Deloitte Touche Tohmatsu

Australian Venture Capital Association

Submission to the Review of Business Taxation

A V C A L

16 April 1999

The Secretary
Review of Business Taxation
Department of Treasury
Parkes Place
CANBERRA ACT 2600

Via email: rbt@treasury.gov.au

Dear Sir/Madam

AVCAL and Deloitte Touche Tohmatsu are pleased to make this fresh submission. We believe that an exciting opportunity exists for Australia to significantly stimulate its venture capital markets. This can be achieved by a change in the taxation of capital gains to mirror the experience in countries such as the USA and the United Kingdom. Such a re-alignment will establish an internationally competitive structure for the Australian venture capital sector and remove the current roadblocks to the supply of venture capital from overseas.

This represents an immediate opportunity to stimulate new technology development, jobs growth and new industries expansion. In short, it represents an important opportunity to accelerate the businesses, which are and will be fundamental to the competitiveness of our nation.

We therefore urge you to carefully consider our simple and effective recommendations.

Yours sincerely

…………………………………
W D Ferris AO
Chairman Taxation Committee
Australian Venture Capital Association

…………………………………..
Rick Taylor
Partner – Deloitte Tax Services
Deloitte Touche Tohmatsu

*For further information please contact Deloitte Touche Tohmatsu

INDEX

1: EXECUTIVE SUMMARY

Your "over-arching objective is an internationally competitive economy providing optimum economic growth, encouraging savings and investment to provide employment for Australians".

Given this objective, the Australian Venture Capital Association Limited ("AVCAL") is of the firm opinion that Australia is missing out on billions of dollars of venture capital and the huge economic and social benefits that flow from a thriving venture capital industry. The amount of venture capital in Australia is $1.7 billion[1] and should easily double if the tax changes suggested herein are implemented.

Further, AVCAL considers that it would be a simple matter to sweep aside the roadblocks currently preventing the massive inflow of venture capital from overseas and that this can be done with only positive effects for the tax revenue. Without this capital, the growth of many otherwise viable and vigorous Australian businesses will be stunted and others will be forced to move overseas.

In paragraphs 11.12 to 11.25 of your last report, you have asked for submissions to show the importance of a country's tax regime in the attraction of mobile international capital. You have also stressed the importance of obtaining a balance between the encouragement of investment and attracting capital into Australia on the one hand, and the collection of an appropriate amount of revenue on the other. This paper:

- Sets out the simple tax changes needed to remove the present blockages of international supply;
- Provides objective data to demonstrate the extra venture capital that is likely to come to Australia (in response to your invitation at paragraph 11.24 of the discussion papers); and
- Provides actual examples of how venture capital helps the economy and employment in Australia.

[1] Arthur Anderson/Australian Venture Capital Association (AVCAL) 1998 Survey of Venture Capital - www.avcal.com.au/anderson98print.htm.

2: SUMMARY OF TAXATION CHANGES

The tax changes that should be made to encourage venture capital in Australia can be summarised as follows:

A. Exempt from Australian tax the income and gains made by non-resident investors in Approved Venture Capital Trusts ("AVCT") and also exempt gains made on disposal of an interest in an AVCT (discussed in detail below).

B. Maintain the tax flow through status of venture capital trusts.

C. Provide capital gains tax roll over for scrip-based mergers.

2.1 APPROVED VENTURE CAPITAL TRUSTS ("AVCTs")

AVCAL believes that venture capital trusts that meet certain criteria should be registered as AVCTs and exempted from Australian tax. The subsequent sections of this submission discuss the reasons why such an exemption should be granted. This section details our proposed mechanics for exemption.

An industry regulator such as the IR&D board or the ATO would register venture capital trusts as AVCTs if they meet certain criteria. Having stated this we note that the restrictions on which venture capital trusts can be registered should be as broad as possible in order to ensure that the same problems as were experienced with the pooled development fund approach (a good idea but too limited in its application) are not repeated.

AVCAL would be happy to work with the appropriate regulator to refine the required criteria. However, as a starting point we would suggest that the requirements to be treated as an AVCT be that:

- not less than 75% of funds contributed by non-residents are directly or indirectly provided by a provident, benefit, pension, superannuation or retirement fund;
- investments should be limited to non-listed securities;
- no direct investment to be made in land or real estate development entities; and
- the trust manager should be a member of the appropriate professional body - AVCAL (AVCAL imposes a minimum standard of professionalism on all members).

The actual changes to the Income Tax Assessment Act would be relatively simple and easy to administer as they result directly from a venture capital trust being registered as an AVCT. The specific legislative additions would be:

995-1 **approved venture capital trust** is a unit trust registered as such by the (*appropriate government body*).

23(jba) the income of a non-resident, being income that consisted of distributions from an *approved venture capital trust.

136-17 You do not make a *capital gain or *capital loss if the *CGT asset is:
(a) units in an *approved venture capital trust; or
(b) an asset of an *approved venture capital trust.

We note that the recommended changes to the legislation have been simplified from those provided as part of our original submission dated 22 December 1998. AVCAL believes that the above approach has the same substance as before. The new recommendations recognise that offshore venture capital suppliers often invest via pooled limited liability partnerships and corporate structures.

3: INCREMENTAL FUNDS INTO AUSTRALIA

Mr Kevin Delbridge, manager of HabourVest Partners LLC, one of the largest US venture capital fund, stated that "Australia is the only country around the world where we would like to invest but **because of your current tax status we cannot invest**".

This attitude to Australian CGT is representative of virtually all of the offshore venture capital suppliers. In response to your request for further evidence in this regard, a survey was conducted in April 1999 by Deloitte Touche Tohmatsu of a sample of 32 UK and US venture capitalists.

