Funding the Future

Meeting Australia's investment challenge, boosting jobs and turning ideas into thriving businesses

A report by EY Australia and the Australian Investment Council

AUSTRALIAN INVESTMENT COUNCIL

EY
Building a better working world

About the Australian Investment Council

The Australian Investment Council is the peak body for private capital in Australia. Comprising leading private equity, venture capital, private credit, family offices, superannuation, and sovereign wealth funds, our members collectively manage over $62 billion for investment into the establishment and growth of Australian businesses.[1]

The Council's members support more than 850 businesses of varying sizes across every sector of the economy, and directly or indirectly employ over 500,000 people in Australia.[2] Over time, fund managers have invested capital from a wide variety of domestic and offshore institutional investors to support the growth of thousands of high-potential Australian businesses. In addition to providing financial capital solutions, fund managers provide those businesses with a mix of strategic support, mentoring and networking to help them unlock growth opportunities in domestic and international markets which underpins the creation of new jobs across all sectors of the economy and thereby boosting overall economic growth.

Private capital makes a significant contribution to the Australian economy and accounts for almost three per cent of Australia's GDP.

1 Preqin and Australian Investment Council Private Capital Markets Overview, May 2023.

2 Funding a brighter Future, EY, May 2022.

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FOREWORD

The Australian Investment Council and EY are pleased to publish Funding the Future, an in-depth review of the investment needed to support Australia achieving its economic potential.

This review includes a series of policy recommendations that will help grow investment into the Australian economy, create meaningful employment opportunities, and turn Australian ideas into thriving businesses.

As seen in other major economic centres, and against the backdrop of stretched public balance sheets, private capital is increasingly being called on to address areas of unmet community need. Meeting net zero commitments, providing healthcare to ageing populations, aiding social cohesion through access to services, supporting domestic capability and backing home grown ideas are just some examples of where the need for private capital is most pronounced.

Private capital – private equity, venture capital and private credit – already does much of the heavy lifting, managing $62 billion of assets across the Australian economy in 2022.
In 2022, Australia private capital accounted for approximately 600,000 jobs and contributed three per cent to national GDP.

Increasingly, private capital is being relied on to drive growth in the Australian economy. Economic modelling shows that an extra one per cent contribution to GDP could increase the number of jobs, directly or indirectly supported by private capital by around 600,000. This GDP uplift is equivalent to an extra $70 billion invested into Australian start-ups and growth businesses.

Australians contributing to superannuation funds, are a major beneficiary of higher levels of private capital investment; over the long-term, private capital investment has delivered returns of 17.9 per cent, compared with 9.2 per cent in listed Australian equities and 2.7 per cent in fixed income investments[3].

Private capital investment is a strong vote of confidence in Australia's researchers, innovators and entrepreneurs. It is what will turn fledgling industries with great potential into mature strongholds of comparative advantage. The competition to attract Private capital on a global basis has been exacerbated by geopolitical issues such as conflicts abroad, cyber attacks and shifting trade relations.

This report provides policymakers with suggestions for tangible and impactful reforms that will drive further investment in areas of unmet need and unfulfilled potential. By boosting the efficiency and effectiveness of our investment framework, all Australians can share in a productive and future-ready economy.

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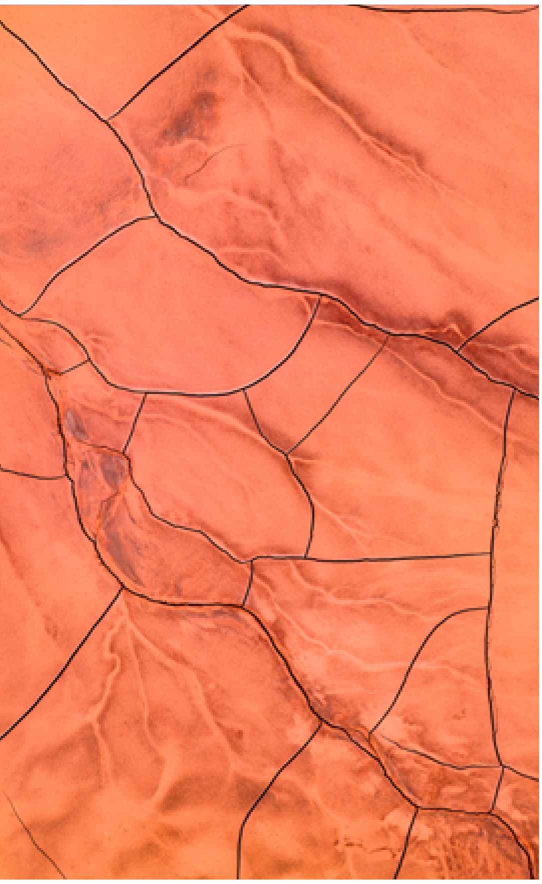
3 Cambridge Associates, 2023

EXECUTIVE SUMMARY

Private capital already underpins Australia's economy, contributing 3% to annual gross domestic product (GDP) and employing over half a million people.

Australia's private capital investment market has grown steadily and significantly over the past decade, and private equity, venture capital and private debt funds managed $62 billion in assets at September 2022.



This figure is a relatively small, but strategically important, component of the vast pool of funds helping Australia to deliver on a number of significant priorities:

- Australia must attract an estimated $1.5 trillion in capital by 2030 and up to $9 trillion by 2060 to fund the transition to net zero emissions.[4]
- The costs of health, aged care and disability care is expected to grow by more than $115 billion between now and 2062.[5]
- The seven priorities outlined in the $15 billion National Reconstruction Fund to diversify Australia's economy and grow high-value industries will only be achieved with at least $30 billion in private funding.[6]

If private capital contributes even 10 per cent of the total investment required in these three priority areas, it will require upwards of $150 billion in new investment.

Australia is similar to other major economic centres in that private capital is increasingly being called on to meet areas of unmet need or fulfil Australia's economic potential, often in working alongside public capital and government spending.

Beyond investing in national priorities, private capital can boost the productivity and performance of home-grown businesses, cultivate jobs in high-value, high-paying industries, and create a more dynamic economy. Private capital can also build wealth for Australians in retirement.
We outline the potential for private capital investment in Section 3 of this report.

Economic modelling undertaken by EY teams has shown that increasing private capital investment to the equivalent of 4% of GDP in 2030[7], moving us closer to the level of our peers, could:

- Increase the economic contribution of private capital to $144 billion by 2030 (an increase of $70 billion from 2022).
- Increase the number of jobs, directly or indirectly supported by private capital by around 600,000 by 2030.

However several handbrakes are preventing the flow of private capital investment into Australia.
To understand the barriers to investment, we spoke to a range of professionals across the private capital sector. They suggested small tweaks to taxation policy and regulation, and sensible reforms to superannuation that can help us grow capital investment. More detail about these opportunities for reform is found at Section 4.

Doubling Australia's private capital contribution is a long-term ambition. But we can start today with modest policy reforms that will have little impact on the budget bottom line, but will help create jobs in sustainable industries, drive innovation in technology and medical science, enhance defence capabilities and underpin the net zero transition.

4 Net Zero Australia, 2023.
5 2023 Intergenerational Report
6 Minister for Industry and Science, 2023
7 Based on mid-term GDP projections in MYEFO 2023-24 Economic Outlook

HOW CAN PRIVATE CAPITAL FUND AUSTRALIA'S FUTURE?

Today's private capital ecosystem

Australia's private capital markets, as at September 2022.

$62bn of assets under management*

$11bn in 'dry powder'

18% average return on investment over 10 years

Total of AUM for private equity, venture capital and private debt

Source: Australian Investment Council, 2023.

Tomorrow's priorities

NET ZERO TRANSITION

$1.5tn in capital by 2030 and $9 trillion by 2060

HEALTH, AGED AND DISABILITY CARE

$115bn additional funding between 2024 and 2062

NATIONAL RECONSTRUCTION FUND

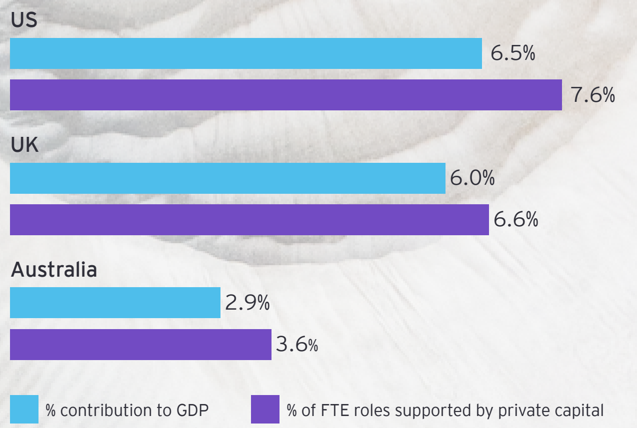
$30bn in private funding

Just 10% of the total investment across three priority areas must attract upwards of $150 billion in new investment.

Sources: Net Zero Australia, 2023; Minister for Industry and Science, 2023; 2023 Intergenerational Report.

Growing private capital in Australia

Figure 1: Australia's private capital contribution to GDP and jobs



Source: Australian Investment Council, 2023.

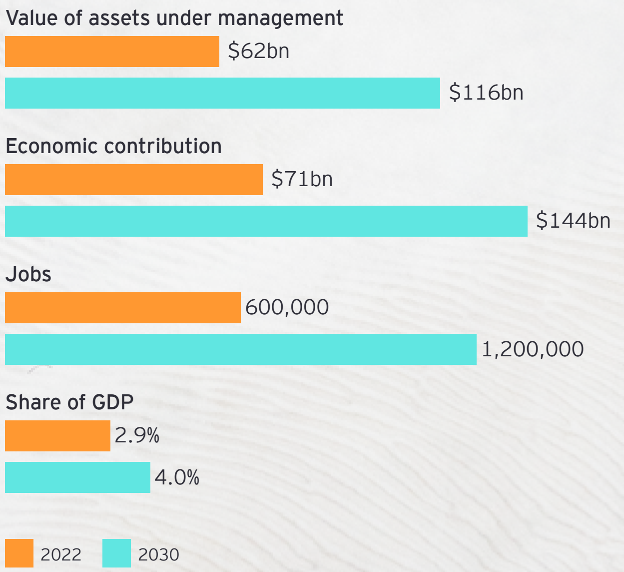
Several impediments stand in Australia's way...

- **Superannuation:** Just 5 per cent of our $3.4 trillion superannuation pool is allocated to domestic private capital markets because a narrow focus on fees and investor sentiment towards alternative investment classes have discouraged increasing asset allocation towards private capital.
- **Foreign investment regulation:** Australia ranks 61st of 69 countries for restrictions on foreign direct investment, as long approvals processes and application fees impact appetite to invest.
- **Taxation:** Australia's fund structures are broadly out of sync with global best practice; creating world-class, competitive investment vehicles, reforming venture capital programs and revisiting foreign investment taxes would bring Australia more in line with global peers.

