Australian Government
Department of Industry and Science

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Senior Adviser
Financial System and Services Division
The Treasury
Langton Crescent
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Via email: fsi@treasury.gov.au

Dear Sir

Innovation Australia is pleased to provide the attached submission in response to the final report of the Financial System Inquiry and its recommendations prepared by Mr David Murray.

Innovation Australia recognises the need for more a more competitive economy that will include new technologies and innovative firms. The Financial Services Inquiry is an opportunity to address market failures and reduce (or remove) current barriers to innovation for growth of Australian companies in both existing and new industries.

Our submission is generally supportive of a number of the recommendations noted in Mr Murray's report and makes comments regarding specific recommendations. We have also referenced our submission to the Financial System Inquiry in March 2014 and attach it for information.

Innovation Australia has indicated additional areas that could be addressed in the current review and is available to provide further clarification if required.

I would be pleased to meet you to provide further clarification if required.

Yours sincerely

Marlene Kanga

Dr Marlene Kanga AM
A/g Chair
25 March 2015

Attachments

- Innovation Australia's submission to the Treasury's *Financial System Inquiry Final Report Recommendations* March 2015
- Innovation Australia's submission to the *Financial System Inquiry*, March 2014

Innovation Australia
Response to the Financial System Inquiry Final Report

Innovation Australia has a key role in providing independent advice to the Government on matters relating to innovation in business and industry, including appropriate financing to support innovation.

Innovation Australia provides financial support for early stage innovation via the following programmes:

- The R&D Tax Incentive, over which the Board has oversight via its R&D Incentive Committee, is a targeted, easy to access, entitlement program that helps businesses offset some of the costs of doing R&D. The incentive is open to firms of all sizes in all sectors who are conducting eligible R&D and assists SMEs that have not achieved profitability with much needed cash flow via a tax refund.
- The Early Stage Venture Capital Limited Partnerships (ESVCLP) and the Venture Capital Limited Partnerships (VCLP) programmes. Both were developed to stimulate Australia's venture capital sector with favourable tax treatment for investors. These structures attract both foreign and domestic investors who provide much needed capital for innovative Australian companies.
- A number of legacy programmes, now closed, that the Board continues to administer, including Pooled Development Funds (PDFs) and Commercialisation Australia (CA), both of which provided financial support for innovative companies in early stages of growth.
- The Innovation Investment Fund (IIF) Programme though closed to new commitments continues to provide venture capital support through 10-year innovation funds to develop high growth Australian companies by commercialising research outcomes.[1]

Innovation Australia prepared a detailed submission to the Financial Systems Inquiry in March 2014. We refer to this submission in our current paper and attach it for further reference.

Our submission is made in response to the "Financial Systems Inquiry Final Report" (FSI), issued by Treasury in November 2014. It addresses the pressing need for policy settings that provide financial strength for innovative companies in Australia.

[1]The IIF programme contributed $724 million of capital commitments ($401 million public and $323 million private) to the Australian venture capital sector over 16 years and was a significant factor in supporting more than 120 start-ups. Of this, $530 million has been invested and total returns to date are $505 million, $336 million to private investors, due to their preferential treatment in the IIF model and $169 million to the government. Source: Unpublished AusIndustry data.

1. Recommendations in the Financial Systems Inquiry (FSI) Final Report

Our comments on specific recommendations made in the report are provided below.

Support for Innovation

The FSI Report concludes the need for support for innovation in the financial system by stating that, "The Inquiry believes the innovative potential of Australia's financial system and broader economy can be supported by taking action to ensure policy settings facilitate future innovation that benefits consumers, businesses and government."

However there is also a pressing need for the policy settings that encourage the financial system to support innovation in the Australian economy. These include fragmented and/or obstructive government policies or regulations, such as tax treatment of employee share schemes, government procurement of innovation and low incentives for research commercialisation/collaboration in the public research sector.[2] Addressing these issues is consistent with the government's *Industry Innovation and Competitiveness Agenda*.

We support **Recommendation 14** of the report for collaboration to support innovation and for a permanent public–private sector collaborative committee to facilitate financial system innovation and enable timely and coordinated policy and regulatory responses. We agree that the committee should address matters such as the low risk appetite for innovation and regulations that might impede innovation and to provide a co-ordinated approach to support innovation.

