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1 May 2014

Mr David Murray AO
Chairman Financial System Inquiry

Submission re Venture Capital

I have long been a practitioner and proponent of venture capital (VC) in Australia. Having established the country's first VC company in August of 1970 I have a collection of scars and bouquets which perhaps qualify me to offer a contribution to your committee's important task.

I and others have written about the need and the challenges for venture capital funding of new enterprises and innovation in this country. Considerable evidence exists of Australian capacity and prowess in discovery but this is juxtaposed with a rather modest record in commercialization of its innovations. At this time in Australia's development, as new private investment in the resources sector and traditional manufacturing declines, it is likely that growth in jobs and living standards will only be derived from expansion of our internationally competitive products and services sectors. The lifeblood for the expansion of newly emerging technologies and enterprises in these sectors is risk equity capital i.e. venture capital.

The supply and demand for VC may be best understood in three broad segments:

- Online business models (6 months to 24months funding timeframe)
- High growth privately owned enterprises in traditional models (3 to 7 year funding timeframe)
- Biomedical devices and drug development models (7 to 15 year funding timeframe)

My recommendations in each of these three segments are as follows:

On-line business models

On-line business models, whether disruptive and/or complementary to extant business processes, have proliferated in recent years in Australia and worldwide. Many of the web based applications, and the software to drive them, can be developed and market tested within relatively short time frames, often with 6 to 24 months. The internet has revolutionized the ability to test markets globally in very short time periods, so reducing the venture funding amounts and risks for proof of concept. It has reduced Australia's "tyranny of distance" for many of these new businesses and dropped the average pre-revenue funding requirement to less than $1m per project. As a result we are seeing this type of venture capital increasingly being provided by high net worth private investors, small specialist VC funds (e.g. IIF licensed funds and others such as recently formed Blackbird Ventures) and crowd funding.

- **Recommendation One**

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I do not believe there is any longer a plausible "market failure" case to be made for additional intervention in this segment of VC markets, but I strongly support the call by AVCAL and others for the removal of up front tax assessment of the equity options or sweat equity allocated to entrepreneurs and founders of these innovative and early stage enterprises. This obligation prior to any liquidity event and marketing of such equity is a fundamentally flawed "handbrake" on innovation and the commercialization process.

Higher growth privately held companies

Higher growth privately held companies, whether in IT, specialised manufacturing, renewable energy projects, agribusinesses or other products and services, will not usually be able to fund growth only from cash flow and traditional bank and other lenders. They almost always require increasing amounts of equity capital. This risk capital is not accessible from public equity markets until the business demonstrates credible scale of revenue and profit performance.

- **Recommendation Two**

Existing Federal Government incentives to stimulate the provision of private venture capital to this segment should be continued and made subject to a "sunset review" by 2020, in particular, the Innovation Investment Fund Program (IIF) and the Early Stage Venture Capital Limited Partnership (ESVCLP) taxation concessions.

VC for the commercialization of biomedical devices and molecules (drugs).

In my view (in part informed by my own experience in biotech company investments, in part by my experience as Chair of the Garvan Institute of Medical Research, and in part via my participation as a member of the Federal Government's panel reviewing the future of Health & Medical Research), the biomedical products and services sector in Australia represents the single greatest national opportunity we have for sustainable jobs growth, for production gains in health service delivery, and for better health outcomes nationally and internationally. Successive Federal Governments have enabled the establishment of a world class medical research infrastructure. This infrastructure of medical research institutes, university labs and hospital clinics provides the R&D for our $140BN national health sector but there is negligible "D" in this "R&D" mix.

Different to the on-line business model referred to in section #1 above, the biomedical business model will often involve time lines of 10 to 15 years before revenue. Discovery and proof of concept (usually involving animal models and testing) then lead to human clinical trials. These trials are phased through toxicity, efficiency and safety, and regulatory approvals, requiring many years and multi-millions of risk venture capital.

Already, Australia's drugs, vaccines and medical devices constitute our largest manufacturing export sector. Our clinical trials business already attracts offshore pharmaceutical companies but could produce literally billions of incremental revenue within a decade.

- **Recommendation Three**

In my view there is a compelling case for Federal Government investment, 50/50 with the private sector, in a national scale translational biotech fund (TBF), This TBF would provide venture capital to biotech enterprises whose medical devices and/or drugs are at clinical trials stage. Such enterprises will require on average $10m to $15m of risk capital to advance their clinical Phase 1 and Phase 2 trials to the point where later stage venture commercialization can be viable.

The TBF is designed as a for profit investment fund whose Manager would be selected via a competitive tender process among qualified investment managers in the life sciences sector.

This TBF proposal is included in detail as a core recommendation in Chapter 6 of the Strategic Review of Health & Medical Research (Fund Report, Feb 2013), including a detailed term sheet. Please refer attachment A herewith. I should emphasise that this TBF proposal has been "road tested" with key Australian super funds who have indicated preparedness to underwrite the proposed private sector funding component. The risk/rewards sharing formula, outlined in the TBF term sheet (page 221 of Attachment A), was designed to enable the super fund investors to justify the longer time and greater risks involved in the clinical trials development phase.

Unless venture capital is mobilized via this TBF structure, or something similar, I believe the nation will squander the opportunity to benefit from one of the very few IP intensive sectors it has that can realistically claim to be internationally competitive. We don't have time to waste!

WD Ferris AC

Attachment A: Chapter 6 of Strategic Review of Health & Medical Research

Attachment B: CV, WD Ferris