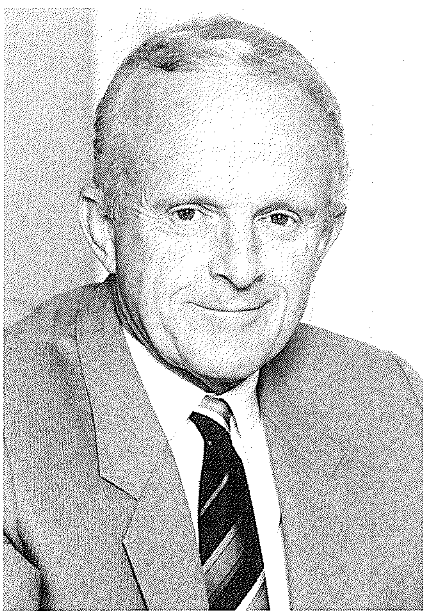
WHERE HAS ALL THE CAPITAL GONE?

A ROLE – AND A PROFIT – FOR INSTITUTIONS



By JOHN BUTTON

Any study of the shortage of development capital leads to questions about the pool of funds in the care of investment institutions. Some of it could prime the pump of progress.

ONE of the concerns of industry expressed most frequently to me as Industry Minister is the failure of the Australian capital market to provide long-term development capital for productive investment. This is not a new issue.

In recent Australian economic history, the Jackson Committee (1975) noted that capital accumulation for companies was a problem. The Campbell Committee (1981) and the Martin Review (1983) inquiries into the banking system both pointed to the difficulties facing Australian firms seeking long-term capital. The Espie Committee (1983) reported that the lack of long-term capital was a major obstacle to viable, new, high-technology enterprises. As a result of the Espie Committee, the Management and Investment Company (MIC) Program was implemented in 1983/84. That program continued until 30 June of this year.

Looking beyond Australia, 60 years ago a committee was established in the UK to consider the question of finance for industry. This committee was chaired by Lord MacMillan and it identified a shortage in the availability of capital to the corporate sector as a serious problem. In fact, the shortage is still referred to as the "MacMillan gap".

What does the data show?

It is difficult to obtain statistical evidence to support the notion that there is a shortage of capital, but there are some useful indicators.

In the first instance, on the supply side we can trace the new capital raisings on the stock exchange over the past decade or so. These show a marked downturn in recent times from a high of $16 billion raised in 1986/87 to an estimated $7 billion in 1990/91.

Another source of capital raisings by companies over the years is debentures—and once again we can see that there has been a very severe drop in recent times; there have been virtually no debentures raised in the past few years.

The difficult situation facing young companies tends to be confirmed by the evidence available through the MIC program. The MICs themselves are, of course, small businesses and they have faced difficulties in raising capital. Capital raisings in 1988/89 dropped to about $16m, down from $41m in 1987/88. In 1989/90 they came back to about $44m and in the most recent year, capital raised amounted to $87m.

However, special factors need to be taken into account in looking at the raisings under the MIC program in 1990/91. First, this is the last year of the program and therefore

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ASX CAPITAL RAISINGS
Year Ending (June 30)

	Equities $m	Debentures $m
1979	919.5	878.4
1980	2211.9	1453.4
1981	4171.0 1	616.4
1982	2269.6	1813.6
1983	2288.2	1386.6
1984	3508.7	372.8
1985	3582.8	550.6
1986	6955.9	158.6
1987	16081.0	1276.0
1988	13395.0	1196.0
1989	10952.0	1059.0
1990	9147.0	0
1991	6597.2	N/A

the last year in which investors could obtain a tax deduction—the MIC program provided one of the few tax deductions still around. Second, the MICs were forced to resort to investment products incorporating guarantee schemes—investments, some would argue, that are not exactly development capital in nature.

Taking the supply side a stage further, we also know that the MICs have narrowed the number of companies in which they are prepared to invest.

