ECONOMIC DEVELOPMENT AND INFRASTRUCTURE COMMITTEE

Inquiry into Manufacturing in Victoria

Melbourne — 30 November 2009

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Mr R. Harrington, Managing Director, Advent Private Capital; and

Mr S. Dighton, Managing Director, Catalyst Investment Managers.

The CHAIR — Welcome to this all-party parliamentary Inquiry into Manufacturing in Victoria. All evidence taken at the hearings today will be protected by parliamentary privilege, but comments made outside the hearing are not protected by parliamentary privilege. I ask you each to state your name, your business address and your position within that business, because I know you are appearing as business witnesses and not private witnesses.

Mr HARRINGTON — Rupert Harrington, Managing Director of Advent Private Capital. We are on level 17, HWT Tower, 40 City Road, Melbourne.

Mr DIGHTON — Simon Dighton, Managing Director, Catalyst Investment Managers. The address is level 4, 51–53 Flinders Lane in the city.

The CHAIR — Thank you. It is over to you for your presentation. I know you have handouts, so I presume that — —

Mr HARRINGTON — The handouts have been structured so they dovetail. We have tried to eliminate a degree of overlap. If you take the Advent one first, we thought we would just give you an overview of what is private equity. Private equity is a niche funds management sector of the industry, and most of the funding in Australia comes from pension funds and superannuation funds. When you go to international markets it will come from endowment funds as well. Typically superannuation funds might allocate up to 5 per cent of their funds to this sort of sector of the market.

We talk about the sector itself as, if you like, the larger end of town, which is the billion dollar-plus deals you would have seen. I suppose when Myer was privatised it was of that ilk, and there has been a series of other large transactions at that end of the market. That is serviced not only by local players but some international players, predominantly based out of Asia but heavily associated with US, UK and European funds.

In the middle market, which is where Catalyst and we belong, we fund established businesses that are inherently profitable, and we try to take them to the next phase where we actually create growth and wealth in the business that we want to share in. The bottom end of the market, as we would call it, or the small end, is venture capital, which deals with predominantly high-tech, technology-driven, early-stage businesses, and it is quite a small part of the market. It is a much bigger part of the market in the US relatively speaking, but it is actually quite small here. It seems to be hard to develop a full portfolio in that market against international trends.

We do not try to run the businesses, but we engage and are active investors. I suppose the easiest way to think about us is we really are the joint-venture partner who is there to help drive and assist management in growing the business, but ultimately with the intent of crystallising value in a three-to-five-year period. In a simplistic fashion, if we find a business that, say, has profits of $5 million to $10 million, the question we will ask ourselves is: 'Is there a feasible plan that we could take this business through to make $20 million to $30 million in a three-to-five-year period; and if so, is there a plan; is it executable; and how do we do it?'. That might probably be a mixture of rejuvenating an existing business and then adding on some acquisitions and so forth and some organic growth. We are really trying to create value and as a consequence share in the upside associated with the value that we have created.

We are unashamedly medium-term investors, and the institutions that give us our money usually give in a closed-end fund. We invest in one time round and we give them back profits and their capital. On a portfolio basis we will share somewhat in the upside on the total portfolio, and we get some fees for managing the money. If you want to stay in this business, the institutions do know how successful you are and they see behind the scenes, so your success is the ability to raise multiple funds, as Catalyst and we have.

Mr DIGHTON — In a sense we are private equity funds management businesses. That is essentially what we do. Many funds management businesses invest in property or in public equity markets. We basically invest in private businesses. The funds typically have a 10-year life, hence the ability to invest over typically a five-year period and subsequently look to divest the businesses in the balance of the period of time that the fund is open for.

Mr HARRINGTON — The next slide is just a snapshot of the moneys that have been raised to invest in the sector. Over the last five years some $20 billion or so has been raised into the Australian market. The US market is substantially larger. As you can see, 2009 was a pretty flat year, and I am sure that 2010 will be similarly flat, but it is now pretty well enshrined as part of the funds market. The next is just an indication of sectors. Sorry, back on the previous slide you will see the dark green, which is really the venture capital end, which is quite small.

