Chapter 9

Venture capital

Background

9.1 Venture capital is the very early stage external equity funding that businesses, particularly in innovative industries, may need to start up. The Committee received far more submissions about lending to small business than about the provision of venture capital. A brief discussion of venture capital is included in this final chapter.

9.2 New innovative firms, sometimes called 'gazelles', require some form of equity because until they finish commercialising their product and start making profits they are not in a position to repay debt (and often have little in the way of hard assets to offer as collateral). It is probably only a minority of new firms that are funded by formal venture capital. Most entrepreneurs initially rely on their own savings, or money provided by family and friends (also known as 'love capital'), employees ('servant capital') or individual private investors ('angel capital') or by borrowing from a bank using property as collateral.

9.3 The Reserve Bank note:

> Compared with large companies, small businesses tend to make greater use of debt funding and less use of equity funding; the latter is generally limited to the personal capital of the owners.[1]

9.4 Venture capitalists tend to be more closely involved in the company's operations than a typical shareholder, sometimes acting as a mentor to the company's management or holding a seat on the board. Sometimes the provision of further capital is promised subject to meeting performance benchmarks. Venture capital fund managers typically specialise in certain industries, such as biotechnology or information technology. Some now large and well-known companies, such as Apple, Google, Intel, Microsoft and Starbucks, started life with support from venture capital. Australian companies to have benefited from venture capital include Cochlear (makers of the bionic ear) and ResMed (medical technology).

9.5 As there is inherently more risk in subscribing venture capital than in making a secured loan, the increase in risk and risk aversion that occurs in recessions tends to lead to larger reductions in the provision of capital than in loans.

9.6 The House Economics Committee looked at the medium-term adequacy of venture capital. A review of ABS data suggested to them that:

> …if there is any problem in the venture capital market, it is not a lack of money coming in but either the poor quality of many of the companies

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1 Reserve Bank of Australia, *Submission 2*, p. 1.

seeking funding or excessive conservatism of the venture capital fund managers.[2]

9.7 At least implicitly, Australian governments have apparently regarded the market as under-providing venture capital, as there have been a number of programmes to encourage it. Treasury comment:

> The Government also supports access to financing for innovation by investing in Australia's venture capital market through the Innovation Investment Fund, which was allocated $224.7 million over 5 years in the 2006-07 Budget. In August 2009, a further $64 million was invested through the Innovation Investment Follow on Fund (IIFF) to support venture capital during the downturn. The IIFF is a temporary response to address the lack of capital available during the global financial crisis. The IIFF will enable previously supported companies to continue to develop and to commercialise research.[3]

9.8 The Reserve Bank noted:

> … there is a venture capital market. It is not as large here as it is in other countries.[4]

9.9 As well as capital, many new ventures need loans and some submitters claim this has also become harder to attract:

> …there has been a significant reduction in the availability of start up loans from banks and other financial institutions.[5]

9.10 Industry has noted the problem of securing venture capital for small business:

> …a barrier for the new business starting up with an experimental idea is a financing problem because it is like the chicken and the egg, you have to prove yourself before you can attract finance and you have to have the finance to prove yourself. That is an area where we think ideally the market would provide more funds.[6]

9.11 Asked about the role of government, the Australian Industry Group replied:

> We think that there is a case for government involvement in those areas where information failures occur, if you like, so that the market is not working as efficiently as it might. The feedback we received at the time the Commercial Ready program was axed was that this was having an

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2 House of Representatives Standing Committee on Economics, *Australian manufacturing: today and tomorrow*, August 2007, p. 89.

3 Treasury, *Submission 50*, p. 17.

4 Dr Guy Debelle, Assistant Governor, Reserve Bank of Australia, *Committee Hansard*, 12 April 2010, p. 21.

5 Business Switch, *Submission 9*, p. 1.

6 Dr Peter Burn, Australian Industry Group, *Committee Hansard*, 12 April 2010, p. 46.

> influence on the interests of venture capitalists in providing funds to emerging businesses, that that source of liquidity into that area of the market was withdrawn and that the flow-on of that was less venture capital was available to small businesses. That was an area where government intervention was facilitating lending in that area, but that was withdrawn a couple of budgets ago.[7]

Superannuation funds and venture capital

9.12 A potential source of venture capital is superannuation funds, but they appear not to have a large involvement. The House Economics Committee's report commented:

> The reason for the limited involvement of superannuation funds in venture capital is not clear. It may just be that the returns offered by venture capital are inadequate, or it may be that superannuation fund managers are being unduly 'conservative' in their investment practices.[8]

9.13 Their regulator's view is that:

> APRA recognises that investment in venture capital can form a legitimate part of a diversified portfolio. As with all investments, any venture capital investment has to be consistent with the investment objectives and strategy of the fund. The trustee needs to, inter alia:
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> - make an appropriate assessment of the expected risk and returns of venture capital investment, with specific regard to the risk profile of such investments;
> - undertake due diligence and ongoing monitoring of venture capital investments;
> - consider the liquidity profile of venture capital investments, especially due to the requirement to meet future commitments; and
> - understand there is greater dispersion of returns from venture capital funds; as such, the trustee needs to make a stronger assessment of manager skills.[9]

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7 Dr Peter Burn, Australian Industry Group, *Committee Hansard*, 12 April 2010, p. 46.

8 House of Representatives Standing Committee on Economics, *Australian manufacturing: today and tomorrow*, August 2007, p. 95.

9 APRA, answers to questions on notice.

Equity-loan hybrids

9.14 Another possible type of finance is a kind of equity-loan hybrid where repayments on the loan are income-contingent, and so the lender shares more of the risk. The best-known example of such income-contingent loans is the 'HECS' scheme for students. Unlike a normal loan where the lender shares in any bad fortune by not being fully repaid, it would be possible for a lender to also share the benefit of a better than expected performance by being repaid more quickly or even getting a 'bonus' interest rate.

Senator Alan Eggleston
Chair