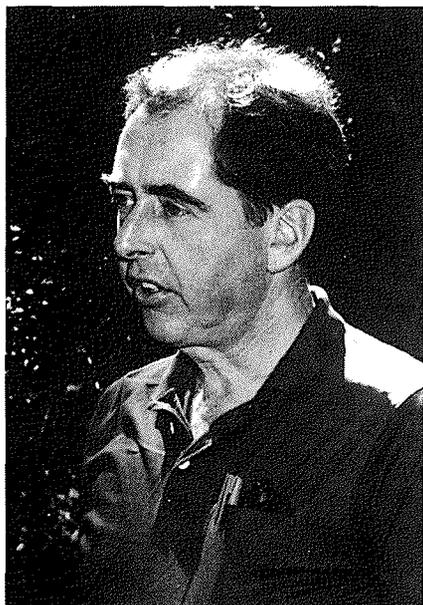


CAN DCFs SUCCEED WHERE MICs FAIL?

\$2bn OF DEVELOPMENT FUNDS: HERE'S HOW



by GRAHAM WALKER

Articles by Senator John Button and Christopher Golis in the September issue of JASSA on the need for development capital have prompted this further proposal for funds-raising.

The September issue of *JASSA* contained a fascinating pairing of articles. One was by the Minister for Industry, Technology and Commerce, Senator John Button, titled "Where has all the capital gone? A role — and a profit — for institutions" and the other by Chris Golis, of Viewnex Pty Ltd, on "How to make risk irresistible: Incentives for venture capital". These articles tend to reveal the current capital market attitude or conventional wisdom, that venture capital is discredited, development capital is "in", and buyout funds are below the level of awareness.

The views expressed by Button and Golis on venture capital and the MIC scheme call for a fuller review. Has the MIC scheme, with so much expected of it, been a disaster? Are there positives or lessons to be learned about something that has apparently died without a whimper and without a supporter?

Button and Golis discuss venture capital from two quite different viewpoints, although both have long and deep knowledge of the area and both obviously have a sincere desire to see Australia's capital pool put to the best use.

Golis's closing paragraph asserted: "The problems with the MIC program were that the financial incentives did not attract the institutions, and 'agency capture' arti-

cially limited the size of the market. Correct these two faults and a major impetus to the Australian economy would result." As he noted: "The original licensees argue strongly against allocating further licences and, by persistent lobbying, 'capture' the licensing agency."

Certainly there was a lack of incentives for institutions. Surely, though, attempts to "agency capture" were a consequence of the size of the MIC allocation, \$40 million, and the requirement for relatively fast investment of funds raised.

The original MICs were licensed for lesser amounts than they applied for. (Interestingly, the 1983/84 and 1984/85 MIC Board annual reports do not appear to disclose the amount of unsatisfied applications). The *maximum* allocation of capital to any one MIC in the first year of the MIC scheme was \$10 million, whereas, at the time, opinions were that \$10 million was a *minimum* for an effective fund. The first allocation, in 1983/84, was spread across seven MICs.

Given these economic constraints it could only be expected that there would be intense competition to gain further funds in future years (and thus resistance to the approval of new licensees) in order to smooth the

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level of operations, to support growing investees and to reach an economic fund size.

On the whole, though, the MIC scheme had a good deal going for it. The Espie Committee had suggested the general approach and many of the built-in requirements were based on successful US practice. However, a scheme such as this is as strong as its weakest links. The weak links were the clawback provisions and the "instant investment requirement". Both were unrelated to normal practice in the US or UK.

Let it be suggested that the clawback provisions could have been "pound-of-flesh" or "dog-in-a-manger" reactions by administrators to the tax-free largess being handed out by politicians. The clawback had no rationale to MIC operations but it had a deadly impact on them. Shareholder liquidity did not exist. Stockmarket valuation of the listed MICs did not arise as selling would trigger the clawback. Listing was a waste of time and money.

The stupidity of the clawback was probably a reaction to the uncontrolled tax deductions available during the oil boom of the 1960s, a time of stags' delight and financial musical chairs. The possibility of such excesses in the MIC scheme was fully under control because of the maximum taxation revenue give-up of \$20 million (thus maximum capital allocations of around \$40 million). The clawback represented a belt-and-braces approach.