We believe that this committee should have broader responsibilities to provide policy and regulatory responses not just for the financial sector but also to provide essential financial support for innovation across industry.

Better use of data

Innovation Australia supports **Recommendation 19** to provide access to and improve the use of data. While this recommendation has been provided in the context of the financial sector, *Innovation Australia* believes that there are wider opportunities for innovative applications using data.

For example, *Innovation Australia* has championed the case for more innovative uses of both public and private sector data where better information flows and adroit uses of digital technologies can help unlock barriers to innovation.

[2] Australian Innovation System Report 2014, http://www.industry.gov.au/industry/Office-of-the-Chief-Economist/Publications/Pages/Australian-Innovation-System.aspx#, pages 6-7

- *Innovation Australia* acknowledges the benefits of **Recommendation 23** for innovative disclosures that will overcome the asymmetric information gaps and imbalances between lenders and borrowers and additional costs to SMEs. We broadly agree with **Recommendation 20,** for more comprehensive credit reporting.
- We support the FSI finding that the use of technology and access to data will encourage better decision-making and the Productivity Commission recommendations on how this could be achieved.[3]
- There is also merit in **Recommendation 34** in the report dealing with unfair contract term provisions as well as recommendations for reforming the payments system (which could assist in reducing the difference in fees paid by large and small firms).

Crowd sourced equity funding

Innovation Australia supports FSI's **Recommendation 18** for fundraising regulation to facilitate crowd funding for both debt and equity and, over time, other forms of financing.

Innovation Australia recently responded to the Treasury discussion paper on Crowd Sourced Equity Funding (CSEF) in February 2015.[4] Our submission addressed the importance of both crowd sourced equity funding and peer to peer lending and how both can make a difference to the funding constraints facing early stage innovative firms and entrepreneurs.

Importantly, our submission emphasised the strategic opportunity presented by crowd sourced funding mechanisms, not only to support innovation and innovative companies by providing new sources of capital to start-ups and small business, but also to create a new industry that provides financial services internationally.

This recommendation is consistent with the view of the FSI report that regulators need to have regard to the whole-of-system benefits of innovations like crowd sourced funding.[5]

The FSI report has also noted that in Asia, for example, the monetary authorities have statutory mandates to promote and market financial sector development.[6]

The ability to establish a viable crowd funding industry in Australia, through effective, efficient and competitive regulation, will be an important test of our ability to follow our own economic blueprint – to continue to transition our economy to a predominantly knowledge based one - through the progressive digitisation of existing and new products and services. It is also an important new channel that might positively strengthen a key economic pillar of the Australian economy – financial services, creating jobs and economic growth. A copy of our submission can be provided for further information.

[3] FSI Final Report page 283
[4] *Innovation Australia:* Submission to Issues paper on Crowd Sourced Equity Funding, February 2015
[5] FSI Final Report, page 148.
[6] FSI Final Report, page 149.

Better targeting of tax settings

Innovation Australia agrees with the FSI Report for better targeted tax settings for start-ups and innovative firms, as listed in Appendix 2 Tax Summary and recommended for consideration as part of the Tax White Paper process.[7]

In supporting further consideration of this recommendation, Innovation Australia notes that tax-advantaged structures such as VCLPs and ESVCLPs are necessary but not sufficient measures, given that the nature of early-stage equity capital markets are changing and venture capital firms are only one channel for supply of early-stage capital. Tax settings that support other channels are required.

Innovation Australia will address these issues in its submission to the forthcoming Tax White Paper review.

2. Addressing market failure in financing innovation

The main focus of *Innovation Australia's* submission to the Financial System Inquiry (FSI) in March 2014 was: ***"The significant issue of market failure in early stage and development capital in Australia".***[8]

A number of additional measures will be needed to adequately address this market failure. Some of these are discussed below.

Support for early stage equity finance

The matters noted above that are addressed in the FSI final report have the potential to help overcome some of the constraints that SMEs face in accessing timely, affordable and appropriately structured finance. Nevertheless, the major concerns outlined in our 2014 submission to FSI remain largely unaddressed in the Final Report.

In particular, we noted that the nature of early stage equity capital markets has changed rapidly, significantly and perhaps permanently. Emerging new approaches to sourcing, managing and mobilising venture capital provide alternatives to the VC Fund approach. They indicate that support for early stage equity finance may need to be targeted differently from past approaches. Simply put and as stated in our FSI March 2014 submission:

"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...."