The results of the survey were:

- **None** of the funds will invest in Australia if they have to pay Australian CGT; and

- If the CGT were removed between **$0.6 - 1.9 billion** would be available from eight of these venture capitalists.

Please note that there are over 1,300 venture capitalists in the US alone. The survey covered a small sample of these and hence the amount that is potentially available for Australia is likely to be significantly higher than the amount mentioned.

Another indicator of the amount of venture capital that will flow into Australia can be obtained by looking at the UK experience. In the UK there is no CGT on US and most other foreign pension funds and as a result 57%[2] of venture capital in the UK comes from foreign investors. The amount of foreign venture capital in Australia was 12%[3] in 1998 (note 0% from the US). If the UK experience is mirrored in Australia, then by extrapolation, **$1.8 billion** of additional foreign funds will potentially flow into Australia. As demonstrated by the Deloitte survey, minimal overseas funds will be invested in Australia if these investors have to pay Australian CGT.

In addition, Venture capital markets around the world are expanding at a very rapid rate (the US market has doubled in the last 30 months[4]) so by the time that any changes are introduced

---

[2] British Venture Capital Association Survey (BVCA) of 1998 www.bvca.co.uk/BVCA/UKStats.html..
[3] Arthur Anderson/Australian Venture Capital Association (AVCAL) 1998 Survey of Venture Capital – www.avcal.com.au/anderson98print.htm.
[4] *Pratt's* Guide to Venture Capital Sources (1998 ed), Securities Data Publishing: New York; National Venture Capital Association Survey www.nvca.com

the above figures will have "gone through the roof". For example, the expected inflow of US funds could be expected to grow to as high as **$4 billion** by July 2001.

In light of this analysis, the $0.6 - 1.9 billion inflow predicted by the Deloitte survey may be considered a conservative figure.

Our taxation laws have inhibited any of these funds coming into Australia and therefore we have a relatively immature venture capital market. This has contributed to the disproportionately large number of Australian companies whose growth has been stunted because of a lack of venture capital.

It should be emphasised at this stage that the new funds that would be attracted to Australia would be additional funds for investment and would not replace existing funds. This is an important feature of this submission.

4: THE BENEFITS OF VENTURE CAPITAL

4.1 GROWTH, JOBS AND MORE TAX

Venture capital leads to significant economic growth, innovation, job creation and ultimately has a positive effect on tax revenues. This is illustrated by a survey conducted by Coopers & Lybrand[5]. In the four years to 1996 Australian venture capital backed companies performed significantly better than the top 100 Australian companies, as follows.

	Growth By VC Companies	Growth By Top 100 Companies
Staff levels	**20%**	**2%**
Sales	**42%**	**6%**
Profits	**59%**	**7%**
Exports	**27%**	**-**

The effect of venture capital on enterprises is the same worldwide. For example, the British Venture Capital Association survey of the results of venture capital based companies over the four years to 1998[6] showed the following growth results.

	Growth By VC Companies	Growth By National Average
Staff levels	**24%**	**1%**
Sales	**40%**	**20%**
Profits	**24%**	**-**
Exports	**44%**	**8%**
Investment	**34%**	**7%**

[5] The Economic Impact of Venture Capital, Coopers & Lybrand Policy and Economics Survey 1997 – www.avcal.com.au/coopersprint.htm.
[6] British Venture Capital Association Survey (BVCA) of 1998 – www.bvca.co.uk/BVCA/UKStats.html.

Other results of the Coopers & Lybrand survey included:

- **40%** of companies surveyed indicated that they would not currently exist if it was not for the funding provided by their venture capitalist; while

- a further **47%** stated that they would have developed slower without venture capital.

We believe that the considerable growth shown by such companies demonstrates that venture capital investment promotes expansion across a range of areas, including incremental growth in respect of profits, expertise, sales and staff levels. This growth along with the resultant growth in the companies' suppliers results in additional tax revenue.

4.2 THE NON FINANCIAL BENEFITS OF VENTURE CAPITAL

Venture capitalists are not passive portfolio investors. They operate as business partners providing management advice and assistance in many ways. By encouraging UK and US venture capital to flow to Australia there will also be a very important transfer of knowledge and experience to Australian companies and the local venture capital managers.

Dr Jeffry A Timmons and Dr Harry J Sapienza[7] interviewed more than 40 entrepreneurs and venture capitalists and surveyed the CEO and the lead investor in 51 venture backed US companies. The results consistently showed that the entrepreneurs valued the non-financial services of their venture capitalist as being even more important than the venture capitalist's contribution as a financier.

The following ratings out of five were given:

- sounding board 4.4

- business consultant 4.3

- financier 3.7

Venture capitalists specialise in making small companies big. It is what they do day after day after day. An entrepreneurial company only has to grow once. Its management will typically include people who are skilled in the day to day aspects of running the business. However, it is normal that management does not have the experience of growing a business from nothing all the way to the stage where it may justify a public listing.

[7] Timmons, J & Sapienza H, *Venture Capital More Than Money*, in *Pratt's* Guide to Venture Capital Sources (1998 ed), Securities Data Publishing: New York.

The introduction of foreign venture capital into Australia will be accompanied by the migration of small business expansion know how, due diligence capability, and increased market and technology intelligence and access.

Current Australian venture capital backed companies recognise the non-financial support provided by their venture capitalists[8]:

- **65%** companies credited their venture capitalist with contributing to their performance by acting as a sounding board for ideas
- **58%** advising on corporate strategy and direction;
- **48%** providing financial advice; and
- **40%** by challenging the status quo or providing another option.

4.3 SOME AUSTRALIAN SUCCESS STORIES

Everybody knows of the success stories that have arisen from the US venture capital industry. Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel and Microsoft are a few of the venture capital backed companies that have gone on to be household names.

