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Keep Venture Capital Open to Retail Investors

- Submission to ASX on: Updating ASX's Admission Requirements for Listed Entities

By Victor Bivell

Attention: Diane Lewis
Senior Manager, Regulatory & Public Policy
ASX Limited
20 Bridge Street
Sydney NSW 2000

Thank you for the opportunity to comment on the ASX's proposed changes to its admission requirements. My comments and suggestions relate to the issues of: the spread test, the assets test, and the $1.5 million minimum requirement for working capital.

The aims of the proposed changes - that the ASX can continue to be a market of quality, integrity and internationally competitive - are fine; but I am concerned that the nature of some of the changes in the areas I will discuss may have unintended or detrimental effects for retail investors and for smaller, early stage companies.

Perspective

Before I discuss these, let me put the proposed changes and my comments in perspective. The proposed changes to the spread test, to requirements for net tangible assets and market capitalization, and to minimum working capital would affect only a small number of companies and investors. Compared to the size of the ASX and its major listed companies, the proposed changes are minor and will have minimal effect on the ASX's objectives to maintain its quality, integrity and international competitiveness.

A much greater boost to quality, integrity and international competitiveness can be had by applying higher standards to the ASX's leading companies, those in for example the S&P/ ASX 200 Index or the All Ordinaries Index. As these stocks hold the overwhelming majority of the market's capital and investors, this is where the greatest quantum of losses, social disruption, and consequent loss of quality, integrity and international competitiveness occur.

While I am sure the ASX is familiar with this, please let me give a couple of examples to make clear the size of the point. As an investor in both "blue chip" and micro cap companies, my greatest losses by far have been in the biggest stocks. In 2008 GPT Property Group virtually wiped out its entire capital and had to be recapitalized to the tune of around $3 billion plus another over $1 billion in asset sales. Just this year, National Australia Bank sold its interest in Clydesdale and Yorkshire Banking Group and wrote off $4.2 billion. In both cases the causes for such massive capital destruction were over-indebtedness and foolish overseas expansions. There are many, many other example of such wealth destruction among top tier stocks.

The point is that measures to limit such large scale capital destruction would go much further in maintaining the ASX's quality, integrity and international competitiveness than tinkering with micro caps.

They would also better assist the economy. The $4.2 billion lost by NAB, for example, is enough to float 210 companies raising $20 million each. Combined annual losses by blue chips through the mismanagement of debt and overseas ambitions could easily be enough to fund thousands of micro caps each year.

It should not be difficult for the ASX to devise and implement guidelines or measures that can help directors and senior management to limit their exposure and risk to these two issues.

Likewise, it can be argued that the capital losses caused by short selling are also substantial and could fund the equivalent of many small cap IPOs. But that discussion is for another paper.

Venture Capital and Retail Investors

A second point of perspective is to emphasize that the ASX is by far Australia's largest and leading source of venture capital. I know that the ASX has been aware of this in the past, but it may be worth repeating.

In my capacity as a journalist and editor for the past 29 years, I have spent much of that time writing about the venture capital market and innovative technology companies. I have long held to the view that the venture capital market can be divided into three sectors. The largest by far, both in terms of invested capital and funded companies, is the ASX. The next biggest sector is the angel and private investor sector. This is followed by the formal, managed venture capital sector, which after 30 years of government assistance is still struggling to develop.

Given the ASX's role over the decades in assisting many thousands of start-up and early stage companies to find investors and capital, the ASX must be careful not to disrupt this crucial role it plays, and which it does with great success.

A key to the ASX's success in raising venture capital has been retail and high net worth investors. Institutional investors are known for their long standing reluctance to commit to venture capital, both listed and unlisted. For unlisted companies, the number of institutions that invest in venture capital are not enough to form a substantial sector, in part because their investment experience so far has not been a happy one. For listed companies, few if any of the companies that will be affected by the ASX's proposed changes would attract institutional capital as the amounts of capital are too small, they have too little liquidity, the time to commercialization is too long, and the overall risk is too high.

In contrast, the retail investor and the high net worth private investor have always been the backbone of the Australian venture capital market. This includes the ASX, the angel market, and the more successful government backed programs. The great majority of the companies that will be affected by the ASX's proposed changes are companies that will be backed by high net worth and retail investors. So it is important that the ASX consider how the proposed changes will affect these investors and companies. From their perspective, the proposed changes are quite large.

The Spread Test

My concern with the proposed change to the spread test is the significant increase in the minimum value of each security holder's parcel of shares from $2,000 to $5,000.

This is too high, and it is unnecessary as the same effect can be achieved in a less disruptive way.

A key reason retail investors are strong supporters of high risk micro cap companies is that they understand that these are speculative investments and treat them as a "punt". They take the risk with the risk part of their allocation, and they treat the investment as they treat a punt on Lotto or a horse race at the TAB. This approach works for both the investors and the companies. So why change it?

$2,000 for an IPO or $500 as a minimum trade on the ASX are small enough for this strategy to work and yet not be too painful if it does not.

