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Backwards Down Under

While the U.S. returns to early-stage investments, Australia's rebounded economy has clung to the latter-stage, shied away from biotech and IT—and suffered. But things may be turning around.

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SYDNEY – Australia's economy is booming, its IPO market is surging, and there has never been more money available for private equity. Things look good—unless you're in early-stage IT or biotech.

While the United States is shaking off its post-boom wounds and carefully heading back to early-stage investment, Australia is a case study in caution, clinging to latter-stage investments and corporate buyouts. Yet new Silicon Valley friends may help to convince early-stage investors to enter the market.

Australia is experiencing a relative boom. A record total of AU $2.06 billion (U.S. $1.6 billion) in private equity was raised in Australia in the year ending June 30, 2004 (most recent figures), of which about 40 percent was considered to be venture capital (pre-seed to expansion capital), with the rest for buyouts and mezzanine financing, according to the Australian Venture Capital Association Limited (AVCAL). Australia also broke its ASX exchange IPO record in 2004, debuting a record 163 companies—up from 124 in 2003 and 100 in 2002—and raising AU $8.8 billion (U.S. $6.9 billion) from investors. Of the 2004 group, 102 companies finished the year with their share issues above their initial offering prices. The most active sector was mining and mining stocks, with more than 60 companies listing.

Yet investors are staying conservative and, as a result, early-stage venture capital is still relatively underdeveloped and immature here, with only a handful of experienced funds willing to place money into speculative technology plays. For example, the managers of Australia's superannuation funds—the equivalent of American pension funds—have been reticent to inject money into small, entrepreneurial businesses. Australia's angel investment community also remains relatively weak, as the market lacks a strong networking setup.

In the U.S. meanwhile, a "return to seed" trend is gaining traction (see "Return of the Seed"). While their early-stage deals as a percent of total deals was roughly the same in 2004—around 30 percent—that figure has been inching up in the U.S., and slipping down in Australia, according to statistics from VentureOne, AVCAL, and Thomson Venture Economics.

According to *Australian Venture Capital Journal* publisher Victor Bivell, the split between latter-stage and early-stage investors has never been so pronounced.

"That differentiation is far stronger now due to the wide performance disparity between the two sectors," says Mr. Bivell. "Private equity is getting some fantastic performance results in Australia, whereas the main problem with VC is the performance hasn't happened yet—people are still waiting."

The outlook is slightly better in biotechnology, he says, than in IT. "The sector is in favor with investors, getting institutional money and doing a lot of deals, whereas the IT sector is still depressed from the tech boom. People are wondering if there is a future for it in Australia."

Bad Timing

The problem with Australian VC, says Mr. Bivell, is that it has tended to buy in at the wrong time in the cycle. VC investment in technology was practically unknown in Australia until the mid-1980s. That decade's technology boom brought a large number of investors into the market, but they bought in at the cycle's peak. The resulting crash shattered investor confidence, which did not return until the cycle peaked again in the late 1990s.

"During that down-cycle Australian investors should have been investing in early-stage VC, particularly IT, and had they done so they would have had a portfolio and companies to sell into the boom. Instead, they had nothing to sell into the boom, so they were buyers rather than sellers."

They may have learned from their mistakes. Early-stage investor Innovation Capital has announced plans to raise AU $75 million (U.S. $59 million) for a new fund concentrating on early-stage investments in IT and biotech. Chairman Michael Quinn is confident that the boom in management-buyout-based private equity is reaching its peak.

"The super funds managers tell me that they want to have a presence in this space. They want to get into early-stage investments to diversify."

If institutional investors are more willing to hand money over to VCs, it is because many of the less-successful managers have been weeded out. According to Australian entrepreneur and Santa Clara Group consultancy director Tony Surtees, many of the funds started in the late 1990s were staffed by people who had no knowledge of the actual entrepreneurial process, including fund managers and investment bankers. They needed business skills.

"The previous VC funds did not work," says Mr. Surtees. "Where they didn't have domain-specific expertise building the business, the only thing they really added was money. These businesses obviously need money, but they need a lot more than that as well."

Moving Up

Only one early-stage technology investment fund in Australia raised a significant amount of capital in 2004: Melbourne-based technology specialist Starfish Ventures scored $123 million from private investors last November.

Starfish investment principal John Dyson sees brighter days ahead. "Prior to June 2003 it had been pretty tough in the Australian market for 18 months or so, when not many funds were raised," he says. "But following the improving stock market over the last 18 months and the IPO window opening up, and people becoming a bit more confident about the economy and the private asset class as a whole, investors have started to recommit."

To succeed, they need better footing in the U.S. Small as Australia is (population: 20 million), its startups have a difficult time delivering a healthy internal rate of return domestically. As a result, many aim to capture a part of the much larger American market, and stumble. The need for U.S. experience among VCs has long been discussed, but rarely enacted.

The U.S. has also struggled to make a connection. But a major milestone came in November 2004, when Menlo Park, California-based Draper Fisher Jurvetson announced it would partner with the Australian firm Allen & Buckeridge to create the AU $200 million (U.S. $157 million) DFJ Southern Cross Fund specifically for investment in early-stage Australian technology companies.

For Allen & Buckeridge, which is considered one of Australia's most experienced group of VC investors, it is a shot in the arm for their attempts to raise new funds, as many of its investment companies are yet to present an exit opportunity. The fund will be used to invest in companies identified as having specific potential in the U.S. market, with DFJ using its connections to assist in their transition across the Pacific. Allen & Buckeridge joins 16 other DFJ-affiliated funds in the U.S. and Canada.

Silicon Valley-based Allen & Buckeridge partner Frank Foster says the fund's goal is to find Australian companies with immediate potential in the U.S., and use its investment to assist in the migration process.

"Australia is much better positioned to participate in the early stage," says Mr. Foster. "The strength of Australia lies in the innovation, not the ability to generate later-stage companies in the Australian market.

"I'm a big believer that countries such as the U.S. and Australia have got to invest in venture capital," he continues, "as India and China take away the manufacturing base. And the way you are going to have your economy have higher-value goods is by taking risk with venture capital."

The "safer" wait-and-see approach has proved the riskiest for Australia. With DFJ showing it the ropes, the country may now be ready to be adventurous.