While Australia has yet to produce a success story of this magnitude (possibly partly due to the lack of significant foreign venture capital) there are $1.7 billion of locally generated funds which have been invested in Australian venture capital backed companies and those funds have produced a lot of Australian success stories.

Below are just three examples of how venture capital has assisted in the growth and prosperity of small Australian enterprises. Further examples can be provided if required.

Energy Development Limited ("EDL") received its first round of venture capital in 1991 when it owned a single 16MW power station just north of Alice Springs. EDL is now listed on the ASX with a market capitalisation of $300M and owns 24 power plants with 262MW of total generating capacity. EDL is currently on the path towards strong international expansion.

[8] The Economic Impact of Venture Capital, Coopers & Lybrand Policy and Economics Survey 1997– www.avcal.com.au/coopersprint.htm.

Austal Ships Limited ("Austal") received $15M of venture capital in 1994 when it had sales of $40M and only one product line (a 40m fast ferry). Since 1994 sales have increased to $183M and it now produces a range of ferries, customs patrol vessels and other ships as required. Austal now employees 1100 people as compared to 180 back in 1993 and is listed on the ASX with a market capitalisation of approximately $250M and after tax profits in excess of $20M pa.

The IMAX cinema venture began with seed capital. The founding entrepreneur invested his own money establishing the IMAX concept before obtaining $20M in expansion capital in October 1996 from an Australian venture fund. Since then the IMAX brand has gained strong recognition and has raised another $31M from a public float. It is currently intended that additional cinemas be opened in Melbourne, Adelaide, Brisbane and Auckland.

4.4 THE ONES THAT GOT AWAY

Unfortunately, not all of the success stories involving small Australian companies and seed capital result in increased profits and jobs in Australia. Due to a lack of funds in Australia, several small Australian companies have been forced to migrate offshore to grow. The loss to Australia in terms of intellectual property, profits and jobs is significant.

Two examples are discussed below.

Hypercom Corporation, now listed on the New York Stock Exchange with a market capitalisation in excess of $300 million, was unable to secure Australian venture capital in the early 1990's and moved offshore.

Hypercom is a worldwide developer, manufacturer and supplier of high performance, comprehensive point-of-sale payment systems and sophisticated enterprise networking products. Annual revenues are now approximately $400 million.

ResMed a healthcare group, which as a small company was based in Sydney, made the Forbes 200 leading small companies in the US in 1997. ResMed, which specialises in the development, manufacture and marketing of medical equipment to assist people with sleep disorders, is listed on the New York Stock Exchange's NASDAQ index.

ResMed was successful in obtaining a limited amount of venture capital support in Australia; however, it found it necessary to move to the US to access the venture capital and IPO markets for its subsequent expansion.

A more fully funded and mature domestic venture capital market can be expected to dramatically reduce the regularity of this experience.

5: RECOMMENDED EXEMPTION

5.1 WHAT WILL BE THE TAX COST TO AUSTRALIA?

AVCAL's opinion is that there will be no tax cost to Australia if the proposed tax reform is implemented. As the US and UK funds have not and will not come to Australia given the present CGT incidence, the economic growth desired and the subsequent capital gains are not happening. Accordingly, no existing tax revenue would be forgone as a result of the proposed changes.

In addition, any potential loss of CGT receipts occurs in the future and only after a company has been successful. In the meantime, the tax revenue will be boosted significantly as a consequence of the increased income earned by venture capital backed companies and from taxes on the salary and wages of their employees.

In 1996 venture capital backed companies in Australia contributed $129M[9] in tax to the revenue and this does not include the tax paid on the salaries taken home by the employees of these firms or tax paid from the suppliers or customers of these businesses.

This conclusion is supported by the findings of the US Senate Joint Economic Committee[10] who refer to historic evidence "*that capital gains tax reductions tend to increase tax revenue. When capital gains tax rates were lowered in 1978 and again in 1981, revenue climbed steadily. Conversely, when the tax rate was increased in 1987, revenue began declining despite forecasters predictions it would increase*".

---

[9] The Economic Impact of Venture Capital, Coopers & Lybrand Policy and Economics Survey 1997– www.avcal.com.au/coopersprint.htm.

[10] Saxton, J, (1997), *The Economic Effects of Capital Gains Taxation,* Joint Economic Committee Study.

In summary, we again note that as venture capital is not being invested into Australia, there is no tax revenue being forgone as a result of granting a CGT exemption.

5.2 SHOULD A NIL OR SMALL CGT RATE BE APPLIED

The US, the UK and the vast majority of other countries do not tax non-resident investors who earn capital gains on the sale of their venture capital investment. If Australia wishes to be internationally competitive in the venture capital market, it must also allow these gains to be tax-free. We note that Australian superannuation funds, which invest into the US venture capital market, are not subject to US capital gains tax on their profits.

For example, if the US was to adopt the Australian taxation system, then Australian superannuation funds would be subject to a 36% tax in the US and could only utilise a 15% foreign tax credit in respect of this amount. To provide an after tax return of similar value the US investment would have to be a third again as good as a local investment. This is unlikely and Australian super funds would not invest in the US if this were so.

We note that as the US has a more developed taxation system than Australia, our super funds are investing into the US economy. While this benefits our super funds it also benefits the US economy. The Australian economy should be allowed to participate in these benefits by having a level playing field. The tragedy is that it is the Australian Government that has unwittingly tilted that field against the Australian economy.

US pension funds are tax exempt. Hence, the effect of a 36% Australian capital gains tax is to only make it worthwhile for these funds to invest in Australian companies that will outperform their international counterparts by an additional 56%. A reduced Australian tax rate would reduce this effect (15% rate would require an additional return of 18%) but until it is reduced to nil, Australian entrepreneurial companies will be competing at a disadvantage.

Based on AVCAL members' own extensive discussions with offshore pension funds and confirmed by the recent Deloitte survey, we do not believe any of the exempt offshore funds will invest in Australian venture capital trusts until their exposure to CGT is nil.

