



Milton House
25 Flinders Lane
Victoria 3000
P) +61 (0)3 9650 8800
F) +61 (0)3 9650 6066
www.melbourne.org.au

Wednesday, 8 June 2005

Martin Webb
Venture Capital Secretariat
C/- Department of Industry, Tourism and Resources
GPO Box 9839
Canberra ACT 2601

Dear Martin

**RE: SUBMISSION TO THE AUSTRALIAN FEDERAL GOVERNMENT REVIEW OF
THE VENTURE CAPITAL INDUSTRY**

On behalf of the Committee for Melbourne I am delighted to provide the following submission to the Australian Federal Government Review of the Venture Capital Industry.

Yours sincerely

George Pappas
Chairman

**Attachments: 1. Organisational details; 2. Summary of Submission; 3. Expansion
Capital for Innovation Study - prepared for the Committee for Melbourne by
Boston Consulting Group**

Attachment 1

Organisational details

1. Details of individual/organisation providing the submission:

Committee for Melbourne	P) 03 9650 8800
Level 2, 25 Flinders Lane	F) 03 9650 6066
Melbourne 3000	E) gpappas@melbourne.org.au
George Pappas	W) www.melbourne.org.au
Chairman	

2. Background of individual/organization:

a. Committee for Melbourne:

The Committee for Melbourne is a private, non-political and not-for-profit network of leaders drawn from the most senior levels of major corporations, institutions and organisations across Melbourne's business, scientific, academic, community and government sectors. The objective of the Committee for Melbourne is to champion key issues to make Melbourne successful. A full list of the Committee's members can be found at www.melbourne.org.au.

b. George Pappas - Chairman:

After gaining his MBA with Distinction from Harvard Business School in 1971, Mr George Pappas joined The Boston Consulting Group in Boston, later moving to Tokyo. He returned to Australia and co-founded Pappas Carter Evans and Koop (PCEK) in 1979. Following PCEK's merger with The Boston Consulting Group in 1990, he became a member of BCG's worldwide Executive Committee and the Managing Partner of the Australian and New Zealand offices, positions held until July 1994. During his career, Mr Pappas has also consulted to a number of Government organizations at both Federal and State Level. His corporate background is complemented by his recent experience as Under Secretary in the Department of Premier and Cabinet for the State of Victoria where he has led projects to enhance the State's future economic development. Mr Pappas has been involved with the Committee throughout its 20-year history and was elected as Chairman of the Committee in 2005.

3. Market details

In 2005 the Committee for Melbourne formed the Expansion Capital for Innovation Taskforce to specifically seek solutions to the scarcity of specialized later-stage venture capital in Australia. This Taskforce counts as participants high level representatives from biotechnology firms, superannuation funds, fund of funds, 'gate keepers', financial institutions and related service industries.

Attachment 2

Submission to the Australian Federal Government Review of the Venture Capital Industry - Summary

The Committee for Melbourne believes that this review is both timely and necessary. The future economic growth and prosperity of our country – particularly Victoria and the greater Melbourne region – depends on the development of more innovative, export oriented and technology-based industries. This development requires three elements to work in harmony:

- Research and development activity that produces patentable intellectual property;
- Commercialization activity to inject the most promising ideas into the market place; and
- Patient capital to nurture and fund the expansion of new businesses built on these ideas.

We believe that our region of the country does a creditable job in terms of research and development – particularly in the life sciences. We also believe that we are doing a better job in the commercialization area – particularly spinning out new companies built around the research output of our Universities and Research Institutes. We believe, however, that the absence of a mature Venture Capital industry, particularly in Melbourne, hampers the growth of new business based on the products of our Research and Development. This issue is particularly acute when new businesses get past the seed funding stage of their development.

Our work indicates that this is not due to a shortage of investible funds, per se, but rather a shortage of willing institutional investors. Australian superannuation funds are brimming with money – but only a trickle, if that, finds its way to ‘real’ venture capital. Besides the statistics, we are aware of a number of well-credentialed venture capitalists who have found it extremely difficult to raise money from Australian superannuation funds to invest in Life Sciences related industries – an area where our R&D is universally recognized as world class.

To understand the reasons for this lack of investment and to develop possible solutions, the Committee for Melbourne constituted a task force late last year (30 September 2004.) The task force conducted several workshops involving a cross section of leaders from Melbourne’s Biotechnology, Research, Superannuation Fund, and Venture Capital Sectors. It also commissioned some specific research from The Boston Consulting Group (see attachment 3).

Recognising that there has been an enormous amount of work undertaken in this area, our efforts have focused on a narrow topic “why are superannuation funds not investing in “Real” Venture Capital”.

