AVCAL
Australian Private Equity &
Venture Capital Association Limited

Funding the new economy: A 'scale-up' policy blueprint

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A transitioning economy

With the Australian economy undergoing rapid structural change, the nation and its policy-makers are faced with the question: where will the jobs of tomorrow come from? Supporting and growing those Australian industries that are well-placed to innovate and create the next wave of employment growth is critical. In particular, this will involve startups and small and medium size enterprises (SMEs) attracting capital and expertise to grow their businesses, and turn great ideas into commercial reality.

To date, the National innovation & Science Agenda (NISA) has focused on bolstering the startup ecosystem, including providing early stage investors with the right incentives to back promising ideas and products. These policy changes will be transformative for the startup sector.

The next phase of Australia's innovation reforms – NISA 2.0 – must now move to support 'scale-ups': those businesses that have graduated from the initial startup phase with a proven product and market opportunity which now need further capital (often $5m-20m) and expertise to hire staff, drive sales growth and invest more deeply in research and development.

Currently, a lack of institutional funding at this vital stage pushes maturing, innovative Australian companies abroad. Making sure that these companies receive the support they need has economy-wide implications, including the nation's ability to drive innovation, productivity and employment growth into the future. Over the last five financial years (FY2011-15), only 19% of venture capital-backed companies received later/expansion stage funding, down from 30% of companies in FY2006-11.

This document sets out AVCAL's views on how Government and industry can work together to ensure that Australia retains and nurtures its promising entrepreneurs and businesses. In a globalised economy where capital and labour is increasingly mobile, and the rate of technological change rapid, it is essential that Australia has a competitive environment for those companies at the heart of the economy.

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The role of private equity and venture capital

The PE and VC industry can play an important role in this transition to a new economy by providing the necessary capital and expertise, and partnering with innovators and entrepreneurs to build better businesses. The majority of PE and VC investment is in SMEs and startups, who often struggle to attract financing from traditional lenders, and may lack the experience to fulfil their companies' potential. PE and VC funds regularly meet those funding and experience gaps, providing crucial support at critical stages of a company's life cycle.

A strong PE and VC sector is a key element in developing a vibrant startup and high growth business environment in Australia. It also makes a strong contribution towards reinvigorating businesses. Figures 1 and 2 illustrate that most PE investment is in SMEs, with VC focused on startups and early stage companies.

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Figure 1: Average PE & VC investment (A$m), FY2013-2015

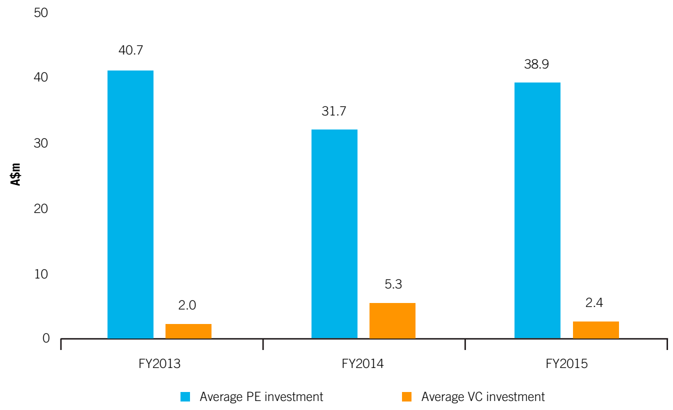
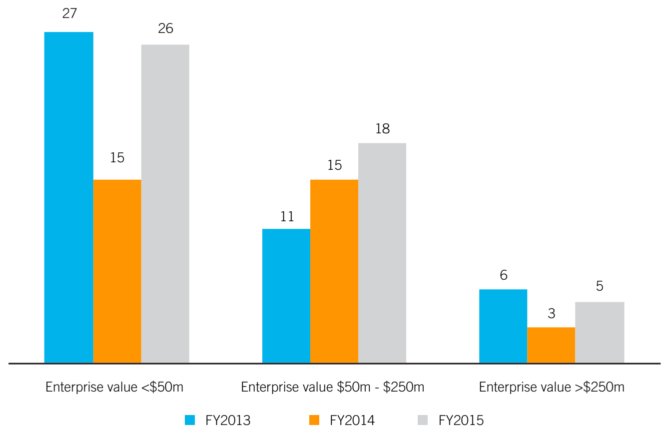


Figure 2: PE deals focused on lower mid-marketNumber of new PE transactions by EV band, FY2013–FY15



Source: AVCAL

Economic contribution to Australia: fuelling high-growth businesses

PE-backed businesses alone contribute more than four per cent per annum to Australia's GDP and support, both directly and indirectly, over 500,000 full time equivalent jobs across the economy. Economic analysis confirms that the average workforce for a PE-backed company grew from 378 to 1,636 FTE jobs over a five year period, representing an annual growth rate of 27.6%.

