

DEPARTMENT OF INDUSTRY, SCIENCE AND RESOURCES

MS22-001096

To: Minister for Industry and Science (For Information)

VENTURE CAPITAL LANDSCAPE, PROGRAMS AND REVIEW

Timing: 9 August 2022, ahead of your meeting with Main Sequence Ventures

Recommendations: That you			
1. Note the current state of venture capital investment in Australia			
Noted / Please Discuss			
2. Note the Australian Government programs that encourage venture capital investment			
Noted / Please Discuss			
3. Note the status of the review of venture capital tax programs.			
Noted / Please Discuss			
Minister:		Date:	
Comments:			
Clearing Officer: Sent: 5/8/2022	s22(1)(a)(ii)	A/g General Manager, Commercialisation Branch, Science and Commercialisation Division	Ph: s22(1)(a)(ii) Mob: s22(1)(a)(ii)
Contact Officer:	s22(1)(a)(ii)	Manager, Early Stage Finance Policy section, Science and Commercialisation Division	Ph: s22(1)(a)(ii) Mob: s22(1)(a)(ii)

Key Points:

1. You have requested a discussion on venture capital. Ahead of this, and a meeting with Main Sequence Ventures on 10 August 2022, we are providing you with information on the current state of Australia-focused venture capital investment, tax concession programs and the 2021 review of these programs.
2. Venture capital plays an important role in financing the launch, early development and expansion of innovative, high-growth potential companies. These companies may have difficulty accessing other sources of finance due to their higher risk profile and lack of tangible assets.

3. Venture capital investment in Australian companies is small by international standards but typically follows global trends.
4. Various data sources have reported that Australia experienced record venture capital investment in 2021. For example, Preqin and the Australian Investment Council reports that in 2021, \$7.9 billion was invested, double the \$3.9 billion invested in 2020. Other data sources have different headline figures but show similar trends.
5. There has been a trend toward larger investments, and at later stage of development, in recent years. The average deal size in 2021 has increased from \$191 million to \$296 million (Preqin and Australian Investment Council).
6. In 2022, global venture capital investment and the number of venture capital deals have declined, and similar trends have been observed in Australia. Commentary suggests the downturn is in part due to higher inflation and interest rates, falling public and private valuations for technology companies and the exit of non-traditional venture capital investors from the market, geopolitical uncertainties and supply chain issues.
7. There are also views that the Initial Public Offering window will remain virtually shut, keeping exit values depressed until market conditions improve. However, some predict that merger and acquisition activity could increase as investors look to take advantage of the drop in valuations to make acquisitions and some industries see companies consolidating to improve their market position.
8. Some Australian venture capitalists have told the department that there may be decreased raising of new venture capital funds in 2022–23 and potentially into 2024, while venture capital investment is likely to focus on their most promising existing portfolio companies. However, others have stated that 2022 may be a more typical environment following unusually large funding events and valuations in 2021.
9. Further detail on the current state of venture capital is at [Attachment A](#).

Australian Government Programs that encourage venture capital investment

10. Current incentives to attract venture capital investment in startups is largely provided by tax concession programs and co-investment funds (where the Commonwealth invests alongside private investors and can receive returns on investments).
11. Examples of programs administered by your department include:
 - a. Early Stage Venture Capital Limited Partnerships (ESVCLP):
 - i. Aims to increase investment in early stage businesses;
 - ii. ESVCLPs are pooled investment vehicles that provide flow-through tax treatment;
 - iii. Investors (whether resident or non-resident) receive a complete tax exemption on their share of the fund's income (both revenue and capital);
 - iv. Investors also receive a 10 per cent non-refundable tax offset on capital invested during the year;
 - v. Minimum \$10 million and maximum \$200 million of committed capital;

- vi. Eligible investments (investee company value) must be less than \$50 million in total assets
- b. Venture Capital Limited Partnerships (VCLPs):
- i. The VCLP is aimed at increasing foreign investment in the Australian venture capital sector;
 - ii. VCLPs are pooled investment vehicles that provide flow-through tax treatment;
 - iii. Income tax exemption for eligible foreign investors on their share of gains made by the partnership from disposal of eligible investments;
 - iv. Minimum \$10 million committed capital;
 - v. Eligible investments (investee company value) must be less than \$250 million in total assets.
- c. Australian Venture Capital Fund of Funds (AFOF):
- i. The AFOF is a fund of funds structure that is able to invest in a portfolio of different venture capital funds that are ESVCLPs or VCLPs, and direct investments;
 - ii. The AFOF structure is used for further diversification for the fund and the investors, enables flexibility for the investors and the fund, and assists larger sized venture capital funds as it may assist them reduce and help them manage risk;
 - iii. Registration as an AFOF entitles the entity to flow-through tax treatment;
 - iv. Income tax exemption for eligible foreign investors on their share of gains made by the partnership from disposal of eligible investments.
- d. Biomedical Translation Fund (BTF):
- i. The BTF is a \$500 million co-investment fund to support the commercialisation of biomedical discoveries. It is comprised of \$250 million of Commonwealth capital and \$252.5 million in private sector capital;
 - ii. The BTF is closed to initial investments, but follow-on investments are ongoing;
 - iii. The Biomedical Translation Fund is a Department of Health program delivered by your department.
- e. Other co-investment funds:
- i. Earlier co-investment funds are in the process of exiting investment, winding up or closure;
 - ii. The Innovation Investment Fund (IIF) closed to new rounds in 2014–15;
 - iii. The Innovation Investment Follow-on Funds (IIFF) had the final fund wind up in 2021;
 - iv. For the Pre-Seed Fund (PSF) the department is administering closure.

12. Flow through taxation vehicles and tax incentives for venture capital investment through programs including Early Stage Venture Capital Limited Partnerships and Venture Capital Limited Partnerships. For these programs your department has joint policy responsibility (with Treasury) and joint delivery (with the Australian Taxation Office). Further information is at [Attachment B](#) and [Attachment C](#).
13. The CSIRO Innovation Fund (branded Main Sequence Ventures) was announced in 2015 to invest in new spin-off companies and existing startups and SMEs which are developing technology from, or have ongoing research connections with, the CSIRO, universities and other publicly funded research agencies. The Fund is overseen by CSIRO.
14. The tax incentives for early stage investors is a Treasury program delivered by the Australian Taxation Office. It is aimed at increasing the flow of capital to new, high growth potential businesses, and target the gap between pre-concept stage financing and venture capital financing. Benefits include a 20% non-refundable tax offset on investments, capped at \$200,000 per investor per annum and a 10 year exemption on capital gains tax, provided investments are held for at least one year.

