Capital misadventure

Why going-it-alone is holding back Australian investment

BRENDAN SHAW examines issues in the development of the Australian venture capital industry, drawing on interviews with venture capitalists, superannuation fund managers, asset consultants, industry analysts and government officials.

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The Australian venture capital industry has undergone a resurgence after a sluggish period through the early 1990s. The 2000 *Australian Venture Capital Guide* reports that the Australian venture capital market, broadly defined, comprises 102 venture capital firms with total funds of about $5.5 billion. While growing in size, the industry is also becoming more sophisticated. Some Australian venture capital firms have specialised in particular industries such as information technology, health and wine, in particular stages of venture capital, with the growth of management buy-out funds being an example, and in particular regions, as in the case of some of the state-based funds.

Other trends such as the growth of venture capital "funds of funds" — intermediaries who manage funds between institutional investors and venture capitalists — the emergence of industry standards on issues such as management fees, and the formation of alliances between Australian and overseas firms all suggest the continuing development of the Australian venture capital industry. However, these trends are merely beginning to appear, suggesting that the Australian industry is at an embryonic stage. The Australian government's recent publication *Australian Science and Technology at a Glance 2000* confirms that Australia has a relatively small venture capital market compared with many other industrialised countries, particularly in early-stage financing, even after adjusting for the sizes of those economies.

A problem for the Australian industry is that collaboration between venture capital firms is largely non-existent. In Australia, strategies such as networking and co-investment are the exception, with the mainstream culture of the industry still individualist, compared with more developed venture capital markets such as the United States.

This reluctance to form investment alliances reflects a mindset in the Australian industry. It limits investment opportunities and potential returns for entrepreneurs, investors and venture capitalists themselves. Joint investments between a number of venture capital firms, or co-investments, enable venture capital firms to spread investment risk, facilitate information-sharing and allow investment syndicates to draw on the strengths of different venture capital firms in managing different aspects of an investment. Collaboration among venture capital firms is widespread in the US and is a major factor in the success of the industry there.

Another key reason for the growth and success of the US venture capital market is that collaborative activity extends beyond the venture capital industry to strong linkages with outside supporting industries and institutions.

Venture capital operates best as a system of interaction between key players, including the venture capital firms themselves, small technology firms, institutional investors — particularly superannuation funds — asset consultants, technology analysts, industry associations, accountants, lawyers, small business advisers, universities and government. In the US, technology firms are supported by various players, thereby increasing their investment readiness, and pension funds actively nurture new venture capital firms. Without this support system, or "cluster", venture capital becomes a hit-and-miss operation where entrepreneurs try to find venture finance in isolation, venture capital firms attempt to develop experience alone, and superannuation funds lack the information and confidence to invest in a potentially lucrative, high-growth sector.

This type of collaboration or coordination between players inside and outside the venture capital industry is absent in Australia, or weak at best. While all the potential players are present, none is prepared or able to initiate the approach in an environment characterised by inexperience. Trustees and asset consultants in the superannuation industry argue that the lack of a venture capital track record in Australia deters them from advising funds to diversify into venture capital.

The irony is that Australian venture capitalists find it difficult to demonstrate good returns to investors because they have not received sufficient initial funding from those investors. Some economists call this coordination failure, where potentially viable investments do not proceed because no economic player, in this case superannuation funds, is prepared to initiate an expensive investment in the absence of information, experience and trust.

The result has been that Australia's superannuation fund investment in venture capital has been significantly below that of the US, and more conservative in nature. Australian superannuation funds are estimated to invest about 1% to 2% of their assets in "private equity", which includes venture capital, the bulk of which is lower-risk, later-stage operations, and other non-venture capital investments such as infrastructure projects. In contrast, US pension funds typically invest 4% to 5% of assets in private equity, a far larger share of which is early-stage venture capital investments. Overcoming the lack of an Australian venture capital track record and educating Australian superannuation funds are crucial steps in encouraging innovation and developing profitable firms yielding high returns.

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In Australia the lack of information on venture capital is compounded by attitudes in the superannuation industry which inhibit superannuation investment in venture capital. One interviewee in the superannuation industry commented on the role of "group think" which colours superannuation funds' perceptions of venture capital: "A lot of people are focusing more on short-term performance or on not looking too different from everybody else. While not many funds hold investments in venture capital, then that's almost like an impediment stopping other people getting into it, because they say, 'If I go into that I'll be quite different'."

Another interviewee in the superannuation industry noted the presence of "reputation risk", where trustees and asset consultants avoid endorsing investment strategies that may be regarded by their peers as too unconventional. Many superannuation funds are unwilling to expose themselves to venture capital unless other superannuation funds have already become involved and some asset consultants are reluctant to recommend such investments for fear of damaging their reputation.