The CHAIR — Yes, I will ask about that in my question.

Mr HARRINGTON — The next is information from AVCAL. It collects information about the industry. This sort of information is available on the AVCAL site: www.avcal.com.au.

Mr DIGHTON — AVCAL being an acronym for the Australian venture capital association.

Mr HARRINGTON — Manufacturing will slot into a couple of those sectors, and it is a relatively small part of the scene. If you go back over time, we would have mutually invested in a number of manufacturing businesses. We currently have three investments in manufacturing in Victoria, and Simon can talk about his portfolio. We tend to reflect the economy, so there is a growing number of services businesses in our portfolio as part of the mix.

To give you a brief backgrounding on Advent, we are Melbourne based or established, and we had our genesis in the MIC program, which was high-tech, early-stage businesses. That is where we cut our teeth, so we know a little bit about the sector. We have invested over time in over 70 businesses. We are currently investing in our fifth fund, which is a $300 million fund. The style of things we do is working with how we can grow good businesses, whether that is divisions of larger businesses that we will buy out with management, or we will work with the existing management, probably the founders of a family business, to take it to the next phase. We are looking for line partners, because crystallising the value in the medium term is important to us. We have 11 investments still active; 7 are in Victoria and 3 of those are in manufacturing. There is a little bit of a summary of each of those in the next three pages. I am happy to talk about them, if necessary.

Mr DIGHTON — Perhaps we can swap presentations for a minute. I ask you to turn to Catalyst 1 and, so that we do not cover the same territory, turn to the heading 'Evolution of Catalyst', which is the next page after that one. To put some context around the issue and question of private equity investing in manufacturing in Victoria it is worth understanding that as an asset class in Australia, private equity has only really got genuine traction over the last decade, so in a sense the history of Catalyst is a bit of a metaphor for the asset class as a whole.

Our business was established in the late 1980s. It raised its first funds then, which were very modest indeed, $12 million and $32 million, by comparison to our latest primary fund of $440 million with a co-investment program. In those early years it was very much a cottage industry — small businesses. Today, we look at businesses in a range of $50 million to $400 million. In those days, by definition, with a fund of $12 million we were very small indeed. It was really only from about 2000 onwards that the asset class as a whole started to get genuine traction in this marketplace. The institutional investors in the wholesale superannuation funds who support us discovered it as an investment opportunity and started to allocate much more serious capital towards its.

In the context of agenda of this committee, thinking about what role private equity has played and what role might it play going forward, it is worth appreciating that it is a relatively recent investment phenomenon in the context of buying businesses in this country, in a sense that is of scale and relevance. Today, by definition, and as Rupert's statistics illustrate, there is a lot of capital that has been allocated towards private equity, and therefore it is significantly more relevant than it was 10 or 15 years ago.

Mr HARRINGTON — The critical issue was that — I think it was roughly around 1997 and 1998 — the institutional investors finally recognised this as an asset class in its own right and therefore they could allocate capital to it. Prior to that, if they wanted to allocate capital to it they had to find it from somewhere. It was like: which asset class does it belong to? It is not a listed class so you cannot take it out of listed. It was very hard for the trustees of a superannuation fund to say, 'We would like to allocate, but we do not have any capacity to do so because it does not form an asset class within the defined regulations of our mandate'.

Mr DIGHTON — On the following page we have set out the investment philosophy to bring to the table when looking at opportunities and it will cover the same sort of territory that Rupert alluded to. What I would make reference to is the bottom right-hand corner 'sustainable model'. In the context of thinking about manufacturing investments in general and in Victoria specifically, one of the critical things for us is that you have a business model that will survive and sustain itself. That is one of the great challenges when thinking about manufacturing, because, as we will allude to, the broad macro themes that overlay manufacturing in general in Australia — and we think about it as being a significant part of the Victorian economy — are generally difficult, so when you look at a specific opportunity locally you have to remember that overlay that the macro themes represent.

There is no point in us buying a business with a five-year time horizon that is doing okay now but is gradually going to erode over that time. That is not what we are paid to do. If you do not feel that the business has the capability to respond to that or is operating in a niche that allows it to stand outside of those macro themes, then it is very challenging for guys like us to put capital to work in support of those sorts of businesses.