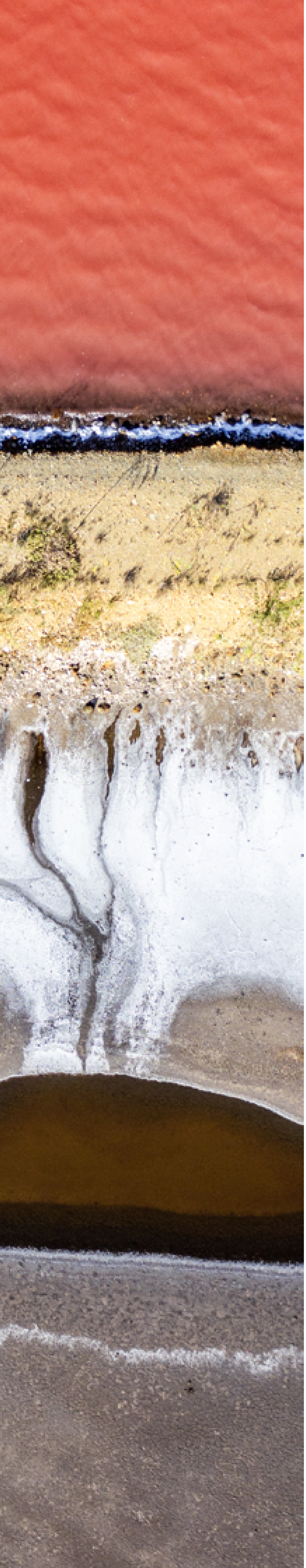
Sources: Ernst & Young Australia, 2024; Foreign Direct Investment Regulatory Restrictiveness Index, 2020.

Realising potential

Figure 2: Private capital's potential contribution to Australia's economy by 2030



Sources: Ernst & Young Australia, 2024.



INTRODUCTION

Increasing private capital investment in Australia to be equivalent to 4 per cent of GDP by 2030 would increase private capital's contribution to the Australian economy to $144 billion and add an extra 600,000 jobs to the economy.

Australia's innovation ecosystem is underpinned by investors that are willing to take risks on new businesses. This funding is accompanied by valuable strategic and operational advice that helps early-stage businesses to grow.

Private capital's approach of investing financial and intellectual capital is the 'x-factor' that can help innovative businesses realise their ambitions – and to help Australia nurture prosperous and productive industries.

The exponential growth of private markets is well documented. More capital has been raised in private markets than in public markets each year for more than a decade. Advances in technology and increased globalisation have made it easier for companies to access capital and investors globally. This has enabled companies to find funding and support outside traditional public markets.

Australia punches well above its weight on a per capita basis. However, Australia is in competition with other established economies like the United States, United Kingdom, Germany, Japan, and France and suffers from several significant disadvantages, including geographic isolation, inconvenient time zones and a relatively small market.

We are poised at a pivotal moment in time. Foreign Direct Investment into China fell into negative territory in the third quarter of 2023, and the Chinese Ministry of Commerce posted a 33 per cent decline on the year-to-date total from 2022.[8]

As investors adopt de-risking and diversification strategies, Australia is emerging as an attractive alternative. Implementing a best-practice regulatory framework means Australia will have an opportunity to command a greater share of global capital allocated to the Australian region.

Australia needs to reform the investment environment to attract the scale required to meet our ambitious national agenda. To date, Australia has not realised its full potential in attracting foreign capital and retaining domestic capital. Our foreign account deficit of $22.2 billion in 2022, following a deficit of $61.1 billion in 2021, is testament to this fact.[9]

8 Herren Lee, A, 2021
9 Australian Bureau of Statistics, 2023

Australia also needs to grow its workforce of private capital professionals at a time when talent is mobile and employment markets are competitive. People who can take a business from concept to commercialisation have specific skills – and we are competing with the world for those skills. Analysis of job vacancies in Australia's largest venture capital funds shows significant skills gaps in FinTech, health, medical, information technology and design.[10] This underscores the technical skills and expertise required to drive business growth, innovation, and entrepreneurship.

While the Australian Government's Migration Strategy, released in December 2023, provides a framework to solve some of these talent challenges, more needs to be done in parallel to equip Australia's private capital industry as a preferred global investment destination.

With supportive, sensible reforms to regulatory settings and policies, Australia can better attract the scale of private capital investment required to: create jobs in sustainable industries, drive innovation in technology and medical science, enhance our defence capabilities and underpin the net zero transition. Increasing private capital can also build wealth for Australians in retirement.

In other mature nations like the United States and United Kingdom, private capital makes double the contribution to GDP and underpins many millions of jobs.

Lifting Australia's level of private capital to be equivalent to just 4% of GDP by 2030 would have a significant impact – with more than $144 billion in economic contribution and an additional 600,000 jobs.

Growing Australia's private capital contribution is a long-term ambition. But we can start today with modest, sensible policy reforms that will have modest impact on the budget bottom line.

These policy reforms will directly fund key priorities, like those outlined in the National Reconstruction Fund. Reforms will also create high-quality jobs in Australia – jobs that are mission-critical to the productivity and performance of our existing industries and will underpin future ones.

10 Australian Investment Council, May 2023

2

AUSTRALIA'S INVESTMENT CHALLENGE

NET ZERO TRANSITION

$1.5tn 1 2030

Australia must attract an estimated $1.5 trillion in capital by 2030 and up to $9 trillion by 2060 to fund the transition to net zero emissions.

HEALTH, AGED AND DISABILITY CARE

$115bn 2 2062

The costs of health, aged care and disability care is expected to grow by more than $115 billion between now and 2062.

NATIONAL RECONSTRUCTION FUND

$30bn 3 PRIVATE FUNDING

And the seven priorities outlined in the $15 billion National Reconstruction Fund to diversify Australia's economy and grow high-value industries will only be achieved with at least $30 billion in private funding.

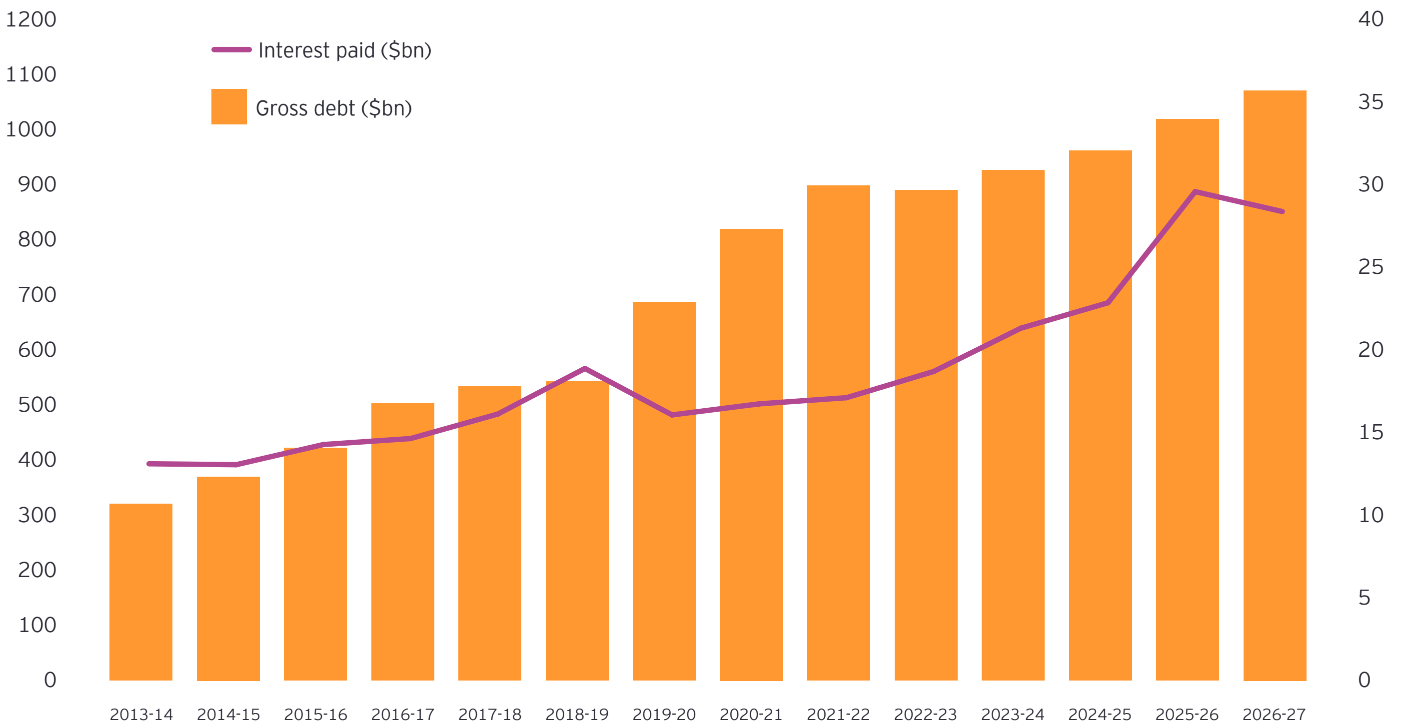
Australia's private capital investment market has grown steadily and significantly over the past decade making a significant contribution to Australia's economy. But our current levels of private capital are a fraction of the total funding required to meet Australia's most pressing priorities.

There are several big shifts currently underway in the economy, as the renewable energy transition, a transforming industrial base, geopolitical uncertainty and demographic change converge.

Consider the funding required in these three areas:

- **Energy transition:** Australia has committed to net zero by 2050, with a 43% emissions reduction by 2030. The role for private capital in this space is significant. The level of investment required – in generation technology and infrastructure – is enormous. The Net Zero Australia project estimates that $1.5 trillion in capital must be attracted by 2030, with a mix of Government and private capital investment. This figure is predicted to expand to between $7 and 9 trillion by 2060. The Commonwealth has currently committed $40 billion.
- **Modern manufacturing:** Following COVID-19, and in a more geopolitcally volatile environment, the Australian Government has committed to diversifying and transforming Australia's industry and economy, by building our domestic production capability in areas where we have natural and competitive strengths. This will help Australia move up the value chain in terms of innovation and productivity, thereby assisting the Australian economy with shelter from geopolitical risks and supply chain vulnerabilities. The Australian Government has committed $15 billion to the National Reconstruction Fund and is hoping to match this with over $30 billion in private capital funding. (See Section 2.6 for more details.)