5.3 AUSTRALIAN INVESTORS ARE NOT DISADVANTAGED

Australia currently has 37 double tax treaties with countries around the world. The basic philosophy of these treaties is to establish which jurisdiction should have priority to tax entities of one jurisdiction, which derive income from activities in the other. In short, the treaties decide whether the income should be taxed in the jurisdiction of the entity or the jurisdiction of the activity.

The exemption proposed in this submission would bring Australia into line with the rest of the world, which does not impose tax on the income of venture capitalists in the jurisdiction of the activity. Australian super funds pay 0% in the US – US pension funds should pay 0% in Australia.

Australia (and the rest of the world) currently tax super funds in their own jurisdiction. An Australian super fund investing into the US is only taxed in Australia at the appropriate Australian maximum nominal rate – 15% (typically 7-8% or less is paid). Likewise, a US or UK super fund investing into Australia should only be taxed in the US or UK at their appropriate local rate.

Furthermore, we have demonstrated in section 3 above that our changes will stimulate incremental funds and investment into the Australian economy without displacement of the local investors. That is, the proposed changes will not adversely effect existing Australian venture capitalists. In fact, the arrival of experienced offshore investors should educate and encourage heretofore reluctant Australian investors to allocate more venture capital funds.

5.4 SHOULD THE TAX CHANGES ENCOURAGE ALL STAGES OF THE VENTURE CAPITAL PROCESS?

Venture capital can assist small companies to grow into large companies. This assistance is required at all stages of the development of the companies, starting with seed capital, moving into expansion capital and pre IPO ("initial public offering") funding. Venture capital provision for Management Buyouts ("MBO"), Management Buyins ("MBI") must also be included at all three stages of growth.

Any development of just one of these stages will result in a bottleneck in the creation of dynamic large companies and will negate the benefits achieved or achievable at other stages. For example, the benefits of a strong seed capital environment will be lost if those companies can not access adequate expansion capital or need to go offshore to find such capital.

Having noted this, AVCAL does realise that as seed capital represents the highest risk investment for venture capitalists this sector typically struggles for funds as compared to other stages. Hence, the Government initiatives, such as the Innovation Investment Fund program, are to be applauded. However, unless the entire Australian venture capital industry is strengthened the benefits that result from this program will be much less than they should be.

A comparison of the percentage of funds committed to seed capital by the venture capitalists in the US, UK and Australia shows the following:

- US (mature venture capital market) 26%[11]
- UK (maturing market) 15%[12]
- Australia (immature market) 9%[13]

Another statistic demonstrating the relative immaturity of the Australian venture capital market is the average age of venture capital backed companies – 9 years in Australia versus 4.5 years in the US[14].

This confirms AVCAL's view that as the Australian venture capital industry matures with greater funds under management, so too will the availability of seed capital expand as demonstrated in the US and UK.

[11] *Pratt's* Guide to Venture Capital Sources (1998 ed), Securities Data Publishing: New York.
[12] British Venture Capital Association Survey (BVCA) of 1998 – www.bvca.co.uk/BVCA/UKStats.html..
[13] The PricewaterhouseCoopers Economic Impact of Venture Capital Survey, 1998
[14] The Economic Impact of Venture Capital, Coopers & Lybrand Policy and Economics Survey 1997 – www.avcal.com.au/coopersprint.htm.

6: TREATING VENTURE CAPITAL TRUSTS AS FLOW THROUGHS

6.1 INTERNATIONALLY ACCEPTED METHOD

The venture capital industry worldwide flourishes by using “flow through” taxation structures. This has proven to be the most efficient way of facilitating the flow of patient risk capital from nil and low tax paying savings pools (super and pension funds) into portfolios of smaller high growth companies.

The legal form of these flow through entities varies around the world. Some of the more commonly used flow through vehicles are the limited liability partnership (“LLPs” - used in both Europe and the US) and the limited liability company (used by US investors). Australian law allows for LLPs to be created here but as they are not taxed as flow through vehicles they are not widely used. Instead Australian venture capital is typically invested via a unit trust structure.

The arguments as to why Australia should not impose a tax on foreign venture capitalists investing into Australia were discussed above. If venture capital trusts are taxed as companies then in order to avoid Australian taxation (and hence alienation) of these investors it would be necessary to also exempt the income of the venture capital trust.

The provisions to implement this would be fairly simple, as the major issue would be registration as an AVCT. However, it seems an artificial approach to tax the trust as a company and then to provide additional exemptions to produce the flow through effect for foreign investors.

6.2 VENTURE CAPITAL TRUSTS SHOULD NOT BE TAXED AS COMPANIES

In your discussion paper at 16.16, you define a widely held trust as being one whose units are held by 50 or more persons. You do not make it clear if the 50 or more people need to hold the units directly or whether they could hold those units via another widely held, look through vehicle. While venture capital trusts typically have less than 50 different investors, those investors are typically widely held Australian pension and super funds.

If these trusts are taxed as companies, there will be less venture capital available in Australia. In other words the Australian pension and super funds will be discouraged from investing in venture capital trusts because of the cash flow disadvantages and greater administration cost.

This will disadvantage the fledging venture capital industry we have created and will certainly be inconsistent with your over-arching objective, namely to provide international competitive taxation reform.

7: SCRIP FOR SCRIP ROLL OVER RELIEF

You have raised the possibility of scrip for scrip roll over relief in your discussion paper at 11.46 – 11.50. AVCAL agrees with the argument that the lack of scrip for scrip roll over relief is severely hampering the merger of economically compatible entities.