Mr HARRINGTON — We mutually use a phrase 'sustainable competitive advantage' as part of what we are looking for in the business. That can come in a whole variety of guises. It can be an amalgam of things, but ultimately you are looking for a business that is competitive on a sustainable basis, otherwise it is hard to see how you are going to win.

Mr DIGHTON — On the following page we have set out the current portfolio of businesses we are looking after, or stewardship, as we call it because, as Rupert observed, we are not the managers of these businesses; we support and partner with management teams. We typically are the majority shareholder, but it is very much a stewardship sort of role. The observation to make there is that there is generally a bias towards lower capital-intensive businesses, service-type providers and/or consumer facing businesses. This is because capital is no longer a commodity, capital is a scarce resource, and we are driven by generating returns on capital. Therefore, capital-intensive businesses, as some manufacturing can be, structurally are not necessarily well suited to how we generate our returns.

In our case we have two businesses in that group with manufacturing operations in Victoria. They are Aperio, a flexible packaging company that is now the largest in the country — we have some 48 employees across a number of sites in Victoria; and Envotec, which is Australia's largest envelope manufacturer that employs some 90 people in a facility at Notting Hill. So we have had for some time relevant ongoing experience in a context of working with manufacturing operations within this local business community.

That extends over time, and the following page illustrates some of the businesses we have previously owned and exited. Pacific Brands had significant manufacturing operations here. We owned it together with an international private equity firm until 2004 when it was floated. There is also Olex Cables, with significant manufacturing operations out at Lilydale; B&D Doors, a local fabrication company. The other businesses had operations here, other than the airports business, but obviously not manufacturing-intensive.

We then flick through to the following section and reflect on private equity and manufacturing, further to Rupert's points. These are from the AVCAL database, which is an analysis of private equity investments in Victoria in total, and private equity investments in total in Australia, divided by different classes. What you will see is that the private equity industry has 18 investments in Victoria at the moment, and that is the part of private equity that Rupert and I operate in; this excludes venture capital or start-ups. Of those there are nine which might be classed as manufacturing operations, and that is the sort of percentage you might expect — some 50 per cent — recognising that when you consider the significance of manufacturing in Victoria relative to other states, that is about what you would expect.

In Australia, private equity currently has 71 investments, of which 29 are in manufacturing-related activities, so that percentage is a little lower; again, what you would expect. There are two interesting observations. One is that the market share of Victoria in the context of private equity investment is modest for the size of the Victorian economy as a percentage of Australia. Only some 25 per cent of deals are based in Victoria, which is illustrative of the fact that typically speaking — —

Mr DAVIS — That is about the size of the economy, though, is it?

Mr DIGHTON — The Victorian economy as a percentage of the national economy, if you exclude property and that kind of thing, you would expect to be punching a bit higher than 25 per cent.

Mr HARRINGTON — I think in that context, if you look at the amount of private equity in Western Australia and South Australia, it is almost non-existent. What you are now really looking at is the eastern seaboard as being the population, if you like, so it is really 25 per cent of the eastern seaboard, if you want to use — —

Mr DAVIS — Of the three states.

Mr HARRINGTON — Yes, if you want to use the relative percentage.

Mr DIGHTON — The second thing is that if you did a time analysis and asked, 'When were these investments made?', what you will see over time is that there is a reduction in the level of capital being committed towards manufacturing-based activities, be it in Victoria or in Australia. It then begs the question, 'Why is that?'. I guess that is the heart of what this discussion is about. The last two pages were designed to sort of capture, if you will, how people like Rupert and I think about manufacturing opportunities. When you have finite pools of capital and you have various alternatives in which to invest, how do you think about it? Where do you look to put your money to work? We have tried to set out on those two pages the key drivers, particularly in the context of the phrase 'enduring moat'; we are looking for what is the protection around the business that will ensure that your capital is protected and, ideally, well positioned to grow.

