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Market Failures in Australia's Capital Market

Why Australian Medium Size Firms Find Growth So Hard

John H Howard, September 2024

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"Failure" in the Australian Capital Market for Medium Size Technology Growth Firms

The challenges Australian medium-sized growth firms face in accessing private equity suggest some market failure characteristics. Key indicators of such a market failure include. These are outlined below.

Under-provision of Capital to Medium-Sized Firms

There appears to be a gap in the Australian capital market, where capital is disproportionately flowing to larger, more established firms and sectors perceived as lower-risk or offering higher returns. This leaves medium-sized growth firms underserved, especially those that require smaller amounts of capital or operate outside of favoured sectors like technology.

This under-provision could be described as a form of market failure, where the financial market does not efficiently allocate resources to businesses that could benefit from private equity investment.

Lack of Financial Sophistication Among Medium-Sized Firms

Many medium-sized firms in Australia may lack the financial sophistication or networks to engage effectively with private equity investors, further exacerbating the capital gap. While this is less an outright market failure and more a reflection of firm-level readiness, it does highlight a structural weakness in the market that limits the flow of private equity to these firms.

In comparison, medium-sized US and European firms often have more established ecosystems of financial advisers, legal experts, and networks that can facilitate private equity transactions.

Concentration of Investment in Certain Sectors

The Australian private equity market is highly concentrated in specific sectors, which could indicate a form of market failure where other important sectors for broader economic growth are neglected.

In more diverse markets like the US and Europe, private equity capital is more evenly distributed across industries, allowing for more balanced economic growth.

Access to Private Equity

Accessing private equity (PE) for medium-sized growth firms in Australia is generally considered more challenging than in the US, UK, or Europe. Several factors contribute to this, ranging from the maturity and depth of the PE market to regulatory and structural differences between these regions.

Market Depth and Scale

The US and UK PE markets are significantly larger and more developed than Australia's. The US, in particular, has a much deeper capital market with a long history of PE investing across a wide range of industries and deal sizes. Similarly, the UK and European markets benefit from a larger pool of PE firms, a more established network of advisers, and a broader base of institutional investors. In contrast, Australia’s PE market is smaller, and much of the capital is directed towards large buyouts rather than the medium-sized growth firms that may require smaller, growth-stage capital injections.

Deal Size and Investor Preferences

In Australia, PE firms often prefer larger deals due to the fixed costs and complexities of managing investments. This can limit the availability of PE funding for medium-sized firms, which might not meet the typical deal size expectations of many private equity investors.

In the US and Europe, where the markets are more mature, there is greater diversity in PE funds, including more specialised funds that cater specifically to mid-market or even smaller growth companies. This diversity gives firms more options to find the right fit for their investment needs .

Sector Focus

The Australian PE market has been heavily concentrated in specific sectors such as natural resources, real estate, and, more recently, technology. This focus can make it difficult for medium-sized firms in less "trendy" sectors, such as manufacturing or retail, to attract PE. In contrast, in the US and Europe, the variety of sectors represented in PE portfolios is broader, which provides more opportunities for firms across diverse industries to access growth financing.

Geographic Isolation

Australia's geographic isolation and relatively small population limit the domestic market for many firms, making medium-sized businesses less attractive to PE investors looking for scalable growth.

In contrast, US and European firms often have access to larger domestic and regional markets, increasing their attractiveness to PE firms that seek to scale businesses more easily. The geographical advantage in these larger markets reduces the perceived risk for investors, allowing PE firms to be more open to mid-market deals.

Government and Institutional Response

To address this issue effectively, a concerted effort must be made to develop Australia's mid-market PE ecosystem through initiatives like targeted tax incentives, co-investment schemes, and enhanced advisory services.

Furthermore, improving access to PE for medium-sized firms would likely require more robust networks between firms and investors and a cultural shift within the private equity industry to recognise the growth potential of these businesses.

Conclusion

While medium-sized firms in the US, UK, and Europe generally face fewer barriers to accessing private equity due to the more developed nature of their financial markets, Australian firms encounter more challenges, indicating a degree of market failure. The limited scale of the Australian market, sectoral focus, and reluctance of private equity firms to engage with mid-market deals all contribute to the difficulties faced by growth-stage companies. Addressing these barriers will require structural changes in the market and proactive measures from both the government and the financial sector to make private equity more accessible to medium-sized firms in Australia.

Access to Capital Through the ASX

Evidence suggests a potential market failure in Australia for medium-growth technology firms that cannot access sufficient funds through the ASX (Australian Securities Exchange) to finance

expansion and growth. The limited number of technology companies listed in the ASX top 200—only 14—highlights a structural issue that may be impeding the growth of Australia's tech sector. This reflects broader challenges technology firms face in raising capital through equity markets and private funding mechanisms like private equity and venture capital.

