NATIONAL RECONSTRUCTION FUND SUBMISSION

7 February 2023

aic.co

AUSTRALIAN INVESTMENT COUNCIL

The voice of private capital

About the Australian Investment Council

The Australian Investment Council (**the Council**) is the peak body for private capital in Australia and has 200+ members who work to build strong businesses that support our communities, create new employment opportunities, and grow our nation's economy.

The private capital investment industry employs close to 500,000 people across the economy and is a critically important investment and efficiency driver for Australian industries and businesses. Fund managers invest capital from a wide variety of domestic and offshore institutional investors to support the growth of thousands of high-potential Australian businesses. In addition to providing equity capital, private capital fund managers provide those businesses with a mix of strategic support, mentoring and networking to help them unlock growth opportunities in domestic and international markets, which underpins the creation of new jobs across all sectors of the economy and boosts economic growth.

Private capital makes a significant contribution to the Australian economy and accounts for almost three per cent of Australia's GDP. Economic analysis confirms that one in nine new Australian jobs are created by private capital-backed Australian businesses, which reinforces the important job-creating role that private capital investment can play across all sectors of the economy.

Members of the Council comprise the leading domestic and international private capital firms operating in Australia, and span private equity, venture capital, private credit, family offices, superannuation and sovereign wealth funds.

They invest into a wide range of businesses across every sector of the Australian economy from early-stage to fast growth, turnaround and those requiring expansion capital. These are businesses that require a steady flow of foreign and domestic investment capital to provide goods and services to meet community need in industries such as healthcare, education and hospitality, aerospace, agriculture, manufacturing, decarbonisation and climate change, financial services, and consumer goods.

The Council represents private capital on policy issues that support investment into high-growth potential Australian businesses covering the themes of maintaining a steady and reliable flow of domestic and foreign investment capital; building and retaining a world class talent pool; and harnessing and empowering innovation to support the national interest.

Statistics on Private Capital

Community	Australian Investment Council members support more than 850 businesses of varying sizes businesses across every sector of the economy that provide products and services to meet community need.
Economy	Australian-based private equity and venture capital fund managers have close to $50 billion in assets under management and contribute approximately three per cent of GDP through the investments they make into businesses from early stage to fast-growth and turnaround.
Employment	Around 500 000 full-time jobs are supported directly or indirectly through private capital investment in Australia.

Contents

1. Summary of recommendations

The Council thanks the Department of Industry, Science and Resources for providing the opportunity to comment on the establishment and operation of the National Reconstruction Fund (**NRF**). The Council commends the Federal Government's focus on building Australia's sovereign capabilities and industrial base and is broadly supportive of the NRF concept.

The Council further supports the proposed intent of the NRF, which is to 'crowd-in' private sector investments in priority areas without displacing private investments that would otherwise occur.

To ensure that the NRF successfully promotes investment in the identified priority areas, the Council recommends the following actions:

1. The NRF replicate the statutory framework of the Clean Energy Finance Corporation, striking the right balance between predictability and certainty, and the discretion to respond to changes in market dynamics.
2. Establish an advisory panel of industry and investment community experts for periodic engagement with the NRF Board to ensure the NRF's settings are conducive to maximising private investments in the Federal Government's priority areas.
3. Definitions and scope for investing in priority areas be sufficiently broad to allow the NRF the ability to co-invest in activities that will best build the desired sovereign capabilities and industrial base.
4. In setting the NRF's targeted rate of return, Government recognises and incorporates the public policy benefits of NRF investments into the rate of return.
5. To support the longevity of the NRF, ensure mechanisms exist to periodically review and amend the seven priority areas to ensure they remain appropriate from national priority and investability perspectives.
6. Ensure that the NRF's risk tolerance does not preclude involvement in early stage or emerging investments within stated priority areas.
7. Empower the NRF to make cornerstone investments at the size and scale required to catalyse private sector investment.
8. As a complementary measure to the NRF, introduce a skills and workforce package that includes the doubling of the Global Talent Scheme and facilitation of other forms of skilled migration, provides federal funding that establishes STEM skills into the Australian school curriculum and amplifies programs that provide visa extensions to foreign students upon graduation.

