in Australia. A copy of the submission is provided for your consideration at **Attachment A**.

Innovation Australia would be very keen to meet with representatives of the Inquiry Committee to expand on the issues identified in the submission prior to the finalisation of the interim report.

A profile of Innovation Australia is provided at **Attachment B**

Yours sincerely

Nicholas Gruen
Chair
31 March 2014

Encl.
Attachment A: Submission
Attachment B: Innovation Australia Board Profile

Attachment A

FINANCIAL SYSTEM INQUIRY
(Submission by Innovation Australia)

> *"Australia is falling behind as a lucrative environment to start new companies, due to the lack of accessibility to significant customers and funding, a World Economic Forum report says. The findings, based on a survey of more than 1000 early-stage companies globally, showed Australia scored an average of 53 per cent when judged on eight key criteria for encouraging start-ups in global economies.*
>
> *Though local start-ups reported that accessible markets and funding were the most crucial aspects of starting a new company, the country scored just 69 per cent in those categories. By comparison, the United States scored above 90 per cent for markets and funding, with an average score of 77 per cent, the highest among economies rated in the report."*

The Australian Financial Review 28 January 2014

Market Failure in Early Stage Equity Capital

There is long-standing and unresolved failure in capital markets in Australia to provide capital for new ventures, particularly in relation to technology-based and other innovation-intensive start-ups.

Past government response has been directed towards the VC Fund mechanism, with limited success (the industry has seen returns negative for two decades, perhaps not least as a consequence of the tech-wreck and GFC, its relative immaturity and also its lack of scale), and Australian VC Funds are currently not a significant source of capital to new ventures. It seems unlikely that this situation will induce significant flow of venture capital from overseas VC Funds.

Emerging new approaches to sourcing, managing and mobilising venture capital provide alternatives to the VC Fund approach particularly in current circumstances. However, the efficacy of the new approaches in Australia is yet to be fully demonstrated. Moreover, they appear to be narrowly focussed on low-capital "lean" start-ups that are software-based, web-mediated and disruptive of existing business models. Larger areas of more capital-intensive innovation (e.g. biotech, medtech, new materials, advanced manufacturing) remain starved of capital.

The early success of these new approaches in other comparable economies owes something to government intervention, enablement or incentives, underpinned but not obviated in a few cases (e.g. in USA) by a deeper and more established propensity to support early-stage ventures.

An efficient and effective future early stage equity capital market in Australia will depend on a deeper understanding of the changing nature of early stage capital and on the nature of the market failures, to determine what sort of policy may be appropriate to the circumstances and to the objective of ensuring sufficient capital is allocated efficiently to early-stage ventures.

More fundamentally, having an efficient and effective early-stage equity capital market depends on our recognising the national imperative to support the development of innovative businesses, in the interests of greater productivity, competitiveness and export.

Development Finance

A disproportionate number of the jobs of tomorrow will be created within small to medium high growth firms seeking to expand rapidly – so called Gazelles. Funding such firms is a difficult endeavour for several reasons.

It is difficult, as such high growth firms do not typically have long established track records, and even if they did, rapid expansion may be risky for them. Financing in such circumstances is high risk and requires high levels of skill, both in building relationships and in understanding risk. Yet, though the task absorbs more capital than start up and venture capital, it is still a small fraction of the task of financing major corporates and household lending. This means it is not 'centre of mind' for large banks.

As a recent paper argued regarding the British economy:

> *Even a rushed 'emergency scheme' relationship-banking institution, set up by the Government, succeeded in lending to a sample of firms, 95 per cent of whom had been refused loans by high street banks, without any difference in loan default rates. The market does not self correct because the scale of current banking creates strong incentives for conformity to a single business model and substantial barriers to entry for new banks offering better services to SMEs. The subsidies given to large highly leveraged banks through implicit government guarantees…further constrains entry.*[1]

The Australian banking sector is configured similarly to the British banking sector – except that concentration is higher in Australia. In the IA Board's experience it is likewise not performing well regarding the provision of development finance.

Given the risks involved, equity and quasi-equity finance are also relevant to the question of supplying Australian Gazelles with adequate development finance. Here there has been more diversity than in banking. There are three major superannuation fund streams – Industry super, for-profit super and self-managed super funds (SMSFs). In each case however, development finance is a difficult market to serve, requiring specialist skills that may be difficult for the trustees to govern, and yet which should occupy only a relative small share of a properly balanced portfolio. In such circumstances development finance typically falls through the cracks.

A somewhat different set of issues arises for mid-market firms who are growing rapidly. In Australia the case is often made that while the nation has a proliferation of micro businesses and small SMEs, we lack the presence of a sizeable number of mid-size firms with the capacity to expand globally while anchoring their value adding activities at home. Ministers, business leaders and academics frequently raise the question "where is the next generation of Cochlears, Resmeds and CSLs coming from?"

