**ECONOMIC DEVELOPMENT AND INFRASTRUCTURE COMMITTEE**

**Inquiry into Manufacturing in Victoria**

Melbourne — 7 September 2009

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Mr I. Silk, Chief Executive, and

Mr T. Charalambous, Investment Manager, Australian Super.

**The CHAIR** — I welcome to the all-party parliamentary committee Inquiry into Manufacturing in Victoria Mr Ian Silk and Mr Terry Charalambous. I ask each of you please to state your name, your business address and your position within the organisation.

**Mr SILK** — My name is Ian Silk. I am the Chief Executive of Australian Super. We are located at level 33, 50 Lonsdale Street, Melbourne.

**Mr CHARALAMBOUS** — My name is Terry Charalambous. I am the Investment Manager at Australian Super, responsible for private equity. I am at the same address: level 33, 50 Lonsdale Street, Melbourne.

**The CHAIR** — Mr Silk, normally what we ask people is whether they would care to make a few introductory comments. I know you have said at the outset you would be happy for us to ask questions. Is there anything you do want to say though?

**Mr SILK** — Perhaps I will just briefly inform the Committee about Australian Super. In brief terms we are a not-for-profit or profits-for-members superannuation fund — a multi-industry fund, which means our members are drawn from just about any industry you can imagine, albeit, with reference to the terms of reference of this committee, the historical genesis of our fund was the manufacturing industry. Today somewhere in the order of 15 per cent of our members and 15 per cent or so of the employers that contribute to the fund are drawn from the manufacturing industry. We have about 1.4 million members around Australia and around 115 000 employers around Australia, and we have got about $28 billion in assets. We have about 480 000 members employed in Victoria.

In investment terms, as I said, we have about $28 billion in assets, and that is growing at the rate of around $2.5 billion a year. We have an investment committee that meets monthly. It is chaired by Bernie Fraser, and it has two fundamental roles. I will step back a bit. The overarching primary objective of our fund is to maximise the retirement outcomes of our 1.4 million members. We do not have any other agenda, and no other corporate objective; it is simply that: to maximise the retirement outcomes of our members.

The investment committee, which meets monthly, has two fundamental roles. One is to determine which asset classes the fund’s assets will be invested in — how much will be invested in Australian equities, how much in international equities, how much in property, how much in private equity and so on. Having made that determination the next level of decision making is choosing which specialist manager we will allocate the investment mandate to. Having identified that we want to put more money into, say, Australian equities, we ask which specialist Australian equities manager will we identify as the most appropriate to add to our line-up of managers. The fund itself does not decide to buy Coles Myer shares and sell David Jones shares; rather we will appoint a specialist manager who will make those decisions themselves.

**The CHAIR** — You mentioned before giving evidence that you are here because we really sought you two as witnesses. The reason we sought you as witnesses is that a number of previous witnesses have said they have got excellent manufacturing opportunities, they have got proven products, they have got markets, but should they wish to expand their business there is often difficulty in obtaining finance to do so. Super funds at this point do not seem to be, on the evidence we have heard, playing a significant part in manufacturing. We want to understand that better. Is it accurate; is it inaccurate? If it is accurate, what is required to enable your investment committee to have an understanding of how to maximise retirement outcomes of members by investing in manufacturing?

**Mr SILK** — I will start off this answer, and Terry will come in and supplement it. Terry is responsible for the fund’s private equity program, both domestically and internationally. He will talk in a bit of detail about Australian Super's private equity investments, including in manufacturing.

Before coming to your question, Chair, I just reiterate the first point I made — that is, our unambiguous objective is to maximise the retirement outcomes of members. That is the sole frame of reference we use in making investment decisions, albeit that we recognise there are some collateral benefits that we can contribute to in the course of making investment decisions that are motivated only by maximising members' retirement outcomes. Investing in Australian infrastructure and investing in Australian businesses are some of those collateral benefits.