Figure 3: Australian Government debt and interest payments



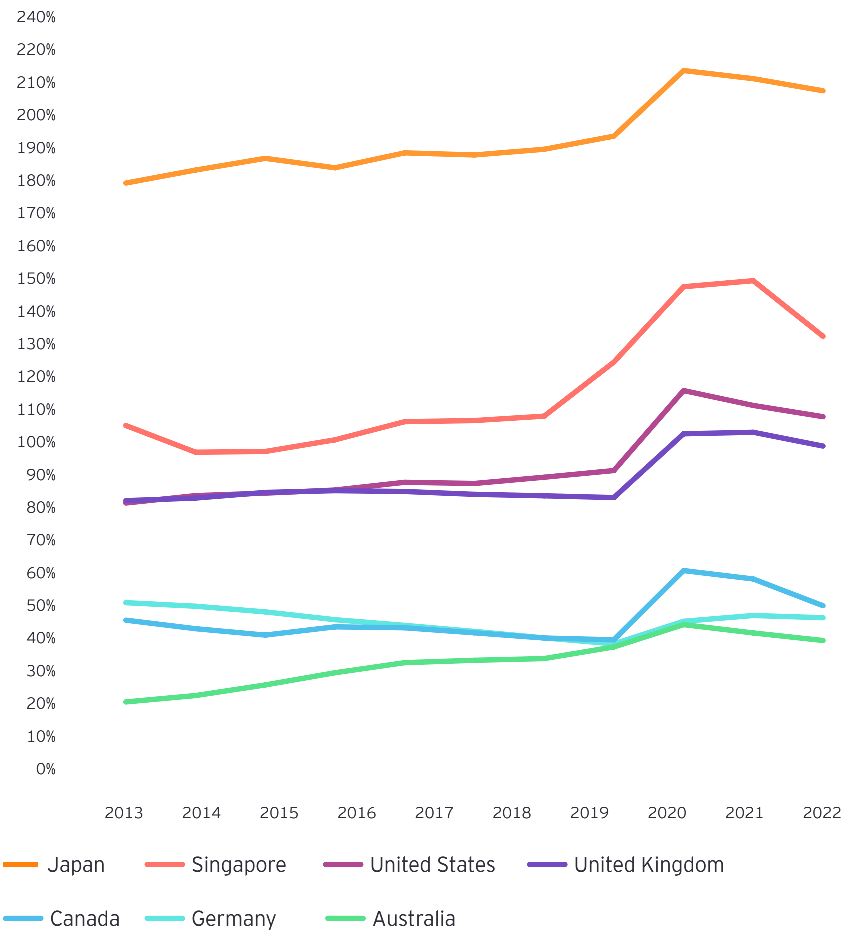
Source: Australian Government Budget, 2023-24

- **Care sector:** Demand for quality care and support services is rising, particularly as Australia's population ages. Governments have expanded access to formal care arrangements for children, older Australians and people with disability. The three fastest growing Government payment areas are in health, aged care and the NDIS, with all three growing faster than GDP. The 2023 Intergenerational Report predicts that payments for these three areas will reach 10.7% of GDP by 2062. That is growth of more than $115 billion. Private capital investment can help ease the burden of funding this huge growth. (See Section 2.6 for case studies.)

Australia has an ambitious policy agenda to transition to a net zero economy, provide world class health care, aged care and disability services and grow our sovereign capability in key manufacturing sectors. However, the cost of this agenda is well over an additional $1.5 trillion by 2030. If private capital contributes even 10% of the total investment required in these three priority areas, it will require upwards of $150 billion in new investment.

At the same time, fiscal responsibility and budget repair are incredibly important. This agenda cannot be funded by Government alone – there is an immense role for private capital.

Figure 4: Central Government Debt as a percentage of GDP



Australia's levels of national debt are at record highs, reaching a level relative to GDP that has not been seen since the Second World War.[11] As a result, interest payments on Government debt are also increasing, with the 2023 Intergenerational Report estimating that interest payments will be one of the Government's five largest payment pressures through to 2062, and is likely to peak at 1.4% of GDP.[12]

Against this backdrop, there is an obvious role for private capital in supporting Government's ambitious agenda without adding to budgetary pressures and increasing our national debt. Borrowing to fund these policies only leaves future generations to foot the bill, whereas growing our private capital industry can boost the productivity and performance of home-grown businesses, cultivate jobs in high-value, high-paying industries, and create a more dynamic economy. At the same time, private capital can also build wealth for Australians in retirement.

Similar trends are playing out internationally, with almost all OECD countries having borrowed heavily to fund stimulus packages and medical equipment during the COVID-19 pandemic. Coupled with rising interest rates globally, the debt burden is increasing, reducing the amount of Government funds available for investment in businesses, innovation, and sectors critical to the net zero transition. There is global scramble for private capital to fill the gaps, further exacerbating Australia's challenges in attracting the scale of investment that we need.

Policymakers need to apply a whole of Government approach to the policy settings that will attract and retain capital in Australia. Given increasing domestic asks, putting sectors in competition against one another for capital does not solve the overall investment challenge.

11 Australian Parliament House, June 2022
12 Intergenerational Report, 2023

3

PRIVATE CAPITAL IN AUSTRALIA

3.1 What is private capital?

Private capital is a term for investment in assets, typically through funds, that are not available on public markets.[13]

Private capital asset classes include private equity, venture capital, private debt, real estate, infrastructure, and natural resources The Australian Investment Council's membership comprises private equity, venture capital and private debt managers and allocators of capital to these asset classes. This report is focused on these asset classes.

Interests in these assets are typically arranged as limited partnerships, or LPs, with General Partners, or GPs, that act as investment managers.

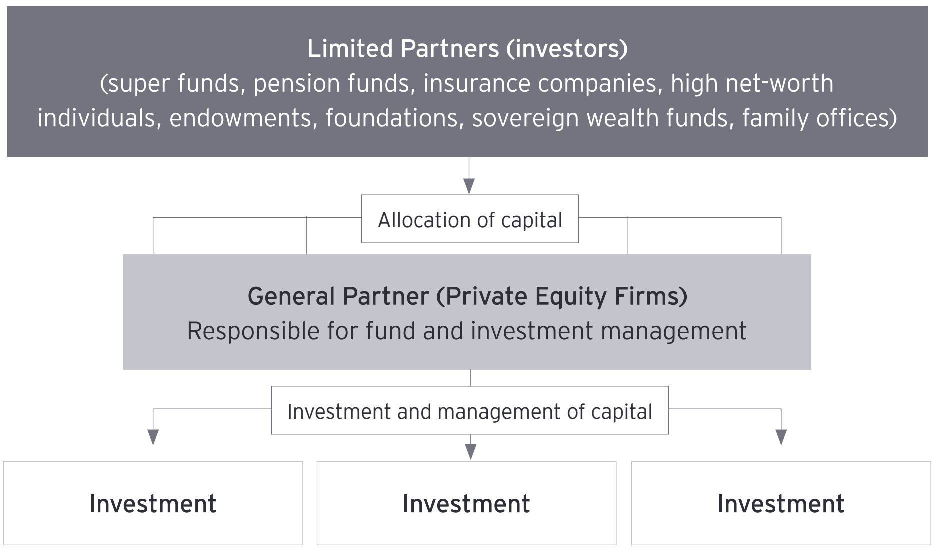
Private capital investment firms use capital raised from a variety of sources, including institutional investors such as superannuation and pension funds, and family offices. They generally invest these funds in promising private companies over a period of around five to seven years. Sometimes this is referred to as 'patient capital'.

One of the key differences in the investment strategy of private capital firms is that the investment is typically accompanied by strategic support to help the business grow and become more profitable in a sustainable and measurable way.

IN BRIEF

- Private capital firms bring funds, as well as networks, expertise, and experience to nurture businesses – and this boosts productivity and prosperity for all Australians.
- Australia has more than $62 billion in private capital assets under management, with dry powder reaching a record $11 billion in 2022.
- The Australian Government's ambitious policy agenda across three areas – the energy transition, modern manufacturing, and healthcare – will require upwards of $150 billion in new investment.

Figure 5: Typical private capital structure



Source: EY, 2023

13 Prequin, 2023

Figure 6 shows how Australian private equity and venture capital overperforms with time relative to larger markets. Private capital firms don't just bring funds to Australia. They also bring networks, expertise, and experience to nurture businesses with the goal of increasing their value over time – and this boosts productivity and prosperity for all Australians.

> "Australia competes with every other nation for its slice of the global economic pie. We keep arguing about how to divide the pie, rather than grow the pie.
>
> **High net worth family investor**