In the 2015 financial year, PE fundraising almost tripled to $2.7b (from FY2014 levels), with investment at $3.3b (representing a 54% increase on FY2014 levels).

VC is also playing an important role in the record growth of the Australian startup sector. In this financial year over $1b has been, or is currently being, raised by Australian VC funds, almost three times the amount raised in FY2015, over eight times the FY2014 total, and ten times the FY2011 total. Over $900m was invested by VCs in Australia over the last three financial years.

These VC investments are concentrated in the future-focused sectors of life sciences, ICT, and renewable energy. By 2023, PwC has projected Australian tech startups alone will contribute 1.1% of Australia's GDP, and create over 100,000 jobs for the economy.

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Research released in September 2015 by the Office of the Chief Economist, Department of Industry and Science, has highlighted that young SMEs – the businesses that PE and VC routinely invest in – disproportionately drive Australian employment growth. The Government's research showed that despite the Global Financial Crisis, over the period 2006-11, the largest contribution to job creation in Australia (40%) came from young SMEs: firms aged 0-5 years that had less than 200 employees and accounted for 15% of total employment. These companies created 1.12m net FTE jobs in that period. OECD research shows similar employment trends across its member countries (2001-11).

The potential for Australian VC to transform our economy must be recognised. In November 2015, research from Stanford University and the University of British Columbia highlighted the major economic contribution of VC in the US, particularly in financing innovative companies. In 2014, VC-backed companies accounted for 44% of the total R&D spending of US public companies, despite only representing 17% of US public companies by number, and 21% by market capitalisation.

Three of the five largest US public companies by market capitalisation – Apple, Google, and Microsoft – all received most of their external financing from VC. The employment dividend of such investment is clear: since 1974, one quarter of net job growth for publicly listed US corporations came from VC-backed companies.

There is every reason to expect that Australia can achieve similar outcomes in the context of our own economy. In fact, it is critical that we set ambitious objectives to create significant new employment opportunities over the next few years.

Bi-partisan political support for change

AVCAL has been very supportive of the bi-partisan political commitment for recalibrating the Australian economy towards a greater focus on innovation and creating new, highly skilled jobs. Over the last year, a number of important initiatives have been progressed by the Coalition in Government as part of the NISA including: a commitment to introduce a new collective investment vehicle for limited partnerships; new tax incentives for early stage investors; important reforms to the VC investment framework; and the decision to create a Biomedical Translation Fund (BTF) to commercialise promising health and medical research discoveries.

The ALP in opposition has also shown great interest in progressing innovation policy reform, and supporting the development of a world-class startup ecosystem. Progress has been significant, and we call on all political parties to continue to work collaboratively in the national interest.

Policy priorities for the next Parliamentary term – implementing NISA 2.0

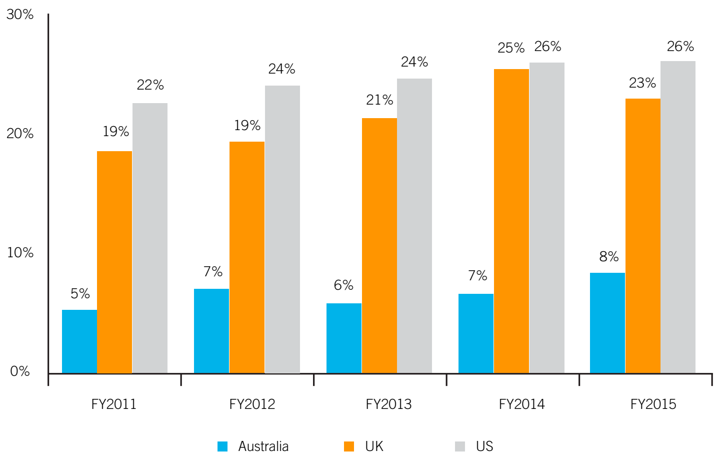
Australia is in a global race for talent and capital. Following the 2 July 2016 election, we call on the incoming Federal Government to prioritise reforms aimed at ensuring Australian business, especially those which are 'scaling-up' their operations, can thrive in the new economy. The PE and VC industries are well-placed to support this transition and recommend the following initiatives:

Attracting foreign capital to invest in high growth, Australian businesses

1. Accelerated introduction of a new, collective investment vehicle for limited partnerships

Issue: Australia's current suite of collective investment vehicles is out of step with international practice, necessitating complex structures, and deterring foreign investment. If Australia wishes to grow the funds available for investment into unlisted assets such as high growth, Australian businesses, a new, best practice vehicle must be created. Limited partnerships are the globally accepted PE and VC vehicle of choice, and could be transformative for the industry.

Figure 3: No. of PE transactions as a % of total M&A transactions, FY2011-2015



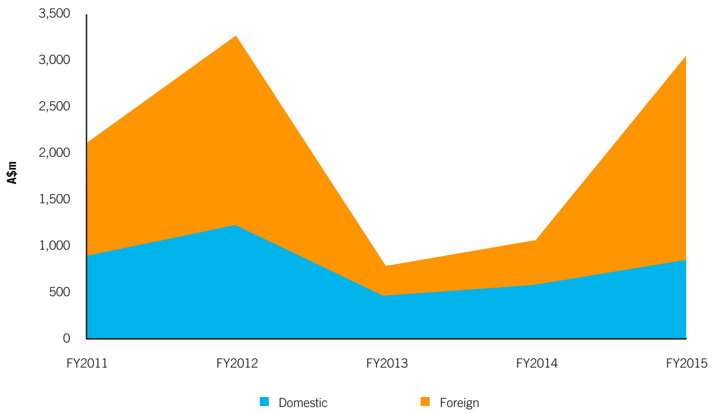
Source: AVCAL/S&P Global Market Intelligence Market Observations Report 2015

Recommendation 1: That Government work with industry to legislate a streamlined, simplified, limited partnership vehicle available to investors from 1 July 2017.

2. Better targeting of Australia's foreign investment framework

Issue: Given Australia is a net capital importer, our national interest necessitates an internationally competitive foreign investment framework. Some recent changes have created artificial barriers to off-shore passive investment into non-sensitive parts of the economy. These changes have had a disproportionate impact on Australian PE and VC given a majority of funds are now sourced off-shore (Figure 4). Consistent, principled policy is essential to the continued funding of high growth Australian businesses.

Figure 4: Domestic vs foreign PE & VC fundraising in A$m, FY2011-2015



Source: AVCAL/EY 2015 Yearbook

Recommendation 2: That Government review recent changes to the foreign investment framework to ensure they do not unintentionally deter routine passive investments into Australia.

Attracting domestic capital, including super, into high growth, Australian businesses

3. Addressing roadblocks to superannuation investment in PE and VC

Issue: With Australia facing the demographic and fiscal challenges of an ageing population, more needs to be done to facilitate super funds investing into high performing asset classes, such as PE and VC (see Figure 5). Despite superior returns, super funds committed just over half a percent of their assets under management to Australian PE and VC funds in FY2015, with a majority of MySuper products lacking any PE investment allocation. The percentage allocation has almost halved since FY2009.

Government policies that have had the unintended effect of discouraging investment into PE and VC need to be addressed, particularly at a time of slow global growth. Passive investment options will no longer deliver adequate returns for Australian superannuants, and other investors.

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Figure 5: Australian PE & VC returns vs listed equities