Of the issues we have set out there, some are a bit generic, but it starts from the perspective that you can still generate a compelling return for your investors in looking at manufacturing. It is not as if we are at the stage where it is off the drawing board completely.

But what are the things that are important? One is the business model itself, so we need to determine whether it is manufacturing, or whether it is both producing a product and involving a process which might be described as very high quality or best in breed; how the cost of production compares today versus its competition locally and offshore, and how sustainable it is; and how stable the workforce is. That is a very important issue — the skilled and semi-skilled workforce is a critical issue, which I will come back to.

The second thing we need to determine is whether there happens to be a technology advantage. The issue that you, Chair, were raising before can be a very important element in support of pursuing a manufacturing operation, perhaps either because it is genuinely unique or because this is a better place in which to exploit that technology than some other jurisdiction might be.

The only observation we would make is that international markets and Asian competitors are incredibly adept at adopting technology very quickly, so it would be a mistake to think you have something that you can keep to yourself for the longer term. Because of the high capacity of Asian markets to copy and match in our view the perception that manufacturing quality or capability is low in given Asian markets is misplaced. They are rapidly catching up across most arenas.

Flexibility can be a key advantage. If you have the ability to meet your customer needs with short lead times, you can turn up with product. For example, with our flexible packaging business we produce chocolate bar wrappers for Nestlé, Cadbury and the like. As you might note, we are always running campaigns: you can buy two for $3 or you can get an extra large one.

The ability to provide that packaging to support that marketing push, which might last a month and it might lead up to Christmas, is very important. If you are trying to import that product from Asia, it is very difficult to do, so if you are finding yourself with opportunities to support that sort of customer need, you tend to have a competitive advantage which can be described as sustainable.

Clearly local supply chains are easier to work with than international ones, and Victoria has an advantage in that regard; there are better working capital benefits and there is less risk than trying to import things across longer kinds of streams.

Mr HARRINGTON — And the flipside of that would be the extent to which your supply chain could be disintermediated, so it is not just a matter of having the supply chain, it is a question of how easily it can be disintermediated. So people might, for instance, well grow the distributor base as part of an efficient way of getting to market, but your distributors might well disintermediate you over time and work with an importer and therefore you can get cut out. There are many layers.

Mr DIGHTON — Having said that, though, the next one is actually quite an important issue. One of the great challenges for local manufacturers here is what has happened to their customer base, so the extent to which that has merged or reduced over time. The retail sector is a classic example. If you are producing something and feeding into the supermarket chains, you have two customers basically. That is a huge issue in the context of taking on manufacturing risk in this country.

In regard to export opportunities, obviously it is helpful if you have those. We put in the 'Buy Australian' issue purely to say that its relevance is questionable, other than in quite iconic circumstances, as a driver to support a local manufacturing business.

The areas of concern in relation to the question of what motivates people to go and manufacture overseas rather than here, one is the stark difference in infrastructure costs. As an example, as I mentioned, over the last two years we have commissioned a new packaging facility in Thailand. A variety of factors were related to doing that, including servicing Asian customers more locally than trying to do it from Australia. But the cost of land, infrastructure, support from government, tax — there are myriad structural elements which feed in to make it a materially lower cost issue to pursue. It is not uncommon to find there are differences in raw material costs, so the same product here costs more as a raw material input into the manufacturing process than it does in other countries. Sometimes we even find that product is actually produced here, but we can buy it more cheaply internationally than we can buy it here. That makes for a significant consideration.

Mr HARRINGTON — Just on the last point, most materials that you buy here, even if they are local, are priced f.o.b. somewhere, plus transport costs.

Mr DIGHTON — Yes, that is right. Labour rates and quality are also factors. I think we are all aware of the differential in the cost of labour. If it transpires that labour is a very high component of the local direct manufacturing cost base, that is quite a challenging issue to overcome in an overall macro scene, hence we tend to be looking for manufacturing businesses where labour is a lower overall component of the existing cost base.

Industrial relations has had a mixed history in Australia and Victoria, so that is a relevant consideration when thinking about whether you will buy into manufacturing in this state. I have talked about the channels to market as being a difficult issue because of the degree of concentration that has been allowed to occur.