The following submission provides further details and insights into these recommendations.

2. The overarching purpose and structure of the National Reconstruction Fund

Recommendation 1: The NRF replicate the statutory framework of the Clean Energy Finance Corporation, striking the right balance between predictability and certainty, and the discretion to respond to changes in market dynamics.

The Council is supportive of the Federal Government's intent to establish the NRF as a vehicle to stimulate private investment in sovereign capabilities and Australia's industrial base in the seven targeted priority areas.

The stated purpose of the NRF is to be an agent that 'crowds-in' private sector investors into the priority areas identified by the Federal Government. The NRF envisages co-investment through a variety of channels including direct equity investment in relevant projects, concessional loans and government guarantees for businesses within the priority sectors, or investments into managed investment schemes. The Council's submission is focussed on issues relating to the involvement and interactions of managed investment schemes with the NRF.

Noting that the primary focus of the NRF is to stimulate private sector investment, the Council is supportive of the intention to model the statutory framework for the NRF on the Clean Energy Finance Corporation (**CEFC**). The 2018 Statutory Review of the CEFC found that for every one dollar invested by the Fund, $2.70 was invested by the private sector. The review found this conclusive in determining that the CEFC was meeting its mandate to facilitate increased flows of finance into the clean energy sector.

As with the CEFC, The Council supports a principles-based approach for the governing legislation of the NRF, allowing the proposed NRF Board to set the investment decision-making process of the Fund, and to respond to changing market dynamics, while the proposed investment mandate mechanism provides ministerial input on a defined set of policy and investment issues. The Council believes this framework will provide the right balance between predictability and certainty of the NRF's operation, and the ability for the Fund to have the discretion to respond to changing market conditions.

As an example, the flexibility provided by the CEFC investment mandate mechanism has been integral in the CEFC achieving its mandate. The initial targeted benchmark returns were too high and risk profile too conservative, significantly reducing the CEFC's ability to invest in emerging and innovative clean energy technologies that would transform Australia's renewables industry. This was resolved through 2016 mandates that explicitly suggested a focus on emerging and innovative technologies and noting that such investments will necessarily increase the corporation's exposure to risk.

3. Types of private capital investment

Recommendation 2: Establish an advisory panel of industry and investment community experts for periodic engagement with the NRF Board to ensure NRF settings are conducive to maximising private investments in the Federal Government's priority areas.

The proposed NRF seeks to spur private investment through direct equity investment in projects and companies, concessional loans and guarantees, and investments in managed funds.

To this extent, providing an investment structure that is conducive to both the managed fund sector and co-investment that enables private capital funds to make investments broadly aligned to their investment mandates will be critical for the NRF to meet its investment objectives.

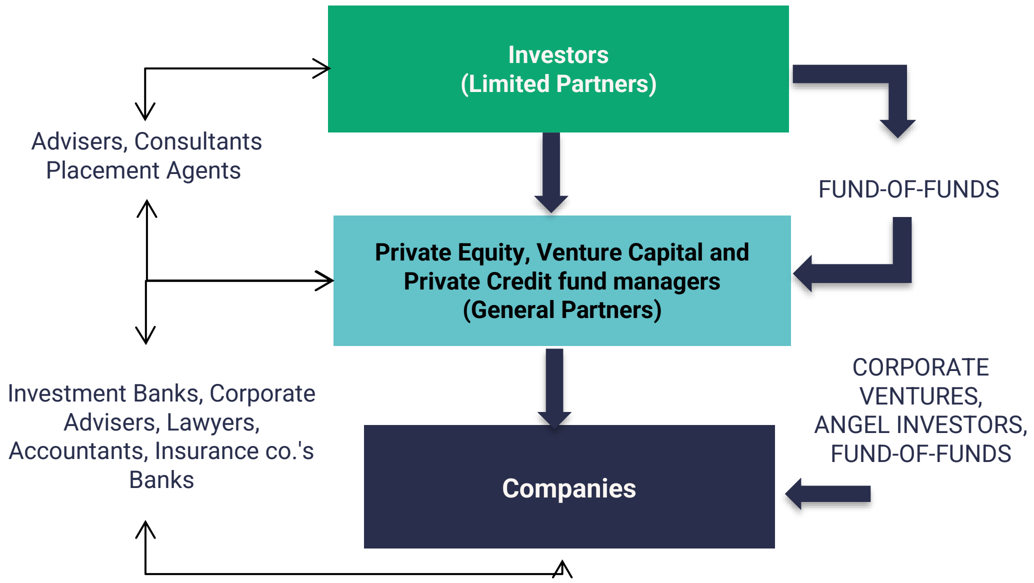
The managed fund sector alone is made up of distinct entities and funds with significantly different operations and drivers including private equity, venture capital, superannuation and sovereign wealth funds, family offices, institutional investors and private credit funds.