Structural Challenges in the ASX for Tech Firms

Companies from sectors such as mining, banking, and industrials traditionally dominate the ASX. This presents challenges for technology firms, which may struggle to attract attention from investors more accustomed to these traditional sectors. Investors on the ASX tend to prefer established, dividend-paying companies with stable earnings, while technology firms, particularly those in the growth stage, often operate with high levels of uncertainty, requiring significant capital for expansion but with delayed profitability.

In markets like the US, where tech companies dominate indices like the NASDAQ and have access to deeper pools of capital, there is more alignment between the needs of growth-stage technology firms and investor expectations. By contrast, Australian investors may be less willing to support high-risk, high-reward technology companies, which results in a lack of visibility and support for these firms on the ASX.

Lack of Liquidity and Institutional Support

Liquidity and investor interest in Australian technology firms are also limited. The ASX, with its relatively small tech presence, does not provide the same level of institutional support and market liquidity that the NASDAQ or even the London Stock Exchange offers to tech companies. This limitation means that Australian tech firms may struggle to raise sufficient funds for growth, even when they go public.

Moreover, Australia’s relatively smaller domestic market limits the scale at which technology firms can grow. This discourages institutional investors, such as superannuation funds, from allocating significantly to high-growth tech firms. When tech firms fail to attract institutional backing, they face a more limited pool of available capital.

Indicators of Market Failure

Several indicators suggest a potential market failure in Australia:

Concentration of ASX Companies: Only 14 technology firms are listed among the top 200 ASX companies, which suggests that the market is not sufficiently supporting or scaling high-growth tech firms. This is disproportionate compared to other developed markets where tech dominates indices.

Under-provision of Capital: Medium-sized tech firms' inability to secure necessary funds either through private equity or public offerings may indicate a failure of the financial markets to allocate resources efficiently to sectors crucial for future economic growth.

Investor Risk Aversion: There is a general preference for low-risk investments in Australia’s equity market, particularly among large institutional investors. This risk aversion is problematic for tech firms, which typically operate with high levels of risk during their growth phases.

Comparative Market Failures: The Global Context

In contrast, technology firms in the US and Europe have greater access to public markets and more diversified pools of capital. The NASDAQ, for example, provides a dedicated platform for tech companies, offering them access to a wide investor base, sector-focused indices, and liquidity. European stock exchanges have also developed specialised segments to support high-growth tech firms (e.g., the London Stock Exchange’s AIM market for smaller companies.

Additionally, governments in these regions provide more targeted support for scaling technology firms through grants, innovation hubs, and policies that encourage risk-taking. In Australia, while some government initiatives exist (e.g., R&D tax incentives), they are insufficient to bridge the funding gap for medium-sized tech companies unable to raise capital through the ASX.

Policy Implications

To address this market failure, a few policy interventions could help:

- Creation of a Technology-Specific Market or Index: A dedicated tech-focused segment within the ASX could help increase visibility and liquidity for Australian tech companies, similar to the NASDAQ or AIM markets.
- Government Co-Investment Funds: Expanding government-backed co-investment schemes, in partnership with private equity or venture capital firms, could bridge the funding gap for medium-growth tech companies that are too large for venture capital but too small for the ASX.
- Institutional Investor Incentives: Policy changes that incentivise superannuation funds and other institutional investors to allocate more capital towards high-growth sectors, including technology, could also help address this gap.

Conclusion

Australia's relatively small number of technology firms in the ASX top 200, combined with the challenges medium-sized tech firms face in accessing both public and private capital, suggests a market failure in the provision of funds for this sector.

Unlike in larger, more developed markets like the US and Europe, Australian tech firms struggle to find the capital needed for growth, exacerbated by the market's structural and cultural aversion to risk.

Addressing these issues requires a multi-faceted approach, including changes to public market structures, increased institutional investment, and supportive government policies to bridge the funding gap for growth-stage tech firms.

The Australian Banking System

Similar considerations apply to Australia's banks, which are often reluctant to lend to medium-sized technology growth firms. This issue stems from several structural, market, and risk-related factors that make traditional bank financing a less accessible option for tech companies, particularly those in the growth phase.

Risk Aversion and Collateral Requirements

Like many traditional lenders, Australian banks tend to favour companies with stable cash flows and tangible assets that can be used as collateral. Medium-sized technology firms, especially those in their growth stage, often lack the physical assets banks typically require as security for loans.

Instead, these companies tend to have intangible assets such as intellectual property (IP) and software, which are harder for banks to value and use as collateral.