Review of venture capital tax programs

15. On 6 May 2021, the previous government announced a review of the venture capital tax concession programs to ensure they are achieving their intended objectives. The review incorporated the requirements of an impact assessment imposed by legislation (s118-455 of the *Income Tax Assessment Act 1997*).
16. The review was undertaken by the Treasury and Industry Innovation and Science Australia (IISA). The legislation requires the impact assessment report to be tabled by the Treasurer in each House of the Parliament.
17. The review found that overall the tax concessions have been well received. These programs have supported the growth of the Australian venture capital sector and stakeholders recognised that the programs are just one factor contributing to the growth of the venture capital sector. The review made no policy or reform recommendations as specified in the Terms of Reference. Further information is at [Attachment D](#).

Data referenced: Preqin Ltd and Australian Investment Council, 2022, Australian Private Capital Market Overview: A Preqin and Australian Investment Council Yearbook 2022, viewed 3 August 2022.

Consultation: YES

18. Treasury, Office of Industry Innovation and Science Australia, Technology and National Security Division.

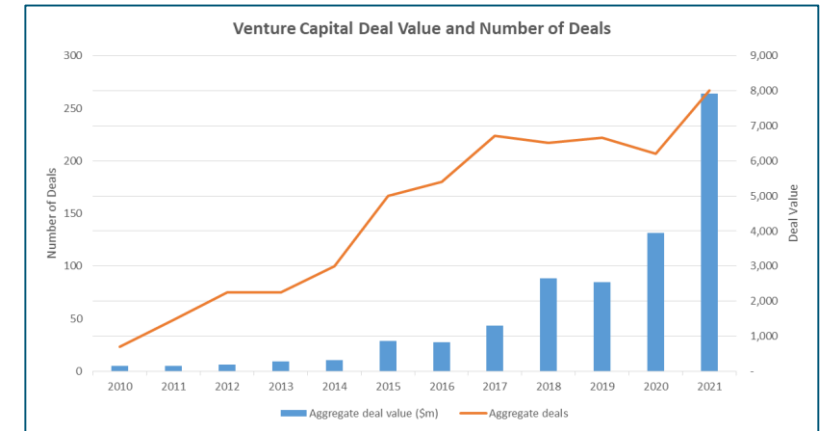
Attachments

- A:** Venture Capital Placemat
- B:** Venture Capital Programs on a Page
- C:** Venture Capital Act Program Dashboard – Early Stage Venture Capital Limited partnerships
- D:** Review of Australia's venture capital tax concession programs

Venture Capital

State of play

- Innovative startups play a crucial role in the economy, introducing new products and services, creating high value jobs and contributing to increased productivity.
- Venture capital (VC) is an important (but not the only) source of finance for the launch, early development and expansion of innovative, high-growth potential companies.
- These companies find it difficult to access traditional sources of capital due to higher risk profile and lack of tangible assets.
- Industry data, including Australian Investment Council (AIC), shows record levels of investment in recent years.
- \$7.9 billion invested by VC funds in Australian companies in 2021, doubling the 2020 figure, which was itself a record (AIC).
- Value of investments predominantly to start-ups in the IT, consumer discretionary, and financial services sectors (AIC).
- Recent quarterly data for 2022, released by CB Insights, shows a large decline in the number of investments and their aggregate value, compared to previous quarters.



Source: Preqin and The Australian Investment Council. Yearbook 2022. May, 2022.

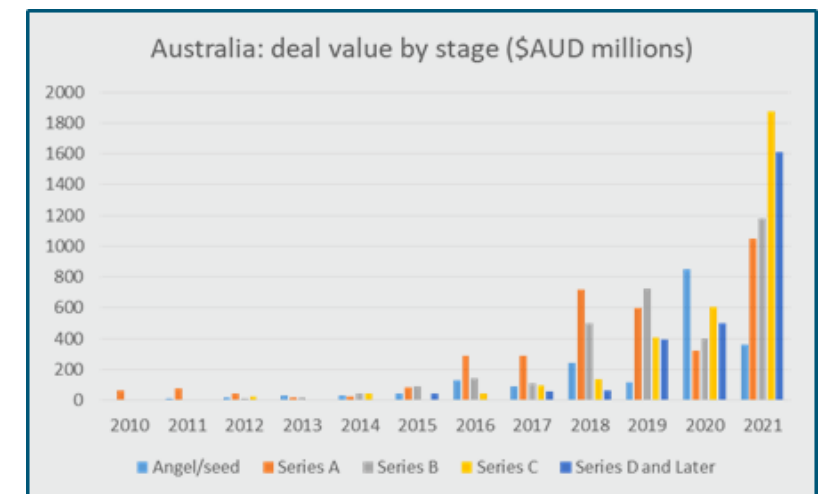
Emerging themes

Global downturn in 2022

- Recently, global VC investment and the number of deals have declined amid ongoing geopolitical uncertainties, supply chain issues, increasing inflation and interest rates.
- VC investors are focussing on profitability.
- Venture capital funds suggest the downturn follows global trends:
 - Higher interest rates and inflation.
 - Falling public and private valuations for technology companies.
 - Potential exit of non-traditional investors from the market, including overseas investors.

Shift towards later-stage investment

- As VC funds have grown in size, average deal size has increased and investments have shifted to more later stage rounds.
- In recent years, angel and seed investment has not grown at the same rate as later stages.
- It is important to maintain a strong pipeline of early-stage companies to grow and scale in the future.



Calculated using data from: Preqin and The Australian Investment Council. Yearbook 2022. May, 2022.

Government programs to support innovative businesses

Research and Development Tax Incentive	•Helps companies to reduce the cost of undertaking R&D activities in which they are likely to underinvest without support.
Early Stage Venture Capital Limited Partnerships	•Designed to increase investment in startups through Australian early stage VC funds by providing tax offsets and capital gains tax exemptions on eligible investments.
Venture Capital Limited Partnerships	•Aimed at increasing investment through Australia's VC sector by providing tax concessions to eligible foreign investors.
Biomedical Translation Fund	•Equity co-investment fund to invest in commercialisation of promising biomedical discoveries. Closed to new initial investments, but follow-on investments are ongoing.
CSIRO Innovation Fund	•Equity co-investment funds to invest in spin off companies and SMEs that engage Australian research institutions to create products and services.
Entrepreneurs' Programme	•A suite of advisory and facilitation services complemented by grants which aims to assist SMEs to innovate, unlock productivity potential and grow.
Boosting Female Founders Initiative	•Provided matched funding grants to help majority women owned and led businesses grow and scale. Additional funding is available for those women facing other intersectional barriers.
Business Research and Innovation Initiative	•Provides SMEs with grant funding to develop innovative solutions for Government policy and service delivery challenges.
Tax Incentives for Early Stage Investors	•Tax incentives for investments in qualifying early stage innovation companies.