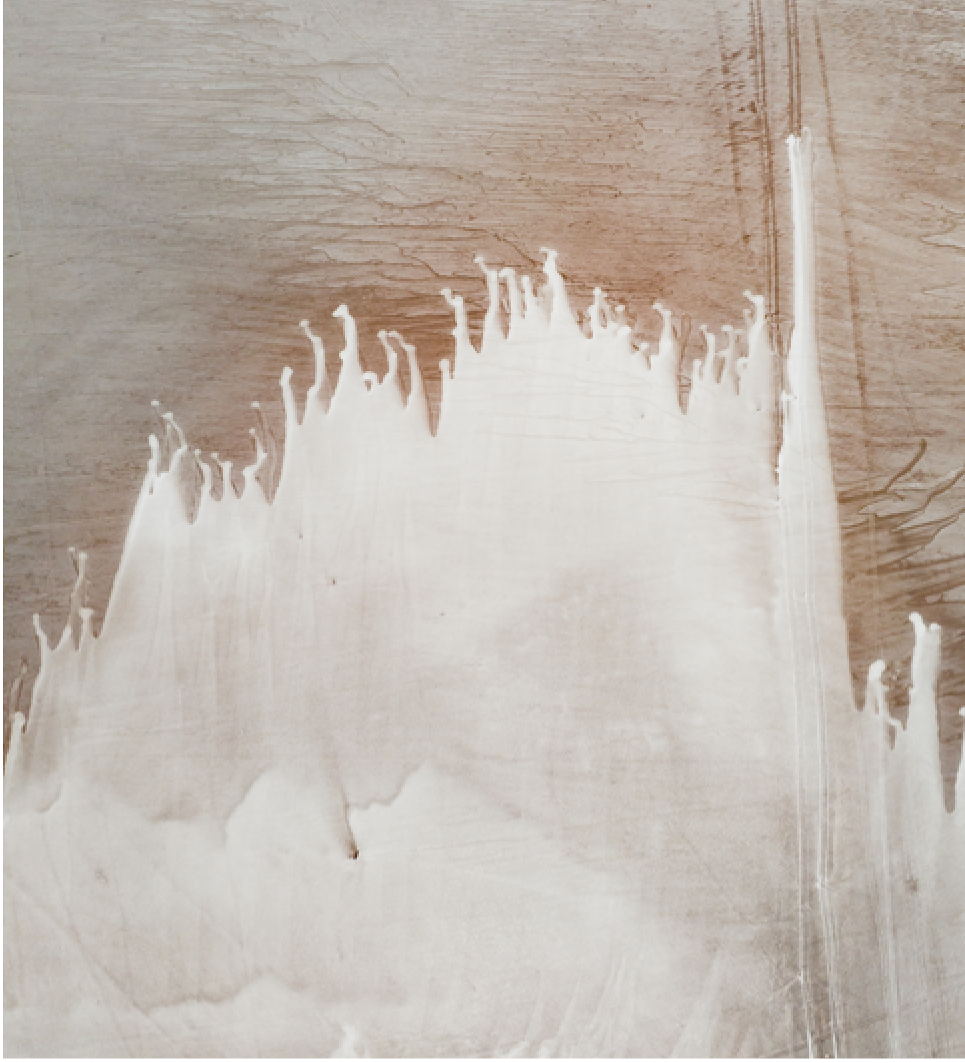
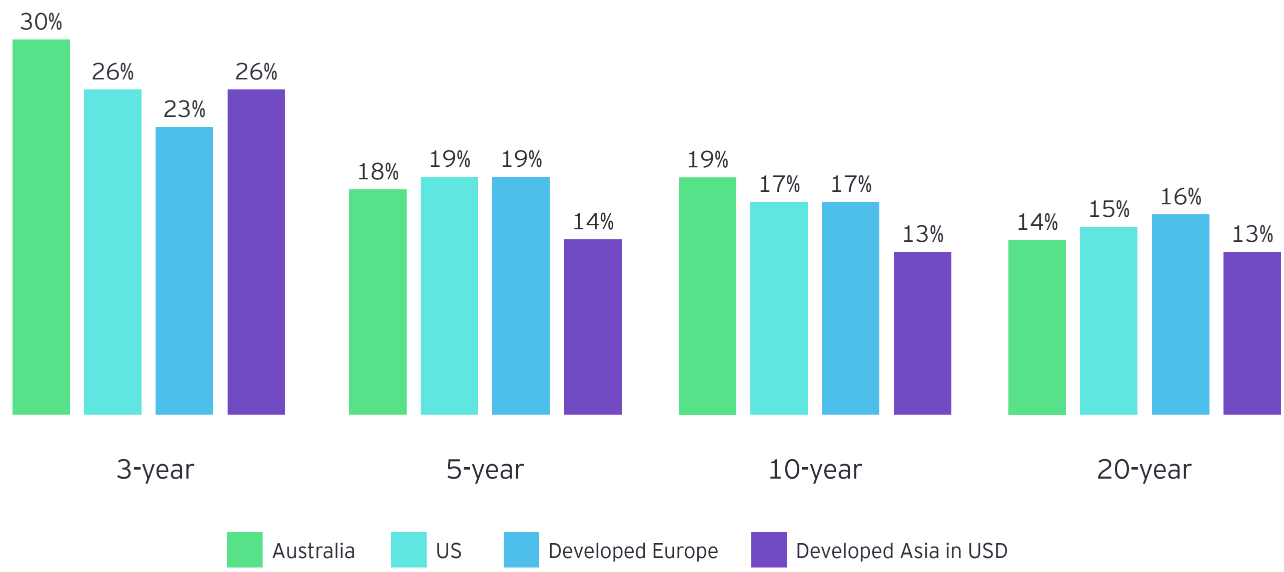


Figure 6: Australian private equity and venture capital performance compared with global peers

Cambridge Associates Australia PEVC index peers by region



Source: Cambridge Associates, as at 31 March 2023.

3.2 Snapshot of Australia's private capital ecosystem

Australia's dynamic private capital ecosystem encompasses various forms of private investment that fund and grow businesses.

Private equity

Assets under management:
$41.7 billion

Aggregate capital raised more than doubled between 2021 and 2022, rising from $4.3 billion to $9.0 billion. Private equity invests in everything from mature businesses seeking expansion to distressed companies in need of restructuring to high-growth startups with significant potential. These investments often involve active management and strategic guidance to enhance operational efficiency, drive growth and ultimately generate substantial returns for investors. Without this investment a number of well-known Australian brands would have collapsed or moved offshore.

Venture capital

Assets under management:
$17.9 billion

Venture capital is a form of private equity funding that investors offer to startup and small companies with long-term growth potential in exchange for ownership equity. Venture capital has supported the growth of countless new and innovative Australian companies. These include 10-plus home-grown tech 'unicorn' companies – businesses whose value exceeds $1 billion – in 2023 alone.

Private debt

Assets under management:
$2.1 billion

Private debt refers to loans or bonds issued to private companies or individuals by non-bank entities, such as private debt funds, rather than traditional financial institutions. Despite being the smallest asset class among Australia-focused private capital, private debt AUM more than tripled to $1.9 billion between 2020 and 2021, and continued to grow by 10% between December 2021 and September 2022 to stand at $2.1 billion.

> "Australia's ecosystem is like a barbell — there is a big end of town and then startups at the other extreme. It's a small market, but, with investment, those startups can grow up to be the next big end of town.
>
> **Venture capital investor**

Superannuation

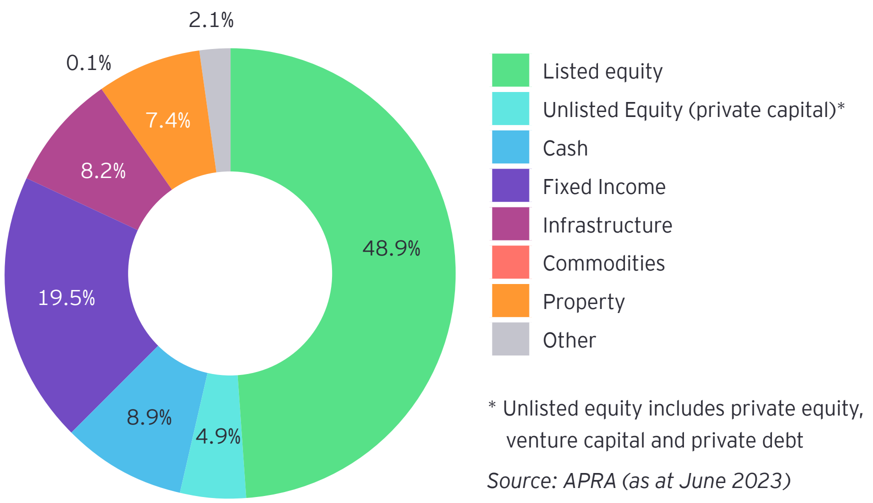
Total assets under management:
$3.4 trillion

Private capital assets under management:
$170 billion

Australia's superannuation funds control assets that represent 150% of the nation's GDP. While superannuation funds in search of diversification and higher returns are committing more to alternative assets, such as private capital, their allocations remain below 5%, which is lower than their international counterparts.

Superannuation funds often leverage a combination of approaches to diversify their investment strategies and optimise returns. Super funds can allocate capital to external fund managers and directly co-invest alongside those managers. Allocating to external fund managers allows super funds to benefit from professional expertise, while co-investing provides them with a more direct and hands-on involvement in specific investment opportunities.

Figure 7: Australian superannuation allocations



* Unlisted equity includes private equity, venture capital and private debt

Source: APRA (as at June 2023)

3.3 The state of private capital in Australia

Australia has strong fundamentals for private capital investment and a solid history of private capital making strong economic contributions. But there is room for improvement if we want to compete with global markets as an investment destination.

Australia's economic fundamentals are strong. Real GDP – after adjusting for inflation – is projected to grow by 1.5% in 2023-24[14] and then maintain at least a 2% per annum growth rate over the forward estimates.

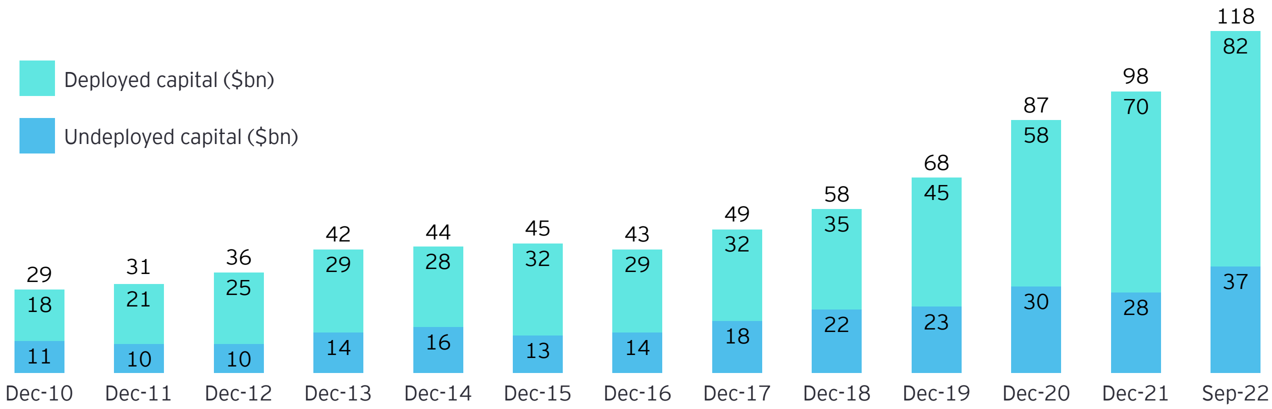
At the end of 2022, Australia had $62 billion in private capital assets under management (AUM)[15]. Private capital assets grew at a compound annual rate of 12.4% over 10 years.

Notably, dry powder – the reserves of capital that are ready to be deployed – grew by 30% between December 2021 and September 2022, reaching a record $37 billion in 2022, of which $11 billion is from private equity, venture capital and private debt.

Australia has many advantages that make it an attractive destination for private capital. We have a stable political system with a long history of democratic governance, robust legal and financial systems, and strong economic fundamentals. Our nation is rich in natural and human resources, with abundant minerals and a skilled workforce.

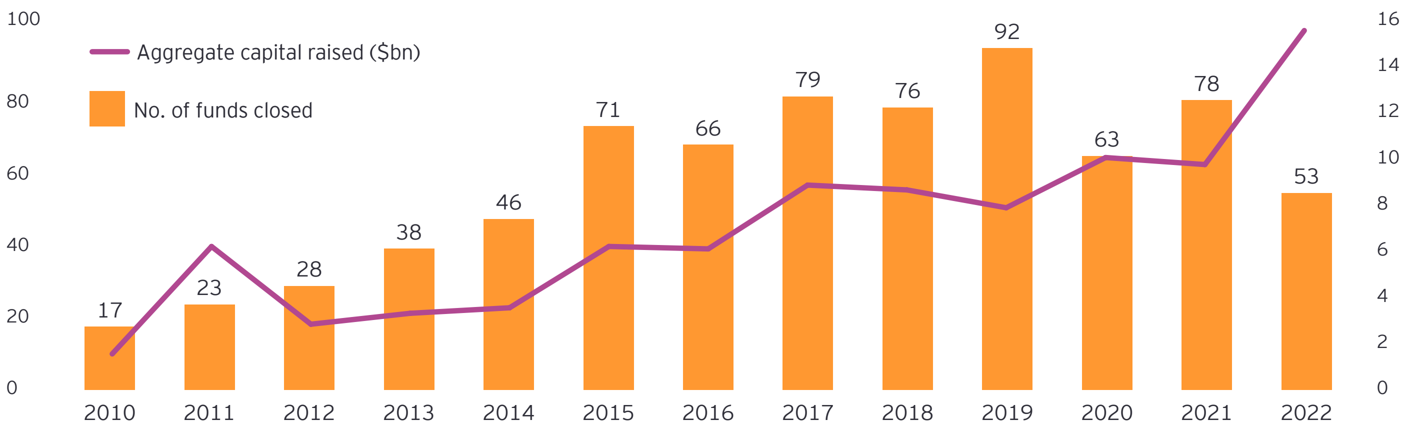
Australia ranks highly in the World Bank's Worldwide Governance Indicators[16]. Australia also places 13th on both the 2023 Index of Economic Freedom and Transparency International's anti-corruption index.