The fund's investment in Australian business and Australian manufacturing specifically is driven through two avenues. The first is through listed markets, and the second is through unlisted markets. As far as listed markets are concerned, we have invested around $8.8 billion in Australian equities. About $1.5 billion of that is in the manufacturing sector. We have been unable to break that down in any meaningful sense for the Victorian manufacturing sector, but we can, on the basis of Victoria's role in national manufacturing, assume that there is a greater than proportionate representation in Victoria.

That is the mainstream investment through our specialist investment managers; about $1.5 billion in listed Australian companies. The sorts of comments that you mentioned you have received from witnesses before this committee, I imagine that was the smaller to medium-sized end of the sector; would that be right? They are presumably looking for one of two types of funding: debt funding or equity funding. We do not provide debt funding of that nature, but we do provide equity funding through specialist private equity managers. I will hand over to Terry to talk to that in the context of the terms of reference of this committee.

**Mr CHARALAMBOUS** — The private equity portfolio represents about $1 billion in assets in market value, and approximately $600 million of that is invested in Australia. We have a large allocation to the Australian market. To take a step back, in terms of the way the investment vehicles are structured, as Ian mentioned, we invest via funds that are managed by specialist private equity managers. The arrangement is that we make a commitment to their fund of a dollar amount, and then the manager will draw down that capital as they make investments, as they find attractive investment opportunities. To put some context around the figure, we have about $600 million invested in Australian businesses, in unlisted businesses. There is an additional, roughly, $5 million in undrawn commitments that we have made to Australian private equity managers. Those managers have an investment objective to deploy that capital in unlisted, privately owned businesses in Australia.

**Mr ATKINSON** — So your allocation is actually $1.5 billion — $1 billion which is active at this point and $500 million which has not been drawn down at this point?

**Mr CHARALAMBOUS** — Partly correct. It is actually closer to $2 billion; there is $500 million that has not been drawn down in Australia, and there is another, roughly, $500 million for international opportunities.

Those managers are scouring the Australian marketplace for investment opportunities in, as I mentioned, private companies, companies outside the stock market, to deploy that capital. We also have some numbers around the manufacturing sector. Specifically $651 million was the latest market value of our Australian portfolio and $75 million of that was invested in the Australian manufacturing sector.

**Mr ATKINSON** — Can I just draw a line on that? Essentially in those two figures that you have given — your figure and the figure on equity — 20 per cent is roughly the weighting to manufacturing. Is that a weighting ratio that you use? Is that a rough weighting ratio?

**Mr CHARALAMBOUS** — Yes, I think closer to 15 per cent.

**Mr SILK** — It is between 15 and 20 per cent.

**Mr ATKINSON** — Do you have a perspective on whether or not that is consistent across the superannuation industry? Again I can appreciate there are differences from fund to fund, but would that be a fairly consistent view within a 15 to 20 per cent weighting for manufacturing?

**Mr SILK** — It would be broadly consistent in this sense. Some industry funds invest disproportionately in the industry that they cover.

**The CHAIR** — In their own thing.

**Mr ATKINSON** — Construction.

**The CHAIR** — That is the one I was thinking of.

**Mr SILK** — Yes. Cbus, the building construction industry fund, has a higher allocation to property.

The historical genesis of our fund is the manufacturing sector. The sole employer representation on our board is the Australian Industry Group which, as you know, was born of the amalgamation of the Metal Trades Industry Association of Australia and the Australian Chamber of Manufactures, two manufacturing-based organisations. The AMWU, the AWU and the LHMU are three unions represented on our board. Each of them has somewhere between a modest and a comprehensive coverage of the manufacturing sector. If there was any industry fund that would have a predilection to investing in manufacturing, it would be our fund. All of that said, we do not have that conscious bias to investing in manufacturing.

To come back and answer your question, I cannot imagine there is another fund out there that has a bias that we do not. I think the figure that we have of somewhere between 15 and 17 per cent would be broadly representative of what you would find through most institutional investors, and certainly most industry super funds.

