INVESTING FOR GROWTH

Policy Proposals for the incoming Federal Government

April 2019

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AUSTRALIAN INVESTMENT COUNCIL

The voice of private capital

Australia stands at a pivotal period in 2019. More than ever, ongoing shifts in the global economy are highlighting the need for government, industry and businesses to work together to ensure that Australia is ready to tackle complex problems and take hold of the big opportunities that are available to us.

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Our strengths and challenges

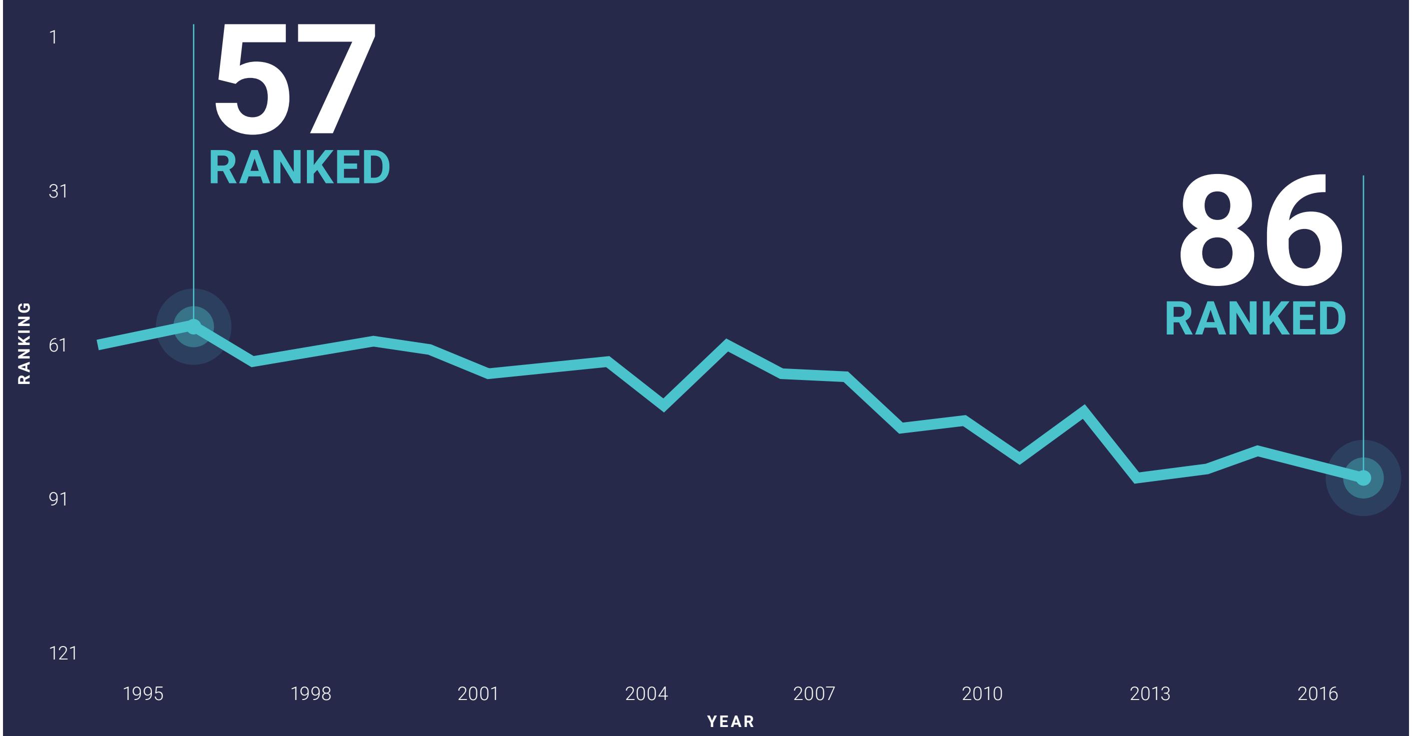
Australia stands at a pivotal period in 2019. More than ever, ongoing shifts in the global economy are highlighting the need for government, industry and businesses to work together to ensure that Australia is ready to tackle complex problems and take hold of the big opportunities available to us.