Figure 8: Australia-focused private capital assets under management, 2010-Sept 2022



Source: Preqin and Australian Investment Council, Australian Private Capital Market Overview, 2023

Figure 9: Australia-focused private capital fundraising, 2010-2022



Source: Preqin and Australian Investment Council, Australian Private Capital Market Overview, 2023

14 Parliament of Australia, 2023
15 Prequin and Australian Investment Council, 2023
16 The World Bank, 2023

Australia's strong fundamentals continue to attract foreign investment, which rose by $432.9 billion to just under $4.6 trillion in 2022[17].

However, our national advantages are not always well understood by the global investment community that provides capital to Australia. This is a significant impediment to raising investment required to address imminent challenges and opportunities.

Our distance from major global economic hubs presents physical and time zone challenges, and can lead to an "out of sight, out of mind" mentality among global investors. A small population can mean some investors underestimate Australia's economic significance; others perceive Australia as a commodity-driven economy.

To overcome these misconceptions, we must work harder than our international counterparts to promote the country's advantages to foreign investment.

17 Australian Bureau of Statistics, 2023

3.4 Private capital at work

Companies backed by private equity, venture capital and private debt drive growth in sectors that will enable Australia's long-term prosperity, such as healthcare, digital technologies, and advanced manufacturing.

Private capital is playing a key role in building healthcare models of the future by investing in innovative service delivery in areas such as disability and aged care, and by commercialising new medical technologies and pharmaceuticals.

The Australian Government's $15 billion National Reconstruction Fund[18] is intended to galvanise private capital investment into areas of national priority. By partnering with businesses, the Australian Government aims to unlock more than $30 billion in private investment to diversify and transform the nation's industries, create well-paid jobs for Australians, and accelerate the net zero emissions transition. Here are just a few ways private capital sector is already supporting nation-building across Australia:

18 Husic, 2022

19 Bain Capital, 2023

CASE STUDIES: **PRIVATE CAPITAL IN ACTION**

Renewables and low emissions technologies

Based in New South Wales' (NSW) Hunter Region, the team behind 3ME Technology has spent 15 years developing the capability to electrify heavy-duty vehicles and machines operating in mission-critical environments. 3ME Technology developed a pioneering cell-level battery management system which prevents thermal runaway — the most significant fire risk in batteries. With $15 million from the Australian Business Growth Fund — a public-private partnership between the Australian Government and six leading banks in Australia — 3ME Technology can expand its production facilities, invest in research and development, and accelerate Australia's domestic battery manufacturing sector.
The investment is expected to triple 3ME Technology's business capability over the next five years and grow jobs in the Hunter region.

Aged care

Estia Healthcare was acquired by Bain Capital in August 2023 for AU$838 million. Estia operates more than 70 aged care homes in South Australia, Victoria, NSW and Queensland, and cares for 8,000 residents a year. Bain's leaders have signalled their expectation for a long-term, active presence[19] that transforms the quality of care for older Australians.

Agriculture

Loam Bio, based in Orange, is working with farmers and scientists to enable high-quality carbon removal at scale. Loam's technology helps plants take carbon dioxide from the atmosphere and transform it into the most stable forms of soil carbon, turning the world's croplands into giant carbon sinks. Loam aims to develop a product that can help farmers improve yields while also storing tradeable carbon. In February 2023, Loam attracted $105 million in capital from a range of private investors, including Australian Investment Council member, Main Sequence Ventures, alongside the Australian Government's Clean Energy Finance Corporation.

Defence capability

Advanced Navigation has been developing innovative navigation and robotics solutions for sea, land, air, and space applications since it was established in 2012. The company is headquartered in Sydney, but now has offices around the world. It operates in several complex technology fields including global navigation satellite systems, sensors, acoustics, and full robotic systems. In November 2022, Advanced Navigation attracted $108 million in Australian and US investment, including from KKR and Main Sequence Ventures, following the Swedish Government's decision to use its technology to upgrade its defence capability.

20 Australian Prudential Regulation Authority, 2023

4

OPPORTUNITIES TO ADDRESS THE INVESTMENT CHALLENGE

The Australian Investment Council and EY have engaged with local and global investors and other participants in the private capital ecosystem to understand the key challenges in attracting the required scale of investment into Australia.

Australia's private capital industry is ready to support the Australian Government's policy priorities and ramp up its co-investment, but several impediments stand in the way.

Some of these impediments are impossible to eliminate. We cannot change our geographic isolation, our time zones, or the size of our market.

But we can make some modest changes to our tax and regulatory landscape to remove friction, encourage superannuation funds to allocate private capital to help Australia's investment capital to grow.

From our deep dive discussions with investors across the private capital ecosystem, we identified three areas of reform – superannuation, foreign investment regulation, and taxation – and several key policy responses that would help private capital fill the investment void and support Australia's future.

These industry participants are on the frontline of making the case for investing in Australian ideas, businesses and communities.

IN BRIEF

Australia's private capital industry is ready to support the Australian Government's policy priorities and make an even bigger contribution, but several impediments stand in the way.

- **Superannuation:** Only 5 per cent of Australia's $3.4 trillion superannuation pool is allocated to domestic private capital markets. Shifting the focus of performance benchmarking would encourage funds to allocate more to high return alternative investments.
- **Foreign investment regulation:** Australia ranks 61st of 69 countries for restrictions on foreign direct investment; fast-tracked foreign investment approvals for trusted, regular customers and an internationally competitive fee structure would help to position Australia as a destination of choice for foreign investment.
- **Taxation:** Australia's fund structures are broadly out of sync with global best practice; creating world-class, competitive investment vehicles, reforming venture capital programs and revisiting foreign investment taxes would bring Australia more in line with global peers.

4.1 Superannuation reforms

Superannuation, valued at $3.4 trillion and equating to more than 150 per cent of GDP, is the largest pool of Australian capital.

However, only a small portion of that is invested domestically in Australian private markets. Close to 48 per cent of superannuation assets are now invested overseas, and only 4.9 per cent of assets are invested in private equity and venture capital, which is the type of capital that invests in start-ups, scale-ups and growth businesses.[20]

Consequently, Australians are missing out on two fronts:

1. Firstly, when superannuation funds limit their investment in private capital funds, Australians may not fully benefit from on the high returns that these investments deliver for their retirement savings over the long term (see Table 1 below).
2. Secondly, restrictions on capital investment in domestic industries limit our ability to reap the benefits that come from nurturing new industries and capabilities, including jobs, productivity and contribution to GDP.
3. Thirdly, areas of unmet need continue to be unmet or met at sub-optimal levels.

Two recent developments have impacted the allocation of superannuation into private asset classes: Your Future, Your Super (YFYS) and Regulatory Guide 97.

Your Future, Your Super (YFYS)

The Australian Government's YFYS reform package, announced in the 2020-21 Budget, was designed to improve the transparency of the superannuation system and increase Australians' control over their retirement savings.

The intent of the YFYS reforms is logical but, in application, they have unintended adverse consequences.

Private capital's challenge is one of timing: a fund is likely to underperform the YFYS benchmark early in its life, while outperforming later on. This limits capital investment by superannuation funds into companies with longer investment horizons, such as Australian research and companies focused on science, technology, engineering and manufacturing. This can have cascading consequences, limiting the ability for Australia to grow or sustain high skill industries, develop manufacturing capabilities, enhance supply chain sufficiency, and attract skilled talent.

Treasury's Review of the YFYS, published in April 2023, found the 'performance' test, introduced as a simple and objective assessment of performance, can "unintentionally affect investment decisions of all funds to reduce the risk of failure and closure by encouraging short-termism and benchmark hugging as well as discouraging certain investments".[21]

Similarly, the YourSuper Comparison Tool allows for default sorting of products by fees. The Review found this can "unintentionally increase the ranking of products with relatively poor investment performance that have temporarily lowered fees".

> "International super funds will allocate to Australia as part of their 'Developed Asia' strategy and in line with their allocation to private capital.
>
> **Superannuation fund manager**

Table 1: Performance of Australia's private markets to 30 June 2023

Index	1 year	3 years	5 years	10 years	15 years
Australian listed equities	14.3	11.6	7.6	9.2	7.0
Australian bonds	1.1	-3.6	0.3	2.7	4.8
Australian private equity and venture capital	4.6	28.9	17.6	17.9	11.9

Source: Cambridge Associates, 2023

21 Australian Government Treasury, 2023
22 Australia Prudential Regulation Authority, 2023

ASIC's Regulatory Guide 97 (RG 97)

The Australian Securities and Investments Commission (ASIC) RG 97 outlines the requirements for the disclosure of fees, costs and other charges associated with financial products. RG97's purpose is to drive greater transparency and consistency in fees and cost disclosures.

Private capital investments typically require greater resources to execute than liquid investments like bonds and listed equities. There are several reasons for this.

1. Private capital deals often involve extensive due diligence, specialised knowledge and expertise, and proactive management.
2. Private capital investments are usually made over a long-term horizon and require ongoing monitoring, strategic adjustments and a commitment of resources over an extended period. Funds will bring in outside expertise, including advisors, consultants and board members to help the business run more effectively. Investors, therefore, demand a premium for tying up their capital. As a result, fees are higher.

Regulation around fees (such as ASIC's RG 97) encourage superannuation fund competition based on fees, rather than returns after fees, an area in which private markets investments typically do very well.

Both sets of reforms have, understandably, been driven by a determination to protect members and ensure Australians have sustainable retirement savings. However, they have also had unintended consequences.[22]

The reforms have also resulted in significant consolidation in the super industry, with the number of funds with more than 6 members decreasing by 57% in the last 10 years, from 299 funds in 2013 to 128 funds in 2023. This limits the scale at which private capital can work with super funds to facilitate investment.