The ASX's Consultation Paper does not give an argument or good reason for the limit to be changed, let alone raised so significantly to $5,000. It only asserts it would represent "a real and significant financial commitment to the entity seeking admission" but it does not give any evidence or discussion on this. Why is $5,000 any more real than $2,000? How is $2,000 not significant? The Paper says nothing on these questions.

Nor does it canvass the effects of the change. I believe these would be major. Many more people can afford to punt with $2,000 than can afford $5,000. The proposed change does not offer any real or significant benefit, yet it puts at risk the only part of the Australian venture capital funding system that works really well and has worked for many many decades.

A $2,000 limit is also a better risk management strategy for investors. Where investors have an allocation to a portfolio of micro cap or high risk companies, $2,000 parcels can be spread across more companies - a standard venture capital risk management strategy - so it is lower risk. In contrast, $5,000 parcels will buy a smaller spread of companies, so it is higher risk.

We know Australians are big Lotto and horse punters. Why reduce their ability to be technology punters? Australia needs more technology punters, not less. I believe this proposed change is a mistake.

It is also unnecessary. If the ASX wants to see "a real and significant financial commitment to the entity seeking admission", it can achieve this by simply raising the minimum number of investors from 400 to 500.

The ASX can have both rules. My suggestion is - 500 security holders who hold a parcel of securities with a value of at least $2,000; or 200 security holders who hold a parcel of securities with a value of at least $5,000.

Capital-wise the result is the same, and it is better for the companies as they can capital raise to their strength - whether it is fewer but higher-risking investors or more but lower-risking investors.

If the ASX keeps the $2,000 level it is preserving a system that has served Australia very well for many decades, and it is not putting at risk its own position as Australia's pre-eminent venture capital platform.

The Assets Test Thresholds

The proposed changes to the assets test thresholds - increasing the minimum net tangible assets from $3 million to $5 million, and increasing the minimum market capitalization level from $10 million to $20 million - are of uncertain benefit.

They are large increases but no evidence or arguments are given as to why they would be better. The Consultation Paper only asserts they would "assist to maintain the quality of the market" and "provide greater surety that the listed entity has sufficient resources to carry on its business for a reasonable period".

These are not proven or compelling arguments. The amount of capital a company has before or at listing only speaks for its ability to raise capital as an unlisted company in Australia's small economy and very under-developed venture capital market for unlisted companies.

That is why a company seeks to list - to gain access to new potential investors in the ASX's much bigger and deeper pool of venture capital investors. So a better measure of a company's quality and prospects to carry on business is not how much it raised as an unlisted company but how much it can raise once it is a listed company. This can only be fairly judged once it is on the ASX and investors have a chance to see how it performs - whether it meets technical milestones, spends its capital wisely, can meet its competition, overcome its risks, etc.

So a newly admitted company only has to have enough capital to get to and succeed at its first post-IPO capital raising. Investors will then indicate if it has a future or not. Having more capital to begin with only delays this crucial test. More initial capital may or may not improve its chances of passing this test, but other factors such as management, competition, the economy, and luck will be just as crucial to its success and perhaps more so.

The proposed changes make it harder for good little companies to join the ASX but do not offer any real gain in return.

There may be alternative strategies for the ASX to achieve its desired result - to "assist to maintain the quality of the market" and "provide greater surety that the listed entity has sufficient resources to carry on its business for a reasonable period".

One suggestion is for the ASX to help organize training courses or seminars for company directors and senior management on capital raising and capital spending. These could include ASX case studies of where companies went wrong, how they have misspent capital, and why they went out of business. There is no shortage of potential case studies.

Perhaps such a course, in a short form and perhaps in conjunction with a university or institute, could be mandatory for directors, chief executives and chief financial officers of companies below a net asset or market capitalization level.

The $1.5 Million Minimum in Working Capital

The new asset test thresholds are also unnecessary if the ASX introduces the $1.5 million minimum working capital requirement. This, of itself, would determine if a cash flow negative company can stay in business. If investors support the company, it will stay in business. If they do not, it will fall below the threshold.

$1.5 million seems a fair minimum for micro caps. There are many companies on the market with cash of much less than this, and they struggle. A low cash position tells investors the company needs to raise capital or it will go out of business. Very low cash companies can be desperate and many have fallen prey to ruthless investors, some of whom use convertible notes to dump shares on market.

The proposed change is a good one. Raising the working capital or cash level to $1.5 million would give the company and investors more room and more time to raise new capital.

I also think it would be helpful to require companies to maintain a minimum of $1.5 million in working capital at all times, and for their shares to be temporarily suspended if they fall below this even for short, one-off periods.

In Conclusion

I agree with the Consultation Paper that the "ASX has a long history in supporting the listing of early stage and start-up enterprises". The ASX should be proud of this and should not do anything to change or endanger it. Companies and the economy need to continue to enjoy and benefit from the ASX's proven and essential role as Australia's leading platform for raising risk capital.

I believe my suggestions are reasonable and moderate and will enable the ASX to achieve its objectives without unnecessary risk or disruption to companies, investors and the market.

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