One example, of the problems caused by the lack of a scrip for scrip roll over is the recent sale of the previously venture capital backed Ozemail to America Online in exchange for cash. It had been the preference for the owners of Ozemail to merge with the Australian listed company AAPT by way of scrip for scrip exchange. This would have left the company resident in Australia and greatly strengthened AAPT in the process. However, the Ozemail vendors could not accept the straight scrip for scrip transaction as proposed by AAPT, as they required funds with which to pay the CGT liability that would have arisen upon the scrip for scrip transfer. The vendors accepted the all cash alternative and Ozemail is now 100% foreign owned.

AVCAL is strongly of the opinion that scrip for scrip roll over should be made available in respect of scrip for scrip issues of both private and public companies. Scrip for scrip mergers occur frequently between compatible venture capital backed private companies in order to create an entity with sufficient economies of scale and of sufficient size to be listed. Despite the fact that the merged businesses are owned by their previous shareholders there is a capital gains event for half of these shareholders. The incidence of the capital gains tax on an unrealised gain and its application to only some of the shareholders are two wrongs which scrip for scrip roll over relief would remedy.

In Canada, roll over relief is available, where a Canadian corporation purchases shares of another corporation from an arm's length vendor and in exchange, issues shares of its own to the vendor and no other consideration is received.

In the UK, where a shareholder receives new shares in exchange for existing shares as a result of a "scheme of reconstruction or amalgamation", the shareholders are not treated as disposing of their shares for capital gains tax purposes, and the new shares are treated as the same assets as the original shares. This includes the issuing of shares by company A to the shareholders of company B in exchange for their shares in company B, provided company A acquires at least 25% of company B as a result. If shares are exchanged partially for other shares and partially for cash, a proportionate CGT disposal occurs to the extent of the cash element.

An anti-avoidance provision requires that such a scheme must be effected for bona fide commercial reasons and must not form part of a scheme for the avoidance of capital gains tax or corporation tax.

US law allows for certain transactions defined as “tax free reorganisations” to be effected without gain or loss. In general, a stock for stock exchange or a “B reorganisation” is the acquisition by one corporation of stock of another corporation, in exchange solely for its own or its parent’s voting stock. No gain or loss will result from a B reorganisation if immediately after the acquisition, the acquiring corporation has control of the other (whether or not it had control before the acquisition).

These measures avoid the “lock-in effect” where capital fails to be re-allocated efficiently because vendors prefer not to be exposed to CGT, on unrealised gains. This lock-in effect is probably significant in the Australian context. AVCAL believes that roll over relief should be provided not just in respect of public scrip but also private scrip transactions.

8: BIBLIOGRAPHY

Deloitte Touche Tohmatsu, Survey of Offshore Venture Capital Investors, April 1999

Arthur Anderson/Australian Venture Capital Association (AVCAL) 1998 Survey of Venture Capital -www.avcal.com.au/anderson98print.htm

British Venture Capital Association Survey (BVCA) of 1998 – www.bvca.co.uk/BVCA/UKStats.html.

The Economic Impact of Venture Capital, Coopers & Lybrand Policy and Economics Survey 1997– www.avcal.com.au/coopersprint.htm.

National Venture Capital Association Survey – www.nvca.com

National Venture Capital Association – www.nvca.com/ - Steady Growth for Venture Capital in the Midst of a Turbulent Market.

Pratt's Guide to Venture Capital Sources (1998 ed), Securities Data Publishing: New York.

The PricewaterhouseCoopers Economic Impact of Venture Capital Survey, 1998

Saxton, J, (1997), *The Economic Effects of Capital Gains Taxation,* Joint Economic Committee Study.

Timmons, J & Sapienza H, *Venture Capital More Than Money*, in *Pratt's* Guide to Venture Capital Sources (1998 ed), Securities Data Publishing: New York.

9: APPENDIX - AVCAL ANNUAL REVIEW 1998

ABOUT THE ASSOCIATION

The Australian Venture Capital Association Ltd ('AVCAL') evolved from the Development Capital Forum, which was initiated in April 1992 as an informal forum for industry participants to meet and pursue topics of common interest.

Once formed, the Association aimed to promote the local venture capital industry and encourage investment in growing business enterprises.

A major role for AVCAL is to represent members' views and interests to government, other regulatory authorities, industry associations and professional bodies.

In October 1995, the Association appointed its first Executive Director, Anne Howard, to raise the profile of the venture capital sector with Governments and industry, and to build a strong industry Association.
Today, the Association has more than 240 members including fund managers, banks, advisers, accountants, lawyers, government organisations, business associations , academic institutions and other parties associated with the industry.

AVCAL's Investor members constitute virtually all of the active venture capital companies in Australia. These firms typically specialise in providing capital for early stage companies, later stage development capital, and finance for management buyouts and buyins of established companies.

AVCAL promotes the venture capital investment class as a professionally managed, ethical sector of the Australian investment community which is worthy of support by institutional and corporate investors.
AVCAL has established itself as the peak body representing venture capital in Australia.

CHAIRMAN'S REPORT

The Australian Venture Capital Association Limited has enjoyed a successful sixth year as the industry body for Venture Capital. AVCAL has pursued the dual objectives of increasing the supply of venture capital, as well as increasing the number and quality of opportunities in which this capital can be employed.

The AVCAL Council continues to believe that a vibrant venture capital industry is critical to Australia's economic and technological development. A survey on the Economic Impact of Venture Capital last year confirmed that venture-backed companies both create jobs and achieve sales growth rates, well in excess of those achieved by the top 100 Australian companies. This record should encourage continued support for the industry from both Government and the private sector.

The taxation committee of the Council continued its vigorous efforts to bring about and overhaul of components of the present taxation system. The capital gains tax sections of the current tax system inhibit the principal suppliers of venture capital - the US pension funds - from investing in Australia. The committee has significantly increased the level of public awareness of this problem and will present suggested changes to the "Ralph Review" in the near future.