Currency is also an ongoing issue. We now live with far more volatility in the Australian dollar. It is not a specifically Victorian manufacturing issue, but if the business is not looking to export and it is selling in US dollars with an Australian dollar cost base, then it is certainly something that you think about.

The last one is the talent drain. It is less of a consideration in Victoria, but we have experienced it with vigour in Western Australia, for example, where we have a manufacturing facility and where we lost significant volumes of the workforce to the mines. I think the themes behind resources is a continuing and growing component of the Australian economy, and the likelihood that as we look forward people will probably be more transportable than not means that we will probably grow as a consideration in Victoria, even though we are much better placed than perhaps is the case in other places like Western Australia.

The CHAIR — Thank you very much. I have given you considerable latitude. Normally I keep people to a much tighter time frame, but you were addressing so many of the issues that would have been raised in questions; so thank you for a well-constructed presentation.

I would like to go to the Advent slide on industry size. You have explained that most of your work is not venture capital, but we had an earlier conversation before your actual presentation about venture capital. I want indulgence, if you do not mind, in asking about venture capital. If you ever did get involved in venture capital, what would be the requirements necessary for you to invest, and are they different to your current modus operandi?

Mr HARRINGTON — As I explained earlier, we had our genesis in that venture capital area in the 1980s and the early 90s. I think the considerations are different. Australia has a history of producing some very good technologies. The issue is how you go about commercialising. The technology that wins is not necessarily the best technology. It is the one that gets to market with a reasonable solution, and often that one will finish up by going and buying the people with the best technology in due course. It is about markets and it is about customers and how you actually take it from an idea into a business.

The secondary question is to do with access to management with the skills. You have to ask: if you start the business here as a raw starter, so it is research driven, do you have the right people to actually run the business as the ultimate business; where are your customers; and is there a rationale for why you should be here or somebody else. There is a whole raft of considerations that sit around it.

For instance, it is quite usual for the venture capital funds in the USA to have management teams that they will bring in. They are also dealing with a substantial market. Even if it is a niche market in the USA, a niche market there might be anywhere from $50 million to $300 million as a niche market, whereas the equivalent niche market here might be one-twentieth of the size just on relative terms. I think it is the whole issue of time and scale.

The CHAIR — Who in your view should be the organisation or the government department that assists with those business skills and management training? You commented that it may not mean the best technology gets up but the best presented.

Mr HARRINGTON — I think there is another leg to that insofar as I am not sure Australia always honours people who take risk and succeed — the environment of saying, if you take the Gen Y kids who are coming through today, 'Actually go out and take risk and want to put yourself out there'. I think it is a broadly cultural issue as much as anything else. People winning and having taken risk are almost pariahs.

Mr DAVIS — It is fine if you are a sportsperson.

Mr DIGHTON — Sporting entrepreneurship, there are no problems at all — but not if it is business entrepreneurship.

The CHAIR — I do not know how we are going to change that.

Mr DIGHTON — I think the tertiary institutions have some role to play in the context of helping to add a component of people's develop through their study period, to understand actually how to expand and develop into business. We have observed over time that people come out of tertiary institutions with a very blinkered view about life.

I expect if Katherine Woodthorpe has not participated in the forum, then I am sure she will have spoken of elements about the other critical need that subsists here though, which is that, for better or for worse, all of capital that has been made available for venture capital and/or start-up businesses is shrinking and shrinking quickly. Unfortunately the harsh reason for that is that the institutional investors who support people like us have made decent returns out of investing in later stage but have not made those same returns out of venture.

That is not to say there should not be a venture segment, but it is a classic example where some form of government participation is probably going to be necessary if it is going to be able to participate in a fashion which supports the agenda that this committee is looking to drive, for example.

The CHAIR — Do you think it would be unreasonable for governments to stipulate that a certain percentage of superannuation funds — minute or a little larger — should be allocated to venture capital?

Mr DIGHTON — That is a quite challenging public policy issue, I think, around the discretionary element of the role here.

The CHAIR — I am sure it is.

Mr DIGHTON — It is a solution.