Collectively, we face major challenges – including political instability and global trade issues, the increasing pace of technological change, and changes to monetary policy around the world that could have significant impacts on financial markets and the overall economy. Positive economic fundamentals such as low unemployment, low interest rates, and stable economic growth shouldn't be discounted, but many businesses face challenges such as accessing debt capital and lower business confidence. How to lift productivity and invest more in skills and talent, productive capacity, and technology are just some of the questions that policymakers and industry leaders alike must turn their minds to.

Australia still has much work to do to transition and advance our economy, which hasn't kept pace with the development in complexity and technological transformation of other economies globally. The latest available rankings of economic complexity, developed by Harvard University's Center for International Development, ranked Australia 86th globally – the lowest ranked of all developed economies and lower than many developing countries. Since 1996, when Australia was ranked 57th globally for economic complexity, we have dropped 29 places, which shows that we need to do much more if we want build and future-proof a sustainable and growing economy.

It is therefore important that the economic challenges that Australia faces are recognised and tackled through leadership in long-term and visionary policy reforms. Industry as a whole has a role to play in informing and engaging with all sides of politics on these challenges. This includes the private capital industry, which invests in a wide range of Australian companies, be they early stage tech startups or long-established agricultural or manufacturing businesses. In particular, our members seek to invest in high-growth companies which use that capital to expand their workforce, increase sales growth and engage in new research and development.

Figure 1: Economic Complexity Index Ranking



Source: The Atlas of Economic Complexity, Center for International Development

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Capital raised by Australian private capital funds is sourced from a variety of domestic and offshore investors, including superannuation funds, sovereign wealth funds, overseas pension funds, and family offices. Attracting further private capital investment, both local and offshore, is necessary to keep high-growth businesses well funded and thriving.

Regionally, Australia more than punches above its weight in terms of performance by such high-growth companies. A report by the Financial Times[1] included 115 Australian companies on its list of the top 1,000 high-growth companies in the Asia-Pacific region, with five of the top ten places claimed by Australian businesses in terms of percentage growth in annual revenue between 2013 and 2016. These Australian companies employed close to 42,000 people in 2016, and generated more than US$17 billion in total revenue. A substantial number of the Australian companies highlighted in the report have benefited from private capital investment in order to achieve such significant growth.

The role of private capital in growing Australian businesses and new sectors

Private capital investment isn't just a capital injection into businesses that need it to hit the next stage of growth. This is 'smart capital' that brings with it industry expertise, access to networks, and other value-add that businesses wouldn't get with other forms of funding or financing.

The majority of private capital investment is directed into SMEs and early stage businesses. Private capital fund managers partner with entrepreneurs who often lack the experience and resources to fulfil their companies' potential, or to navigate risk and uncertainty. Private capital funds regularly meet those funding and experience gaps, providing crucial support at critical stages of a company's life cycle.

A study by the Australian Small Business and Family Enterprise Ombudsman in November 2017[2] identified access to finance (both in the form of equity and debt financing) as a significant barrier to greater levels of investment by SMEs, despite theoretically favourable conditions.

The study also noted:

"There appear to be constraints on attracting domestic and foreign capital for private equity (PE) and venture capital (VC) that are acting as a handbrake on business growth and investment. There is a strong, healthy pipeline of candidate businesses for PE and demand is perceived to be outstripping supply and availability of capital. The estimated gap is about double the number of existing businesses currently receiving investment."

VC is also helping Australia to make strides in developing new and emerging industry sectors. According to a recent Deloitte report,[3] Sydney was listed eighth on a list of 44 top global fintech hubs driven by its innovation culture, proximity to expertise and proximity to customers. VC funds have played no small part in Australia's burgeoning fintech space, investing a total of close to $100 million into the sector across FY2016 and FY2017.

Bright spots are being seen in other promising sectors. An increasing number of agritech-focused startups are progressing through incubator and accelerator programs, and being funded at the seed and early stage. In the next few years, these new businesses will need further funding, particularly VC investment, to get to the next stage of growth. Their innovative products and services have the potential to revolutionise Australia's agricultural sector, making it more competitive and sustainable.