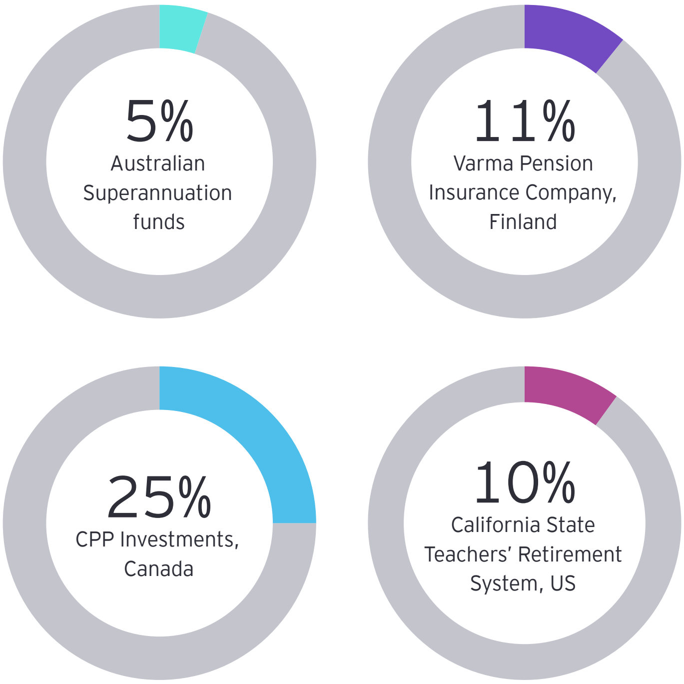
Reforms to improve transparency and disclosure have delivered meaningful and real benefits to members of super funds. But a narrow focus on fees and costs have promoted only one part of the performance equation. Superannuation fund performance is the product of both a fund's returns and its costs. Put simply: fund performance equals returns less expenses.

An investment option that is 'low cost' may not be 'high performing' due to having low returns. Existing policy settings can encourage or nudge superannuants to myopically focus on a fund's expenses or short-term performance.

Private capital, which is an active investment that tends to produce higher returns over 10-plus years, but lower returns year-on-year — as illustrated in Table 1 above — is disadvantaged by these disclosures. Investors may not see the fruits of the management for several years, and only then on exit. Potentially favourable short-term returns, and higher costs, make LPs reluctant to invest in private capital.

23 Organisation for Economic Cooperation and Development, 2023

Superannuation allocation to private equity – Australia vs international benchmarks



Source: Organisation for Economic Cooperation and Development, 2021

> "
> Australia has the badge of being 'too difficult and not worth the time' due to it being a fee-sensitive market.
>
> **Superannuation fund**

Opportunity

Australian superannuation is a ready stock of capital that could be deployed to private investment while fulfilling members' best interest obligations: however very little gets allocated to domestic private capital markets.

If we are to achieve our ambitious goal of growing private capital to unlock an extra 600,000 jobs and $144 billion in economic contribution by 2030, we need to ensure the policy settings incentivise the superannuation industry to invest in private capital.

We suggest the following opportunity to signal to super funds and members the benefits of private capital:

- Transition the focus of performance benchmarking for APRA-regulated superannuation funds from fees to net returns. This would bring Australia into line with international peers and provide fund members with clearer line of sight over the bottom-line impact of investment options on overall superannuation fund balances. It would also encourage development of investment options that deliver superior returns to members.

4.2 Foreign investment regulatory reforms

4.2.1 Foreign investment review regime

Australia relies on a mix of domestic and international capital to support economic activity. At the end of 2022, foreign direct investment in Australia was $4.5 trillion, making Australia the 15th highest destination for international capital in the world. Mining attracts the most foreign investment, with one-third of capital allocated.

While this statistic shows that Australia presents opportunities for international capital, it needs to be considered alongside another statistic: Australia ranks 61st of 69 countries, including all OECD and G20 countries, for restrictions on foreign direct investment.[23]

The Foreign Direct Investment Regulatory Restrictiveness Index (FDI Index) ranks economies across four areas. Australia's FIRB screening and approval process is the second most restrictive in the OECD, second only to New Zealand.

There are strong and obvious reasons for Australia to scrutinise how and where foreign capital is being invested, and to have robust governance frameworks in place. However, FIRB's extensive information requirements, long approvals processes and associated application fees can have a significant impact on appetite to invest within Australia, relative to other countries which are also competing for the same capital.

A 2020 study by the Productivity Commission shows that a 10 per cent increase in the OECD's Foreign Direct Investment Restrictiveness Index was associated with a theoretical decrease in inward investment stocks of 2.1 per cent. Therefore, the restrictiveness of the FIRB regime directly impacts investment. The median processing time by Treasury for non-real estate transactions was:

- 51 days in 2020-21
- 52 days in 2021-22

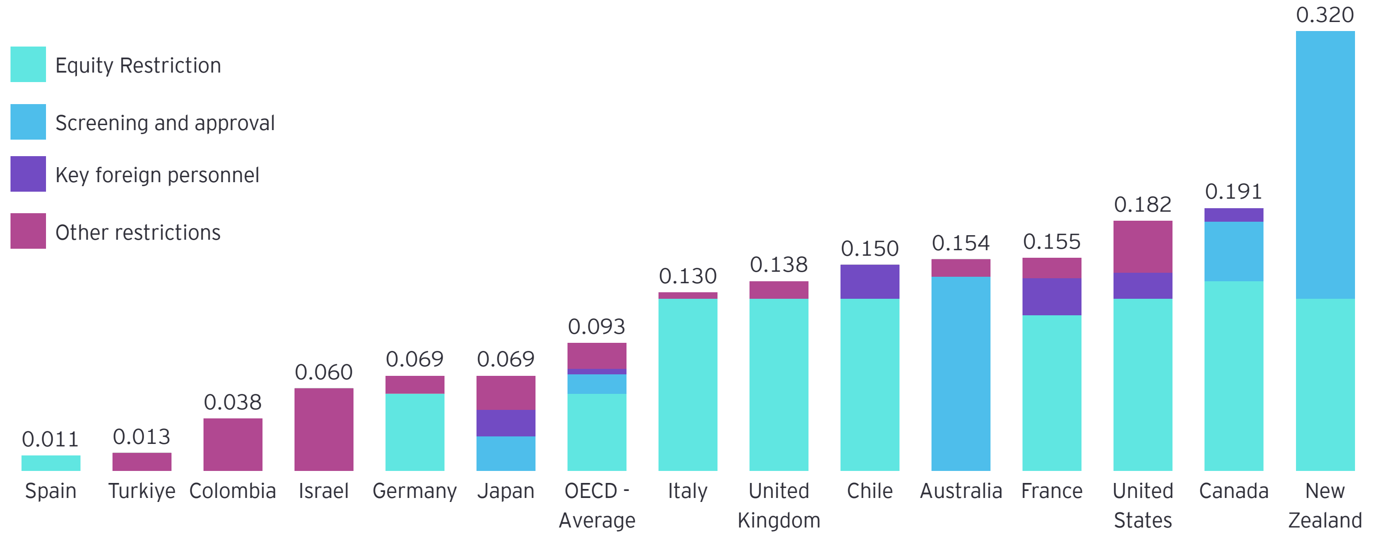
Changes introduced in July 2022 have reduced the median processing time to 41 days in 2022-23. But this still remains above the standard 30-day legislated period, outlined in the Regulatory Performance Framework Self-Assessment Report (2020-21) and makes foreign investment less competitive than purely domestic investors, particularly where slow and or uncertain FIRB processes can derail commercial negotiations.

The FIRB regime costs significantly less to administer than the revenue it generates through fees. In 2020-21 FIRB proposal fees generated $85.6 million in revenue, but the operational costs of administering the regime were only $36.1 million. This $45.5 million surplus is effectively an additional tax on foreign investment.

The Productivity Commission has previously suggested the following reforms to FIRB:

- improve transparency and certainty;
- provide greater explanation of decisions and adherence to timeframes; and
- align fees with the cost of administration.[24]

Figure 8: Restrictions to private capital inflows



Source: OECD, 2020

24 Australian Government Productivity Commission, 2020

4.2.2 Register of Foreign Ownership of Australian Assets

In addition to obligations under the FIRB process, a new Register of Foreign Ownership of Australian Assets was introduced in 2023. This creates additional reporting obligations for foreign investors in relation to certain interests in Australian land, entities and businesses. The scope of registerable actions is significantly broader than the FIRB regime.

All legal interests (including leases of greater than five years) and some equitable interests in land acquired by a foreign person after 1 July 2023, or where a company becomes a foreign person after 1 July 2023, must be reported to the Australian Taxation Office, which maintains the register. Given the structures of private capital investment, this has the potential to create significant compliance burden on allocators and managers of capital as well as portfolio companies which must register their interests.

The registration must be completed by the relevant directors and public officers personally via their MyGov account (resulting in the disclosure of their personal information) and there is little scope to delegate this to advisors. It is incongruous that the onus for investments made by an entity is placed on individuals. This asymmetry may also be problematic in the event that the relevant director or public officer who has completed the registration leaves the entity.

Further, there remains some uncertainty as to the reporting obligations of each party. This is a meaningful deterrent for foreign investors given the significant penalties in place for non-compliance.