The CHAIR — What other solutions are there?

Mr DIGHTON — Another solution is that the government, state or federal, establishes a separate investment vehicle itself, that it runs and provides ancillary forms of capital to support given opportunities. It may be that there is a business opportunity that needs development, that none of the local venture capital guys can provide sufficient capital to make it work. But it might work with some form of government support, be it a funds vehicle, be it tax breaks in the context of how capital is invested — some form of economic participation to support and back-fill for a period of time the lack of capital that is there today.

The CHAIR — Should there be insistence on management skills? How do you make sure we do not have, as Bruce has raised a number of times, another VEDC? There seems to be a willingness to go down the exploring options, but there is a political cringe.

Mr HARRINGTON — Shared risk and reward is the only way you ever win. In the last year of the VEDC, if you have a look at the back of the report, if you put up three business plans, you would be unlucky enough to get two funded. That is not the reality of getting businesses funded. It is the whole rigour around the process. I suspect people were rewarded for getting money out rather than for outcomes. So it is inputs rather than outputs.

The IIF program, for instance, is part of the blend. It is some government money with private money, so there is a sharing. Even if it is a disproportionate sharing, there is a risk and reward element that is actually measured. There is private money going in as well. It is, if you like, diluting on a differential base the ease with which some of these businesses can get money.

The CHAIR — Is there a report on IIF?

Mr HARRINGTON — I suspect there is something under the IIF program. It was administered out of Canberra, and there was public money that went into the mix, and there were returns. Normally there is a requirement for annual returns and so forth associated with those.

The CHAIR — I know Bruce has pursued this with a number of witnesses, so I will pass to him.

Mr ATKINSON — I have actually had a look at the model in Israel of seed capital, if you like, funds that involve government investment and the involvement of companies like yours, which bring some expertise and some rigour to the process, but there is also a funding source. There are also programs in Germany and Canada that we are aware of. VEDC is very raw for us, particularly in Victoria, but there were other examples around the nation. But it certainly seems to be a model that had some value at a point in time. It was probably stuffed up by politicians. Did you have a model in mind for any participation by government funds?

Mr DIGHTON — It would be presumptuous of me to make that observation, because it is not an area of expertise for us. We are operating in a different arena. This is an observation from the side, if you will; it is simply to say that there is a gap and a need. Personally I think it simply comes down to people. I think the VEDC was not a mistake because of the concept; it was a mistake in the execution, and the execution comes back to people and having a very tight and clear investment mandate. To use your vernacular, if it was stuffed up by politicians, perhaps it was because the political agenda clouded the investment mandate and the investment execution. But the heart of it — the heart of anything we do — is about people, and it is having the skills.

Mr HARRINGTON — People, alignment and outcomes driven. If you have those as the core of most things, the rewards are outcome driven, and you have got some shared risk and reward. It is about execution and people. Have you spoken to the guys from Starfish — John Dyson and the others — because this is an area that they actually specialise in, the Victorian base?

The CHAIR — We thank you for helping us with this, because we have pursued it.

Mr ATKINSON — Another model that was presented to us was a push-pull model which in effect suggested that perhaps what we ought to be doing is looking at guarantees of orders for technology development — in other words, perhaps for the sake of argument, a broadband system and providing a guaranteed order process.

Mr DAVIS — It is a procurement model.

Mr ATKINSON — Yes, a procurement model — a guaranteed procurement model that would encourage investors to say, 'Okay, if they are going to get to this stage of development and actually get some out there in the field, there is perhaps more interest in investment'. What do you think of that model?

Mr DIGHTON — It possibly can help, but from our world we are always extremely wary about investing in businesses that have some sort of reliance upon government support. Government support is not forever, so you would need to look at it in its specific nuanced circumstance, and if, for example, it helped push or allowed the business to step up another level and gave it the sort of revenue base to be able to attract the right people for a period of time, then yes, that could work. But it needs to be judged individually, recognising the government's support, by definition, does not last. We will not invest where you are relying upon government subsidies, for example.