FOOTNOTE

[1] *FT 1000: High-Growth Companies Asia-Pacific,* Financial Times, February 2018

[2] *Barriers to Investment: a study into factors impacting small to medium enterprise investment,* Australian Small Business and Family Enterprises Ombudsman, November 2017

[3] *A Tale of 44 Cities Connecting Global Fintech: Interim Hub Review 2017,* Deloitte, April 2017

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The contribution of private capital to the Australian economy

At a time when each dollar of investment makes a difference in helping to grow existing businesses and fund the development of new industries, the private capital industry contributes more than its fair share. This means that private capital firms, and the businesses backed by those firms, makes a significant contribution to the overall economy.

An April 2018 study by Deloitte Access Economics[4] provides some deeper insights into the economic contribution of PE in Australia. The study found that:

- In FY2016, private-equity backed businesses contributed $43 billion in total value added to the Australian economy – equal to 2.6% of Australian GDP;
- PE-backed businesses supported 327,000 FTE jobs (172,000 directly, and 155,000 indirectly);
- In FY2016, private equity-backed businesses added almost 20,000 FTE jobs, accounting for 11% of total Australian employment growth in FY2016;
- PE-backed businesses typically delivered annual revenue growth of 20%, while boosting the size of their workforce by 24%;
- More than 85% of private-equity businesses introduced some type of process or product innovation in FY2016, far greater than the average profile of non-PE backed businesses.

VC firms provide capital to startups and other high-growth companies at vital stages of growth. These startups have the potential to grow quickly and become the next crop of large businesses, driving economic activity and employing thousands of people. But these startups are already making a significant economic impact.

According to the 2016 Australian Innovation System Report, startups (those businesses aged 0-2 years) are the largest contributor to job creation in Australia. From 2004 to 2011 they created more than 1.2 million jobs. This represented 90% of net positive job creation. In the same period they contributed $164 billion to the Australian economy out of a total of $440 billion that was added to the economy. VC investment has played a role in maintaining positive job creation in Australia, aiding the economic recovery from the global financial crisis particularly by creating new industries and demand for new skills and labour.

In more developed VC markets, venture funding provides other economic benefits. Evidence from 20 industries in the United States suggests that VC is 3-4 times more effective than corporate research and development at fostering innovation.[5]

How government can help

Governments at all levels have an important role in making sure that businesses are given all the necessary tools to grow and succeed, including a stable policy and regulatory environment to operate within, access to capital and the expertise of professional business managers and operators.

The Australian Investment Council, as the voice of the private capital industry, calls on the incoming Federal Government to take up a number of policy recommendations that would help to increase the flow of capital to startups, SMEs and other high-growth businesses. Our recommendations would help to unlock greater levels of private capital support that would in turn allow for businesses backed by private capital to expand and grow through investment in capital stock, innovative technology, and in their employees.

$43b

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≥85%

More than 85% of private-equity businesses introduced some type of process or product innovation in FY2016.

20%

PE-backed businesses typically delivered annual revenue growth of 20%.

FOOTNOTE

[4] *Private Equity: Growth and Innovation*, Deloitte Access Economics, April 2017

[5] *Boom and bust in the venture capital industry and the impact on innovation*, Josh Lerner, Federal Reserve Bank of Atlanta Economic Review, Issue Q4 2002

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Policy priorities for the next Parliamentary term

1 Removing roadblocks to greater levels of superannuation investment in private capital

Issue: Despite the strong investment return profile of private capital, super fund allocations into this high-performing asset class remain far below that of peers overseas and other pooled investment funds such as the Future Fund (Figure 2).

The unintended effects of certain government policies and regulations that discourage investment into private capital need to be addressed, particularly at a time of slow global growth and Australia's changing demographics. Investing in high performing asset classes is the only way that super funds will deliver adequate returns for retiring Australians.

Recommendation 1:

That Government shift superannuation policy settings to ensure super funds are focused on achieving competitive net returns, and remove regulatory hurdles to greater levels of investment in value-adding asset classes like private capital, in order to boost retirement savings for members. This includes fee and cost disclosure regulations and whole-of-system changes which could have unintended consequences for superannuation funds and fund members.