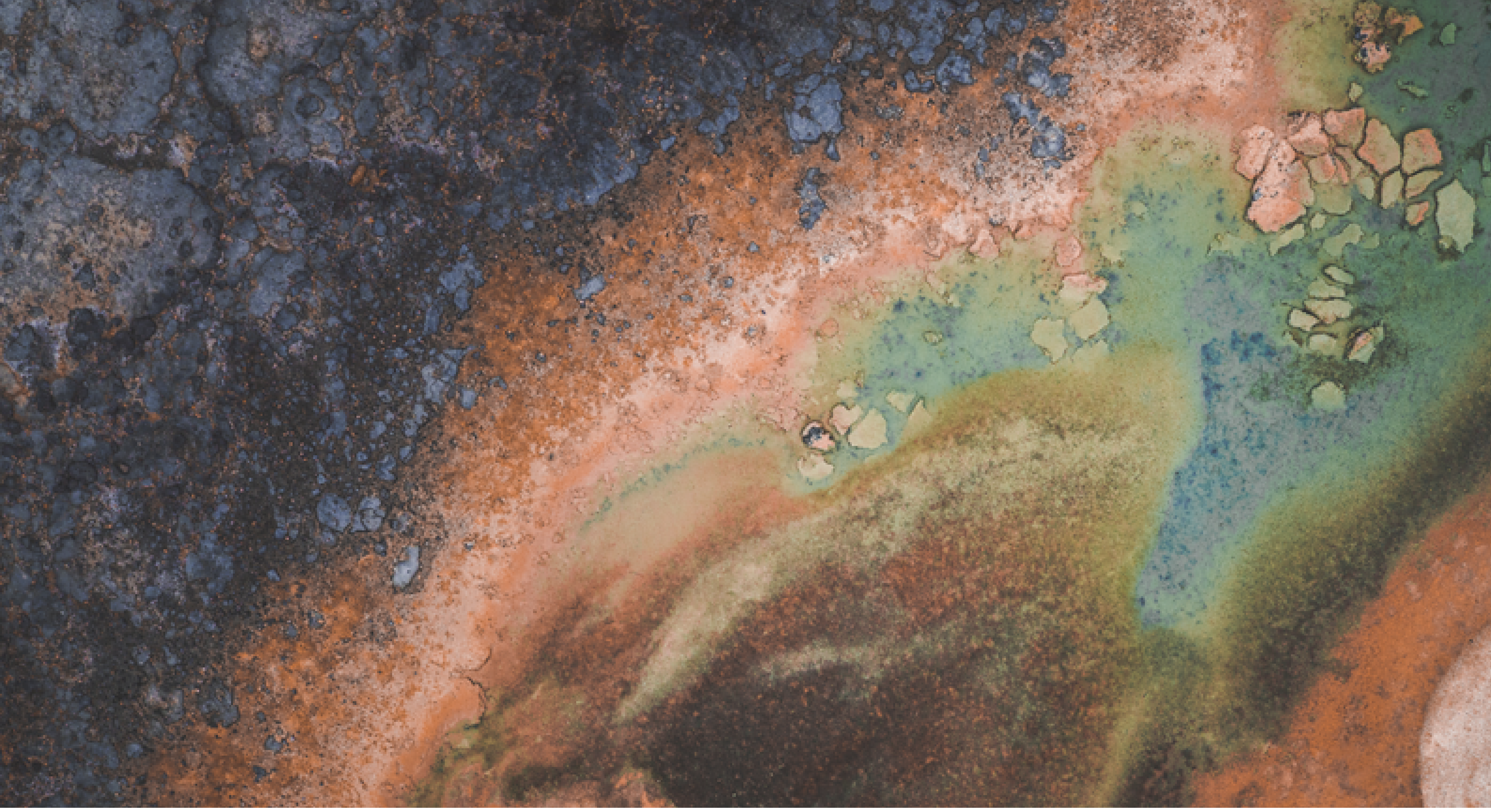
Opportunities

If Australia wants to attract the necessary capital to meet our national priorities, particularly in non-mining sectors, we need to outperform other countries when competing to attract and retain capital.

While Australia is an attractive investment destination, our regulatory frameworks are overly restrictive and expensive. We suggest the following measures could position Australia as a destination of choice for foreign investment:

- Signal that Australia is open for business by fast-tracking investment approvals, offering pre-approvals or reducing the information requirements for trusted and regular FIRB customers. This could be achieved by setting a baseline approval for funds that have previously passed FIRB's direct interest threshold, with exclusions for sensitive areas like defence.
- Undertake an independent review of the current foreign investment fee structure to assess the extent to which the fees are globally competitive. Fees should cover the cost of administering the FIRB system and not act as an additional tax on foreign investors.
- Clarify the responsibilities of allocators of capital, managers of capital and portfolio companies under both the legislative and operational requirements of the Register of Foreign Ownership of Australian Assets. If needed, amend to place the reporting obligations on a single party only.
- Reconsider the use of personally linked applications such as MyGov in the reporting process. Work with relevant stakeholders to develop an alternative registration mechanism.
- Streamline the process of appointing representatives to report on behalf of the foreign person (including reconsidering the requirement that representatives use their personal MyGov account to report on behalf of the foreign person).

> “You can have a 1% foreign government investor in a fund, and the rules apply to the whole fund, making it subject to a whole set of regulatory burdens.
>
> **Legal expert**



4.3 Taxation reforms

Australia's funds management tax structures are incongruous with global best practice which is a deterrent, particularly for international investors who are not familiar with the local frameworks. There are three areas for reform that would generate efficiencies in Australia's taxation system and make it more navigable for foreign investors.

4.3.1 Rethink investment vehicles

Australia's funds management structures are broadly considered to be out of sync with global best practice in investment.

Currently, Australia's main managed investment vehicles are unit trusts, such as Managed Investment Trusts (MITs). These structures are not considered standard investment vehicles in other jurisdictions, and as such, these vehicles are unfamiliar to foreign investors and several uncertainties in their application act as deterrents to investment.

Most other comparable jurisdictions have long used a Collective Investment Vehicle (CIV) structure, the globally accepted private capital vehicle of choice. This includes the EU (UCITS), UK (OEIC), Hong Kong (OFC) and Singapore (VCC). Most overseas CIV structures are in the form of limited partnerships; trusts are a concept unique to Australia.

In 2022, Australia introduced the Corporate Collective Investment Vehicle (CCIV) regime. The idea was first proposed in the Johnson Report in 2009 and accepted by the Australian Government in 2016. This 2016 decision included a commitment by the Australian Government to also introduce a Limited Partnership Collective Investment Vehicle (LP CIV). An LP CIV is different from an MIT, in that it is not a trust, and different from a CCIV, in that liability is limited to a partners contribution.

Given the scale of capital required to meet Australia's most pressing priorities (including the clean energy transition, and the costs of healthcare, aged care and disability care), Australia must be competitive in retaining domestic, and attracting international, capital. An LP CIV, comparable to models in operation in the EU, UK, Hong Kong and Singapore, would make a significant contribution to our competitiveness.

Opportunities

World-class, competitive CIVs that are readily understood by foreign investors are essential to build and expand the pool of capital that can be attracted into the Australian economy. If foreign investors are not familiar with a vehicle, or it is too hard to navigate, their money will be invested elsewhere and will contribute to the business, productivity, jobs and GDP growth of other nations.

If Australia lags, we risk missing out on opportunities to attract investment and bolster the Australian economy. As such, we suggest the following:

- Introduce a Limited Partnership Collective Investment Vehicle as the major outstanding component of a globally competitive Collective Investment Vehicle and funds management regime.

4.3.2 Reform VCLP and ESVCLP vehicles

Venture capital and private equity growth funds are an essential element of Australia's innovation system, underpinning the competitiveness of Australian businesses and the growth and vitality of the domestic economy.

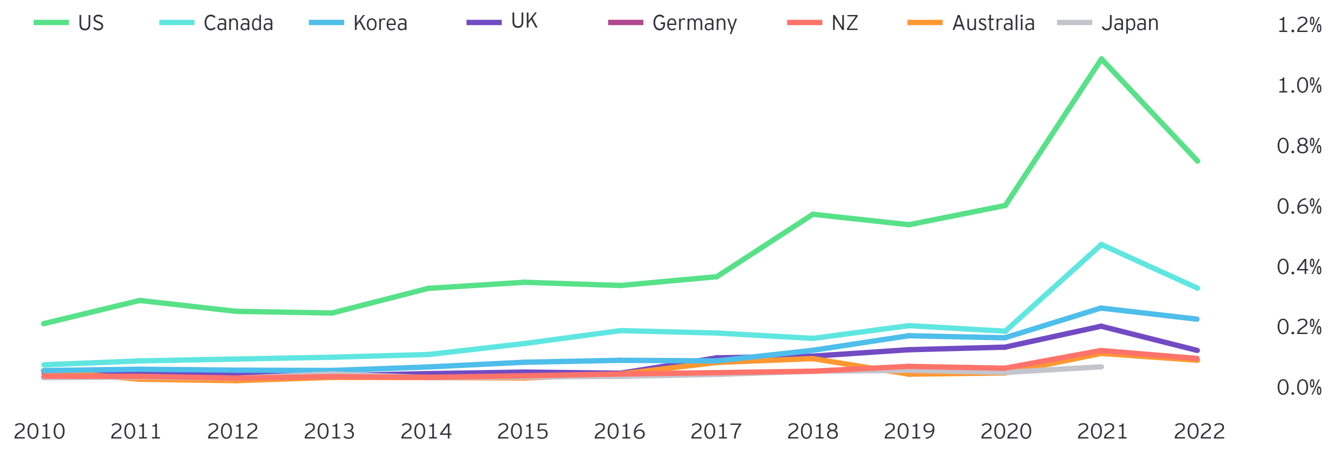
Despite a growing venture capital sector, Australia is still small by international standards. According to the OECD, Australia's venture capital investment as a percentage of gross domestic product was 0.034 per cent compared to an OECD average of 0.081 per cent in 2019.[25]

Venture Capital Limited Partnerships (VCLPs) and Early Stage Venture Capital Limited Partnerships (ESVCLPs) were introduced into Australia in 2002 and 2007, respectively to increase venture capital investment in Australia by giving tax concessions to eligible investors. Concessions include flow-through tax treatment, where the income is taxed at the owner's individual tax rate for ordinary income, and the business itself pays no corporate tax. Other concessions include exemptions on income tax on certain capital and revenue profits and taxing fund managers on capital account rather than as income.

The programs were designed to help stimulate venture capital investment and were strongly supported by the private capital industry. Since their introduction, and as of June 2023, VCLPs and ESVCLPs have attracted $30.2 billion in committed capital and supported investment into 2,636 businesses.[26]

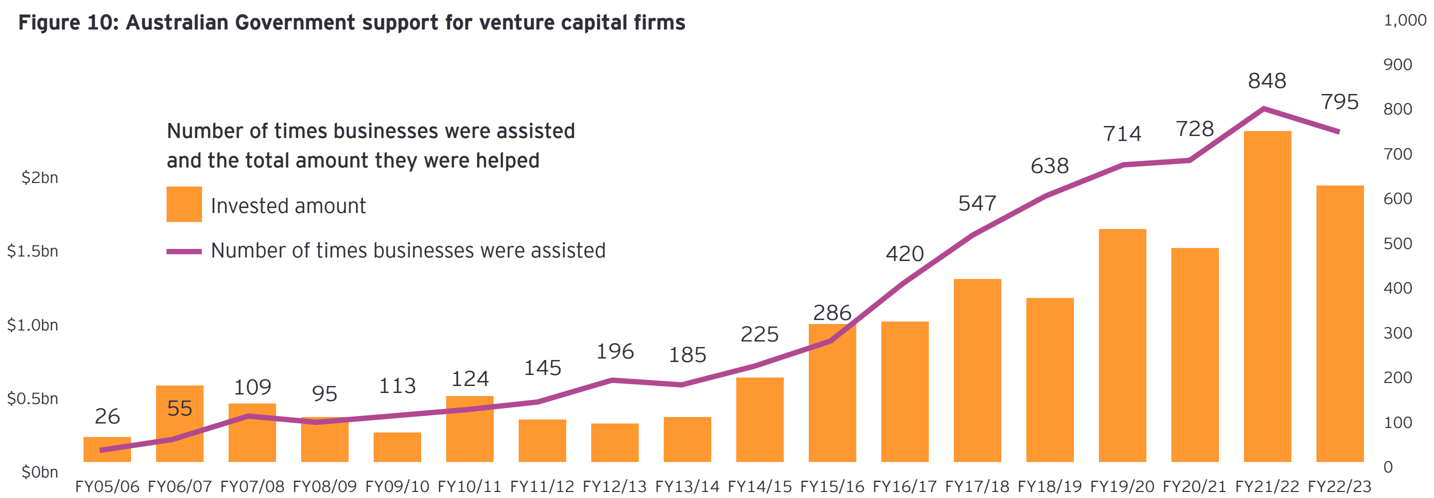
However, the investment thresholds have not kept pace with evolution in the market, and do not reflect today's transaction sizes or valuations.