[7] FSI Final Report, Appendix 2, Tax Summary, page 278
[8] *Innovation Australia:* Submission to the Financial System Inquiry March 2014

"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."

"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."

It is *Innovation Australia's* assessment that both the level of risk and the perception of risk associated with the provision of early stage and development capital result in market failures that can only partially be addressed by the reforms advocated in the FSI. Changes in public policy together with industry-led changes in private sector behaviours that support an innovation culture will be needed if these problems are to be systematically addressed.

Utilising Australia's large savings pool in superannuation

As stated in our 2014 submission to the FSI, 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 a range of incentives could drive more private investment in this sector.

This is not simply the case of refining or adding to existing incentives but also examining the conditions under which the favourable tax status of superannuation should be retained and whether any conditionality should be attached to this, particularly for large superannuation funds (say those with assets above $25billion). This issue can be canvassed in the Taxation White Paper but can also be addressed in the Treasury examination of recommendations made in the current review.

Support for expansion capital

There is a variety of definitions given for development or expansion capital. For some it refers mainly to a combination of various equity and debt instruments (often referred to as quasi equity or mezzanine finance) made available to relatively new fast growing firms who have progressed past the proof of concept and early stage commercialisation phase of development and are embarking on their next stage of growth. For others it refers mainly to more established firms (say five years or older) entering an expansion stage of growth.

In its recently released report[9] the OECD examination of trends for SME financing in 31 nations (which included New Zealand but unfortunately not Australia) included a feature chapter on mezzanine finance and the circumstances where it is deployed by SMEs. These include young high growth companies that may use mezzanine financing for expansion rather than additional funding from venture capital, established companies using mezzanine financing to develop new markets, and transitioning and restructuring companies moving from private to public ownership as part of a leveraged buy-out or as a bridge to equity finance.

The same OECD report noted that many OECD countries had found serious market failure to exist in the provision of development capital and had put in place measures to address this problem, especially in the wake of the global financial crisis and its impact on the banking system.

Innovation Australia's submission to the FSI in March 2014 made three points about the underdevelopment of Australia's market for development or expansion capital to fund SMEs going for growth.

- A disproportionate number of future jobs will come from high growth firms or "gazelles”. These firms typically do not have a long established track record and more often than not will be required to undertake expansion activities that involve greater risk.
- These high growth firms require equity and quasi-equity finance to tool up for new business, expand off-shore through acquisitions, or substantially increase capacity at home to service domestic and export markets.
- In *Innovation Australia’s* assessment, neither the Australian banking system nor the major superannuation fund streams (retail, industry funds and Self-Managed Superannuation Funds (SMSFs) is strategically positioning their future deployment of capital to service this market opportunity. Similarly Australia’s $109 billion Future Fund is not seen as strategically positioning itself to support Australian innovative firms, in contrast to its well-publicised investment in foreign firms, including US start-up firms such as Moda Operandi.[10]

It should be noted that many foreign owned banks, especially from Asia, are moving into the Australian market and providing various types of mezzanine financing for established companies from Asia that are expanding into Australia. Fostering appropriate conditions for mezzanine financing is another market opportunity for the Australian finance sector that should be explored.

Benchmarking performance and communicating outcomes

Australia would benefit from a deeper knowledge base about SME high growth firms, and where the market failure is most pronounced for development capital.

[9] OECD: Financing SMEs and Entrepreneurs 2014:An OECD Scoreboard pages 59-60, http://www.oecd.org/cfe/smes/financing-smes-scoreboard-2014.htm

[10]http://www.smh.com.au/business/banking-and-finance/future-fund-goes-haute-couture-investing-in-fashion-website-moda-operandi-20150305-13vlz1.html

The Office of the Chief Scientist recently released report “Benchmarking Australian Science, Technology, Engineering and Mathematics (STEM) observed the need for benchmarking Australia’s performance as being essential not only to establish Australia’s relative standing internationally but also areas for improvement.[11]

Similarly, *Innovation Australia* recommends that Australia develop benchmarking for the availability of early stage and development capital in Australia. In assessing the options for doing this, and the data and case study material already available, the due diligence process for proceeding should also assess the costs and benefits of becoming the 32nd country to participate in the OECD Scoreboard “Financing SMEs and Entrepreneurs”, mentioned above.