> **Investing in high performing asset classes is the only way that super funds will deliver adequate returns for retiring Australians.**

2 Accelerating the introduction of a new investment vehicle and providing stable tax and regulatory settings to existing vehicles

Issue: Australia's legal and tax framework for private capital investment is inconsistent with international best practice. It currently necessitates duplicate and complex structures and deters higher levels of foreign investment.

Firstly, in order to grow domestic and offshore funds available for investment into unlisted assets such as high-growth Australian businesses, a new best-in-practice limited partnership (LP) collective investment vehicle (CIV) must be created. This would allow Australia to compete globally for capital and would be transformative for the domestic private capital industry.

Secondly, consistency and certainty in the tax treatment of investors committing capital through existing vehicles should be provided in order to encourage domestic investment into high-growth businesses and attract offshore capital. This should apply to investors that provide capital through a number of different investment vehicles such as Venture Capital Limited Partnerships (VCLPs), Early Stage Venture Capital Limited Partnerships (ESVCLPs) or Managed Investment Trusts (MITs).

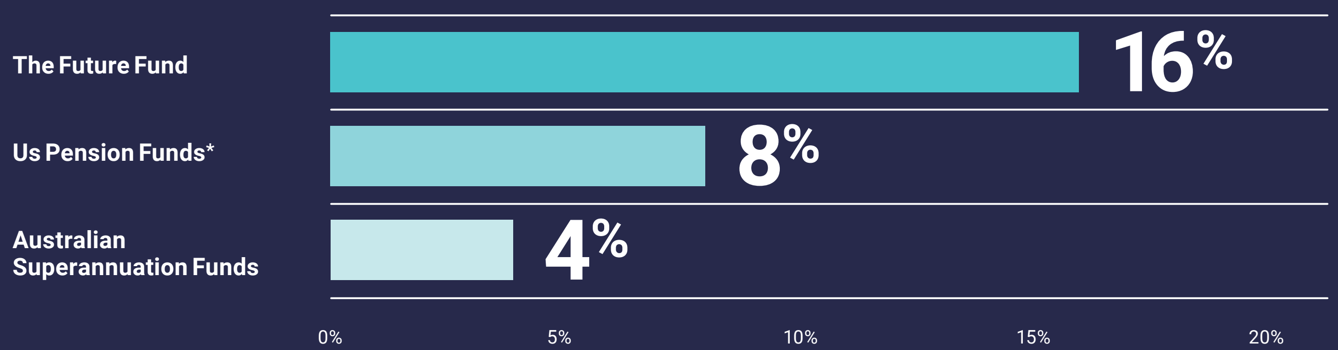
Recommendation 2:

That as a matter of priority the Government develop and legislate a limited partnership collective investment vehicle to be available to investors from 1 July 2020.

Recommendation 3:

That Government ensure regulation of investment vehicles such as VCLPs, ESVCLPs and MITs is stable and principled, providing investors with the certainty necessary for medium and long-term investment.

Figure 2: Asset Allocation To PE & VC (%)



*Top 200 funds only

Source: AVCAL analysis, Productivity Commission, *Pensions & Investments*, Future Fund

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3 Maintaining certainty and openness of Australia's foreign investment and trade policy

Issue: Australian jobs and industry rely on a steady inflow of foreign capital to support investment into growing businesses across all sectors of the economy. Some of Australia's largest private capital firms rely on offshore investors to raise their funds, and importantly private capital funds from overseas invest into a range of small and large-scale businesses.

Ensuring that the policy environment around foreign investment remains stable is one of the key ways in which Government can help maintain Australia's reputation as an attractive investment destination.

International trade has for decades been a significantly important driver of Australia's economic development. It is estimated that 2.7 million Australian jobs rely on trade, while the average Australian family has benefitted by up to $3,900 each year because of trade.[6]

Foreign investment also goes hand-in-hand with trade, which provides enormous benefits regionally and globally. It is our view that Government has an active role to play in maintaining strong trade ties across the region and the globe, especially during a time when free trade is coming under more pressure through geopolitical tensions.