In the halcyon days of the scheme, in the mid-1980s, the MICs found themselves as the initial or early-stage investors and they spread their investments across a fairly wide number of companies. They did this in the knowledge that other capital was available for the young firms and that follow-on capital would be found from other sources.

However, following the 1987 stockmarket crash, these other sources tended to dry up, with the result that the MICs faced greater demands from existing investee businesses as well as new businesses at a time when their own funds were dwindling.

On the demand side, the evidence is mostly anecdotal. As I hinted at the outset, a lot more companies are approaching my office and department with alleged problems of capital shortage.

Fallout in the financial sector from the recession is adding a large cyclical component to the normal level of complaints from small to medium-sized businesses about the shallowness of the domestic capital market.

Who do capital-hungry firms turn to?

Traditionally the first port of call for young, capital-hungry companies has been the local, friendly bank manager. Despite their shortcomings, the banks have had a range of mechanisms, mainly overdraft facilities, which have been the backbone of finance for Australian industry.

In the past, the banking system has been the major repository for savings and it has used these savings to provide capital in the form of debt to Australian business. In recent times there has been a diversion of savings from the traditional repositories to new ones, namely superannuation funds. It is a fact that superannuation funds have grown and will continue to grow very rapidly.

Being equity investors, they will play a progressively greater role in all levels of business investment in Australia and overseas.

There is a lot of debate on the figures, but estimates of the amount under management by superannuation funds by the year 2000 range from $1,000 billion down to more recent calculations put together by the life offices and major institutions of $400 billion. No matter which figure we take, there is a substantial increase over the present level, which is in the range of $125 - 180 billion.

Life offices have been the major beneficiaries of the superannuation funds and while trustees of superannuation funds can be expected to look further and wider than life offices in the future, the traditional institutions will still be major managers of super funds.

It is a fact of history that these institutions, while they have invested in the higher-risk area of development capital, have not, in the main, directed this investment to areas which are of major interest to my portfolio.

Recently the life offices' association produced statistics to show that they have total investments in development capital of $2.3 billion.

However, even with a very liberal interpretation, it is probable that only about 10 per cent of this figure would be "classic" development capital for manufacturing and services businesses.

The large financial institutions have also had an opportunity to participate in the venture-capital market through the MIC program which has, until recently, been the core of the venture-capital industry in Australia.

However, based on statistics of the MIC program, we find that less than 15 per cent of the total funds in the program at 30 June 1991, would come from these major institutions.

This contrasts with the situation in the US and the UK. In both of these countries the participation by the financial institutions is much greater than in Australia. In the US, for instance, institutions account for around 60 per cent of the total funds in the venture-capital industry.

These facts suggest that Australian institutions can participate much more heavily in development-capital investment than they have. This low level of involvement is another reason for my continued focus on this area. It must be emphasised that I am not asking institutions to reduce their vigilance and due prudence.

In addition to this, I should emphasise that the government's continued view is that it will not regulate how superannuation funds are invested. These decisions must be left to trustees and fund managers.

Have businesses made themselves attractive to equity investors?

We must also recognise some of the difficulties faced by the finance sector in making equity investments in small and medium- sized companies in manufacturing and services.

First, many of the proposals for financial backing put to us and to the institutions by Australian industry are not well presented: they have unrealistic objectives; at times they do not show satisfactory business ethics; and there is often a decided lack of accounting data and detail.

It should also be recognised that, by and large, the companies that come to government in this way are unlisted. For large institutions, dealing with unlisted companies means increased work in calculating the real net worth of the business. This makes it difficult to determine a starting price and often the price that the founder of the business asks will be over-inflated. Further, in the case of unlisted companies, it is difficult for institutions, particularly superannuation funds, to regularly assess the value of their investment.

I also recognise that it is not easy for institutions which are very large bureaucratic bodies to deal with smaller Australian companies. The quantities of capital required tend to be in smaller lumps than investment institutions prefer.