The Association aims to achieve increased support from domestic institutional investors for Venture Capital. The first AVCAL sponsored Performance Measurement survey was conducted in 1998 to provide these investors with some early indications of the performance of this asset class. Over the next 1 - 2 years AVCAL aims to achieve a standard of Performance Management comparable to the UK and the US.

AVCAL has also focussed in stimulating demand for Venture Capital. Ultimately the continued success of our industry depends on a strong flow of attractive investment opportunities. A booklet entitled Winning Australian Venture Capital was produced by our Executive Director, Anne Howard, and launched by the Federal Industry Minister in May this year. This booklet provides a practical guide for businesses explaining the operating approaches of venture capitalists and how to maximise the chances of a successful capital raising. This will also help those companies, which are not yet ready to raise capital, to become "investment ready".

The Association was pleased to present the second annual Venture Capital Awards at the dinner following our Annual Conference. These awards are a useful mechanism to recognise companies who have achieved their growth potential with the assistance of venture capitalists.

In recognition that venture capital is a national (and increasingly international) business, the Council now includes representatives from the three eastern states of Australia and on occasion, by invitation, representatives from New Zealand. We have established links with the Investment and Financial Services Association Limited and the British Venture Capital Association to facilitate a valuable exchange of ideas between similar industry associations.

In closing I would like to thank all members of the Council for their support during the year and to acknowledge those members of the Taxation and Conference sub-committees for their time and effort. Once again, Anne Howard has demonstrated a high level of enthusiasm and dedication which has been fundamental to the recent achievements of AVCAL.

PETER R CHAPMAN
CHAIRMAN

BOARD OF DIRECTORS

CHAIRMAN

Peter Chapman, B.Comm, CPA, CEO Rothschild Australia Investors Limited.

Vice-Chairman

John Dyson, BSc, MBA, ASIA, General Manager (Australia) of Nomura/JAFCO Investment (Asia) Ltd.
Treasurer

Steve Baldwin, B.Comm (Hons), ACA, Finance Director of Hambro-Grantham Management Limited.

Directors

Robin Beaumont, MBA, Retired.

Geoff Berry, B.Bus, CPA, Investment Director with Catalyst Investment Managers Pty Ltd.

Marcus Darville, MA (Hons), MBA, Head of Development Capital, AMP Asset Management.

Bill Ferris, AO, B.Ec. (Hons), MBA (Harvard), Executive Chairman of Australian Mezzanine Investments Pty Ltd.

Richard Gregson, BSc (Hons 1), MBA, PhD, Joint Managing Director of Equity Partners Pty Ltd.

Robert Inglis, B.Ec., MBA, ACA, CPA, Managing Director of Amgun Holdings Pty Ltd.

Sandy Lockhart, BA (Hons)(Harv), PMD (Harv) Asia, Managing Director of Macquarie Direct Investment Ltd.

John Murray, LLB. (Hons), CA, Executive Director of Technology Venture Partners Pty Ltd.

George Penklis, B.Ec., CA, Investment Director of Westpac Development Capital Pty Ltd.

Paul Rogers, B.Ec., LLB, FCPA, Solicitor, AICD, Managing Director of InterFinancial Ltd.

Jonathan Stuart, BSc. (Hons), MBA, MICE, Executive Director of GS Private Equity Pty Limited.

Greg Targett, B.Ec., Dip.Ed., MCT, AIBF (Aff), Managing Director of National Australia Investment Capital Limited.

FROM THE EXECUTIVE DIRECTOR

The Association has achieved another year of significant growth, and importantly, has gained noticeable public awareness, particularly in the policy arena.

We commenced 1998 with a full agenda including some important public policy initiatives that were carried forward from last year, AVCAL has played and continues to have a major role in promoting the venture capital sector to Government on a range of issues.

One of these issues involves the taxation treatment of offshore institutional investors in Australian venture capital funds. Another, concerns the need to encourage investment in Australia's innovative young companies and AVCAL was very pleased when the first Innovation Investment Funds were signed earlier this year.

An ongoing AVCAL priority has been to continue to create awareness and understanding of the venture capital sector with many different target groups - investors, potential investee companies, their advisers, government and the media. We were delighted to receive funding from the Commonwealth Government to assist in the publication and distribution of our Winning Australian Venture Capital booklet. In our efforts to raise public awareness of the venture capital sector, we participated in trade shows, road shows, seminars and conferences, worked with State and Federal governments, other industry organisations and the media.

As an industry body, we have had a spectacular period of success in expanding the Association's membership and placing AVCAL in a strong financial position. Over the past three years, the numbers of Investor members has increased from 17 to 32. Also, our audited accounts show that AVCAL is in an extremely robust position with our net assets doubling during the year.

For our members, the Association has produced a standard confidentiality agreement, together with valuation guidelines and a code of conduct. AVCAL aims to provide opportunities for its members to get together to exchange ideas and views, and to promote friendship. The annual AVCAL golf day is always popular. So too are the twilight seminars, breakfast briefings and of course our annual conference. The conference dinner featuring the presentation of the Australian Venture Capital Awards was this year, over subscribed.

I would like to take this opportunity to thank my staff, Leanne and Zina, for their assistance throughout the year. I would also like to thank the AVCAL Council members who so willingly provide help and advice as required. In particular, I wish to express my appreciation to Chairman Peter Chapman, Vice-Chairman John Dyson and Treasurer Steve Baldwin for the strong support they have provided throughout the year.

Anne Howard
Executive Director

GOVERNMENT RELATIONS

A major role for the Association is to act as an influential voice for representing members' views and interests to government, other regulatory authorities, industry associations and professional bodies.
The main areas of representation work undertaken by the Association during the year were as follows:
Amendment to the taxation treatment of offshore institutional investors

During 1997 AVCAL established a Taxation sub-committee to review the problem and seek an amendment to the taxation legislation. The sub-committee comprised Bill Ferris (Chair), Steve Baldwin, Geoff Berry and Anne Howard.