Why Venture Capital Programs?

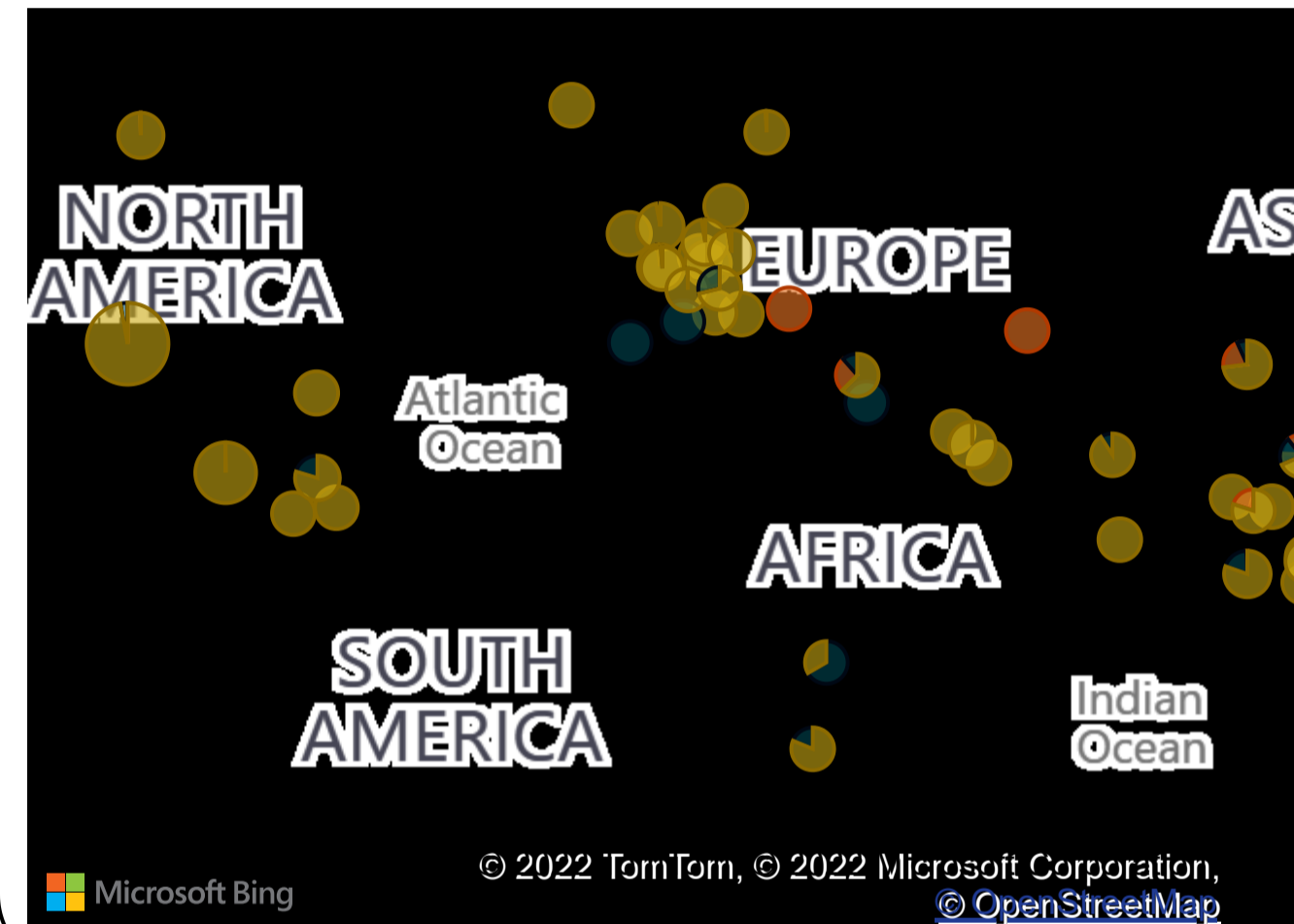
- o Venture Capital grows **Australian businesses, creating jobs and building Australia's economy**
- o Supports the **commercialisation** of Australian ideas
- o Provides **capital injection** to get businesses to the next stage of growth

Which countries do tax concession investors come from?

The estimated number of foreign and Australian investors who may benefit from tax concessions via their commitments of capital to the programs

8478

Programme ● AFOF ● ESVCLP ● VCLP



Customer Focus

- o The department works with industry bodies such as the Australian Investment Council (AIC) to **understand industry and client needs**
- o The department works with clients to **improve user experience, simplify registration and reporting processes, produce guidance material and publish data**
- o Clients engage with the department through newsletters, information sessions, sponsored and other industry events

Fast Facts - Co-investment

There is **\$501.25m** in the Biomedical Translation Fund (BTF) with **\$250m** of Commonwealth capital and **\$251.25m** private sector capital

How do they work?

- o Venture Capital programs **attract foreign and domestic investment** into Australian startups by providing **incentives to invest in early stage Australian companies**
- o Incentives are delivered through two main program streams:
 - 1) **Tax-concession programs** – allows fund managers and investors to claim tax concessions through the Australian Tax Office such as early stage venture capital partnerships (ESVCLPs), venture capital partnerships (VCLPs) and Australian Fund of Funds (AFOFs)
 - 2) **Co-investment programs** – the Government invests along-side fund managers for example the Biomedical Translation Fund

Registered partnerships are published on www.business.gov.au so businesses can contact them directly to [pitch for capital](#)

Who Benefits?