Technology firms also often face uneven or unpredictable cash flows due to high upfront investment costs in research, development, and marketing, with delayed returns. This volatility increases banks' perceived risk, making them hesitant to provide loans to tech firms, particularly compared to more established industries with predictable revenue streams.

Lack of Sector Expertise

Australian banks have traditionally focused on lending to mining, real estate, and agriculture sectors, which are central to the country's economy. Many banks lack the specialised knowledge required to evaluate technology firms' business models and growth potential.

This lack of expertise makes it difficult for them to assess the viability and creditworthiness of medium-sized tech companies.

In contrast, sectors with well-established financing structures and a long history of bank lending face fewer barriers. Tech firms, particularly those that rely heavily on innovation and scalability rather than traditional business models, do not fit neatly into the risk profiles that banks are accustomed to.

Short-Term Focus

Banks are typically more focused on short- to medium-term lending, which requires relatively predictable repayment schedules. However, technology firms, especially those in their growth phase, often require long-term capital as they scale their operations.

The growth trajectory of these firms can involve long periods without profitability as they reinvest revenues into expansion, making them unsuitable for traditional bank loans with fixed repayment schedules.

In the US and UK, banks may partner with venture capitalists or provide more flexible lending products that accommodate the unique needs of tech firms, such as revenue-based financing or venture debt. In Australia, such options are less common, limiting access to suitable funding to medium-sized tech companies.

Preference for Private Equity and Venture Capital

Given these barriers, many medium-sized technology firms in Australia turn to private equity and venture capital for funding rather than banks. Private equity and venture capital investors are more willing to take on higher levels of risk in exchange for potential equity stakes and high returns.

However, as discussed earlier, private equity and venture capital funding for medium-sized firms are also limited in Australia, further constraining growth for tech companies.

Cultural Aversion to Risk

Australian financial institutions, including banks, are often more conservative than their counterparts in markets like the US and Europe. This cultural aversion to risk is reflected in their lending practices, where banks prefer to finance established companies with predictable earnings.

With their high-risk, high-reward models, technology companies are seen as outside the banks' comfort zone. This contrasts with markets like Silicon Valley, where banks are more accustomed to financing tech firms, often collaborating with venture capital funds.

Impact of the Banking Oligopoly

Australia's banking sector is one of the most profitable in the world, driven by its concentration and ability to dominate key lending markets, including mortgages and business loans. This oligopoly discourages competition and innovation in lending practices, as the dominant banks have little incentive to serve riskier, high-growth sectors like technology.

Instead, they focus on safer, well-established industries, where loans are secured by tangible assets such as property or equipment, reducing the need to innovate risk management or loan products.

The Big Four banks have consistently preferred lending to sectors with low-risk profiles, such as real estate, which offers immediate, asset-backed security. In contrast, medium-sized technology firms, which often rely on intangible assets (such as IP) and face cash flow volatility, do not align with the banks' traditional risk frameworks.

This conservative approach limits access to finance for growth-stage firms and reduces the diversity of financing options available .

The Abolition of Development Banks

The abolition of key development institutions such as the AIDC and the absorption of the Commonwealth Development Bank into the Commonwealth Bank of Australia (CBA) eliminated specialised financial institutions designed to support industrial development and high-growth sectors.

These institutions were critical in providing patient, long-term capital for sectors vital for national economic development, but private financial institutions were unwilling to serve due to higher perceived risks.

The absence of these development-focused institutions means that medium-sized growth firms, particularly in technology, now face a market dominated by private banks, which prioritise short-term profitability over long-term, high-risk investments. This creates a gap in the financial market that is not easily filled by private equity or venture capital, which tends to focus on early-stage or established firms.

Potential Solutions to Address the Problem

Several measures could be considered to address this issue and improve access to finance for medium-sized technology growth firms. These are discussed below.

Re-establish a Development Bank

Re-establishing a development bank focused on industrial and technological growth could address this market failure. A new Australian Development Bank could be tasked with providing long-term financing to medium-sized firms in sectors with high growth potential but higher risk profiles, such as technology. This bank could operate alongside private financial institutions, providing loans, guarantees, and co-investment schemes for firms struggling to access commercial banks' funding.

The bank could be modelled on successful international examples, such as the European Investment Bank or Germany's KfW, which provide strategic funding to sectors deemed essential for national development. The focus would be on patient capital, allowing firms to scale over time without the immediate pressure for profitability that traditional banks require.

Incentivise Competition in the Banking Sector

Introducing measures to increase competition in the banking sector could push the Big Four banks to innovate their lending products and take on more risk. This could be achieved through regulatory reforms encouraging new entrants into the banking market, including smaller, specialised banks or fintech lenders focusing on underserved sectors like technology.