In effect, the tax deductions provided were the equivalent of 25 per cent per annum (100 per cent spread over four years). The MIC scheme could just as easily offered a 25 per cent deduction with *no clawback*. This would have meant that capital allocations each year under the MIC scheme could have risen to \$160 million without sacrificing any further taxation revenue (\$160 million at 25 per cent deduction rate = \$40 million of claims; at 50 per cent tax rate = \$20 million revenue give-up). In other words, with \$160 million of capital allocations available there would be no need for agency capture. The MIC Scheme could have been four times the size for no change in tax revenue loss. What a wasted opportunity.

The second weak link in the MIC scheme was the "instant investment" provision. The scheme did not allow for contributing shares, which were

TABLE 1: 10-YEAR CAPITAL ACCUMULATION

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total
1	200	40	40	40	40	40					400
2		200	40	40	40	40	40				400
3			200	40	40	40	40	40			400
4				200	40	40	40	40	40		400
5					200	40	40	40	40	40	400
Total	200	240	280	320	360	200	160	120	80	40	2000

too administratively complicated given the clawback provisions.

Without the clawback provisions, how could capital raisings have been structured? One solution could be \$1 shares initially paid up to 50c with predetermined calls of 10c in each of years 2 to 6. Thus MICs would have been assured of funding as far ahead as year 6. Only if a MIC had been a complete disaster would calls not be met. MICs would not have had to invest at such a fast rate. They would not have been competing with each other. They could stay out of the market, make fewer investments and/or retain funds to support their investees, rather than repeating the situation which occurred from 1987 onward when investees found themselves with no support — just when they needed it most.

To quote Senator Button: "The MICs faced greater demands from existing investee businesses as well as new businesses at a time when their own funds were dwindling."

With these two changes — no clawbacks and contributing shares — MICs could have offered \$1 shares, paid initially to 50c, with a 25c tax deduction in the year of subscription, representing an effective deduction rate of 50 per cent. This is perhaps so attractive that the deduction could be halved, to 12.5c of the initial 50c subscribed, to give an effective rate of 25 per cent, the same as that implied in the MIC scheme. The annual capital allocation ceiling for the scheme now rises to \$320 million — compared with \$40 million for the "real" scheme. The revenue give-up is still the same, \$20 million. Oh, the opportunity lost.

Now here we are in 1991, facing the same capital availability problem. This time it is called a development capital gap rather than a venture capital gap. We are in fact talking about a high-fliers gap (but not yet talking enough about the buyout-financing gap). Can we learn from the MIC scheme? Can we adapt it to today's requirements? What could a

DCS (Development Capital Scheme) look like?

First, to provide an incentive for institutions and all other investors, a bounty is proposed. Tax deductions are sensibly out of favour as incentives nowadays. A bounty is much more straightforward and honest. To maximise its value, it would be included in the investment base for capital gains tax purposes. Because of the use of tax deductions, capital-raising for the MIC scheme was feasible only at the end of the financial year. To a large degree all licensees were trying to raise funds and then to invest at the same time. Under a bounty, raisings could occur at any time.

The federal government will provide a bounty of \$40 million a year for five years, \$200 million in all. The bounty is a similar amount in real terms to that provided in the MIC scheme. Annual capital allocations of \$400 million will be available to DCFs (Development Capital Funds) on a competitive basis, open to all. The preferred or generally accepted capital structure, subject to DCF variations, would be \$1 shares paid to 50c: 40c from subscribers and 10c bounty from the government. The remaining 50c would be called up at a rate of 10c a year in years 2 to 6.

Thus \$2 billion of development capital funds would be raised over 10 years as shown in Table 1.

The "leverage" for government is 10: a \$200 million bounty generates \$2 billion of development capital over 10 years, most in the earlier years. The schedule of capital raisings is reasonably well spread. The opportunity exists to offer bounty to the most experienced development capital groups in year one and the most successful groups in subsequent years.