- o **Investors** through tax benefits
- o **Australian businesses** via investment
- o The **Australian economy** through job creation and revenue income and export sales from businesses that successfully commercialise
- o **SIV investor visa holders** who may be granted permanent residency in Australia after four continual years of commitment to a registered partnership

Fast Facts - Tax Concession

The amount that the programs have attracted in committed capital over their lifetime

\$26.25bn

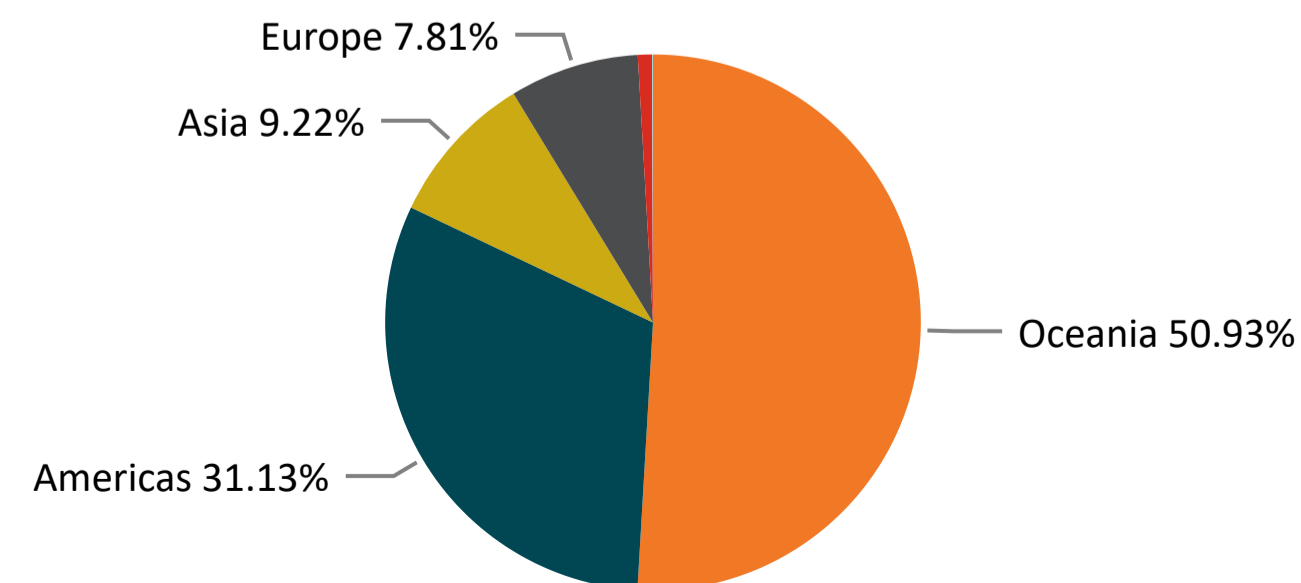
The amount of capital yet to be invested by registered partnerships, helping to grow jobs and the economy

\$12.44bn

The estimated number of businesses that have been helped by the programs to date

2263

What proportion have foreign investors committed to tax concession programs over the life of the programs?



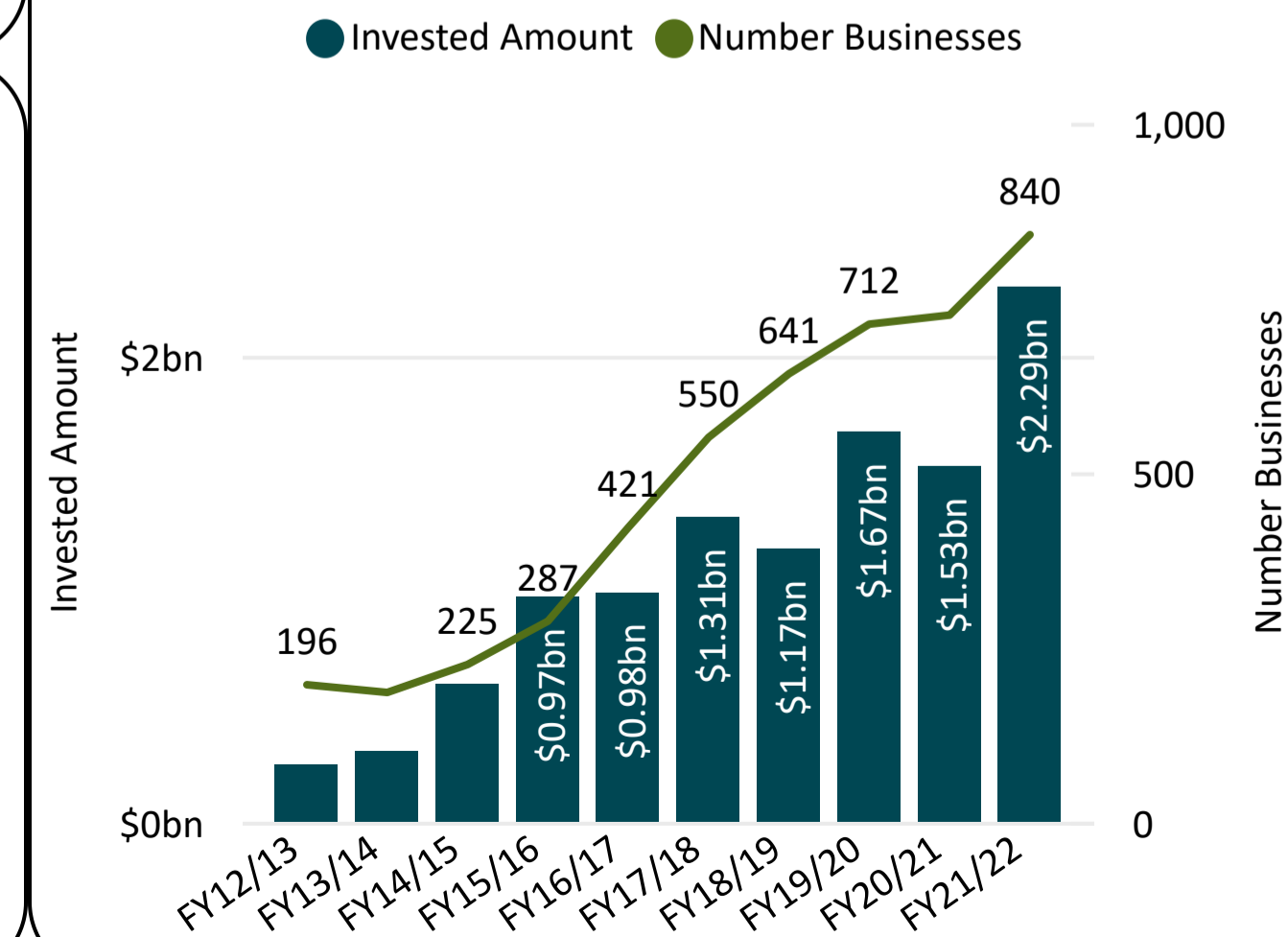
Global and Industry Connections

- o The department is the **first point of contact** for fund managers and startups and **regularly interacts with the venture capital industry in Australia and overseas**
- o The programs **attract foreign and domestic investment** and the department works with **Austrade's international connections** to promote the programs in Australia and abroad
- o We **connect with ATO** and other government agencies to **ensure program integrity**

Flexible

- o **Fund managers decide** which businesses to invest in ensuring their experience is harnessed in making the best possible investment decisions
- o Investments can be made into **most sector** under the tax concession programs
- o There are investment restrictions for some sectors such as property development, finance and construction
- o Businesses can approach registered funds themselves using the client lists published on www.business.gov.au and **pitch for capital**

How much have Australian businesses been helped by tax concession programs?