Additionally, the government could introduce tax incentives for banks that allocate a certain percentage of their lending portfolios to high-growth, innovative sectors. Such policies would

incentivise financial institutions to explore new financing mechanisms tailored to the unique needs of growth-stage tech firms.

Promote Alternative Lending Mechanisms

Alternative finance mechanisms, such as venture debt or revenue-based financing, could be promoted to fill the gap left by traditional banks. Venture debt is a hybrid financing option that blends debt with the flexibility of equity investment, providing tech firms with access to capital without diluting ownership.

Revenue-based financing, where repayments are linked to a company's revenue, offers more flexible terms than traditional loans and could be a viable option for tech firms with fluctuating cash flows.

The government could encourage the development of these financial products by providing guarantees or co-financing arrangements, particularly for medium-sized tech firms that have shown significant growth potential but are struggling to scale.

Leverage Superannuation Funds for Direct Lending

Australia's large superannuation funds could lend more directly to medium-sized technology firms. While super funds already invest in private equity and venture capital, they could be encouraged or incentivised to engage in direct lending or co-investment models with tech firms.

Superannuation funds, which have significant assets under management, could establish dedicated funds to finance high-growth sectors, particularly technology. This would diversify their portfolios while contributing to Australia's economic innovation and competitiveness.

Self-managed superannuation funds (SMSFs) can make capital investments in private companies in Australia, but they must adhere to several strict rules set out by the Australian Taxation Office (ATO) and superannuation law.

These include the "in-house asset" rule, which limits the percentage of the fund's assets that can be invested in related parties, including private companies close to the fund members or trustees. The maximum allowable in-house asset allocation is 5% of the fund's total assets.

Conclusion

Similar to the challenges faced in accessing private equity, medium-sized technology growth firms in Australia struggle to secure financing from traditional banks. Banks are less willing to lend to these companies due to their risk aversion, lack of sector expertise, and preference for asset-backed lending.

This creates a financing gap that hinders the growth of Australia's tech sector, contributing to a potential market failure. To address this, Australia needs more specialised financial products and policy interventions that support tech firms' unique growth trajectories, ensuring that these high-potential businesses have access to the capital they need to succeed.

The oligopoly in Australia's banking system and the dismantling of development-focused financial institutions contribute to a significant market failure in financing medium-sized technology growth firms.

The Impact of APRA on Banks' Lending Profiles

Australia's prudential regulatory framework, overseen by the Australian Prudential Regulation Authority (APRA), imposes strict capital and risk management requirements on the country's banks, affecting their lending practices. While these regulations are designed to promote

financial stability, they can inadvertently limit the capacity of Australian banks to lend to medium-sized, high-growth technology firms. This limitation arises from several interrelated factors that result from APRA's regulatory framework.

Risk-weighted Asset (RWA) Framework

Under APRA's regulatory regime, banks must hold capital against their lending portfolios based on the risk profiles of the assets they hold. *The Basel III framework*, which APRA enforces, categorises different types of loans according to their risk, with higher-risk assets requiring more capital to be held in reserve.

Banks view medium-sized technology firms, especially those with volatile cash flows and intangible assets like IP, as high-risk. This is particularly true compared to real estate or manufacturing industries, which have stable revenue streams and tangible collateral. Since loans to high-risk borrowers require banks to allocate more capital, this increases the cost of lending to tech firms, making banks more hesitant to extend credit.

APRA's capital adequacy rules mean banks must maintain strict capital buffers to absorb potential losses. The higher the perceived risk of a loan, the more capital banks need to set aside, reducing their capacity to lend, especially to high-growth, high-risk sectors like technology. This framework leads to a natural bias towards lending to sectors with lower-risk weightings, such as housing and established corporates.

Lack of Tangible Collateral

APRA's prudential standards encourage banks to lend to firms with tangible assets that can be used as collateral. This is reflected in *Prudential Standard APS 112* on capital adequacy, which specifically discusses the risk-weighting of assets based on the type and quality of collateral.

Medium-sized tech companies, particularly those in the innovation space, often have limited physical assets. Instead, their value is derived from intangible assets like IP, software, and R&D investments. These assets are difficult for banks to use as collateral due to their uncertain future value and market liquidity, further discouraging lending to the sector. Under APRA's framework, banks prefer asset-backed loans with reliable collateral, such as property.

Focus on Housing and Low-Risk Sectors

Australia's banking system, in line with APRA's prudential regulations, strongly focuses on housing finance. This is largely due to the lower capital requirements for loans secured by residential property than for unsecured or higher-risk loans. Housing loans are considered safer, with lower-risk weightings, allowing banks to allocate less capital and achieve higher returns on these loans than those in sectors like technology.