During the 2012 Manufacturing Taskforce, the non-government members of the Taskforce ("the non-government members") considered what was required to "help more SME's grow into the global, mid-size firms Australia lacks".[2] Access to development or expansion capital was frequently nominated as an issue, particularly loans for rapidly expanding mid-market firms (or those breaking into the mid-market space) tooling up for new business, expanding off-shore through acquisitions or substantially increasing capacity at home to service domestic and export markets. Banks perception of risk and restrictive loan covenants were amongst the issues raised.

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[1] Hutton, W. and Nightingale, P. 2011. The Discouraged Economy. London: The Work Foundation.
[2] PM's Manufacturing Taskforce: Report of the Non-Government Members August 2012 page 4.

Similar issues are at the centre of the debate in the UK following the Rowlands Review and the establishment of the Business Growth Fund, the Growth Accelerator Program and other mechanisms to help finance high growth firms.[3]

Interim Report and Final Report

Innovation Australia request that the Financial System Inquiry in the development of its interim and final reports, thoroughly investigate and make recommendations taking into consideration the following points:

- The mechanisms for providing growth capital to new, early-stage and rapidly growing SMEs in Australia are deficient, particularly in relation to technology-based and other innovation intensive opportunities (this stands in marked and largely unexplained contrast to the skill, experience and willingness of the Australian market to provide risk-capital to mining exploration or start-up ventures).
- The "gaps" in availability of capital occur at proof-of-concept and early stage commercialisation stages as well as early expansion development finance, meaning that incipiently successful Australian innovations and ventures are confronted by a sequence of capital barriers well beyond those experienced in other comparable economies.
- Since 2008, the contribution of conventional Venture Capital Funds has declined substantially. It is not assumed that this circumstance of low VC Fund activity will not be remedied in future, but it is clear that, in current circumstances, broader views of venture capital are required.
- Investment in R&D intensive SMEs is highly cyclical. This is on its face a market failure. Whereas the cyclicality of some investments demonstrates the market working efficiently - for instance varying construction activity with the state of demand and supply of dwellings and interest costs – this is not true for R&D intensive stocks - the world will either want the new technology and service being development or not. This shows how VC and development capital tend to be an afterthought - pursued when the market is buoyant and full of optimism and rationalised in difficult times. There therefore needs to be some consideration of this in crafting interventions. We saw this in the wake of the GFC and took some limited and *ad hoc* steps to counteract it. It would be better to build such considerations into institutional design.
- There is no reliable evidence that the vacuum in VC Fund activity in Australia, and the demonstrated availability of high quality investment opportunities in this country, will induce significant flow of early stage capital from overseas markets into Australia.
- Sources of and channels for mobilising venture capital in other countries, and apparently also in Australia, are becoming more diverse.
- The balance between individual and institutional sources of capital is changing with the former becoming more important and the latter presently playing a less systemically significant role.
- In the circumstances where provision of venture capital currently appears to be adequate, it is often narrowly focussed on fast-moving, software-based and web-mediated innovation that is disruptive to existing businesses and business models.
- Major economically and socially important areas of innovation that are linked to the national R&D effort and have larger capital requirements and longer development cycles (e.g. biotechnology, new materials, new manufacturing, energy efficiency) continue to be starved of capital.

[3] The UK debate is canvassed in detail in R. Brown, C Mason and S. Mawson: Increasing the Vital 6 Percent" Designing Effective Public Policy to Support High Growth Firms NESTA Working Paper No. 14/01. As pointed out in the NESTA paper and in the Australian debate, there are many issues besides access to capital that feature in the underdevelopment of Australia's mid-market sector.