Recommendation 4:

That Government commit to maintaining policy certainty within the existing foreign investment framework, and make no unnecessary changes that would restrict future foreign investment into Australian private capital funds or businesses.

Recommendation 5:

That the Government pursue the strengthening of trading ties regionally and globally, whether through bilateral and multilateral agreements and policy settings that seek to encourage trade and investment.

> **It is estimated that 2.7 million Australian jobs rely on trade, while the average Australian family has benefitted by up to $3,900 each year because of trade.**

FOOTNOTE

[6] *10 Facts about Australian Trade*, produced by ACCI, APPEA, BCA, MCA, NFF; April 2017.

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4 Providing funding in areas of most need

Issue: There is currently a lack of capability and investment capacity to support new ventures and innovative businesses located in regional and rural areas of Australia, despite the fact that regional Australia contributes one third of our national output and is home to 8.8 million people. With the recent establishment of the Biomedical Translation Fund and overseas schemes such as the Opportunity Zones program in the US, the Government has a blueprint for launching programs which couple government funding and private capital and direct it towards specific areas of need.

The recent announcement by the Government of an Australian Business Growth Fund, modelled on similar initiatives in the UK and Canada, is a positive change which has been broadly supported by our industry. It demonstrates that relatively minor changes to certain regulations can open up big opportunities for more private capital investment. The Australian Business Securitisation Fund is likewise a good way of encouraging higher levels of business lending into the SME market which otherwise would have been untapped. Such a pragmatic policy approach, coupled with strong industry consultation, could be effective in unlocking new sources of capital that invest into SMEs and high growth businesses more generally.

Meanwhile, social impact investing (SII) plays a vital role in providing capital to organisations and initiatives that generate, along with financial returns, social and environmental benefits to the wider community. We believe that the Government can do more in improving the environment for social impact investors, following on from the release of Australian government principles for SII and various commitments made in 2017 and 2018.

> **The Government has a blueprint for launching programs which couple government funding and private capital and direct it towards specific areas of need.**

Recommendation 6:

The introduction of a Regional Innovation Fund to stimulate and support the establishment and growth of startups, new businesses and industry sectors – such as agritech – to catalyse economic growth in regional and rural areas of Australia.

Recommendation 7:

That the Government give renewed consideration to equity co-investment programs, as well as regulatory changes that unlock private sources of capital, in order to boost investment into high growth Australian companies.

Recommendation 8:

That the Government encourage greater levels of SII in Australian social enterprises through the removal of regulatory barriers to investment, improved access to social impact data, and appropriate government focus and oversight in order to continue the growth and development of the Australian SII market.

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5 Bridging the talent gap, locally and globally

Issue: Startups and scale-ups that are seeking to accelerate their growth can only do so by tapping into a deep pool of talent, both locally or globally. Government should look to address the current talent gap that exists for many high-growth companies by investing in education and opening up pathways for skilled migrants.

A world-class innovation ecosystem needs to be supported by a world-class education system. The nature of work itself is evolving, driven by technological transformation. A leading education system should encompass skills that aren't traditionally taught in schools and universities, such as entrepreneurship, and provide the infrastructure to effectively deliver student outcomes starting from primary through to the tertiary phase of education.

Australia is a net importer of not only capital but talent. Skilled migration has been a key component of Australia's migration system, playing an important role in generating economic growth for a number of decades. Recent changes to the 457 visa program for skilled migrants has reduced the flow of talent to Australian companies, particularly in the tech sector.

Recommendation 9:

That the Government address current labour shortages by funding institutions that can develop and deliver courses for tertiary students aimed at fostering entrepreneurship and teaching digital STEM skills. The teaching of STEM skills should be embedded from primary schooling through to tertiary education.

Recommendation 10:

That the Government introduce a talent visa program targeting entrepreneurs and other highly skilled professionals such as engineers, technology experts and scientists from overseas to boost the pool of talent available to startups and scale-ups.