The emphasis on housing finance effectively " crowds out " lending to more volatile sectors like technology. With a limited pool of capital and the need to meet APRA's stringent capital requirements, banks allocate a significant portion of their lending to the housing sector, leaving less room for high-risk, high-growth sectors like tech.

Conservative Lending Practices Due to Regulatory Scrutiny

APRA's supervisory framework also encourages conservative lending practices across the banking system. Banks are required to demonstrate prudential risk management practices, which include detailed assessments of borrower risk profiles. Given that technology firms often present uncertain growth trajectories, volatile cash flows, and non-traditional business models, they are inherently viewed as higher risk within this regulatory framework.

Banks may face pressure from APRA to maintain prudent lending practices, especially during economic uncertainty or downturns. This pressure can reduce the appetite for riskier lending, such as loans to medium-sized tech firms. The regulatory oversight can, therefore, reinforce a focus on short-term, low-risk lending at the expense of sectors that require more patient capital/

International Comparisons: Differences in Regulatory Frameworks

In contrast, the US and UK have regulatory environments that are more conducive to supporting lending to high-growth sectors, including technology:

The regulatory framework in the US includes more flexibility for banks to lend to high-growth sectors through programs such as venture debt. Banks like Silicon Valley Bank emerged as key players in this space, providing loans to tech firms backed by venture capital funding, reducing perceived risk for lenders. Furthermore, the Small Business Administration (SBA) provides government-backed guarantees, reducing the capital burden on banks when lending to high-growth sectors.

Similarly, the UK's regulatory environment encourages lending to innovative sectors through initiatives like the British Business Bank and various tax incentives that reduce the risk burden on lenders when financing high-growth firms. These mechanisms ensure that banks in the UK are more willing to take on riskier sectors, such as technology than their Australian counterparts.

Potential Solutions

Given the limitations of the current prudential framework, several policy and structural reforms could help address the issues that prevent Australian banks from lending to medium-sized technology growth firms:

Government-Backed Loan Guarantees: Similar to the US SBA model, Australia could introduce government-backed loan guarantees for tech firms. By reducing banks' risk when lending to these firms, such guarantees would encourage more lending to high-growth sectors.

Revised Risk-Weighting for Intangible Assets: APRA could explore revising its risk-weighting rules for loans secured by intangible assets such as IP. This would require developing new methodologies for valuing these assets, but it would enable banks to lend to tech firms without incurring excessive capital charges.

Creation of a Public Development Bank: Re-establishing a development bank in Australia focused on providing growth capital to high-risk, high-potential sectors could bridge the financing gap for technology firms. Such a bank could take on loans that commercial banks, constrained by prudential regulations, may avoid.

Conclusion

Through APRA, Australia's prudential regulatory framework imposes significant constraints on banks' ability to lend to medium-sized technology growth firms. These constraints arise from capital adequacy requirements, conservative risk-weighting, and a bias towards lending to lower-risk sectors like housing.

Compared to more flexible regulatory environments in the US and UK, Australia's framework limits credit availability for tech firms. Addressing these challenges would require structural reforms, including government-backed loan guarantees, revised risk-weighting rules, and the potential re-establishment of a public development bank. These changes could help unlock the financing needed for Australia's tech sector to grow and compete globally.

Failure in Market Analysis

Evidence suggests a market failure in the preferences, biases, and knowledge of financial market analysts, which can significantly impact investor behaviour, particularly regarding technology stocks. Analysts' influence over investor decisions can lead to unnecessary depressions in the valuation of technology firms. This issue is multifaceted, involving a lack of deep understanding of the tech sector and focusing on short-term, politically driven market narratives over long-term fundamentals.

Biases in Analyst Coverage and Valuation Models

Analysts often prefer to cover companies with established business models and predictable cash flows—banking, mining, and retail sectors. Technology firms, particularly medium-sized and growth-stage companies, can be harder to value due to their unique business models, intangible assets, and long-term growth potential. The lack of clear, short-term profit metrics and the reliance on future growth prospects lead many analysts to undervalue tech stocks, even if these companies are well-positioned for future success.

For instance, traditional valuation methods such as discounted cash flow (DCF) or price-to-earnings (P/E) ratios are not well-suited to the unique characteristics of technology firms. Many growth-stage tech firms operate at a loss for years as they invest heavily in research and development or scaling. Analysts may assign lower ratings or target prices to these firms, which depresses their stock price, even when the long-term outlook is strong.