As these funds have different investment mandates, risk profiles, and bound by different regulatory requirements. A one-size-fits-all approach by the NRF to encourage private capital investment may be sub-optimal. This was identified during the evolution of the CEFC which had its investment mandate direction updated in 2020 to reflect changing market conditions and to ensure a more generalised investment mandate is applied in order to attract greater investment from the private sector.

To maximise investment from private capital investors, as outlined in **Recommendation 2** in this submission, the Council recommends the Government establish an advisory panel of private capital investors and industry to meet periodically with the NRF to ensure the fund structure and mandate settings will continue to have the desired effect of encouraging private capital investment.

A high-level outline of the private capital ecosystem is shown in **Figure 1** below.

Figure 1: Private capital ecosystem



Investors into private capital funds include superannuation funds, family offices, sovereign wealth funds, institutional investors, high net worth individuals and endowment funds.

Private equity and venture capital funds are typically set up as limited partnerships. When they have raised their investment targets from the investors, the fund raising is closed and investments are deployed into portfolio companies over a number of years. The funds can have varying strategies on where investment capital can be deployed with some operating in niche industries where they can apply specific expertise while others invest in a broader range of industries to diversify their portfolios.

Private Credit Funds provide debt funding to private capital funds.

Fund of Funds invest in other private equity and venture capital funds and may also invest directly into companies via co-investments.

Compliance and administrative costs

A summary of the key ongoing compliance and administrative costs for private equity transactions and who typically pays for them is outlined in **Table 1** below. To attract private capital investment, consideration needs to be given to areas where there may be a doubling of fees in the construct of the NRF, such as for example an investment by the NRF in a managed fund that targets one or more priority areas on the basis that the fund (or the fund manager) also charges fees that are borne by its investors, and where these may potentially disincentivise investment from the private equity and venture capital investment ecosystem.

Table 1 – Summary of key ongoing costs in private equity investment [1]

Type of fee	Description	Where the cost/fee typically occurs
Management fees	The fee paid out of the fund's assets to the manager (GP) in consideration for the provision of investment management services. Often management fees are reduced for things such as: a) placement agent's fees b) equalisation payments (see 14 below) c) organisational fees that exceed agreed caps d) director's fees (where a representative of the GP serves on a portfolio company board).	Limited Partnership
Performance fees/carried interest	The portion of distributions paid from the Fund to the GP above a return of capital contribution and preferred return paid to LPs.	Limited Partnership
Transactional and operational costs	Organisation's expenses – costs relating to establishing and offering interests in the fund (typically capped)	Limited Partnership (to cap) General Partner (above cap)
Other transactional and operational costs	Expenses related to the Investment (due diligence, acquisition etc) service provider expenses, insurance, investor reporting, regulation and compliance, tax.	Limited Partnership
Placement agent fees	Placement agents help private capital funds attract investments, however, may provide other services to a fund in its initial stages (e.g. marketing and drafting presentations). Placement agents are usually paid a percentage of the funds they raise, typically of around two per cent.	General Partners
Portfolio company costs	The costs that relate to the business held by the operating/ holding vehicle (e.g. staff costs, director fees, rent etc.). ASIC also extends this to include the cost of issuing shares in the operating/ holding vehicle to the PE fund and the costs of listing the operating/ holding vehicle on a financial market.	Portfolio Company