**The CHAIR** — Terry, we have interrupted your evidence; is that all right or do you want us to wait until the end?

**Mr CHARALAMBOUS** — No, that is fine.

**The CHAIR** — You said earlier that the managers scour for appropriate investments. Is there the opportunity for manufacturers to come to you with what they consider to be an excellent investment opportunity? If so, how do they know to do it? I am not a manufacturer. Maybe everybody knows, but I would not know how to do it.

**Mr CHARALAMBOUS** — Sure. Firstly, what I think is more relevant is whether the businesses can come to our managers, who are acting on our behalf and deploying the capital.

**The CHAIR** — So how do they find out about that?

**Mr CHARALAMBOUS** — Typically our managers will identify opportunities through intermediaries — there will be investment banks or accountants that have been appointed on behalf of the business to seek capital. That would be the primary source of deal flow; that is the term we use. The secondary source of deal flow, the secondary means of businesses making contact with our private equity managers, is through networks and relationships. That is through a relationship where they are aware that there is a manager seeking to make an investment in private companies and where they make contact on a proprietary basis.

**Mr SILK** — The third instance is the one that you mentioned. We will sometimes get employers approaching us directly. Often they will be our own employers — that is, employers that are paying into the fund on the behalf of their employees. They will approach us and say, ‘We want to build a new plant', or 'We want some extra funding for whatever purpose. Can you lend it to us or do you want to invest in the business?'.

**Mr CHARALAMBOUS** — In those instances we will identify the most appropriate of our private equity managers and suggest they go and speak to a couple of those managers.

**The CHAIR** — That is clear. Sorry, we have asked two questions in the middle of your presentation.

**Mr CHARALAMBOUS** — No. That is fine. I think that covers the key aspects of the data that I am holding.

**The CHAIR** — If there are commercial-in-confidence imperatives, you may decline — you are not obliged to answer any of these questions — but could you give us some examples of what kinds of private equity projects you would invest in, and obviously why? I think the 'why' is to maximise the retirement outcomes of members, which is your theme.

**Mr CHARALAMBOUS** — First and foremost, our investment managers are seeking an attractive risk-adjusted return from those investments. That will be driven primarily by the price at which they acquire the equity and also the growth prospects for the business growth, in particular, prospects for the earnings of the business going forward — they would be the two key metrics — and then the risk of that growth in earnings crystallising over time. That will be assessed by the private equity managers on a company-by-company basis, or an investment opportunity by opportunity basis. I am happy to provide examples of the nature of the investments that they make.

The two typical areas of investment are where there is a buyout of an existing large stakeholder in that business — the private equity investor is using the capital to effectively acquire the interest of a founding partner or owner of the business. The second area typically is what we term expansion capital, where a business is in need of capital to grow its capacity or to grow the business in one form or another but is often unable to source that capital through the debt markets or banks and therefore offers a stake in the business to a new equity owner. That is good to provide some capital to the business.

**Mr ATKINSON** — Is there generally a skew in the sorts of investments that private equity centres are interested in towards businesses that have a capability of stock exchange flow?

**Mr CHARALAMBOUS** — I think the answer is probably yes. If I take a step back, the investment managers would typically like to have an idea as to the exit strategy — the exit of their investment — before going into the investment, and the two typical sources of exit are listing the business on the stock market or selling the business to a trade buyer, a larger business within that industry, at a later stage. I think the answer to your question is yes. Having a clearer path to an initial public offering on the stock market would almost always make an investment opportunity more attractive.

**Mr ATKINSON** — Has the superannuation industry and its partners given any consideration to the ownership profile of Australian industry? By that, what I mean is that when I have gone into rooms full of businessmen, they all strike me as being of a similar age to myself, or older. When I ask them what they want to be doing in five years, essentially for most of them it involves being out of the business. They are effectively looking at retirement, which is an enormous ownership change of enterprises in Australia. I am not 100 per cent sure how it is going to be funded, particularly coming back to the manufacturing sector which is not necessarily seen as so sexy, and whether or not there is an opportunity to fund that retirement. Has there been discussion in the finance industry and the superannuation industry and its partners of that sort of ownership change within Australian industry and the opportunities that it might present? If so, what is the attitude towards manufacturing investment going forward as an opportunity?