Another reason Australian institutional investors have not become as involved in venture capital as their US counterparts is that the Australian investment community is not technologically literate. Investors have not been comfortable buying into technology because they do not fully appreciate its potential opportunities. One venture capitalist noted: "There is not a deep set of analysts here who understand technology companies. The investment banks haven't taken the time to train their people up so that they can follow the [technology] stocks and then make a market in the stock and disseminate that intelligent information out to the brokerage community."

The superannuation industry is divided about the benefits of investing in venture capital. Some trustees and asset consultants argue that the returns are unproven, that the risks are too high and that there is not enough data to evaluate investments. Other funds invest in venture capital because they do earn good returns from those investments.

Industry funds tend to be the leaders in venture capital investments, probably because they are younger and have a broader agenda, partly influenced by their union association. Public-sector funds also appear have a greater commitment to venture capital. Corporate funds have tended to be more cautious in their approach, preferring to steer clear of venture capital investment.

The reason for differences in funds' attitudes to venture capital may lie in their past experiences. One superannuation industry interviewee suggested that the managers of corporate funds may be excessively wary of higher-risk investments, having been through the excesses and failures of the "boom-bust" investment cycles of the 1980s. Industry and public-sector funds tend to be more ready to invest in venture capital because they are not as conservative as corporate funds.

Trustees and asset consultants predisposed to venture capital investments take the time to investigate the asset class, which further reinforces their decisions. Others, wary of such investments, have been less likely to devote time and resources to developing expertise in venture capital, thereby perpetuating an aversion to these investments.

The future of the Australian venture capital industry rests on overcoming the coordination failure between venture capitalists and institutional investors. There is a widespread view that the ball is now in the industry's own court. It needs to demonstrate good returns, generate success stories and prove to the sceptics that Australian venture capital is viable. The success of the high-profile Internet company LookSmart is an illustration of how collaboration can lead to success. LookSmart grew from humble beginnings in Melbourne, backed by a syndicate of Australian venture capitalists, to become a major worldwide company earning substantial capital gains for its developers.

Venture capitalists themselves need to start thinking as an "industry". Historically they have operated individually, rather than cooperating with each other on issues such as risk diversification and tapping into specialist expertise. Management theorists have identified this cooperation in the development of industry "clusters". As Professor Michael Porter of the Harvard Business School said in his book *On Competition*: "Clusters are geographic concentrations of interconnected companies, specialised suppliers, service providers, firms in related industries, and associated institutions (for example, universities, standards agencies, and trade associations) in particular fields that compete but also cooperate." Porter has shown that the formation of such clusters has been crucial to the successful development of industries in other countries, such as Silicon Valley in the US or the textile and clothing industries of northern Italy.

A similar process in the US venture capital market has been important to the continuing success of American venture capital. This type of venture capital cluster, where firms and institutions support each other, does not exist in Australia, despite some tentative steps such as a number of co-investments and the development of the Australian Venture Capital Association (AVCAL). Australia still has a long way to go if it is to approach the type of linkages and interaction flagged by Porter and present in the US venture capital industry.

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Using AVCAL to publicise the industry — for example, through its recent work on developing detailed data on Australian venture capital — will help to encourage institutional investors to develop an understanding of the sector. The fact that some superannuation funds are earning good returns from venture capital investments suggests improved information can help change attitudes.

Another industry issue is the need for standardised management agreement documentation between venture capital firms and superannuation funds. At present each venture capital firm has its own individual documentation in terms of layout, terminology and formulae. This increases the transaction costs of superannuation fund investment in venture capital. "Such a waste of time and money benefits only lawyers," said one superannuation fund manager.

The success of venture capital in Australia depends significantly on the role of the superannuation industry. Trustees, fund managers and asset consultants should strive to become experts in venture capital and technology investments. The US experience suggest that superannuation funds and their members have the potential to generate substantial returns if they invest more in venture capital, develop their understanding of this asset class and nurture the development of venture capital firms. This is not to disregard the risk profile of venture capital. Rather, the development of more technologically-literate investment analysts, as exist in the US, will help superannuation funds invest in venture capital with greater certainty.

Federal government policy also has a role. The recently revamped Pooled Development Funds scheme, which provides tax incentives for venture capital investments, may finally start making an impact on the industry. The Innovation Investment Funds scheme, which creates joint public and private-sector venture capital investment funds, is highly regarded by the industry. However, several areas of policy need further consideration. Programs to increase investor knowledge of venture capital, such as the new Venture Awareness program, can make a significant contribution if structured correctly. The investment readiness of small business in Australia is also an important issue and developing a supportive venture capital cluster can assist in this, but whether government schemes can help in this area remains to be seen.

A key policy issue is the potential for the proposed "choice of fund" and "choice of investment" superannuation reforms to compromise the growth of Australian venture capital. Designed to give individual consumers more control and choice over their superannuation, these proposals could lead to a restriction of the supply of long-term investment funds. As funds compete to attract and retain members, their focus will shift to short-term investments, leaving less money for longer-term investments such as venture capital. J