The sub-committee was keen to build upon the previous work it had undertaken to gain a satisfactory outcome to the current taxation impediments preventing overseas pension funds from investing in our local venture capital industry. In March of this year, AVCAL made a submission to the Government's Taxation Consultative Taskforce and later presented its case at a formal hearing in Canberra.

AVCAL was pleased during the recent Federal election campaign to note that both the Coalition and Labor parties included venture capital initiatives in their industry platforms.

The Association will continue its representational work in this area when it makes a further formal submission to the forthcoming Ralph Business Taxation Review. This further submission will also review the possible impact of the Government's contemplated amendment to the taxation of trusts as companies.

INNOVATION INVESTMENT FUNDS (IIF)

AVCAL was present when the initial IIF licences were signed at a ceremony held in Brisbane during May this year. Federal Industry Minister John Moore, MP, signed the Agreements with the successful IIF venture capital funds.

The new funds have been inundated with proposals and business plans from early stage companies seeking venture capital, and we are pleased to note that several new investments have already been finalised.

YEAR IN REVIEW

During the year, AVCAL undertook a number of activities designed to increase awareness and understanding of the venture capital sector in Australia.

Launch of the booklet - Winning Australian Venture Capital

This booklet provides relevant information on venture capital and its potential benefits. It aims to assist firms to reach an investment ready stage and enhance their chances of winning the additional capital necessary for growth.

The booklet was officially launched by the Minister for Industry, Science and Tourism, the Hon John Moore, MP, at a luncheon in Brisbane in May this year.

Reaction to the booklet has been excellent, with the Australian Financial Review posting it permanently on its website.

AVCAL would like to thank the Commonwealth Department of Industry, Science and Tourism for their generous financial support in producing this booklet.

NORTH AMERICAN IT ROADSHOW

AVCAL's Executive Director was invited by the Office of AusIndustry to participate in a series of seminars promoting the venture capital market for IT, multimedia and online firms. The seminars toured six Australian capital cities during June this year and were extremely beneficial to small firms.
AVCAL appreciated the opportunity to promote the Australian venture capital market, the Association's Investor members and the new IIF funds that invest in new technology.

CMSF 1998

The Conference of Major Superannuation Funds is held annually on the Gold Coast and attracts in excess of 700 superannuation fund trustees and others during the three day event. AVCAL again hosted a display booth which proved popular with conference delegates. The booth featured a video presentation, testimonials, information about the sector and the Association's Investor members.
The booth was attended by AVCAL Council member, George Penklis and Executive Director, Anne Howard. AVCAL wishes to thank George for the preparation of the video presentation.

BRISBANE BREAKFAST BRIEFING

Members of the AVCAL Council were guest speakers at a breakfast seminar held at the Brisbane Polo Club in May. The seminar focussed on the current state of venture capital in Australia and was a huge success, attracting well over 100 people.
AVCAL would like to thank our Queensland Council member, Paul Rogers and his assistant, Linda Martin, for organising this popular event.

GILBERT & TOBIN TWILIGHT DISCUSSION SESSION

This excellent short seminar was held in May and presented by Gina Cass-Gottleib and Simone Desmarchelier from Gilbert & Tobin. Specific topics included practical implications of the Trade Practices Act, and Intellectual Property Identification and asset management. The free informative evening was attended by many AVCAL members who also enjoyed Gilbert & Tobin's fine hospitality.

JUNE EVENING SEMINAR

AVCAL hosted a mid year evening seminar featuring senior executives from the Silicon Valley Bank, Executive Vice President, Harry Kellogg and Senior Vice President, Larry Lopez. The seminar coined 'the Harry and Larry Show' was extremely well attended by AVCAL members who also enjoyed meeting with our guests at the cocktail function that followed.

SECOND ANNUAL AVCAL GOLF DAY

The 1998 AVCAL Golf Day was once again held at Concord Gold Club, the site of the 1999 Australian PGA Championship. Sixty five players enjoyed pleasant conditions, reflected in the good scoring for the day - for most anyway.

The AVCAL Cup was won by Grayen Forest of VC Mentors and Callen O'Brien of Minter Ellison. Last year's winners, Bill Ferris and Warwick Glen, put up a spirited defence but were unable to reproduce the magic scoring of last year, John Murray just missed a hole in one by 1cm!

AVCAL would like to thank Neil Tomlin, Partner at Gilbert & Tobin and his colleagues Matthew Donnellan and Judy Cooper for the wonderful effort they put into organising the event for a second year.

FIFTH ANNUAL AVCAL CONFERENCE

VENTURE CAPITAL - A GLOBAL PERSPECTIVE

One Hundred and seventy five delegates attended this year's annual AVCAL conference held at the Hotel Inter Continental in Sydney.

Venture capital is a global industry and AVCAL felt the 1998 conference provided the opportunity to explore in more detail the trends and issues occurring in the US, Asia and Europe. AVCAL was pleased to host a number of high profile international speakers who provided a snapshot of the venture capital environment in their home country, and drew parallels with Australia.

The conference opened with the thought-provoking and inspirational wisdom of Dr Horace 'Woody' Brock, President and founder of Strategic Economic Decisions, Inc., in California. Dr Brock explored the global economy in the 1990s, and provided a somewhat optimistic view of a changing world economy centred on the technology revolution.

Keynote speaker Fred Giuffrida, Managing Director of Horsley Bridge Partners in the US examined the US investment environment over the past decade. We have seen increasing capital supplies with greater competition which in turn has put pressure on venture groups to differentiate themselves. Mr Giuffrida shared his insights into how venture groups can succeed in the current environment.

