



National Innovation Fund – suggested design considerations

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Background

In recognition of persistent market failure, successive Commonwealth Governments have sought to support early stage companies via schemes such as the R&D tax incentive, introduction of early stage venture capital limited partnerships (ESVCLPs) and venture capital limited partnerships (VCLPs), and public-private co-investment funds (e.g. the Innovation Investment Fund (IIF) discussed below).

The National Innovation & Science Agenda (NISA), announced in December 2015, outlined a range of additional policy measures designed to further support the early stage ecosystem. We believe, given time, these reforms will be transformative for the sector.

In our view, the next phase of Australia's innovation reforms – NISA 2.0 - must focus on supporting Australian 'scale-ups': those businesses that have graduated from the initial start-up phase with a proven product and market opportunity which now need further capital (often \$5m-20m) and expertise to hire staff, drive sales growth and invest more in R&D. Currently, a lack of institutional funding (e.g. from super funds) at this vital stage pushes maturing, innovative Australian companies abroad. Ensuring these companies receive support has economy-wide implications, including Australia's ability to drive future productivity and employment growth. Over the last five financial years (FY12-16), only 25% of venture-capital backed companies received later/expansion stage funding, down from 29% of venture-capital backed companies in FY07-11.

A National Innovation Fund can play an important role in this next phase of innovation reform. Outlined below is some background on the previous IIF, followed by suggested design features for the proposed National Innovation Fund.

Innovation Investment Fund

The most significant public-private fund implemented by Commonwealth Governments was the sector-agnostic Innovation Investment Fund (IIF) announced in 1997. The IIF had several key features including:

- Matched dollar for dollar public-private commitments;
- A competitive bid process whereby fund managers sought to obtain a license to manage IIF capital;
- Unequal distribution of profits above a hurdle rate of investment return: 90% (private investors) vs 10% (Government investor).

We note that the IIF was abolished in 2014 despite strong opposition from industry stakeholders, including AVCAL, and multiple independent reviews which concluded that the IIF had been successful in channelling greater investment into early stage companies and had helped develop the domestic venture capital sector. Success stories from the IIF program include:

- *AMWIN* fund: one of the first funds licensed under the IIF. Since its commencement in 1998, AMWIN provided investors with a 1,047% internal rate of return, with international independent research firm Preqin rating it the top performing venture fund in the world.¹
- *SEEK*, which returned 6.5 times AMWIN Innovation Fund's original investment in 1999 which was part of the company's first institutional capital raising. Today, SEEK's market capitalisation is around \$5.4bn and it is one of the world's most successful jobs-listing companies.
- *Pharmaxis*, a GBS Venture Partners IIF investment. Pharmaxis is an Australian pharmaceutical research company with a portfolio including two respiratory products (Bronchitol and Aridol) in various world markets and a research pipeline focused on areas of high unmet clinical need. Pharmaxis is working towards approval of its cystic fibrosis drug Bronchitol in the United States (having already been marketed in Australian and Europe) and is already selling its Aridol lung function test in Europe, Asia and Australia. In parallel, Pharmaxis is developing a pipeline of drug candidates for the treatment of inflammatory and fibrotic diseases. Pharmaxis manufactures and exports their approved products from a purpose-built facility in Sydney.

We note that the administered capital provided under the IIF led to the acquisition of a financial asset for the Government, with no impact on the underlying fiscal balance of the federal budget. In return for the IIF funding, the Government received an equity share in the investments made. Returns from the Government's investment were then recycled into the existing revolving fund, and re-committed to future VC funds. The IIF therefore represent an example of successful Government-private sector collaboration, offering commercial returns for all investors.

Suggested design features of a National Innovation Fund

As venture capital and private equity funds are committed for an average 10-year term and returns do not generally start flowing until later stages of the fund's life, a long-term approach is necessary. Considering the lessons learned from the IIF, and the recently launched Biomedical Translation Fund model, we would suggest the following design features for a National Innovation Fund:

- In order for it to have a meaningful impact on the market, and the development of scale-up businesses, the Fund should have a minimum Government commitment of \$500m over two years (with returns reinvested);
- Sector-agnostic fund with matching capital commitments from private investors and the Government;
- A competitive bid process whereby fund managers seek to obtain a license to manage capital (a Fund undertaking individual company investments would be costly to administer, pose due diligence challenges and would be inconsistent with the diversified portfolio approach of venture capital funds);
- Unequal distribution of profits above a hurdle rate of investment return between private and public investors (e.g. 90/10 under the IIF, 60/40 under the BTF);
- An equity financing model offers greater flexibility for companies than debt, while strongly aligning interests between companies and their investors;
- The Fund should make investments into venture capital funds operating at different stages of the company life-cycle, noting that there are particular difficulties in conducting domestic investment rounds of over \$5m;
- Investments should be permitted in both private and public companies as there are many smaller public companies which would benefit from venture capital investment.

Next steps

AVCAL welcomes feedback from the Government on the suggested design features outlined above. We would also be happy to facilitate an industry roundtable with our members to discuss the National Innovation Fund proposal in more detail.

¹ AusIndustry, *AMWIN Innovation Fund rated as world's best VC fund*, Customer Story, Jan 2014.