**Mr SILK** — I am not aware of the discussions having occurred in the way that you have framed them, but a lot of the private equity opportunities that arise, as Terry mentioned, occur in the context of a reshaping and restructuring of the industry, whether it is for a larger player to look to consolidate their holdings and acquire some smaller holdings or where a family that might have founded a business wants to exit the business; that is its strategy that Terry spoke about. You are talking, I think, about a broader issue about generational change in a sense. I am not aware of that being a driver of investment thinking or investment decision making to this point.

**Mr ATKINSON** — When the industry looks at or talks about manufacturing, what is its perspective on manufacturing compared to other investment sectors? I hear the weighting and I think the weighting is actually better than I might have expected in your instance, to tell you the truth. What is the attitude? Again, from the evidence we have had, it tends to be, 'Oh, well, they all think we're dead. They all think that we're a rust belt and it's all done and dusted and they'd rather move on to something sexy'.

**The CHAIR** — And if there was to be any investment, it would be if they did the manufacturing offshore. That is the kind of evidence we are getting.

**Mr SILK** — That is not the perspective that we have. Our perspective is in part informed by the stakeholders in our fund, so we probably have as good an insight into the manufacturing industry as most other institutional investors, which is not to say that we have absolutely got our finger on the pulse, but we have a pretty good appreciation. We have good networks into the manufacturing sector and good organisational and personal relationships right across the board. As far as our investment managers are concerned, both in the listed area and the unlisted area, they are seized of our priority to maximise the retirement outcomes of our members. The mandates we have with them are performance based, so they are all about getting as good a return as possible. So it is in their interest to seek out the best performing opportunities. As you would doubtless have had evidence before this committee, the Australian manufacturing industry's reputation belies the reality in many respects.

**The CHAIR** — Exactly.

**Mr SILK** — There is that rust-bucket perception in some quarters, but some of the Australian manufacturing entities are amongst the most innovative and progressive in the world. It is the responsibility of our listed managers and unlisted managers to seek out the best performers they can, particularly those with strong upside potential, which is where the value increase is going to be. I must say that when we did the exercise to dig out these numbers for this inquiry, I was slightly surprised about the upside, but, having regard to the potential that some of the Australian manufacturing businesses have, including here in Victoria, in retrospect it should not be surprising.

**Mr ATKINSON** — I hear what you say about maximising the return for investors. I wish I were with your fund. I took a low-risk one with another fund and I am only 17 per cent down. They were suggesting that I should look at the risk, and I said, 'How could it be worse?'. I guess in this day and age there are also some issues that challenge all of us in terms of ethical positions. I guess to that extent I would have thought that perhaps green issues would be visiting your doorstep. In the context of manufacturing, I am interested as to whether you have given consideration to a longer term time frame. Getting the best result can mean being in and out of the stock market in a week, a day or an hour, but because of its base, I guess, manufacturing needs a little more certainty about its funding, particularly if it is off-share market and it a more longer term proposition. Are you giving consideration also to what is emerging among even some members of your super funds, saying, 'Well, yes, I want a good return, but I also want to know that my kids are going to have somewhere to work and they're also going to potentially get a return in the future on their superannuation, too'? Are those sorts of issues starting to come into play in terms of your thinking and analysis?