- Past government policy interventions, like the Innovation Investment Fund (IIF), have recognised market failure in early stage capital markets in Australia, and sought solutions by supporting VC Funds or similar entities through co-investment (IIF commenced in 1998, with future funding depending on the upcoming budget). This seems an appropriate form of intervention as it 'crowds in' private endeavour, helping to develop the private capital market in appropriate directions, rather than 'crowding out' commercial funding by competing with it unfairly.
- More recently, governments have established mechanisms like Commercialisation Australia, which is proving successful in overcoming specific market failures and helping early stage ventures to bridge capital and knowledge gaps.
- Future measures need to recognise the continuing market failure, and respond to the shifting nature of early stage equity capital, the emergence of new sources of capital, new channels for mobilising and managing it, and the different motivations and drivers for investment.
- Unsurprisingly, given the level of risk, the majority of capital for early-stage ventures is equity or quasi-equity rather than debt though debt can be a useful adjunct to equity. This means that Australia's large pools of capital within its superannuation system should be a powerful resource; however, owing to a mix of market failures and regulatory settings this has not been the case.
- Australia has one of the largest savings pools in the world (>$1.8 trillion) in government-enforced saving superannuation (institutional, industry and self-managed super), meaning there is no shortage of capital, just a shortage of it being applied to early stage and development investment. The reasons are varied but there are a variety of incentives that could drive more private investment in this sector.
- With regard to institutional investors, there are many reasons why they have not allocated much capital (<0.5%) to venture capital. In addition to historical poor results, there are structural reasons (super funds are too big to write small cheques) and business reasons (asset consultants often advise against venture capital, partly due to lack of education on the sector), as well as a natural conservatism.
- The liquidity requirements of super funds make investing in venture capital difficult, given its long-term illiquid nature. However, an undue focus on liquidity results in a loss of diversification opportunities in funds that may be highly concentrated through comparatively high exposure to domestic equities.[4] Given that allocations to venture capital investment would remain a small share of total portfolios, there are opportunities for gain where funds trade-off very small losses in liquidity for higher returns.
- With regard to individual investors, experience in comparable economies shows that new sources of capital include individual investors with diverse characteristics, from very high net-worth (HNW) investors experienced in building new ventures, to syndicated HNW angel investors, to retail investors.
- Whether Australian individual investors will show a similar predilection for venture investing is unclear. On the one hand is evident enthusiasm for crowd-funding arts ventures; on the other are data showing that Australian HNW investors construct more conservative portfolios than counterparts in comparable economies.
- There are various structural and other barriers that prevent this capital flowing into early stage and expansion capital opportunities in significant quantities. Such barriers include regulatory and individual notions that such investment is 'high risk', when, however true that might be of investment in a single venture, it is less true of a portfolio of such investments and less true again when the riskiness of that portfolio can actually lower risk in a larger portfolio where it is not strongly correlated with the market generally.

[4] 61% of ASX earnings generated by 2 industries; 60% of ASX earnings generated by 10 companies. Source: FactSet 2011

- New channels for mobilising and managing capital include new pooled-fund models, including syndicated angel funds, which may be organisationally linked to accelerator and incubator initiatives, retail investor funds, and crowd-sourced equity, debt or reward funds.
- The result of too little early stage and expansion capital is that many innovative opportunities are relocating to and seeking capital in overseas locations (and therefore moving economic activity and high quality jobs offshore), or “dying on the vine” for lack of capital.

Innovation Australia Board Profile

Innovation Australia is an independent statutory body under the *Industry Research and Development Act 1986* (IR&D Act) to assist with the administration and oversight of the Australian Government's industry innovation and venture capital programs delivered by AusIndustry. Membership of the Board comprises leading Australian business figures with professional and technical expertise across a broad section of industries, technologies and capital markets. Established on 27 September 2007, Innovation Australia assumed the roles, responsibilities and powers of the two former Boards and carries responsibility for past decisions made by the IR&D and VCR Boards.

The IR&D Act promotes the development of Australian industry and aims to improve industry efficiency and international competitiveness by encouraging research and development, innovation and venture capital activities.

The Board also has functions conferred on it by the *Pooled Development Funds Act 1992* (PDF Act) and the *Venture Capital Act 2002* (VC Act) in relation to the administration of the venture capital programmes. The Board evaluates and advises Government on the operation of the IR&D Act, the PDF Act, the VC Act and the Commonwealth's income tax law as they operate in relation to those Acts.

In addition to the R&D Tax Incentive, the Board and its committees assists the government in the administration of two key business programs - Commercialisation Australia and the Innovation Investment Fund. These programs are aimed at commercialising innovative technologies and turning research into new products, service and processes.

R&D Tax Incentive

The R&D Tax Incentive is a targeted, easy to access, entitlement program that helps businesses offset some of the costs of doing R&D. The Program aims to help more businesses do R&D and innovate. It is a broad-based entitlement program. This means that it is open to firms of all sizes in all sectors who are conducting eligible R&D.

Commercialisation Australia

Commercialisation Australia (CA) is a competitive, merit-based assistance programme helping Australian companies and researchers convert their novel intellectual property (IP) into new products and services. CA offers both financial assistance and skilled resources to help build businesses from new IP.

CA assistance targets early stage commercialisation to build businesses that are market ready and attractive to investors. CA does not support basic research and development activities and therefore it complements, rather than duplicates, support available through the R&D Tax Incentive Program. CA is the only national programme operating in this space.

Innovation Investment Fund

The Australian Government’s Innovation Investment Fund (IIF) is a venture capital programme that supports 10 year innovation funds to develop high growth Australian companies to become globally competitive by commercialising the outcomes of Australia’s strong research capability. The Australian Government has supported venture capital through its IIF program since 1998. Over the three rounds the programme has licensed 17 fund managers and has supported over 135 new companies.

When finalised, IIF3 (since 2007) is expected to have injected $370 million (Government and private) of risk capital into the venture capital sector to fund the commercialisation of Australian R&D.