Industry engagement

The Council submission provides high-level feedback on the NRF settings that is likely to facilitate managed funds involvement, however, the Government may benefit from the specific expertise from the broad set of stakeholders within the investment community. To this end, **the Council would welcome the opportunity to host a Government-Council member forum to ensure the settings of the NRF maximise private investor involvement from across the membership.**

[1] Source: Financial Services Council

4. Priority investment areas

Recommendation 3: Definitions and scope for investing in priority areas be sufficiently broad to allow the NRF the ability to co-invest in activities that will best build the desired sovereign capabilities and industrial base.

The Council is agnostic as to what the priority areas of the NRF should be but is concerned as to how they may be defined within the proposed Priorities Areas Declaration.

Prescriptive or narrow definitions for the priority areas may inadvertently act as a barrier for the involvement of private investment schemes, such as private equity and venture capital. Many of the required investments to build Australia's sovereign capabilities and industrial base are enabling technologies or industrial processes that will create significant productivity gains within priority areas but may not be specific to them.

As an example, the Australian Farm Institute has suggested that the introduction of 'digital' agriculture, through the utilisation of big-data and block-chain technologies, can create an additional A$20 billion in value for Australian Agriculture, however, the development and utilisation of these technologies and processes will not be unique or solely for agricultural purposes. NRF prescriptions that would disallow investment in such enabling technologies would limit opportunities to grow Australia's capabilities in identified priority areas.

Similarly, outside of medical manufacturing, renewables and low emissions technologies, there are few viable opportunities for dedicated funds that specifically focus on the Government's identified NRF priority areas. The Council recommends the investment mandate of the NRF be kept sufficiently broad to attract private capital investment and to not preclude or restrict funds wanting to invest into the NRF. A legislative or regulatory requirement that a managed fund must have a sole or predominant focus on a priority area will severely limit the ability of the NRF to catalyse private sector investments.

5. The investment mandate, risk profile and the benchmark rate of return

Recommendation 4: In setting the NRF's targeted rate of return, Government recognises and incorporates the public policy benefits of NRF investments into the rate of return.

Recommendation 5: To support the longevity of the NRF, ensure mechanisms exist to periodically review and amend the seven priority areas so they remain appropriate from national priority and investability perspectives.

Recommendation 6: Ensure that the NRF's risk tolerance does not preclude involvement in early stage or emerging investments within stated priority areas.

Recommendation 7: Empower the NRF to make cornerstone investment at the size and scale required to catalyse private sector investment.

The stated purpose of the NRF is to be an agent that 'crowds-in' private sector investors into the priority areas identified by the Federal Government, suggesting that there is an unmet need in these areas or an inherent market failure in capital flows for these priorities. Conversely, the NRF seeks to avoid displacing or duplicating investments that could be made by the private sector.

Risk and rate of return

As such, an overly conservative risk profile for the NRF combined with an optimistic benchmark rate of return will fail to meet the above-mentioned requirements for the Fund. If a conservative risk profile can still provide healthy expected rates of return, it is likely the private sector would already be investing in these opportunities. At best NRF investments in these opportunities would do little to change the decision-making of private investment, and at worst may displace those investments.

This problem was primarily evident in the operation of the CEFC. The statutory review of the CEFC noted that sought returns for the Fund were too high for the stated level of risk when compared to other similarly constituted government funds, and this may have led to the CEFC investing in activities that displaced private investments.

The CEFC initially sought returns equivalent to the Government bond rate plus 4 to 5 per cent, per annum, despite CEFC's conservative approach to risk. This was later revised down to the Government bond rate plus 3 to 4 per cent, per annum. This equated to a sought return of 5.8 to 6.8 per cent. In contrast, the Government's Future Fund sought a target return rate of the consumer price index plus 4 to 5 per cent, per annum, equating to a target return rate of between 5.5 to 7.5 per cent.