The conference was also treated to presentations dealing with the Asian crisis, the MBO market in Europe, the latest Australian survey data, tips on collecting performance data, and perspectives from three major investors. Our after dinner speaker was Trevor Sykes, well known financial writer and creator of the Pierpont column.

AVCAL would like to again thank the speakers, sponsors and the conference sub-committee members for their efforts in making this year's conference another successful event.

AUSTRALIAN VENTURE CAPITAL AWARDS

As with last year, the conference dinner was the venue for the presentation of the second Australian Venture Capital Awards. Almost 300 people were present to applaud the winning companies. The awards recognise the achievements of venture backed companies which in the opinion of a distinguished judging panel have made the best use of venture capital in their development. This year there were two winning categories:

Best Early Stage Category - includes start up and early stage investing in companies with revenues of less than $5 million at the time of investment. This category is sponsored by Tech Pacific.
The 1998 winner is Zergo Asia Pacific Pty Ltd - now the largest cryptographic security company outside North America. The judges felt that Zergo was the classic start up deal. In 1994 the company was backed by Australian Technology Group and the investment was managed by Technology Venture Partners.

Best Expansion Stage Category - includes companies with revenues in excess of $5 million at the time of investment. This category is sponsored by PriceWaterhouseCoopers.

The 1998 winner is Austal Ships Pty Ltd - specialising in the construction of high speed aluminium vessels. In 1994 Austal completed a $15 million syndicated equity placement which was led by Australian Mezzanine Investments Pty Ltd and included Foundation Capital Ltd and Prudential Asset Management Asia Limited.

A special commendation was made to Airwork and Pacific Turbine Group which was backed by Direct Capital Management Limited. The Awards were presented by Mr Geoff Hiscock, Asian Business Editor for the Australian newspaper.

AVCAL extends its appreciation to the sponsors (The Australian newspaper, Corrs Chambers Westgarth, PriceWaterhouseCoopers and Tech Pacific) for their continued support, and to the judges (Bill Robinson, Graham Pickles and Nigel Stoke) for judging this year's Awards.

RESEARCH

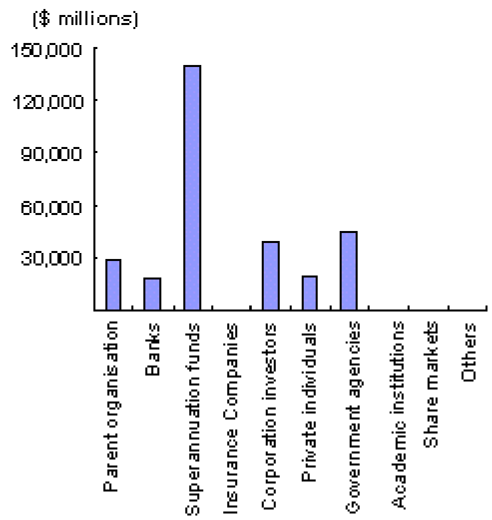
AVCAL / ARTHUR ANDERSEN ANNUAL SURVEY OF VENTURE CAPITAL

The sixth annual AVCAL survey undertaken by Arthur Andersen was completed in 1998. Information was collected from 20 AVCAL Investor members who limited their activities to direct investments in small to medium sized enterprises. The survey found that the level of funds invested by these managers had risen to $602 million, invested in 179 companies, up by 13% on the previous year. The 20 managers have $1,414 million of assets under management, up by 12% from the prior year.

SOURCES OF FUNDS

The survey reported that capital is raised from a wide range of sources. In 1998, superannuation funds continued to dominate the provision of new funding with superannuation funds providing 50% of new funds raised. When compared to the UK venture capital industry where 34% of funds raised came from the US pension and venture capital funds, Australia attracted no capital from these US funds.

Capital raised during year to 30 June 1998 (Disclosed Sources)



Our thanks ro Garry Wayling Partner, Arthur Andersen for his work in undertaking the annual survey.

PUBLICATIONS

The following publications are freely available from the AVCAL office and the AVCAL website.

AVCAL Directory of Investor Members - now in its third edition.

WINNING AUSTRALIAN VENTURE CAPITAL

Directory of Business Angel Introduction Services - The Association has published this popular directory for a second year and our thanks are extended to Council member Rob Inglis for initiating this project.

1998 ARTHUR ANDERSEN / AVCAL SURVEY

Confidentiality Agreement - The Association has prepared a standard confidentiality agreement. Our appreciation to Council members, Geoff Berry and Greg Targett, for their efforts in producing this document.

AVCAL WEBSITE: HYPERLINK http://www.avcal.com.au

Other publications which are available for purchase from the AVCAL office include:

AVCAL Guidelines for the Valuation and Disclosure of Venture Capital Portfolios - The guidelines are modelled on the British Venture Capital Association (BVCA) guidelines and are available from the AVCAL office.

Code of Conduct - The Code has been prepared with the objective of establishing a minimum set of principles which all members of the Association are required to observe.

IN APPRECIATION

PriceWaterhouseCoopers: AVCAL would like to extend its appreciation to PriceWaterhouseCoopers and in particular, Mark Haberlin, who has prepared and audited the AVCAL accounts on a pro bono basis for the past six years.

AVCAL Secretariat: The Association has a small, busy secretariat located in The Rocks in Sydney. The Executive Director is supported by two part time staff members, Leanne Wilson and Zina Di Pino. Their contribution has been greatly appreciated.

AVCAL would like to extend its appreciation to Jenny Pittorino, who for the past three years, has managed the accounts for the Association.

Also we would like to acknowledge the assistance of Felicity Donnelly from Nomura/JAFCO Investment (Asia) Ltd who came to Sydney to assist with the AVCAL conference. Cynthia Waters from Australian Mezzanine Investments and Amanda Adare from Rothschild Australia Capital Investors have also generously supported the AVCAL secretariat.