**Mr SILK** — They are. This issue of time frame is an important one. It is not just a matter of how did we perform in investment terms in the last month, last quarter or last year, because we are a large and growing fund. We are going to remain an investor in most of these markets for decades, so we are not in a position to exit or say, 'Let's get our of private equity' or 'Let's get out of the Australian share market' or 'Let's get out of property'. We are of a size that that option is not open to us, so we want the investment markets that we invest in to be strong and have a viable future. Allied to that is the whole issue of environmental, social and governance, or ESG, considerations that are increasingly factoring their way into investment decisions. Whilst, as I have emphasised a few times, maximising retirement outcomes for members is our absolute objective, it is not seen just through the prism of what the fund's investment performance is today, because if we were to invest in a series of assets that sought to maximise investment performance at the expense of all other considerations today, then there is likely to be a financial penalty to be exacted some time down the track, through for example reputation cost, which sees the value of an investment erode, or whatever the case may be. So we are very mindful of broader considerations.

The fund recently became a signatory to the UNPRI, which is the United Nations' Principles for Responsible Investment. That carries with it a whole series of obligations and responsibilities. These ESG issues and the responsibilities that come through signing the UNPRI are not matters of interest to just Australian Super but are increasingly being adopted and being taken notice of by most institutional investors who are aware of the broader time frame that you have spoken about.

**The CHAIR** — Terry, did you get a chance to finish, as we keep interrupting?

**Mr CHARALAMBOUS** — I did. I have some additional data points here, but more in the event that they were relevant in answering a question, so I feel comfortable that — —

**The CHAIR** — What question have we not asked that you think is relevant? Given you are the investment manager, I would be interested.

**Mr CHARALAMBOUS** — The additional information I have here is around the 10 key portfolio company exposures within our private equity portfolio within the manufacturing sector.

**The CHAIR** — Exposures — that is a bit sensitive, I imagine?

**Mr SILK** — No. It is just the 10 companies where we have the biggest investment. That is all.

**Mr ATKINSON** — Are you happy to table it, or to mention names? You do not have to mention the amount that you have in them.

**The CHAIR** — One of the questions is what proportion of funds is invested and in what types of projects? I have not got to asking those questions.

**Mr CHARALAMBOUS** — I am certainly happy to both provide the information and table the information at a later stage. There are 10 Australian manufacturing companies. It depends on how you define it, but we have excluded the mining sector. I should also add that we have the rough split of employees between Victoria and the rest of Australia.

**Mr ATKINSON** — That would be good.

**Mr CHARALAMBOUS** — To address the latter first, within those 10 portfolio companies there are 2316 employees, of whom 1551 are outside Victoria and the remaining 765 are within Victoria. Those numbers relate specifically to the Australian employees, so 765 of the 2316 are Victorian-based jobs.

**The CHAIR** — Which backs the point that Ian made before.

**Mr CHARALAMBOUS** — Then, if I look at the industries, we have, in no particular order, an air conditioning, a heating, refrigeration manufacturer and a health food manufacturer. We have three businesses in iron, steel pipe and tube manufacturing. We have a mining machinery and equipment manufacturer, an electronic components manufacturer, a pharmaceuticals manufacturer — in fact that is the largest exposure, a business by the name of Innova Pharmaceutical, which is the former 3I Asian operations — and two plastics packaging manufacturers.

**The CHAIR** — So that is quite a spread.

**Mr CHARALAMBOUS** — I would emphasise they are the 10 largest companies we have invested in. In our private equity portfolio of course there is a very large listed element that is not incorporated in that list.

**Mr ATKINSON** — Yes, that is understood. There is just one other thing. In terms of government policies affecting the manufacturing industry, to what extent do you think your private equity investors would rely on the government's policy settings as far as their investment strategies? One of the key things that is emerging at the moment is the emission trading schemes. There would be concern amongst some, I suppose, as to what that might mean for the manufacturing sector if it is not a comparable positioning for Australian firms as it is for overseas. To what extent are those sorts of decisions likely to vary the attitudes of the investment? I would say the nature of our private equity portfolio and its exposure to Victorian businesses is an outworking of the profit outlook of the underlying businesses, so I would think if there was government policy that improved the profitability — the outlook profit-wise — for manufacturing businesses in this state, then as an outcome of that you would likely see an increase in exposure to those businesses within the private equity portfolio just by virtue of the improved investment prospects of those businesses. That would be the first point.