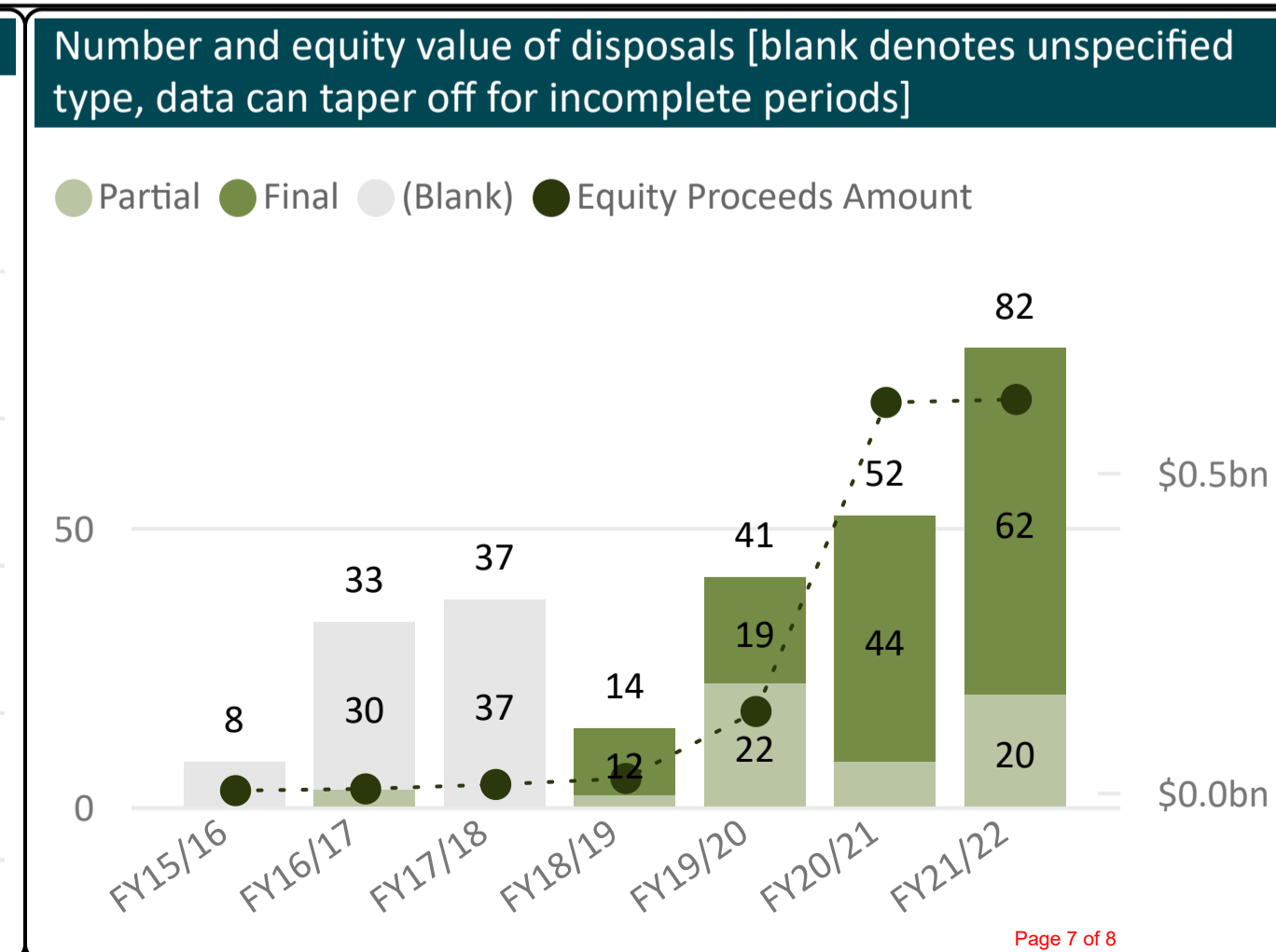
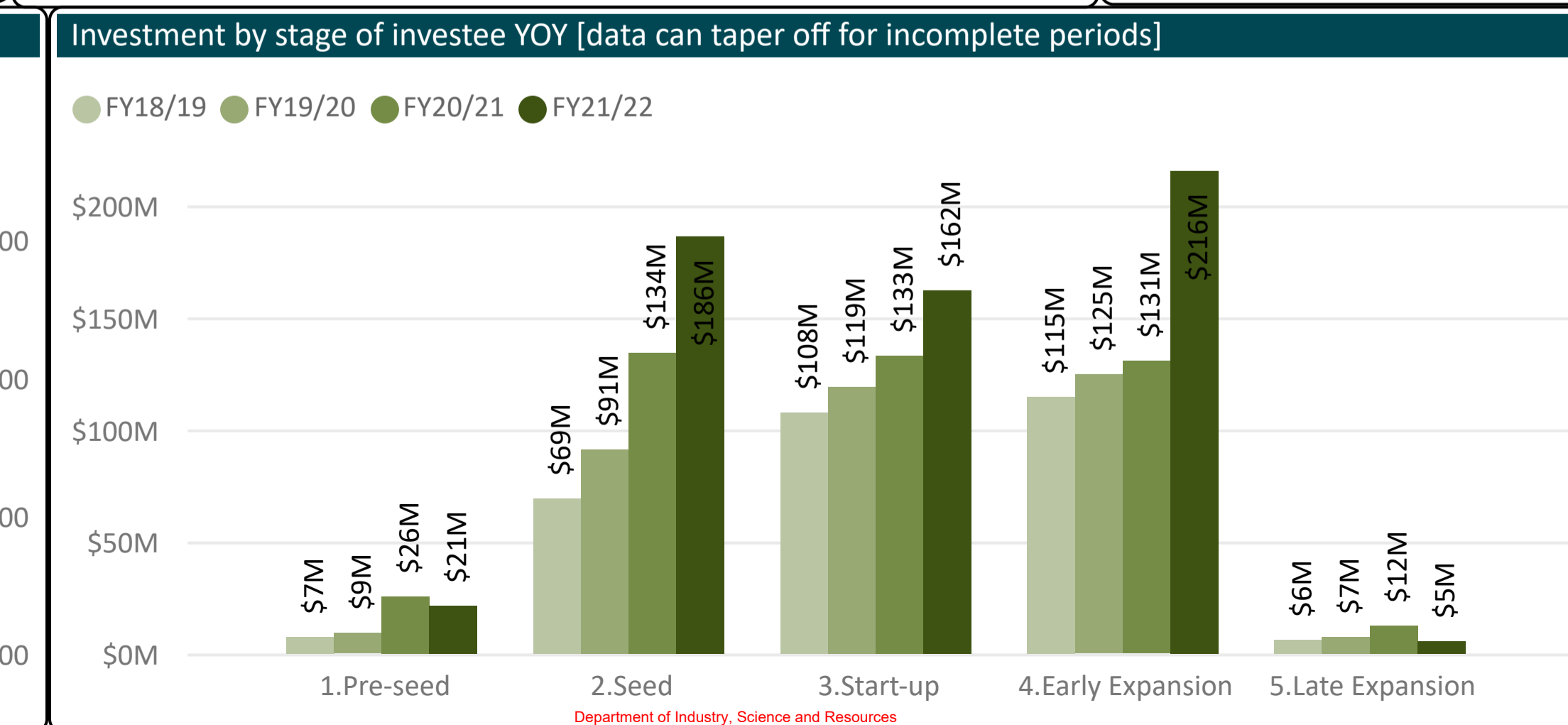