> **A world-class innovation ecosystem needs to be encompassed by a world-class education system.**

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6 Setting a forward-thinking innovation policy

Issue: Recognising the significant reforms to the innovation ecosystem seen over recent years, it is equally necessary to preserve but also build on that momentum by looking at further changes. More can be done to encourage further investment, foster local talent and incentivise the corporate and government sectors to nurture the growth of startups and scale-ups.

For example, Australia has seen a substantial growth in the number of corporates that have launched corporate venture capital (CVC) arms or innovation labs, marking their stakes as serious participants in the innovation ecosystem. We believe this can be further accelerated by incentivising more corporates to play a role as investors and customers. Australia has also made a number of leaps in adopting open data – for example, through the Government's Declaration of Open Government and the planned introduction of an open banking regime. But a wealth of data exists, from the population census to various government departments, which should be opened up to information-hungry companies, keeping in mind the necessity of balancing openness with privacy and consumer rights.

> **More can be done to encourage further investment, foster local talent and incentivise the corporate and government sectors to nurture the growth of startups and scale-ups.**

Recommendation 11:

That the Government introduce a package of measures including:

a) extending the early stage tax incentives to allow corporate entities to invest in Early Stage Innovation Companies (ESICs) and ESVCLPs, and provide further incentives for corporates to engage with startups as investors and first and/or cornerstone customers;

b) adjusting ESVCLP settings to make them more attractive to investors;

c) encouraging government entities to engage (through partnerships, procurement agreements, etc.) with startups and SMEs via targeted grants or other incentives;

d) promoting open data initiatives, including open government data and other sources of information such as health, financial services beyond banking, education, and welfare;

e) opening up the Accelerating Commercialisation program to VC-backed companies; and

f) reforming equity incentive rules for founders and entrepreneurs who hold a significant equity stake in their company.

Recommendation 12:

That the Government commit to and support earlier innovation reforms and measures that have had a net benefit to the innovation and early stage ecosystem, including:

a) making no further cuts or changes to the R&D Tax Incentive;

b) continuing to support the Biomedical Translation Fund by planning for the next round of funding within three years; and

c) keeping Innovation & Science Australia well-funded and functioning.

7 Considering tax policy changes

Issue: A comprehensive tax reform agenda is a key policy instrument for any government. However, tax changes that improve the government bottom-line in the short term may have longer-term consequences in discouraging business investment. This would negatively impact future economic and jobs growth, particularly in the context of the uncertainty about global economic growth.

Thin capitalisation rules govern levels of debt and the tax deductibility of interest for multinational entities. A number of methods for calculating an entity's appropriate threshold are currently available in Australia. Recent legislative changes and court rulings have effectively tightened the rules in this area of tax and addressed much of the concern around profit shifting and transfer pricing. Further changes, for example eliminating currently available threshold tests or only adopting the world-wide gearing test, have been proposed in recent years.

Adopting solely the world-wide gearing test for Australia would create undue complexity for businesses and investors that operate both here and in other jurisdictions. Such a change would thus create business uncertainty for existing domestic and overseas investors and deter future investment. Many of our global peers have adopted the OECD-recommended EBITDA ratio rule as the preferred approach, so adopting this rule should be explored as part of efforts to bring us in line with other jurisdictions.

Currently, individuals and trusts are entitled to a 50% discount on the capital gain amount providing they have held the asset for more than one year. Reducing the capital gains discount could likewise deter future investment - this is especially true in the early stage sector, where a significant portion of funding for small yet highly innovative companies comes from angel investors and other high net worth individuals.

Recommendation 13:

That the Government look to global practice if considering changes to thin capitalisation rules and carefully consider tax policy changes such as increasing the capital gains tax that would operate retrospectively and deter future investment.

ABOUT THE AUSTRALIAN INVESTMENT COUNCIL

The Australian Investment Council is the voice of private capital in Australia. Private capital investment has played a central role in the growth and expansion of thousands of businesses, which when combined represents a multi-billion dollar contribution to the Australian economy.
Our members are the standard-bearers of professional investment and include: private equity, venture capital and private credit funds, alongside institutional investors such as superannuation and sovereign wealth funds, as well as leading financial, legal and operational advisers.

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