ISLAMIC VENTURE CAPITAL: A NEW SOURCE OF ISLAMIC EQUITY FINANCING

Abdullaah Jalil

Universiti Sains Islam Malaysia (USIM)

Previously known as Kolej Universiti Islam Malaysia (KUIM)

Abstract

The concept of venture capital, even in its conventional form, is very close to the equity-based Islamic financing i.e. *musharakah* and *mudharabah*. The concept offers the enterprises lower cost with other value-added services. Its positive impact on economic growth and entrepreneurship attracts Malaysian government to further develop the Malaysian venture capital industry in order foster the development of knowledge- and technology-intensive enterprises. This study is an analysis of the potential and viability of venture capital as a mode of Islamic equity financing, particularly in Malaysia, based on secondary data available in the relevant literatures. Until the end of 2004, there are only 38 VCCs and 34 VCMCs in Malaysia. This reveals that the potential of venture capital was very much underutilized in the country. The study found that Islamic venture capital could be a source of Islamic equity-based financing in comparison to the sale-based and *ijarah*-based financings that are more widely practiced by the Malaysian Islamic financial institutions. Hence, more Islamic venture capital funds and investments should be set up in the effort to promote more profit-and-loss sharing schemes in the Malaysian Islamic financial system.

Keyword: Islamic venture capital

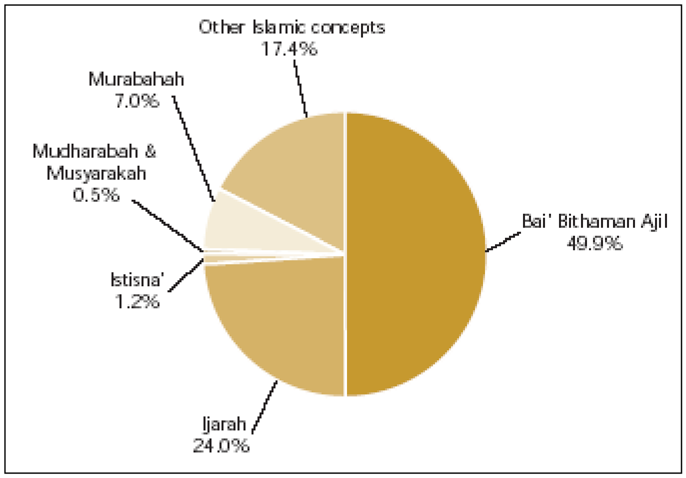
INTRODUCTION

Islamic concepts of profit and loss sharing (PLS) i.e. *musharakah*[1] and *mudarabah*[2] dominate the theoretical literatures on Islamic banking and finance during its early stage of development several years ago. However, the actual up-to-date practice of Islamic banks, investment companies, and investment funds seems to base their financing very much on the mark-up, commissioned manufacturing, or on leasing bases. According to the International Association of Islamic Banks, profit and loss sharing instruments only covered less than 20 percent of investments made by Islamic banks world-wide (Dar & Presley, 2000).

In the Malaysian scenario for example, *musharakah* and *mudarabah* financings constitute only 0.5% out of total Islamic financing totaling RM 9.2 billion as at end-2004. *BBA*-based (deferred payment sale) financing remains overriding, constituting 49.9% of total financing while *ijarah*-based (leasing) financing constituted 24% (BNM, 2004). This is shown in Figure 1. With due acknowledgement to the current practices of Islamic banking and financial institutions, there are various constraints around them for adopting *musharakah* and *mudarabah* as their preferable modes of financing. However, these constraints are not the focal point of this study. The objective of this humble paper is to highlight the potential of the venture capital concept to be further developed and adopted as an economically viable and Islamically preferable equity-based financing. Consequently, Islamic venture capital industry could provide solutions and alternatives to the practicability of PLS scheme in Islamic financing.

[1] A joint venture financing agreement between two parties or more to engage in a specific business activity aimed at making profit. Distribution of profits will be apportioned according to an agreed ratio. In the event of losses, all parties will bear the losses in proportion to their equity participation (BNM, 2000).
[2] A financing agreement between the capital provider and entrepreneur to enable the entrepreneur to carry out business activities on a profit-sharing basis. The distribution of profit is according to a predetermined ratio agreed upon earlier. In the case of losses beyond the control of the entrepreneur, the capital provider will bear all financial losses (BNM, 2000).