Development capital funds could be any of the following:

■ "Captive" institutional funds, in which an institutional investor is the sole shareholder;

■ **“Captive” industrial funds**, in which an industrial company is the sole shareholder. The fund may wish to invest in a variety of high-flier development projects or in related-industry development projects which could represent a “window on technology”;

■ **Investment management team centred funds**, in which investors are drawn to an investment management team with a superior track record and where the desire is for a few large shareholders, most likely institutions but possibly including major industrial corporations;

■ **Listed development capital funds**, in which the investment management team’s track record is the drawback but where it is intended to attract funds from the public and provide a continuous market for investors.

Some suggestions regarding structure are outlined below. The intention is to provide minimal constraints with maximum freedom. Little or no public service input or oversight is recommended. Bounty allocators, for example, should come from the business community — people with credibility but without any conflict of interest.

Constraints, to be minimised:

■ **No dividends or returns of capital** until the last call had been paid or

five years had elapsed, whichever comes first. Thus funds generated from income or investment sales would remain within the portfolio, adding to the development capital pool.

There should be provision for distribution of investee equity securities to fund shareholders, probably at any time but certainly on listing of the investee.

■ **Quarterly public reporting.** This should apply whether the fund is “captive”, with perhaps one shareholder, or listed.

It would be desirable to implement a system for shares in small enterprises to be readily tradeable before listing on a stock exchange. This would be particularly appropriate for a development capital scheme that concentrates on high-fliers which are likely to see listing as the eventual source of significant growth funds. In addition listing will probably be the most desirable exit opportunity.

Advantages of pre-listing trading are (a) provision of a share trading history as an indicator of value, easing IPO valuation; (b) an opportunity for an increasing spread of ownership in the period from initial investment to listing, which should lower underwriting costs; (c) early warning, ie selling pressure, to the investor fund that problems are oc-

curing with the investment, and (d) a means of achieving a certain amount of gains realisation and portfolio adjustment.

■ **Majority Australian ownership.**

■ **Principal investment in Australia.**

■ **Fair and appropriate DCF structure**, ie management team rewards and built-in provisions for DCF investors to replace unsuccessful fund managers.

Scheme freedoms:

■ **No “speed of investment” requirements.** Those on the slow side are not likely to attract new funds, and thus further bounty, until they had demonstrated investment success.

■ **No investment certification.** Investment decisions belong to the DCF management team. Their decisions, their performance, will determine their ability to raise new funds and the level of their rewards.

■ **No direction towards high technology, exports and employment creation.** Successful development capital portfolios will include high technology, exporting and jobs creation — *if* these are the most promising investments. Successful development capital enterprises are the objective, rather than complying with preemptive decisions on what kind of enterprises will be successful. □

UNDERWHELMING PERFORMANCE

By ELIZABETH BRYAN

The MIC program has not met the expectations which were held for it. Few successful new ventures appear to have emerged, some MICs have ceased to exist and others have withdrawn from the scheme. It may be, however, that important lessons and experience have been gained which could benefit Australia in the longer term (such as growing expertise in the assessment of venture capital by providers).

The hope that many junior companies listed on the second board would progress to the main board, and thus be able more easily to raise capital for expansion, has not been realised. Not only this, but the failure of these companies has scared many investors towards growth-company investments. The brokers and professionals who sponsored the rash of second-board listings during the

boom were, in the main, inexperienced in development-capital assessment.

In 1983, the commonwealth government also took action to enhance the role of AIDC in the provision of medium-to-longer term equity capital for new and developing businesses. Since then, AIDC’s equity capital business has expanded significantly, to the point where it has probably been the largest single provider of development capital in Australia: since 1984 about 70 companies have been supported, resulting in total investment by AIDC of nearly \$450 million.

The spectrum of investments made includes small, technology-based companies, the establishment of new industry ventures, medium-sized privately-owned companies requiring development capital to finance growth, and the injection of equity to finance industry ration-

alisations and restructuring. Investments range in size between \$2 million and \$20 million (although some smaller and larger investments have been made).

Events in the Australian economy since 1987 have tended to redirect funds away from development-capital investments and those organisations which have built skills based on such investment opportunities.

Further, the tight monetary policy pursued by the government in 1989 and 1990, which resulted in high interest rates, has made equity investments far less attractive. The recent decline in interest rates has seen a pick-up in the blue-chip end of the equity market but little inter-

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est so far in the higher-risk end associated with development capital.