Short-Termism and Quarterly Focus

Financial analysts and the institutions they serve often prioritise short-term performance indicators, such as quarterly earnings reports, over long-term potential. This focus can penalise technology firms that sacrifice short-term profitability for long-term growth. Such an approach is particularly problematic in capital-intensive industries that require significant investment before becoming profitable, such as biotechnology, AI, or cloud computing. In contrast, more traditional sectors with immediate, tangible revenues align better with analysts' short-term evaluation frameworks.

This short-term focus leads to market inefficiencies, where a tech company's intrinsic value is not reflected in its market valuation. Tech stocks can suffer from sharp declines after missing quarterly earnings estimates, even if those misses are due to investments in strategic areas that will drive long-term growth. This deters investors who rely on analyst reports, contributing to the undervaluation of these companies.

The "Herding Effect" and Consensus Ratings

Analysts are prone to herding, where they issue ratings and forecasts that align with the consensus to avoid standing out or being wrong alone. This herding behaviour is particularly pronounced in volatile sectors, such as technology. Suppose the consensus view on a particular technology stock is negative. In that case, analysts are more likely to align with that sentiment rather than take a contrarian view based on deeper research or a more nuanced understanding of the company's growth potential.

This can have a significant depressive effect on technology stocks, especially during periods of market uncertainty or political volatility, when negative sentiment can dominate. Analysts might downgrade a stock simply because it is seen as risky or out of favour rather than due to a fundamental change in the company's outlook.

Influence of "Political Vibes" Over Market Forces

There is growing evidence that some financial analysts are influenced by political or macroeconomic narratives that may not accurately reflect the underlying fundamentals of specific companies, particularly in sectors like technology. For instance, political rhetoric around regulatory risks, national security concerns, or trade tensions can overshadow objective market analysis. This can lead to a situation where tech firms are unfairly penalised in the market due to perceived political risks, even if those risks do not materially impact the company's business model or growth prospects.

For example, during political uncertainty, such as the US-China trade war or debates around tech regulation, analysts have quickly downgraded technology companies, citing these macro concerns, even when they are not directly impacted. This can cause stock prices to drop unnecessarily, reflecting a failure to disentangle "political vibes" from genuine market forces.

Technological Knowledge Gap

Another contributing factor is the knowledge gap between analysts who cover more traditional industries and the fast-evolving nature of technology firms. Many analysts may not have the technical expertise to understand complex fields such as artificial intelligence, quantum computing, or blockchain.

This can lead to oversimplified or inaccurate assessments of a technology firm's potential. For example, analysts may underestimate the future market potential of a firm developing disruptive technology simply because they do not fully grasp the technological advances or the industry-specific nuances.

This knowledge gap can also manifest in misjudged valuations. For example, tech firms' growth potential is often driven by factors like network effects, platform scalability, and IP development—factors that traditional financial models may fail to fully capture. As a result, technology companies may be undervalued relative to their long-term potential as analysts fail to see the full scope of their competitive advantage.

Solutions to the Problem

Increased Sector Specialisation: Encouraging analysts to specialise more deeply in sectors such as technology could lead to more accurate and balanced assessments. Analysts with expertise in tech-specific business models, innovation cycles, and market dynamics are better positioned to provide accurate, long-term valuations.

Focus on Long-Term Value Creation: A shift in financial markets towards longer-term value creation, perhaps through structural changes in analyst incentives, could reduce the pressure to focus on short-term earnings. Encouraging investors to assess companies based on innovation, market position, and long-term growth rather than quarterly performance would help technology firms receive more accurate valuations.

Reducing the Influence of Macro Narratives: Analysts must focus more on company-specific fundamentals and less on overarching political or macroeconomic narratives. This would involve rigorous company-level research, which would help investors differentiate between companies genuinely affected by political risks and those not.

Conclusion

Financial market analysts' biases, preferences, and lack of deep understanding contribute to market failure, particularly in the way technology stocks are valued. Analysts' short-term focus, coupled with their reliance on traditional valuation models and susceptibility to

macroeconomic and political narratives, can lead to unnecessary depressions in technology stock prices. Addressing this issue would require more sector-specialised expertise, a long-term focus on value creation, and an emphasis on fundamentals over market sentiment or political trends.

How Financial Market Failure Encourages Foreign Takeovers and Constrains Australia's National R&D Effort

The market failure in Australia's capital markets, particularly the inability of medium-sized technology growth firms to access sufficient domestic funding, often forces these companies to consider foreign takeovers as a viable exit or growth strategy.

This trend is concerning for several reasons, particularly its impact on innovation, national sovereignty over key technologies, and the long-term sustainability of Australia's research and development (R&D) efforts.

The Lure of Foreign Takeovers

Due to insufficient capital from domestic sources, including banks, private equity, and public markets, medium-sized technology firms often find themselves vulnerable to foreign acquisitions. This vulnerability is exacerbated by the fact that foreign investors, particularly from the US, UK, and Asia, have access to more robust financial ecosystems and are willing to invest in high-potential, growth-stage companies.

