

6 May 2005

The Secretary
Standing Committee on Science and Innovation
House of Representatives
Parliament House
Canberra ACT 2600

Dear Sir or Madam

Further to your request for submissions on Marketing our Innovations dated 11 April and previously published in the Australian Financial Review, I am pleased to enclose our submission.

CHAMP Ventures Pty Ltd is part of the CHAMP Private Equity Group and is responsible for managing CHAMP Ventures Investment Trust#5 (a mid-market MBO and expansion capital fund) and the AMWIN Innovation Fund, an Innovation Investment Fund established in 1998. AMWIN has invested in 11 technology-based SMEs at various business stages from seed to early expansion, across a range of technologies – information technology/media, mining engineering technology and bio-technology.

Our investments include successful exits such as Looksmart, Gekko and Seek (partial exit) and failures such K-Grind and D-store. Our current portfolio incorporates Alchemia, EnGeneIC/mirACL, G2, Maxamine and Seek.

To put the Submission in context, I should explain my definition of "success". As venture capitalists we see many business which could be described as "successful" – they are profitable, they employ growing numbers of people, they generate export revenue and deliver their existing shareholders reasonable returns – but they might not be successful as a venture capital investment which requires very significant growth in value. Whilst such business should not be under valued, nor their contribution to Australia's economy underestimated I have focused our response on the venture capital definition of "success". For example, we would consider Gekko at the border line – we grew revenue from \$560,000 to \$8m (14 times), we grew employees from 4 to 45 but on exit we only generated our "hurdle" of 3 times our money and a 25% or so annual IRR.

Yours faithfully



Stuart Wardman-Browne
Director
CHAMP Ventures Pty Limited

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Marketing Our Innovations

*Submission to the Standing Committee on Science and Innovation - April 2005
Stuart Wardman-Browne, Director CHAMP Ventures, COO AMWIN*

Pathways to Commercialisation: Successful examples

Attachment 1 is a comparison of four AMWIN portfolio companies – two IT related companies and two bio-tech. By their nature the bio-tech companies are much earlier stage and thus fewer of the key issues have yet to come into play.

We are working to make all four a success, but two (A and X) have clearly progressed more successfully than the other two and the comparison is designed to identify the key differentiators. I have served on the Boards of all four companies and remain on the Board of two. Company A is Seek Limited, the Internet jobs board that listed in April 2005 at a market capitalisation of some \$600m. We have not named the other companies although they may well be recognisable, so we would ask that all specific company data remain strictly confidential.

Our primary observations from the comparison are set out below – under six headings, although you will note that they are all interlinked:

1. Quality management and genuine teamwork

Company A and company X (the relative successes) both had established senior teams. They have worked together exceptionally well from the outset and have also evolved their skills through having, and listening to, a Board with the broad range of skills necessary to commercialise innovation.

In my view, the downturn in 2001 made the Company A management team complete by removing (or at least diluting) their one weakness – complacency. As mentioned in the attached summary, this particular team have evolved into one of the best teams I've worked with in 15 years corporate finance and funding experience.

Company B became a one man band when one of the Founders walked away when the going got tough...as did one of the independent Directors. Whilst B's CEO has put enormous energy into the company and we have continued to contribute at a Board level and beyond, I have little doubt the lack of senior team – and broader Board – has limited our success to date.

Whilst company X "management" had no commercial management experience, they had worked well as a scientific team at CSIRO for a number of years. They have subsequently shown remarkable focus and unusually strong man management and commercial skills in addition to delivering World leading science.

In company Y we found our lead scientists didn't really get on. The company only started to make real progress when we re-structured the business into two subsidiaries (each with one of the two lead scientists, really focussing on

the key priorities and what they do best) and brought in a new CEO for the holding company to work with each subsidiary and each lead scientist.

2. Motivated alliances with strong alignment of interest

Alliances can be a real challenge – often the primary reason for success or failure. Successful alliances require a pro-active, rewarded ally who can make a difference and does. Failures arise where allies can make a difference but doesn't, perhaps due to lack of motivation (insufficient strategic drivers or scale/rewards for them). An ineffective alliance is worse than just ineffective – it is highly damaging due to time soak of senior people.