The second point would be that the private equity industry — the managers — are concentrated in Sydney, so within our portfolio we have roughly a dozen Australian private equity managers, but only two of them are headquartered in Victoria. I have not analysed this, but there is probably an argument that managers are going to have a more favourable disposition to businesses in their local area, in the sense that they can potentially get a better understanding of the risks and the characteristics of those businesses.

**Mr ATKINSON** — That is something that we have had led in evidence as well over a couple of the funds. I observed also the Australian Venture Capital Association is basically headquartered in Sydney and most of its members are Sydney based. I drew the same sort of anecdotal parallel that you have done. Why is it that Victoria has not got the private equity firms, and what can we do to improve that balance? I think what you are saying is common sense. If we can have more private equity people here or more venture capitalists in Victoria, then they are going to become more involved in the support of the manufacturing sector, because they will see the good news in the sector. What can we do about that?

**The CHAIR** — Before you answer, my supplementary question on that is: what would you make as the recommendation as a result of the evidence you just gave?

**Mr CHARALAMBOUS** — The latter is the harder one to answer. I think it is at least partly a legacy of the financial services industry being concentrated in Sydney, if you accept that many of the venture capital managers and private equity managers more generally have been formed out of the large financial services businesses — people who have learnt their trade within a large financial services business and then decided to form their own independent specialist private equity firm. I think it is a legacy of the fact that the financial services businesses have historically had a greater concentration in Sydney than Melbourne, but that is just a supposition.

**Mr ATKINSON** — Are the banks' private equity divisions — like ANZ was involved in starting to retrieve at greater knots — also Sydney-centric?

**Mr CHARALAMBOUS** — ANZ certainly had a large Melbourne office. I am not sure if it was headquartered in Melbourne, but it did have a large Melbourne office. The experience within our fund of the large majority of Australian managers being headquartered in Sydney is certainly reflective of the broader market that the managers within the private equity market are concentrated in Sydney. I can only put it down to the fact that the financial services industry in Australia has historically had a larger footprint in Sydney than in Melbourne.

**The CHAIR** — You might like to take a recommendation on notice.

**Mr ATKINSON** — A very good point.

**Mr CHARALAMBOUS** — I will.

**The CHAIR** — Thank you very much to both of you. Terry, we appreciate the offer of tabling the document. It will save a lot of work for Hansard and for our research team, so thank you very much for that. Before you leave — or you may like to get back to our research staff on this — could you give us some indication of a funds manager that we might talk to so that we better understand what they understand as their clients' requirements, that is, the super funds?

**Mr CHARALAMBOUS** — Sure.

**The CHAIR** — That will assist us to counterbalance what the manufacturers are saying is a very tough situation to get finance in order to generate jobs, to generate income, and you know the rest of the story.

**Mr CHARALAMBOUS** — Sure. All right.

**The CHAIR** — Thank you.

**Mr ATKINSON** — Can we also understand that you would only be expecting us to use that as a working paper and not to be published in that material.

**Mr CHARALAMBOUS** — Please; it is commercially sensitive, so if it can be treated as confidential — —

**Mr ATKINSON** — For us it is a confidential working paper.

**Mr CHARALAMBOUS** — Yes, please.

**The CHAIR** — In a fortnight you will be receiving a copy of the transcript. You are free to correct any typographical errors that are in it, but obviously not change the substance of your evidence. We really do appreciate the fact you came along when — —

**Mr ATKINSON** — You did not know why.

**The CHAIR** — We pleaded with you to attend in order to give us a better understanding of the super funds, and you have done that. Thank you.

**Mr SILK** — She did a very good job.

**Mr ATKINSON** — Very persuasive.

**Mr SILK**— Absolutely.

**Witnesses withdrew.**