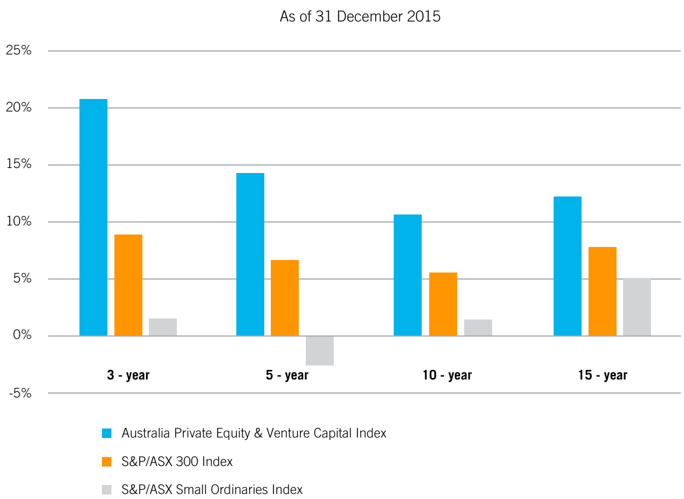


Figure 6: PE allocations of North America-based pension funds, 2016

Sources: Cambridge Associates, Preqin

Recommendation 3: That Government recalibrate existing superannuation policy to ensure there is a focus on net returns, and remove regulatory hurdles to greater investment in value-adding asset classes. Super funds should aim to increase allocations to the PE and VC asset classes to help boost retirement savings for members.

4. Stable and principled tax and regulatory settings to stimulate investment

Issue: Australia's policy settings are constantly shifting, encouraging domestic investors to invest overseas. Consistency and certainty in the tax treatment of investments is critical. While the introduction of venture capital limited partnerships (VCLPs) has been a policy success, there remain areas for reform.

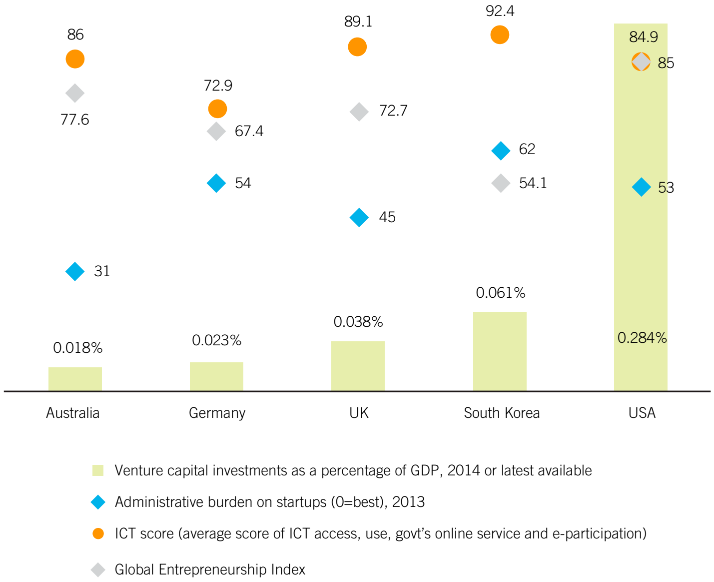
For example, capital gains treatment of investments into VCLPs unnecessarily differs depending on the class of investor. The 2014 Financial System Inquiry found that simplifying the VCLP tax rules would reduce barriers to fundraising, consistent with a 2011 Board of Tax review and in-principle 2013 Government support.

Recommendation 4: That Government ensure regulation is stable and principled, providing investors, including in VCLPs, with the certainty necessary for medium and long-term investment.

5. Developing a world-class startup and scale-up ecosystem

Issue: Recognising the significant recent reforms to the startup ecosystem, Australia must now adopt a greater focus on supporting businesses entering the 'scale-up' phase. More can be done to encourage an entrepreneurial business culture, expand government/private sector commercialisation co-investment, and attract entrepreneurs and innovators to Australia.

Figure 7: Innovation indicators



Sources: Austrade, OECD

Recommendation 5: That the Government introduce a package of innovation measures including:

a) funding commercialisation and business skills courses for tertiary STEM students aimed at fostering entrepreneurship and addressing labour shortages;

b) immediately establishing the BTF, and systematically exploring further co-investment opportunities;

c) swiftly adopting quarterly R&D tax credits for innovative, cash-poor businesses; and

d) continuing reform of out-dated employee share scheme rules.

About AVCAL

The Australian Private Equity & Venture Capital Association Limited's (AVCAL) members comprise most of the active private equity (PE) and venture capital (VC) firms in Australia, who together manage around A$28b on behalf of Australian and off-shore superannuation and pension funds, sovereign wealth funds and family offices.

PE and VC firms provide capital for early stage companies, later stage expansion capital, and capital for buyouts of established companies. Over the last 10 years, PE and VC invested around A$32b in almost 900 Australian companies. In FY15, PE and VC funds invested A$3.3b into 140 Australian companies, across almost all sectors of the economy.

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