In company A early alliances were important in bringing users to the web site and industry related customers. First to critical mass was important in this space where users wanted job advertisements and advertisers wanted a large user base (see 3 below).

Company B has established a critical alliances that I believe will prove the success of the company. However it has also taken us close to extinction twice as the company invests significant resources to generate compelling results for the ally – and receives less than its fair share of the resulting benefit. Without caution, alliances can mean you put in the same effort for half the return.

Both Company X and Y are at early stages of partner discussions, but Company X has clearly demonstrated more compelled interest from major overseas companies – largely as we recognised the potential impact of their technology upfront, recognised the credibility issues of such a groundbreaking technology and thus adopted a stealth strategy whilst we compiled the necessary in vitro and in vivo data to quell credibility concerns. This has worked in part (with Merck and J&J interested in partnerships) but still leaves some (Amgen and Genentech) waiting for third party data on toxicology.

3. The importance of a compelling solution, recognised as such by customers

It is important to have a genuine need for a solution but as important, even where a “need” exists, is that the buyer must want a solution and must recognise your solution meets the need. The “first to market” competitive advantage is rarely real and only of value if it becomes “first to critical mass” – first to market is frequently not the technology which becomes the established leader.

Company A services an existing traditional market through the Internet, reducing costs significantly and offering better features, flexibility and pro-activity for both advertiser and user. Having achieved “first to critical mass” Company A is now the obvious solution with the most users for advertisers and the most advertisements for users.

Company B has one of the most complex technology solutions, offering a remarkable breadth and depth of solution in what is still an emergent market. The users find the breadth and depth hard to understand, a

situation which is actually made worse by lack of competition. Competition is an interesting issue for young innovative technologies: no competition can make market establishment extremely difficult whereas excessive competition means better products can be lost in the noise...or under other companies marketing budgets!

4. Focused strategy – which evolves with the business

The strategy itself is often the barrier to growth – either as it simply not scaleable or not scaleable with sensible financial resources. There is of course always a compromise between scalability, speed and retention of value – for example between OEM arrangements designed for scalability and speed (but often not delivering the latter) at the cost of margin. The related key issue for many technologies is who will drive, and pay for, the changes necessary for technology adoption.

The bio-tech equivalent is in partnering or licensing through clinical trials – and both risk conceding project control at the whim of Head Office strategies.

Company A recognised it needed to decide whether the chicken or the egg came first – in truth it probably didn't matter which it picked as long as it picked one! It picked users and worked hard at building user levels ahead of competitors. They then targeted the logical early adopters of advertisers (job agencies). Following success with agencies, A's advertiser strategy evolved to target Corporates and more recently SMEs.

Company B was continually caught between a direct sales model and a channel model – and was significantly disrupted in the tech crash when a number of distributors disappeared (despite being major companies). The market has also forced Company B to evolve - from enterprise software to ASP whereby the most common purchases from Company B are the tip of the iceberg of the products capability, but still suffer a long sales cycle.

5. Understanding the real costs of sale

The argument for innovative software or related businesses has long been the low cost of sale, primarily through low physical production and distribution costs. The reality for many such innovations is the enormous cost of sale of the sales process itself – often lengthened by the complexity of solutions, apparent alternative solutions (noise) which can also mean a low conversion rate. This has certainly been the case with Company B. However, Company A achieves EBITDA margins of 45% (despite investing resources and expenses in significant future growth opportunities) due to virtually zero cost on sales after reaching genuine critical mass and the simplicity of a compelling offering.

6. Funding

There is still a significant gap in early stage VC funding. This is essentially an issue of Risk & Return:

- Early stage investment can be a difficult sell to the investors in Venture Capital Funds. The time soak on early stage investment is very significant, the risk is higher...and the upside may not really be there.
- If you can double your money on a \$10m relatively moderate risk investment why would you invest \$2m each in 5 early stage companies? Assuming two fail and one gets it money back, the other two will need to quadruple to match the profit from the above \$10m investment...and will probably require some 10 times the time investment.