Mr ATKINSON — I have just got one more question. My apologies for being late, too. I got caught up with things, which is why I am also tongue-tied. Pacific Brands was one of your investments for one of your companies. Obviously that had a high-profile situation earlier this year when it was closing manufacturing and moving some of its production offshore, having already done a lot of production offshore, at any rate. At the point in time, when you had your investment in that company, had you gone through that process? You mentioned that to some extent you are hands-off, there is a management running the investment for you, but no doubt you sat down with management and talked about some of their priorities, the options going forward for that company. I am interested because that is a high profile one that people will be looking at and it is relevant to our report, therefore, as an example of what has happened with a company, and with some iconic brands. Do you have some observations in terms of your investment in that company and what you saw as the imperatives for its production going forward?

Mr DIGHTON — As you observed, the history of Pacific Brands, even back to when it was owned within the Pacific Dunlop public company group, is that it gradually, over a long period of time — probably dating from the early 1980s, like that whole textile clothing and footwear segment — had been under significant pressure. My observation about there being an enduring moat — there was not an enduring moat around the textile, clothing and footwear space.

Mr DAVIS — The walls were gone.

Mr DIGHTON — Yes. There were various attempts over time to continue to support it, and the way the tariff regime worked, and so forth. But basically the simple reality is the cost of manufacturing those products, where there is a very high labour content, and inexorably the competitive opportunity of basing it in other markets was extremely strong, and over time more and more of it moved offshore. Ultimately during our period of ownership there were other priorities, if you will, in the context of changes to that business. We were investors from 2001 through to 2004, but standing back from that, I do not think anyone involved in the company at that stage would have stood there and said, 'There will not be further transference of manufacturing from within that group to international marketplaces', because those forces do not go away.

Mr HARRINGTON — When you look at the labour content, the flip side of that, if you like, is the transport disadvantage for someone bringing it in, and that is really where the gap resides. Unless you have got the position where there is the flexibility, and you have got lead time issues where people will pay a higher price for service, that really tends to be the changeover between labour content and disadvantage of transport logistics on the other side. Inherently the service businesses are labour intensive, but you cannot import the service so it is part of the local regime. That is part of this shift that we see, other than people who have got a suspendable competitive position along these lines we talked about earlier, that will allow you to manufacture locally.

Mr ATKINSON — It would be true, though, that trend-wise, in most manufacturing sectors today, technology has overtaken labour as the major component in terms of production. In other words, labour numbers are not as significant on the manufacturing floor as they used to be.

Mr HARRINGTON — Correct.

Mr ATKINSON — And the labour skills have actually become a more important factor. Would that be your observation?

Mr HARRINGTON — Yes.

Mr ATKINSON — But, as you said, the textile sector has a bit more in it.

Mr LIM — I would be keen to hear what criteria your firm applied when determining the viability of investment transactions and particularly manufacturing-related transactions.

The CHAIR — It is in here.

Mr LIM — Is it in there?

Mr DIGHTON — From our perspective the criteria would be, without going through it again, the issues that appear in the last two pages of our classification.

Mr LIM — I am sorry, probably I am missing a part.

Mr HARRINGTON — We think about a business as, say, we are buying into a business today, we are going to be involved for three, four or five years, and we actually want to sell a much better business, otherwise we are not going to get a return in four or five years time. Whatever we see today, we want to see it enhanced and sustainable, not only for the time of exit but the next buyer would see the same characteristics, otherwise they are not even going to pay the sort of price we have paid. It has got to be something that is sustainable over time. If you look at manufacturing, the key elements that Simon talked about, the value, has it got a sustainable advantage? And that can be partly driven by service, partly driven by technology, partly driven by cost, partly driven by how fragmented its customer base is, if you like, so that it actually has a real reason for being.

Mr DIGHTON — One of the popular misconceptions about private equity is that it is just about stripping costs out, but it is quite the contrary. We actually like to invest and grow businesses, because people will not buy a business off us if we strip all the costs out of it. We find that silly. You have got to be able to grow it and support it, and that is really what we are about.

The CHAIR — You keep talking about buying businesses. Your presentation led me to believe that in about five years time from purchase, you look to moving out and selling.