The benchmarking process would be an important step in filling the knowledge gap that informs policy makers about Australia’s innovation system. Australia needs robust evidence based policy agenda for encouraging more innovative firms and organisations (both public and private). Much of the debate about deficiencies in early stage and development capital is related to available information on the circumstances confronting high growth innovative SMEs. Australia has not done as much in depth empirical research into this issue as has occurred in the UK, Scotland and other parts of the OECD.[12] This overseas work provides meaningful insights into many issues that can help guide policy.

The high standard of work demonstrated in this year’s Innovation System Report 2014 suggests there is in house capability to do such research. The time has come to gather people together for a discussion of what a road map for research around Australia’s Innovation System should look like and how funds and resources from both the public and private sector can be brought to bear to underwrite this agenda.

Maximising the value of new innovation infrastructure

A number of reviews; restructures and initiatives in Australian innovation provide further opportunities to advance the cause of market failure for financing for innovative companies.

The recently established Entrepreneurs Infrastructure Programme, the Government’s five growth centres now commencing their start-up phase and the concluding review of the Co-operative Research Centres, provide opportunities for building connections and institutional arrangements to support the emergence and growth of a new generation of high growth SMEs as well as enlarging the ranks of Australia’s global mid-market firms. The Growth Centre leaders and industry participants will be well placed to gain insights into the capital constraints facing innovative Australian SMEs. Their insights can also help inform the research agenda into benchmarking performance in this sector as discussed above.

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[11] Office of the Chief Scientist: Benchmarking Australian Science, Technology, Engineering and Mathematics November 2014, www.chiefscientist.gov.au/2014/12/benchmarking-australian-science-technology-engineering-mathematics/, foreword.

[12] In *Innovation Australia’s* 2014 FSI submission we relied on R Brown et al “Increasing the Vital Six per cent: Designing Effective Public Policy to support High Growth Firms: NESTA Working Papers 14/01 January 2014. In addition see OECD: High Growth Enterprises and Gazelles 2007; C Mason and R Brown “High Growth Firms in Scotland: Scottish Enterprise October 2010 and also S Parker et al: “What happens to Gazelles? The importance of dynamic Management Strategy”: Small Business Economics Vol. 35 2010.

This evolving architecture will also facilitate the multiplicity of dialogues and engagements that will lead to an industry led innovation policy. This includes industry taking the lead in putting in place the investments in early stage and development capital.

With this in mind we note an important commitment to early stage venture capital that occurred last year when two superannuation funds combined with Brandon Capital to establish the Medical Research Commercialisation Fund.[13] In part this outcome has its origins in successful investments in Brandon's IIF Life Sciences Fund. *Innovation Australia* understands that following on from this initiative, some Funds have commenced a dialogue about expansion capital to invest in high growth firms that are in need of $5 million - $10 million of expansion capital for their next phase of growth.

This opens the way for a useful ongoing dialogue between the Growth Centres and their supporting infrastructure and those in the private sector assessing the prospects for this kind of productive investment and the partnerships and structures that might facilitate more of this investment being available in Australia.

Concluding observations

The Australian government has recognised the need for a more competitive, advanced economy that includes new technologies and innovative firms. A key factor that is limiting the potential for Australian based businesses to win more international business opportunities both at home and internationally includes the ongoing lack of access to additional finance and poor levels of venture and private equity capital investment in innovating companies which remains the most commonly identified barrier to innovation.

The Financial Services Inquiry is an opportunity to address market failures that can reduce the current barriers to innovation and reduce the impediments for growth of Australian companies in existing and new industries. *Innovation Australia* has indicated additional areas that could be addressed in the current review and is available to provide further clarification if required.

Attachment Innovation Australia's submission to the Financial System Inquiry, March 2014

[13] The $40 million MRCF IIF, LP (a Venture Capital Limited Partnership (VCLP) was established under an Innovation Investment Fund (IIF) license (Round 3) from the Commonwealth of Australia. Investors include Australian Super and Statewide Super, two of Australia's leading industry super funds as well as the Commonwealth of Australia. See: http://www.brandoncapital.com.au/funds/medical-research-commercialisation-fund

Innovation Australia

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Committee Secretary
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GPO Box 89
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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

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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.

Innovation Australia

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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.

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