The IIF rightly sought to address this:

- In IIF Round 1, the Federal Government invested 2/3 of the money but once all capital is returned takes only 10% of the profit. AMWIN has returned all the capital and much more...so if one of AMWIN's current investments achieved the above 4 times multiple the private investors would actually achieve an 8* multiple...making the risk of failures and the investment of time more worthwhile.
- The IIF has been criticised for lack of returns but the objective was to get VCs to invest in earlier stage riskier companies...by definition this would lead to higher failure rates (Australia needs to get over its attitude to failure);
- The point of the above risks and inevitable failures was that the IIF risk: return leverage would make the returns worthwhile. As a rule failures will happen early with some successes taking time to achieve. VC Funds are a 10 year vintage; the IIF#1 is only 6 years in. AMWIN has already generated very strong returns (well over \$200m from 3 successful exits from its \$41m fund) and we believe our existing portfolio will generate additional strong returns. We anticipate other IIF funds will also start to generate returns as their portfolio matures towards the end of their Fund life.
- I see a real need for START Grants to continue and for an IIF#3 and probably an IIF#4 before the market gap could be closed. Whilst I may have a vested interest, I also believe that to achieve this goal (contrary to IIF#2) IIF#3 and #4 should be open to previous IIF participants.

The Pre-seed Fund a great initiative but limits funding to \$1m per company. My concern is whether the early stage venture capital will be available for companies within this program to be able to raise next round.

START Grants have been a major contributor to R&D, and continue to play an important role.

Comment on Specific Issues requested by the Committee

1. Pathways to commercialisation

I would see strategy as the pathway to commercialisation. See 4 above.

2. IP and patents

IP and patents are important as a barrier to competitors – they are often a necessity unless companies have the largest marketing budgets and distribution channels, but they are not the be all and end all. A legal fight with a multi-national corporate would sink most small, entrepreneurial companies. That said Company X has invested significantly in its IP – both in terms of time (planning the IP strategy and creating an web of patents and ensuring the company could support its claims with real data) and funds (appointing a US patent attorney for IP strategy and filings, obtaining opinions from a US patent litigator and a US commercial attorney). In my view Company Y tended to file patents without planning and without adequate data – claim as much as possible and see what you can subsequently support. I am confident the approach of X will prove more successful and even more cost effective in the long run.

3. Skills and business knowledge

Without wishing to sound self serving, our portfolio companies regularly comment on the value of our “mentoring” role with the management team and on the Board – thus those that are unable to raise venture capital funds may also miss out on this valuable resource.

Real business mentoring – bringing real experience from those that have been successful, or have learned from failure, to current technology SMEs – would be enormously valuable. The challenge will be finding top quality mentors and getting sufficient dedicated time from them – but the payback to SMEs could be significant.

The Government perhaps sought to address this through BITS/COMET funding. We work with advisers all the time and are happy to do so. The challenge is whether an adviser hides the warts (meaning the VC takes longer to spot them...wasting valuable time for all) or operates on the warts (improving the business and/or the deal...for the benefit of existing and future shareholders)? Re BITS in particular, the people I've met just don't seem to have the necessary experience.

4. Capital and risk investment

See Funding (6) above. I would re-iterate I see a real need for START Grants to continue and for an IIF#3 and probably an IIF#4 before the market gap could be closed. I also believe that to achieve this goal (contrary to IIF#2) IIF#3 and #4 should be open to previous IIF participants.

5. Business and scientific regulatory issues

Other than the obvious, and largely necessary if sometimes inconsistent and outdated regulations on therapeutic sciences, I do not see regulatory issues as a major barrier to commercialising innovation.

6. Research and market linkages

I have found many young companies lack real market knowledge, leading to under-estimating competitors with weaker technologies, but stronger marketing budgets and a local presence or ownership.

7. Factors determining success

See the 6 key points under Examples of Success and the headings used in the table in Attachment 1.

8. Strategies in other countries

Perhaps the best overseas examples of commercialising innovation I've seen are the USA and Israel. The Government rightly copied these countries in establishing the IIF program.