Figure 1: Major Islamic Concepts in the Malaysian Islamic Banking System as at end-2004

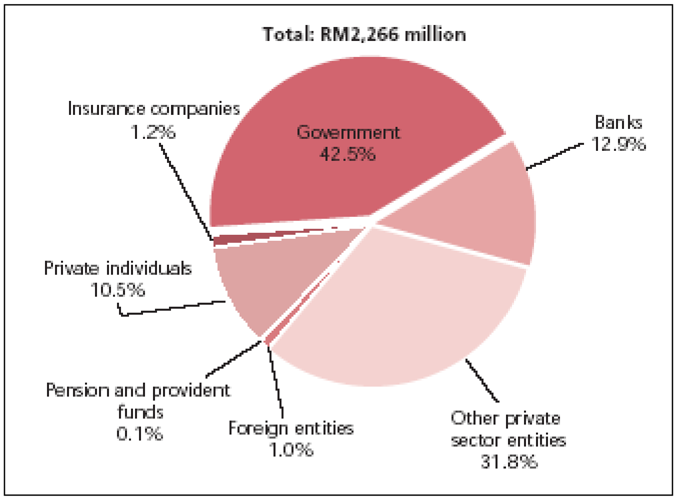


Source: BNM's Annual Report, 2004

THE CONCEPT OF VENTURE CAPITAL

Venture capital refers to "*equity investments in growing, unlisted and more risk oriented companies. The investment scope covers companies at all stages of maturity, with the investors providing value added services such as management skills and network to the companies*" (BNM, 2000). It is an important source of equity for the launch, early development or expansion of a business. VC companies obtain their funds from investors. The investors could be private and public pension funds, endowment funds, foundations, corporations (institutional investors), wealthy individuals, the parent companies of the Venture Capital companies and foreign investors. Their money is comprised in a fund, which is managed by the VC companies. The fund is then invested into investee companies (n.a., 2005; Recklies & Recklies, 2000). The government is still the main source of venture capital funds in Malaysia (42.5%) as Malaysian venture capital industry is still its early stage (fong, 2003). This is illustrated in Figure 2.

Figure 2: Sources of Venture Capital in Malaysia as at end-2004

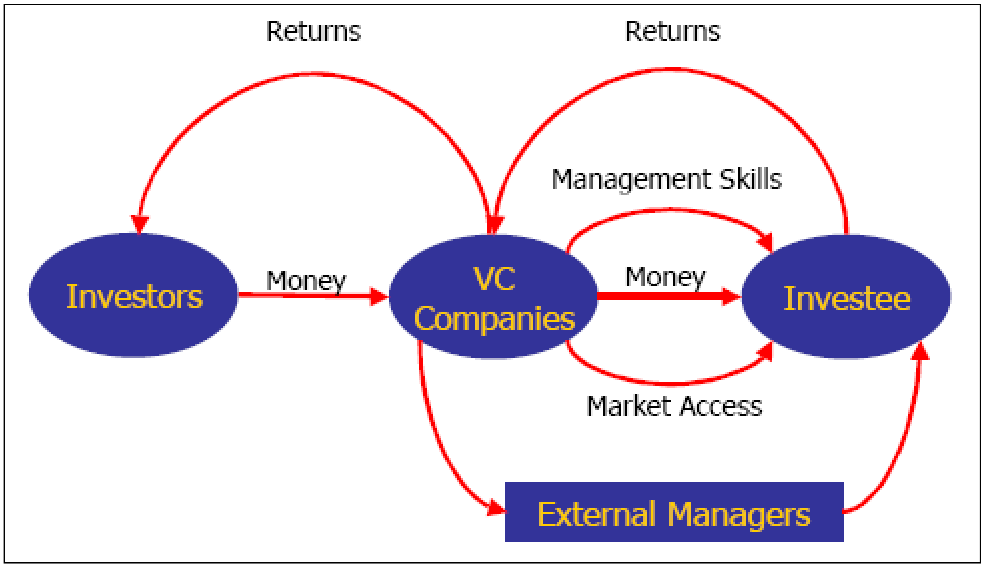


Source: BNM's Annual Report, 2004

One unique character of venture capital compared to other sources of financing is the VC companies can provide their investees value-added services such as management skills, contacts/business networks and market access (Recklies & Recklies, 2000). VC companies generally finance new and rapidly growing companies; purchase equity securities; assist in the development of new products or services; add value to the company through active participation; take higher risks with the expectation of higher rewards; have a long-term orientation, between three to ten years (n.a., 2005). Indeed, the venture capital companies offer the investee companies lower cost of financing with other value-added services.

In several circumstances, they find them external managers. VC companies are not simply passive financiers; they foster growth in companies through their involvement in the management, strategic marketing and planning of their investee companies. Indeed, VC companies play both roles of entrepreneurs and financiers. In most situations, the investees are highly innovative companies in their growth phase that lack sufficient senior management skills (n.a., 2005; Recklies & Recklies, 2000). The support continues until the venture materializes, at which stage an outside investor might be interested in owning the company, or it might be able to go public (IPO). Returns then are distributed back to the investors (Al-Suwailem, 1998). Figure 3 illustrates the whole process of the venture capital concept.