The CEFC was expected to provide returns within 0.7 per cent of Future Fund returns. This targeted return seems unrealistic, noting that CEFC investments are significantly narrowed by the sought public policy benefits it must achieve, while the Future Fund is solely focused on profit maximisation. Other special purpose government investment funds, such as the Northern Australia Infrastructure Facility, seeks a return that covers the Fund's administrative costs and the Commonwealth's cost of borrowing.

The failure to adequately price and include the public policy benefits of CEFC investments into rate of return considerations may have contributed to sub-optimal outcomes in terms of meeting the objectives of the Fund, avoiding worthwhile investments based on an unrealistic risk-return profile. The NRF success will be dependent on avoiding the pitfalls of the CEFC.

Maximising the crowding-in of private capital

An investment mandate with a risk profile that allows and encourages investment in early stage or emerging technologies/processes/businesses within the priority areas is most likely to encourage private sector investments. NRF investments can be utilised as cornerstone investments in establishing nascent funds that have a focus on identified priority areas, providing a level of assurance and confidence to other private investors as to the bona fides and prospects of the fund.

Many of CEFC's successful investments provided the cornerstone investments in capital raising efforts for managed funds focussing on CEFC's priorities. These investments include A$110 million into Investa's Commercial Property Fund A$600 million capital raise for the purposes of investing in the energy efficiency ratings of commercial property; and A$75 million commitment to the Palisade Renewable energy Fund, securing $500 million in overall capital to invest in utility scale renewable energy projects.

These cornerstone investments have been most successful in encouraging private sector investment, catalysing nearly five-dollars of private investments for every one-dollar invested by the CEFC, significantly higher than the A$2.70 generated in the overall CEFC portfolio.

As such, the NRF should have sufficient flexibility for investment on a sliding scale matched to the nature of the investment to engender the confidence of private capital, venture capital and private credit investors to invest into the Fund.

6. Complementary reforms and non-financial measures to boost investment in priority areas

Recommendation 8: Introduction of a skills and workforce package that includes the doubling of the Global Talent Scheme and facilitation of skilled migration, federal funding that establishes STEM skills into the Australian school curriculum, and amplifying programs that provide visa extensions to foreign students upon graduation.

The most critical complementary policy reform required to ensure that the NRF builds Australia's industrial capabilities is addressing Australia's skills shortages and global war for talent. Investments in the seven identified priority areas will require a capable and skilled workforce to convert investments into economic activity. To this end, the Council commends the Federal Government's focus on addressing these skills shortages, including the Jobs and Skills Summit process.

Skilled migration has been a key feature of Australia's migration system, playing an important role in generating economic growth for successive decades. Australia has had a long history of supportive policies to attract business entrepreneurs. However, the rising global mobility of workers and heightened competition for talent, particularly within the NRF's priority industries, suggests Australia's efforts on attracting skills and talent must be amplified.

As a priority, the Council recommends that the Federal Government consider doubling the resourcing for the offshore marketing of the national Global Talent Scheme, which provides streamlined visa pathway for highly skilled professionals to work and live permanently in Australia and facilitates additional opportunities for skilled migration.

Australia should readily exploit its competitive advantage in international education and tap into the talent and skills that the foreign student cohort provide. To this end, the Council recommends the Government extends visas for foreign students who graduate from Australian universities in disciplines where there are skills shortages within the identified NRF priority industries.

In the long-term, Australia must rely on creating its own skilled workforce to avoid the zero-sum game that is the global war for talent. As such, the Council recommends the Government fund the development of an integrated Australian school curriculum for STEM from primary school all the way to tertiary education. This will increase the quality and availability of STEM courses for students at all levels of education.

The contact for this submission is Navleen Prasad, Chief Executive Officer, **P:** +612 8243 7000 **E:** navleen.prasad@aic.co.

Best regards

Ms Navleen Prasad
Chief Executive Officer
Australian Investment Council

Level 12, Aurora Place
88 Phillip Street
Sydney NSW 2000
+61 2 8243 7000
mail@aic.co
aic.co