Figure 9: Trends in venture capital investment in selected OECD countries, as a share of GDP



Source: OECD, 2023

Figure 10: Australian Government support for venture capital firms



Source: Australian Government Venture Capital Dashboard FY 2022/23

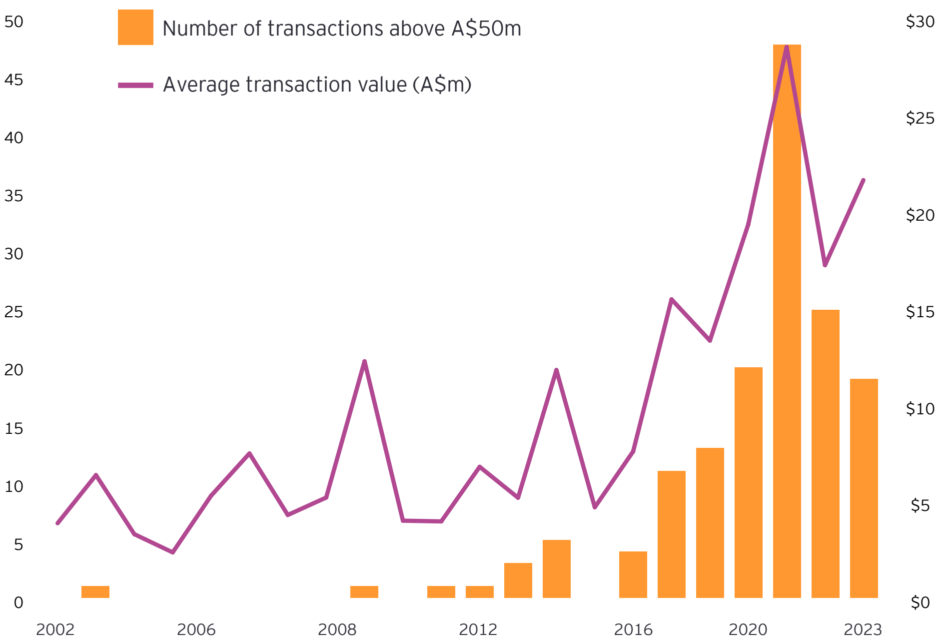
25 OECD
26 Australian Government Department of Industry, Science and Resources, 2023

When it was introduced in 2002, the VCLP program applied a threshold to investments such that the investee entity could not have an asset value above $250 million at the time of investment. For the ESVCLP, introduced in 2007, the threshold value for eligible entities was $50 million. Neither of these threshold values has been subsequently updated, despite a compound growth rate in transaction value of eight per cent since the programs were introduced (see figure 11).

In addition, the rules currently state that none of the investors in an ESVCLP can contribute more than 30 per cent of the committed capital unless they are a bank, life insurance entity, widely-held superannuation fund or widely-held foreign venture capital fund. The Innovation Investment Committee can approve an investor with more than 30 per cent committed capital in some circumstances. It is unclear why, for example, a bank can hold more than 30 per cent but other companies or funds cannot.

> “We’ve created these structures — the ESVCLP and VCLP — that offshore investors understand and look aligned with what’s happening overseas, but then we put restrictions on them. It is hard to understand and adhere to the requirements, and only lawyers benefit.
>
> **Venture capital investor**

Figure 11: Venture capital deals in Australia, 2010-2022



Source: Ernst & Young Australia, 2024; Preqin, 2023.

Opportunities

Ensuring the continued growth and development of innovative and competitive Australian businesses, through increased venture capital funding, is critical to a competitive economy with high-quality jobs at the forefront of new technologies.

Australia has a strong framework for supporting venture capital and private equity growth funding, but it must keep pace with the industry to ensure we amplify the impact of investment. We suggest the following opportunities to ensure the VCLP and ESVCLP programs remain relevant and continue to attract investment:

- Increase the Early-Stage Venture Capital Limited Partnership threshold for the total assets of an investee company from $50 million to $100 million, and Venture Capital Limited Partnership threshold for the total assets of an investee company from $250 million to $500 million to better align with transaction sizes in today’s market.
- Review and refine ESVCLP and VCLP programs and introduce an inflation adjustment mechanism such at the CPI to ensure benchmarks remain relevant.
- Allow for, at a minimum, domestic fund managers to be able to contribute more than 30 per cent of committed capital to an ESVCLP.

4.3.3 Revisit foreign investment taxes

Australia's taxation system has a reputation for being among the world's most complex. The University of Navarra's Venture Capital and Private Equity Attractiveness Index ranks Australia ninth overall, of 125 countries.[27] However, for tax incentives and administrative burden, Australia ranks 94th, placing us among many developing nations. This complexity may impact the scale of investment into Australian private equity and venture capital funds.

The complexity was recognised in Treasury's 2015 Tax White Paper: Australia's corporate tax system is also extremely complex. Artificial distinctions embedded in the system often create unintended biases towards particular forms ofinvestment, distort business decisions."[28]

Australia has high domestic withholding tax rates on passive income such as dividends, interest and royalties. Australia's withholding tax rates on dividends and royalties are particularly high, compared with the OECD average (demonstrated by Table 2). These are subject to reductions only under tax treaties with nations with which Australia has concluded a double tax agreement. High withholding tax rates put Australia at a disadvantage vis-à-vis our OECD peers when attracting foreign investment of private capital, particularly regarding dividends which is a significant income type for the private capital industry.

Australia does have mechanisms in place to make it a favourable destination for investment. For example, when Australian corporate tax is paid in Australia and a franking credit is generated, those profits can be distributed as dividends without additional tax leakage in the form of withholding tax and domestic shareholders receive a credit for the company tax paid.

Table 2: Withholding tax rates in Australia and other comparable jurisdictions

Withholding tax obligation	Dividends	Interest	Royalties
Australia	30%	10%	30%
Canada	25%	25%	25%
Singapore	0%	15%	10%
United Kingdom	0%	20%	20%
United States	30%	30%	30%
OECD average	**20%**	**16%**	**19%**

Source: EY Worldwide Corporate Tax Guide 2023

Note: The above rates are subject to reduction under applicable tax treaties entered into by the above countries with other countries.

27 Groh, A. et al, 2023

28 Australian Government Treasury, 2015

Opportunity

Changes to our tax system that bring Australia more in line with our peers in the OECD and improve our ranking in the Venture Capital and Private Equity Attractiveness Index will help position Australia as a destination of choice for foreign investors.

Drawing in more foreign investment will help Australian businesses unlock the capital they need to grow and deploy innovative solutions across our priority policy areas, including aged care, investment in green energy and innovative local manufacturing solutions. We suggest the following:

- Amend the tax withholding rates to bring them in line with global averages or consider a broad-based reduction for dividend income, such as in the ESVCLP.

> "Withholding tax levels are too high for foreign investors. Investors offshore have to go through MIT structures for 15% or debt for 10%. Then they have the Thin Cap overlay on top of it. It becomes too complicated. They just go elsewhere.
>
> **Investment fund lawyer**

International case study: Singapore

Singapore's Variable Capital Company (VCC) corporate structure offers considerable advantages for fund managers and their investors, including generous government financial incentives. VCCs are flexible and low cost, and the speed and simplicity of incorporation are attractive to both local and offshore fund managers. Approval from Singapore Accounting and Corporate Regulatory Authority takes between 14 days (for the simplest structure) to 60 days.

Source: Accounting and Corporate Regulatory Authority Singapore, 2024

5

CONCLUSION

Investment in Australia is strong — but there is huge growth potential within our grasp. Increasing private capital investment in Australia to be equivalent to 4 per cent of GDP by 2030 would increase the economic contribution to $144 billion and add an extra 600,000 jobs to the economy.

EY and the Australian Investment Council have engaged participants from across the private capital ecosystem to understand the primary challenges preventing us from achieving this goal.

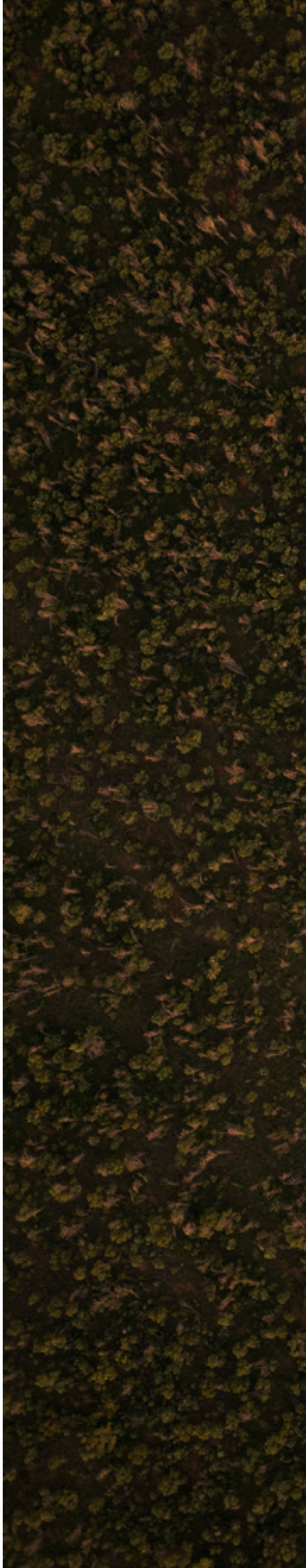
We find modest reforms across regulation, taxation, and superannuation can address significant obstacles and allow private capital to step into the investment void and propel Australia's future growth.

Pragmatic policy changes designed to double private capital investment over time can foster job creation in sustainable sectors, advance breakthroughs in technology and medical science, strengthen our defence capabilities, and facilitate a smooth transition to a net-zero future. Expanding the inflows of private capital can also help Australians save for retirement years.

Private capital is positioned to fund Australia's future. Are we ready?

Thank you to the following entities for participating in this research:

- Allegro Funds
- Bombora Special Investment Managers
- Cbus Super
- Future Fund
- Gilbert + Tobin
- HarbourVest
- HESTA
- Intermediate Capital Group
- Intuitiva Law
- Main Sequence Ventures
- Myer Family Investments
- NAB Ventures
- Pacific Equity Partners
- Roc Partners
- Tanarra Capital



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