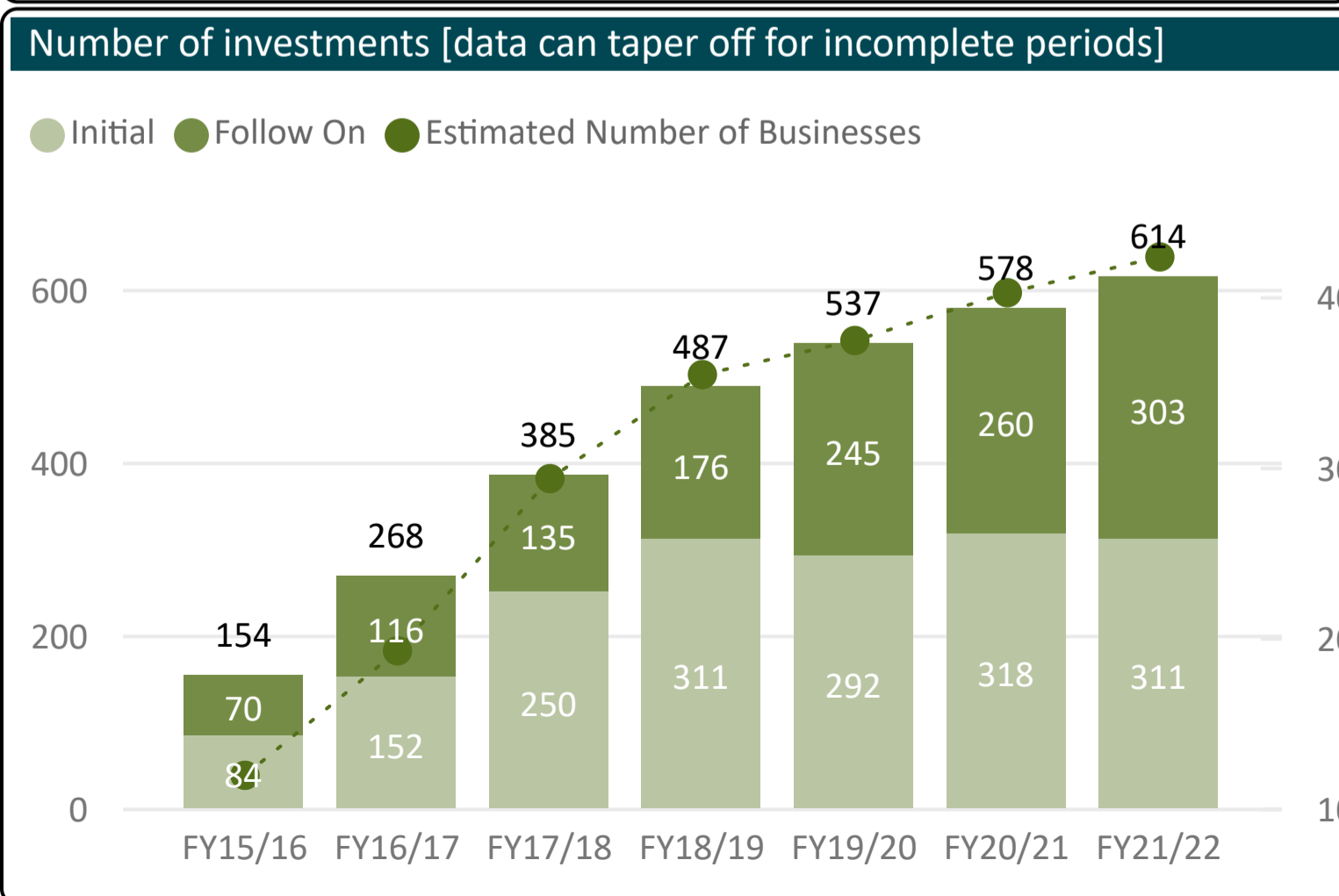
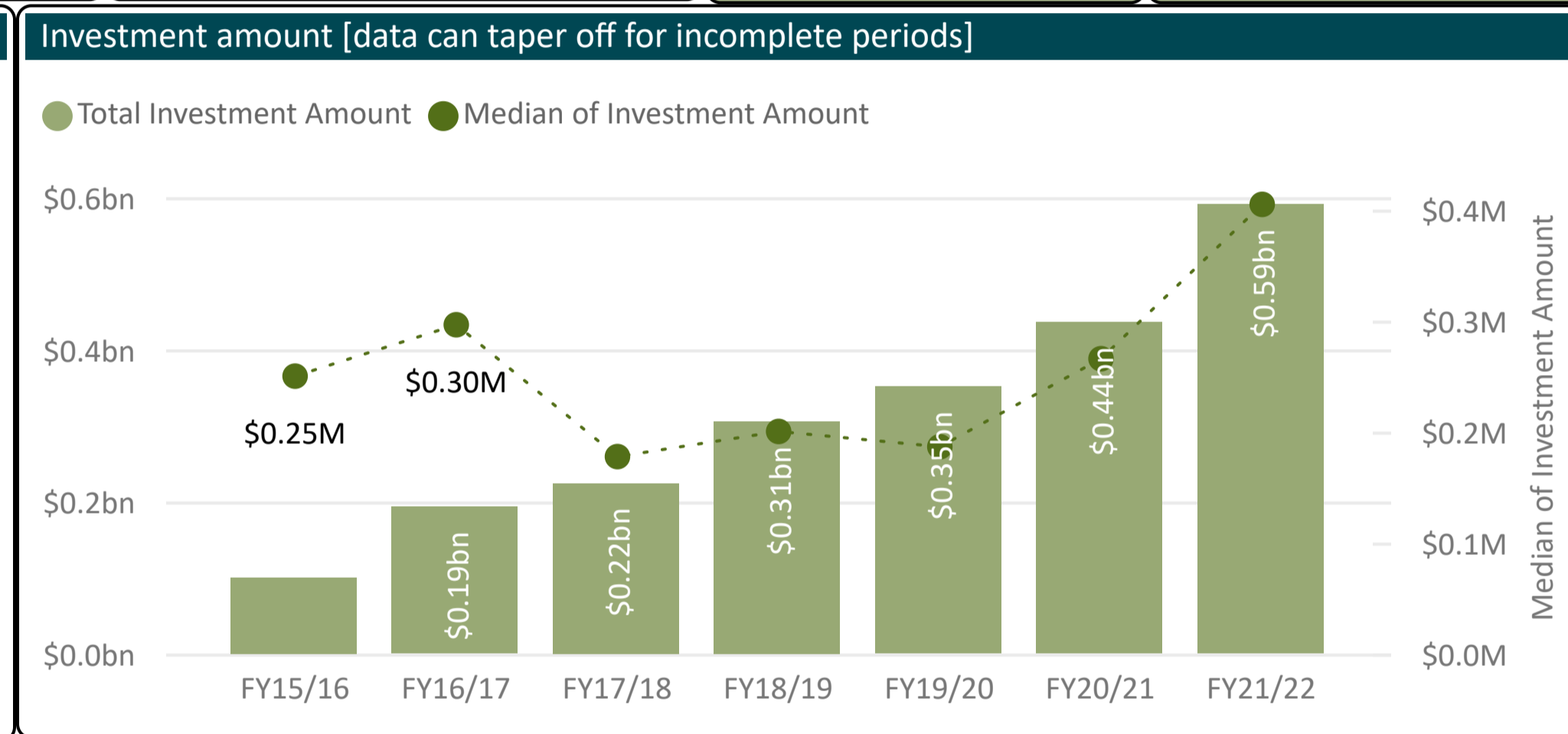