The results of the research and consequent recommendations are summarized in the attached report. Essentially the conclusions are

- Superannuation Funds and their advisor or ‘gate keepers’ are quite conservative investors who are guided by the return performance of prospective investment vehicles;
- They have not been attracted to ‘real’ Australian Venture Capital, because the returns to investors (about 7%) have in the last 10 years been below the average returns from all asset classes (about 12%); and
- They do not see the prospect of returns improving until there is a greater depth of specialised commercialization experience in Australia within both investee companies and locally based venture capitalists.

We believe that these factors will probably improve with time - returns to VC have been far more attractive in the larger and more mature U.S. market for example, where experience in commercialization is abundant. However, this may be a slow and uncertain process, resulting in lost opportunity for Melbourne, Victoria and Australia. The Federal Government has provided a large volume of funding in support of R&D activities, particularly in Life Sciences. It has also taken significant steps to ensure that initial seed funding for new ventures is available. We believe that there is now a need to accelerate the establishment of more venture capital funds to invest in the later stage development of new science and technology based businesses.

There is a role for the Federal government to play here by providing incentives for the Superannuation Funds to accelerate the development of Venture funding. The incentives should be directed at the two issues that Super Funds and their advisors raise as obstacles to greater investment – lower than average returns and insufficient company building expertise.

For example, a possible set of incentives could look something like this:

Provide grants equal to 5% per annum over 5 years of the value of investments into Venture Capital by Superannuation Funds with the following conditions:

1. Super Funds must be ‘serious players’ i.e.: of sufficient size to afford well resourced management teams – say \$5 billion or more of funds under management;

2. To receive the grants, an eligible Superannuation fund must invest a minimum of \$10million and a maximum of \$25 million into a new Venture Capital Fund whose purpose is to support the expansion of businesses built on Australian Research and Development;
3. There should be a maximum of five such supported VC funds established through a tender process. Tenders would be awarded on the basis of:
 - a. The quality, depth and experience of the venture management team proposed;
 - b. The amount of funding to be raised in addition to the ‘supported’ funds e.g. we would expect that the initial commitment of \$10 to \$25 million by each major super fund would lead to additional funds from other investors of 4 to 5 times that level; and
 - c. The degree of emphasis on the products of R&D activities directly supported by the Federal Government particularly Life Sciences, Agricultural Science, Health Information Technology and Environmentally friendly energy technology.

Note: if feasible it may be desirable to introduce mechanisms to ensure that these new venture capital funds focus their investments on ‘later stage’, as opposed to ‘early stage’, opportunities.

We are tempted to add one other condition, that two of the new VC funds be established in Melbourne, but recognize that competitive market forces should be the determinants of location. We are also confident that Melbourne’s strength in Life Sciences, R&D in particular, and its strong base of Industry Super Funds will make it an attractive location for the VC fund managers.

We believe that such a scheme could stimulate the investment of about \$500 million in new Venture funding in the next year or two and accelerate the development and maturation of the industry. The cost to government is relatively small. A 5% grant to \$125 million of supported funds (five investments of \$25 million each) would cost \$6.25 million annually or a total of \$31.25 million over 5 years.

But most importantly, it provides the incentive and the challenge to those institutions with the investible funds to accelerate the development of the venture industry. It provides some compensation for their concerns about low returns. They may use the compensation to enable them to search the world for the best people to manage their venture investments, and investee companies, where needed. These are the key

ingredients that will improve their prospects of generating higher returns for their member.

In conclusion, we would cite two factors that suggest there is urgency for such an initiative to be put in place. Firstly, CEOs of many biotechnology companies, as represented for example by the *BioMelbourne Network* leadership forum, are currently concerned for and investigating ways in which to ensure the viability of their companies. For many of these CEOs this means taking their companies offshore to the more mature funding environment of North America – the direct effect of which is that offshore investors are realising the added value of Australian innovations.

Secondly, there currently exists a unique opportunity to secure access to, what Mark Heesen President of the US's National Venture Capital Association calls, the globalization of US venture capital. According to Mr Heesen, after Israel, Australia is seen as the preferred destination for US firms' globalisation strategies due to the entrepreneurial cultures, strong scientific bases, language, culture, legal structures, highly educated workforces, demonstrated government support of the R&D base and good tech transfer capability evident in both countries. However, the limiting step in the US firms' ability to invest in non-US jurisdictions, such as Australia, is the extent to which local public funds are willing to contribute to life science venture capital funds. These placements are regarded as fundamental 'seals of approval' for this asset class, thereby 'de-risking' it for other investors.

We are hereby pleased to submit this proposal with supporting documentation for your consideration and are happy to answer any further questions should you have any.



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