Nevertheless, we believe that the institutions should be directing more investment into Australian industry. In saying this, I hasten to emphasise that we are not saying that institutions should invest in this area for altruistic reasons.

It should be investing for a very sound commercial reasons. The plain fact is that there are good profits to be made. This is quite clear from US experience in particular, where good statistics and comparative studies with other investments are available.

What are the prospects in the future?

It must be acknowledged that the performance of the development capital industry in Australia is not demonstrably good. However, a number of factors must be taken into account.

In the first instance, it is too early to judge or evaluate the Australian industry. Venture capital by nature is long-term; even with an established industry such as that in the US, you need a life cycle of at least 10 years to judge whether a particular fund has been successful. We must also remember that the Australian industry got under way at a bad time in terms of asset prices: a time of great activity in shares and share markets; the introduction of a second board; generally high and rising asset prices.

The result is that the development-capital managers were continually buying into rising markets. Now it is very difficult for the managers to divest. Further, because they tend to value assets on a conservative basis, the investments that they hold are shown at low book values.

Another factor is that the existing development-capital funds in Australia tend to be first funds. Even in the American experience, first funds have not done as well as subsequent funds.

On the other hand, because asset prices are now much lower than they were, there are many good opportunities for investors who are prepared to take some risk. There is no excuse for not doing due diligence: I certainly would not want to see any lowering of standards. But providing due diligence is done, there are some sound propositions at the moment which would provide the basis of a very good portfolio for somebody who is setting up development-capital funds. These opportunities are available to the superannuation funds.

There is another compelling reason for superannuation funds, in particular, to become involved in investing in development capital. By nature, superannuation funds tends to face contingent liabilities or longer-term liabilities.

They collect money now on which they face payouts in 10, 15 or 20 years. Investments that will mature around the same time as their anticipated payouts are a logical component of balanced portfolios.

Development capital provides the real opportunity for this type of investment because it is, by nature, long-term, patient capital where the money is invested now and is expected to show rewards in 10 or 15 years.

It should be mentioned that TPF&C Asset Consulting Services recently prepared a report on the merits of high-risk capital. They concluded that, subject to the careful choice of managers, large superannuation funds could consider asset allocation of between 1 per cent and 3 per cent, nationally, to high-risk capital, concentrating on development capital over the next two to three years.

Is there a role for government?

Recently, I announced that the government would not take action in the 1991/92 budget to further stimulate the provision of development capital funds for small and medium-sized businesses. This is certainly not to be taken to demonstrate a lack of interest in this area on the part of myself or the government. This decision was taken after a series of consultations that I had with the financial institutions.

To put this in its historical context, the government had earlier proposed a capital development fund to which the major institutions would contribute as a way of providing more investment funds for growing Australian companies. This proposal was extensively canvassed with the institutions earlier this year.

It was widely reported in the media before the government's industry statement of March 12 that the finance industry did not support this particular proposal. However, in many cases the industry agreed that there was a need to increase the availability of development capital. Since that time I have had further discussions with financial institutions about alternative approaches.

Consequently, there are a number of initiatives coming on stream from the private sector. This supports the assertion of the finance industry that there will be adequate funds available through the marketplace for good Australian companies. Although the government is heartened by this response it recognises that it will take time to assess the success of the new initiatives.

I would emphasise that it was always the government's intention that the bulk of development capital should come from the private sector and that the government would never act in more than a catalytic way. This was also the motivation behind the MIC program.

There are now at least the rudiments of a development-capital industry which can supply specialised development-capital managers. Some of these have come from the MIC program and in recent times more specialist funds have entered the field.

I repeat that the government is very concerned to see the further consolidation of a truly private-sector-based development-capital industry. We believe that there is now the basic structure for this. There is a supply of capital available from major institutions, capital which they could invest without in any way lessening their standards of due diligence, and there is a group of specialist development-capital funds to manage this capital.

With these basic building blocks in place, the government has decided to monitor the market development over the medium term and hopes that further intervention will be unnecessary. □