The real concern is whether this loss of confidence will result in worthwhile development capital prospects (those with appropriate risk/return characteristics) failing to gain funding. The number of such investments may not be large, but the implications for Australia in developing competitive industries may be significant.

The arguments developed by Professor Michael Porter of Harvard University in *The Competitive Advantage of Nations*, about the importance of developing related clusters of competitive export industries which can sustain each other, are relevant.

A further factor associated with this cycle is that if the downturn persists for too long, those organisations which have built up their skills in providing equity capital may find this dissipating. This has important implications for commercialising the small technology developments.

At the same time as the market turned down, the government drew back from policies which were aimed at encouraging the provision of equity capital. For example, it decided to wind back the MIC scheme. It also decided not to provide additional capital to meet AIDC's growing business and instead allowed AIDC to raise new equity capital on the stock exchange. The policy framework for the 1990s therefore is one of relying on the marketplace to provide development capital funds. For the market to successfully do this, three major conditions should be met:

■ The market must be able to assess properly the returns from development capital.

■ The development capital skill-base built up in the 1980s in the finance industry needs to be maintained.

■ Development capital business must provide attractive returns; that is, efforts to commercialise our technologies must start generating a few more successes and less failures.

Given that the recent draft report by the Industry Commission on the availability of capital has supported this policy stance, it is worth examining these issues in a little more depth. Over all, I question whether they will be adequately met over the next few years.

For example, failure of the market to understand the long-term nature of the development capital business will make it increasingly difficult for development capital providers to raise further funds.

The market traditionally assesses public companies in terms of standard accounting performance measures, such as earnings-per-share and annual returns on shareholders' funds and assets employed. These are inappropriate measures of performance for a company providing development capital where returns accrue over a period of time and are discontinuous (that is, returns depend upon periodic divestment of assets, not running yield, and can vary markedly from year to year). The appropriate measure of performance is the internal rate of return over a period of years, rather than consideration of annual accounting returns.

A factor which may well be crucial to the supply of development capital is the effect of recent superannuation initiatives by the government. This will undoubtedly result in the growth of assets under management by the superannuation funds. It is clear that development capital providers will be looking to the superannuation industry to provide needed capital.

However, it will be difficult for development-capital providers to attract institutional funds. The institutions have little history from which to assess the performance of development-capital providers; they see such specialist operations as high-risk and not falling within their normal investment areas.

In addition, the current structure of the superannuation industry in Australia is not suited to risky, long-term, illiquid investments — the fundamental characteristics of most investments associated with technology developments.

The nature of the superannuation industry, in providing for contributors' retirement incomes, is risk-averse — as of course it should be. In addition, the industry puts high priority on investment liquidity. It wants investments readily tradeable on the stock exchange.

Major financial intermediaries, such as banks and institutional investors, do not generally invest directly in the development-capital market. This function is limited to specialist institutions (such as

AIDC). The establishment of such institutions, which have the necessary experience in providing in-house intermediation between business demands and the market availability of funds, is of crucial importance in ensuring that good investment opportunities are not left unfunded because of a lack of abilities to assess risk.

While it is possible that the large institutions may develop this skill themselves for the assessment of major funding projects, it is unlikely that they can do this economically at the smaller end of the market. It is therefore by no means clear that these institutions will be a significant source of funds for development-capital investors.

I have to say that I do not believe that the immediate climate for the development capital business in Australia is particularly propitious. Although some organisations have made good returns from this type of investment, the success rate for the industry has not been exciting.

Whether this is because the learning processes in the development of technology have been slow, or because of the severity of the stockmarket cycle we have been through, or because of structural problems in the Australian economy, is hard to say. However, it seems fairly clear that those who control the major sources of funds for development-capital investment are so far underwhelmed by the sector's performance.

In addition, the focus and structure of the superannuation industry is not receptive to either the risks or the lack of liquidity inherent in development capital.

New approaches may be needed to meet these difficulties. These could include the raising of particular special-purpose funds by development capital institutions to meet specific opportunities.

Above all, it appears that if we rely solely on market forces, we will need more success in commercialising R&D and a better understanding of the nature of the development-capital market.

The research community has a role to play. Research which takes account of market needs and existing commercial expertise will result in greater commercial success and help create a more positive attitude among potential investors. But it is a long-term process. □