Without adequate access to capital for scaling, these firms struggle to maintain competitiveness, especially in industries like biotechnology, software, and advanced manufacturing, where significant R&D investment is required before profitability is achieved. Foreign firms, particularly large multinational corporations or private equity funds, view these Australian tech firms as valuable acquisition targets due to their growth potential and innovative capacities. In some cases, Australian firms may actively seek foreign buyers as they provide the capital and market access necessary to achieve the scale domestic markets fail to offer

The systematic undervaluation of technology firms in Australia, driven by conservative investor sentiment and analyst biases, makes these companies even more attractive to foreign investors. Valuation discounts and the need for growth capital create ripe conditions for takeovers. For example, Australian tech companies often trade at lower multiples than their international counterparts, making them relatively inexpensive acquisitions for foreign buyers.

Implications for Australia's National R&D Effort

Foreign takeovers have significant implications for Australia's national R&D capabilities, particularly in strategic areas such as cybersecurity, medical technology, and renewable energy.

When a foreign entity acquires an Australian technology firm, the IP and innovation associated with that firm often become the property of the acquiring company. This can result in relocating R&D activities to the foreign parent company's home country, particularly if the foreign firm has stronger R&D ecosystems. As a result, Australia may lose control over key technological innovations and miss out on the potential spillover effects of such innovation on the domestic economy.

For example, suppose a foreign pharmaceutical giant acquires a biotechnology company with promising new treatments. In that case, much of the ongoing R&D might be shifted to research

hubs outside Australia, weakening the local knowledge base and innovation ecosystem. Over time, this could result in the erosion of Australia’s competitive edge in high-tech industries.

Foreign takeovers also impact domestic R&D funding. Many medium-sized Australian tech firms and foreign companies lose autonomy regarding how R&D budgets are allocated. Foreign parent companies may cut or repurpose R&D budgets based on global priorities that don’t align with Australian national interests. This can stifle innovation in sectors Australia has historically invested heavily, particularly in industries vital for long-term economic growth.

The foreign acquisition of companies in key industries such as defence, energy, and healthcare can raise concerns about national sovereignty. These sectors are often critical for national security and economic stability, and losing control over domestic companies in these areas can have long-term strategic consequences. The potential for foreign ownership to influence the direction of R&D in sectors critical for Australia’s national interest is particularly concerning.

Potential Solutions to Mitigate Negative Impacts

One solution to mitigate the negative effects of foreign takeovers is strengthening government oversight and safeguards on foreign acquisitions, particularly in strategic industries. The Foreign Investment Review Board (FIRB) could play a more active role in scrutinising takeovers of tech firms to ensure that national interests are protected. This could include imposing conditions on foreign ownership to maintain local R&D activity and ensure that key innovations remain in Australia.

Australia could also explore creating specialised investment funds focused on technology sectors. These funds, backed by superannuation assets or government incentives, could provide long-term patient capital for technology firms, helping them scale without the need to seek foreign buyers. By increasing the availability of local capital for medium-sized firms, the pressure to accept foreign takeovers would be reduced, and control over domestic innovation would be maintained.

Conclusion

The failures in Australia's capital markets make medium-sized technology growth firms vulnerable to foreign takeovers as they struggle to access the necessary capital for expansion. While foreign acquisitions can provide short-term capital, they pose significant risks to Australia’s long-term R&D capabilities, IP ownership, and national sovereignty in key industries. To address these risks, the Australian government and financial sector must strengthen domestic capital markets and provide more robust support for the innovation ecosystem, ensuring Australia retains control over its technological future.

Attachment

Businesses That Have Been Financed by Venture

In 2022, venture capital funding in Australia reached approximately $7.4 billion, representing a 30% decrease from the previous year. Despite this drop, the early-stage investment environment remained robust, with record activity in the Pre-Seed and Seed funding rounds. Around 712 deals were completed in 2022, with early-stage startups seeing a 7% increase in funding, reflecting a strong interest in new ventures.

The total number of startups receiving venture capital remains a small proportion of Australia's broader business creation landscape. However, it has been reported that while venture capital-backed firms are vital for high-growth sectors like fintech and enterprise software, they represent a minority of new businesses being founded each year.

In 2022, fintech continued to dominate, securing around $1.3 billion, while business SaaS (Software as a Service) companies attracted significant investment at $1.2 billion. Venture capitalists maintained a cautious but positive outlook for early-stage founders despite global economic pressures, particularly in sectors demonstrating high potential for scalability and innovation.