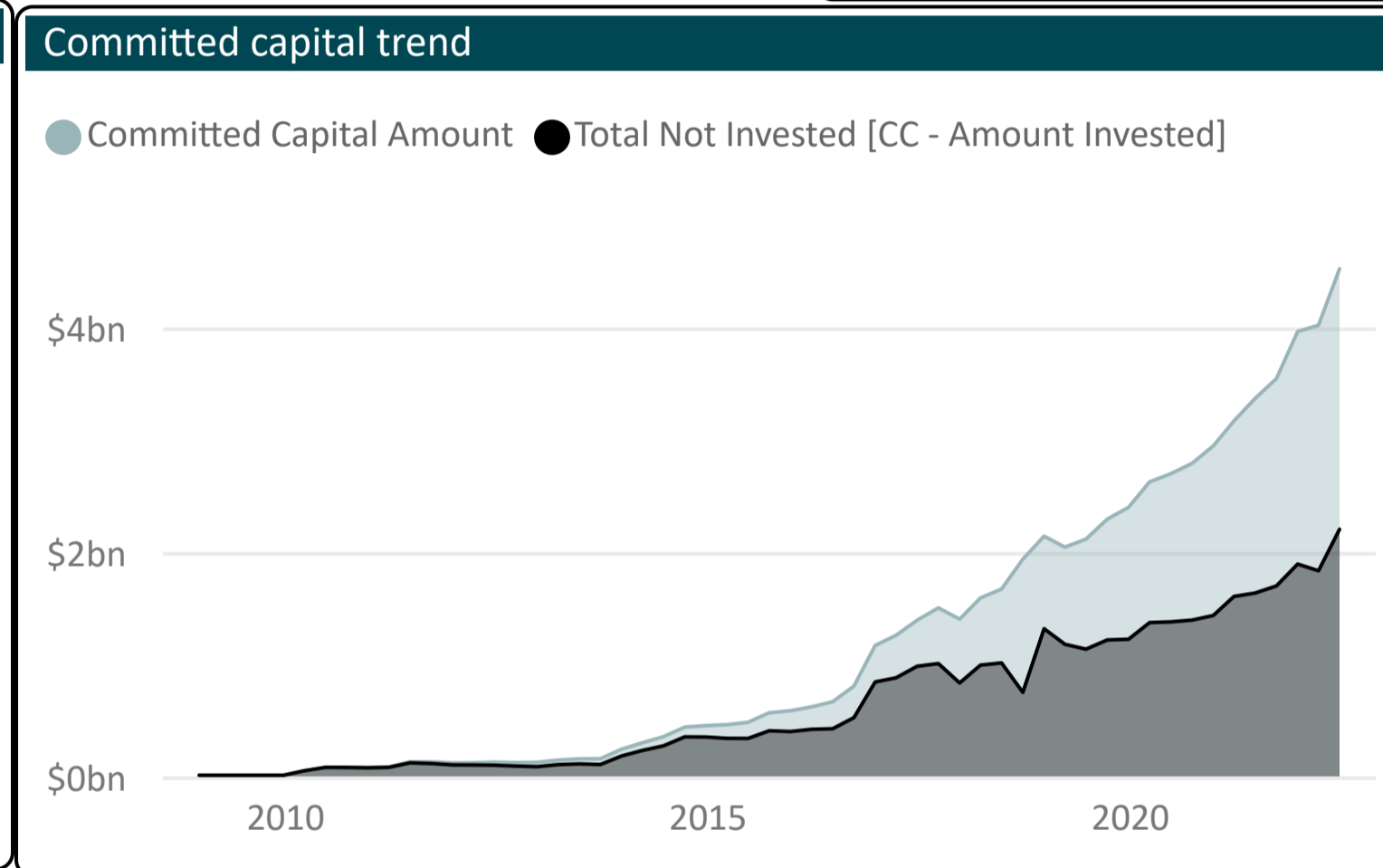
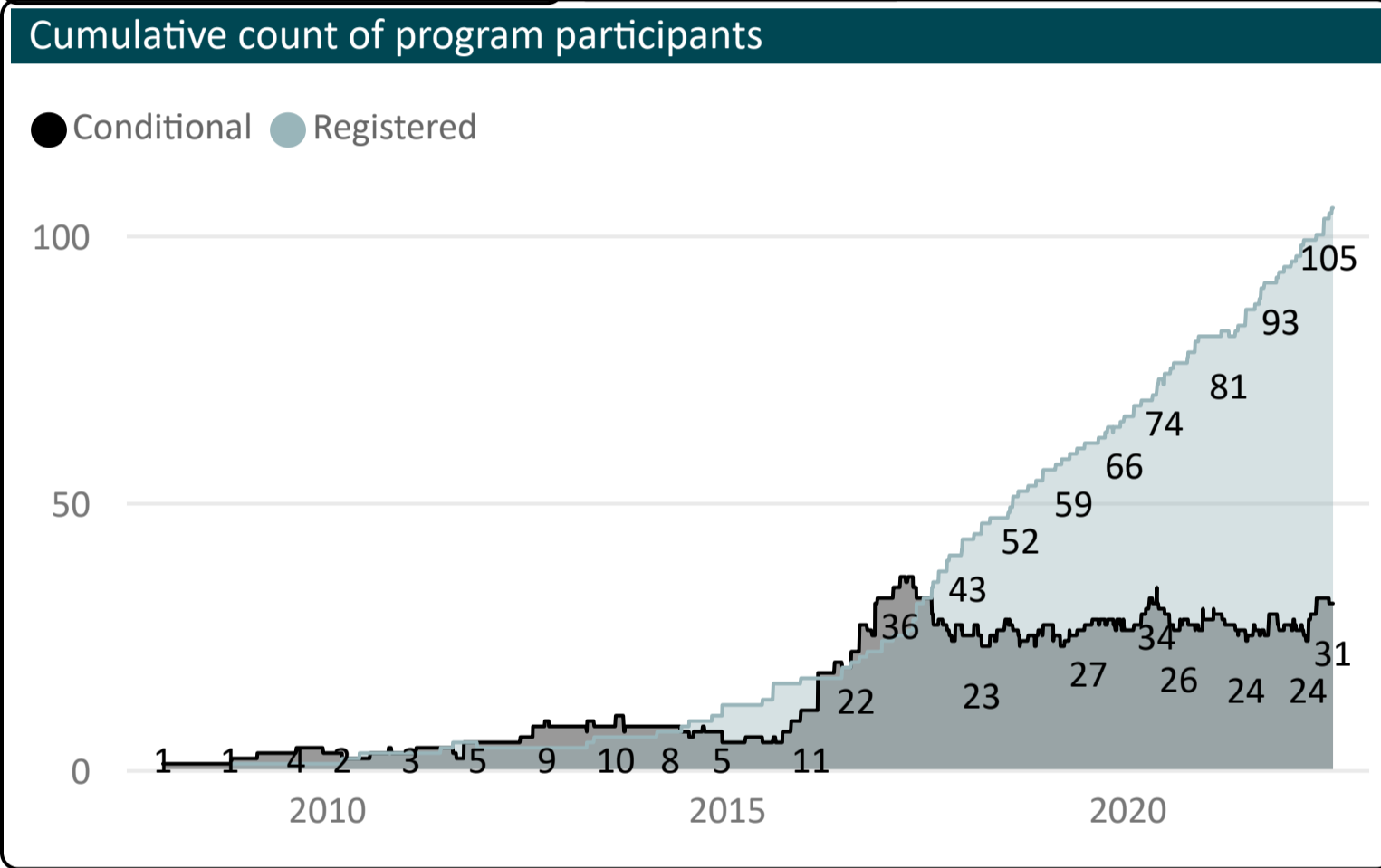
VC Act Programs Dashboard