Mr HARRINGTON — Not look to, we absolutely do, it is part of the requirement. But we are not investors in every businesses. If it is a family dynasty, there is probably no role for us. Again, it is an alignment with the people we are working with, and we are looking to see that we can take a business and make it worth two or three times the value, on market fundamentals, over the time that we are involved in the business.

Mr DAVIS — I have a couple of questions. Katherine Woodthorpe gave us some very good material in Sydney a couple of weeks ago. I am interested to know what you think state governments could do as a matter of public policy to advantage your sector in Victoria. I would be interested — this is the second part of the question — in terms of the venture capital sector, what practical things we could do.

Mr DIGHTON — At our end of the sector, I do not think we look for anything from state government. That might surprise you.

Mr DAVIS — If we wanted to develop the sector, strengthen it, what would we do?

Mr DIGHTON — One thing that could be done, was in the area that we observed before, which was not the VEDC but some variation on that in the context of supporting the development of smaller businesses that could grow up into being effective, sustainable manufacturing enterprises that people like Rupert and I might then want to buy. At a local level that could be a very powerful element, provided you can find the right people to work with to make that objective effective, rather than perhaps has occurred at some stages in the past.

Mr HARRINGTON — The broadening of education for better management, because, as Simon said, often you will see people coming out of our institutions who have a very narrow view of the world. When you look at some of the models in other markets, not in all categories, but there is a broadening of the education base. Historically, if they were engineering based there is often much more exposure to industry as part of the mix. It is that whole engagement of industry and education.

Mr DAVIS — What do you mean by 'broadening'? I am trying to understand exactly what that means.

Mr HARRINGTON — The industrial perspective, the business perspective, the real-life perspective as part of the education system is important. In some engineering degrees in the UK, for instance, there was a fundamental part of a year of engagement with industry. It does not fix every regime, but what it did do was to bring in industry as part of the partnership with education, if you like, which is part of having a broader perspective; and I think it is part of this educational thinking it is fine for an economy not to have people embracing the notion that actually making profit is good, it is part of what pays for all the other social services that we do, and getting people into a different sort of exposure. Part of the migration of people into business, shortening that circuit by engagement with universities, is something the state could actually encourage.

The CHAIR — If you were talking to the Minister for Education, or us, what would you say is the institution or the course that is exemplar?

Mr HARRINGTON — I do not have an answer for that. I think it is — —

Mr DAVIS — You do not have to tell us today, but any ideas on that would be valuable.

The CHAIR — Would you be saying what my son called the sandwich year — —

Mr HARRINGTON — I think it was helpful in certain circumstances, but — —

The CHAIR — Should it be compulsory or almost compulsory?

Mr HARRINGTON — Allowing business to engage more with the education system is something that I think — —

Mr DAVIS — Tertiary or secondary or all the way through?

Mr HARRINGTON — If it starts at the tertiary end, it will probably migrate down to the secondary end.

Mr DIGHTON — The tertiary end is where it would be most effective. Again, if you look at how the US college system works, it is incredibly powerful at producing very rounded, mature individuals out into the workforce. A broad observation from a distance is that there is a lot more corporation or company participation within the US education system — 'association' is perhaps a better word — than we sense here.

Mr HARRINGTON — As a consequence the whole endowment of those universities and their engagement with investment is quite different.

The CHAIR — You might like to take up David's suggestion that if there is a particular institution or course or even business that does this particularly well, the engagement with education to business, we would appreciate hearing about that afterwards.

Mr ATKINSON — Can I also ask if you could provide — not now — some extra information on the statement that you made, which I think is very pertinent, on the relationship of businesses. You were talking about the difficulties for some manufacturing businesses with supply chain issues or when their customer base shrinks; that interrelationship of businesses in the manufacturing sector. If you were able to supply us with some other commentary subsequently, that would be really terrific.

The CHAIR — Thank you very much. You will be provided with a copy of the transcript within about a fortnight, and you are free to correct typographical errors but obviously not to change the substance of your presentation. Good morning.

Mr DAVIS — Thank you very much for a very helpful presentation.

Witnesses withdrew.