While specific data on the exact proportion of new businesses receiving venture capital financing isn't readily available for 2023, the number of startups backed by venture capital has grown substantially over the past decade. However, it remains concentrated in select high-growth sectors like technology.

Overall, venture capital funding, though essential to Australia's innovation ecosystem, finances a relatively small proportion of all new businesses, focusing on those with the potential for high returns and scalability.

Established Businesses That Received Private Equity Funding to Finance Expansion and Growth

In Australia, private equity has become a significant funding source for established businesses seeking to finance expansion and growth. By 2022, private equity deals involving Australian companies reached a record value of A$57 billion, approximately 2.3% of the country's GDP.

This growth was primarily driven by large buyouts and leveraged deals, particularly in stable sectors like industrials and utilities. Although private equity is a critical part of the financing landscape, most deals focus on larger companies with established revenue streams, and its use is less common among smaller businesses.

Despite higher interest rates and global economic challenges, the private equity market continued to perform strongly into 2023. Private equity funds raised A$9 billion in 2022, doubling the A$4.3 billion raised in the previous year. This indicates a growing appetite for private equity investment in Australia, particularly from sectors such as healthcare, technology, and industrials.

Private equity funding is crucial for businesses seeking to expand, but it is still focused on a small proportion of all businesses. The funds are typically directed towards companies with proven growth potential and the ability to scale operations, making private equity more concentrated in mature and established firms rather than newly founded businesses.

The Barriers for Medium-sized Growth Firms Accessing Private Equity to Finance Growth in Australia

Medium-sized growth firms in Australia face several barriers to accessing private equity for expansion. These barriers can be categorised into structural, market, and firm-specific challenges.

Complexity of Private Equity Deals

Private equity financing often involves complex deal structures, which can be daunting for medium-sized firms lacking sophisticated financial management capabilities. These transactions typically require extensive due diligence, including legal, financial, and operational evaluations.

For many medium-sized firms, this level of scrutiny can be a barrier, as they may not have the resources or experience to manage these intricate processes.

Management and Control Issues

Private equity firms generally demand significant control over the businesses they invest in, often involving management, governance, and operational strategy changes. This level of involvement can deter medium-sized firms, particularly family-owned or founder-led businesses, which may be reluctant to cede control. The fear of losing decision-making authority can make private equity unattractive, even when funding is needed for growth.

Scale and Investment Size

Private equity investors typically seek opportunities with high returns, often targeting larger firms with significant growth potential. For medium-sized firms, which may require smaller capital injections, the scale of investment needed might not be large enough to attract private equity interest.

Many private equity firms prefer larger deals where the return potential justifies the time and effort involved in structuring and managing the investment. This creates a mismatch between the needs of medium-sized firms and the investment thresholds of private equity.

Limited Knowledge and Networks

Medium-sized firms may lack awareness of the private equity market and the networks required to access these funds. Unlike larger corporations, which often have dedicated financial teams and advisers, medium-sized businesses may be less informed about the types of private equity financing available and how to position themselves to attract investment.

Without the right networks, firms may struggle to connect with potential investors.

Risk Perception and Profitability

Private equity firms tend to focus on firms with proven growth potential and stable profitability. Medium-sized businesses that have not yet reached predictable revenue generation or operate in volatile industries may be considered too risky for private equity investments.

Investors may perceive these firms as less likely to achieve the high growth and returns required to justify the investment.

High Transaction Costs

The costs associated with securing private equity financing can be prohibitive for medium-sized firms. These costs include legal fees, financial advisory fees, and the costs of restructuring or governance changes required by private equity investors.

For firms with limited financial capacity, these upfront costs can significantly deter pursuing private equity.

Economic and Market Conditions

Economic uncertainty, rising interest rates, and broader global market volatility can impact private equity activity. In recent years, borrowing costs have increased, making leveraged buyouts, a common tool in private equity, more expensive.

This makes medium-sized firms, particularly those in more traditional industries, less attractive to private equity, which is cautious about debt-heavy transactions in an uncertain economic environment.

Sectoral Focus of Private Equity

Private equity firms often concentrate their investments in specific sectors, such as technology, healthcare, and financial services, with higher growth potential. Medium-sized firms operating in sectors perceived as less dynamic, such as manufacturing or retail, may find it more difficult to attract private equity interest.

These sectors often lack the rapid scalability that private equity investors seek.

Conclusion

Various factors hinder medium-sized growth firms in Australia from accessing private equity, including deal complexity and cost, control issues, scale mismatches, and limited knowledge and networks.

While private equity can provide significant growth opportunities, overcoming access barriers requires medium-sized firms to enhance their financial sophistication, build strong networks, and align their growth strategies with investor expectations.