OFFICIAL: Sensitive

ESVCLP

As at 3 Aug 2022

Program lifetime committed capital \$4.67bn	Median committed capital \$20.00M	Committed capital raised by partnerships registered in last 365 days \$1.03bn	Number limited partners 6435	Number of registration decisions YTD Current FY YTD: 2 Previous FY YTD: 2 YoY% Change: 0.00 % →			Total investment amount \$2.35bn	Estimated number of businesses helped 1543
Current committed capital \$4.57bn		Median committed capital raised by partnerships registered in last 365 days \$24.81M	Median limited partner capital \$150.00K	Median age of currently registered partnerships 4	Average years to deploy half CC of currently registered partnerships 1.99	Median investment amount early stage \$250K	Median investment amount late stage \$601K	



OFFICIAL

Attachment D

Review of Australia's venture capital tax concession programs

On 6 May 2021, the former Government announced a joint Treasury and Industry Innovation and Science Australia review of Australia's venture capital tax concession programs to ensure settings are fit-for-purpose and support genuine early stage Australian startups.

As set out in the Terms of Reference, the purpose of the review is:

- to consider how the concessions operate in practice and whether they are achieving their intended objectives;
- to satisfy the legislative requirement outlined in Section 118-455 of the *Income Tax Assessment Act 1997*; and
- to consider the recommendations of other relevant reviews, to which the Government has not yet responded, that examine the venture capital tax concessions.

The programs in-scope of the review include:

- Venture Capital Limited Partnerships;
- Early Stage Venture Capital Limited Partnerships;
- Australian Venture Capital Fund of Funds; and
- Investments made directly by foreign residents registered under Part 3 of the Venture Capital Act 2002.

Policy or reform recommendations or consideration and costing of policy options were out of scope of the review.

The review was an assessment of whether the programs have met their objectives based on the views of stakeholders, including investors, fund managers, lawyers and industry groups, and the available quantitative data.

Drawing on stakeholder consultations, written submissions and quantitative data analyses, the review found that overall:

- The tax concessions and investment vehicles offered by the programs in scope of this review have been well received.
- These programs have supported the growth of the Australian venture capital sector, which has experienced increased levels of venture capital investment, and the development of venture capital fund managers—the two primary objectives of the programs.
- Stakeholders recognised that the programs are just one contributing factor to the growth of the sector, but noted that their removal would be detrimental to the venture capital sector, and there were some calls for changes to the programs.

The review noted that it is difficult to quantify the effect of the programs and separate the impact of the programs from global venture capital trends, macroeconomic factors and the impacts of a broader suite of support for startups and innovation.

The Income Tax Assessment Act requires the impact assessment report to be tabled by the Treasurer in each House of the Parliament. This has not yet occurred.

OFFICIAL