Figure 3: The Illustration of Venture Capital Concept



Source: Recklies & Recklies, 2000

In reality, VC companies do not only invest in “start-up” phase, they will also invest in the various stages of the investee’s business life cycle (n.a., 2005). The business life cycle in relation to the venture capital investment can be categorized into nine major categories (BNM, 2004):

1. Seed-capital[3]
2. Start-up capital[4]
3. Early stage[5]
4. Expansion/Growth
5. Bridge[6]/Mezzanine[7]/Pre-IPO

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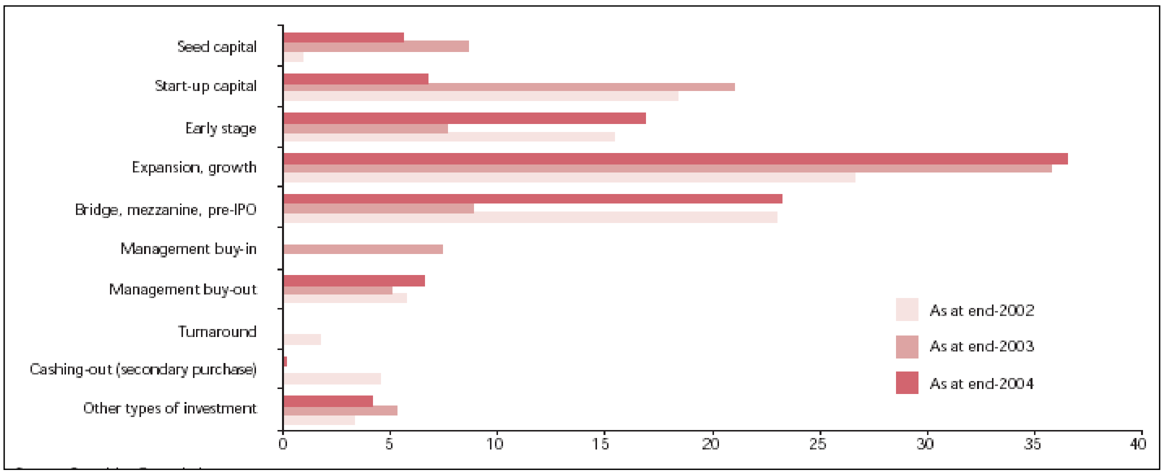
[3] The stage where financing is provided for research and for developing an initial concept or prototype, before a business has reached the start-up phase (BNM, 2000).
[4] Financing provided to companies for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time but have not sold their product commercially (BNM, 2000).
[5] Financing provided to companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales (BNM, 2000).
[6] Bridge financing capital is determined to finance the expenses in the period before the IPO (Recklies & Recklies, 2000).

6. Management Buy-Out
7. Management Buy-In
8. Cashing-out (Secondary Purchase)
9. Others

As at end-2004, VC investments in Malaysia focus on expansion/growth stage (36.6%) where the investee companies have already brought their products into the market and need financing to help them grow beyond a critical mass to become more successful. Investment in more risky stages i.e. seed-capital and start-up capital of a business stages are not so attractive from VC companies' point of view (BNM, 2004). See Figure 4.

Figure 4: VC Investment by Staged in Malaysia



Source: BNM's Annual Report, 2004

VC companies can also be generalist and specialist in term of their investment strategy. A generalist invests in various industry sectors or various geographic locations or various stages of investee business life cycle. Alternatively, VC companies may be specialist in one or more several industry sectors or restrict their investments in only a localized geographic area. Some VC companies specialize in investing funds in selected phases of an investee's life cycle (n.a., 2005).

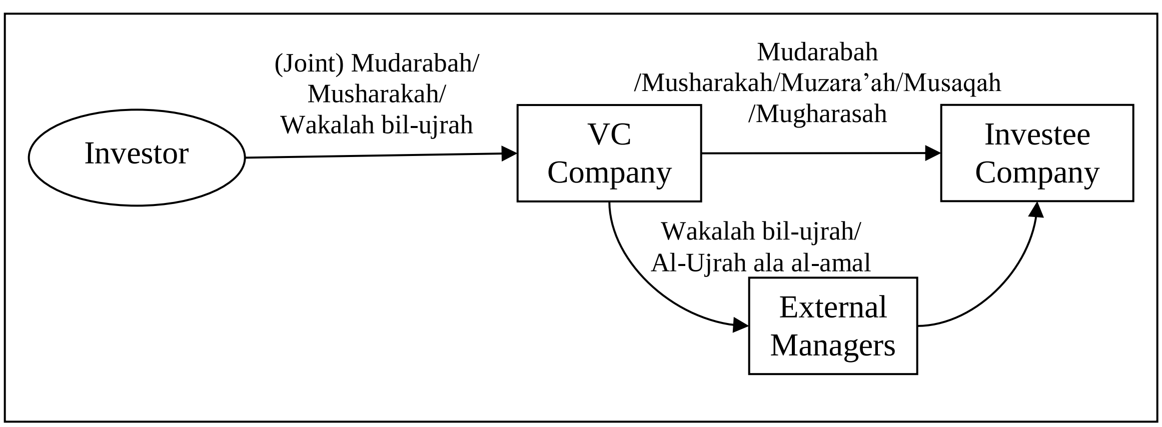
[7] The company has a potential of public listing or undergoing Mergers and Acquisitions within a period of five years (n.a., 2005).

Even though many high-growth companies tend to opt for venture capital financing in order to speed up their growth pace as the venture capitalists do not require the pledging of assets as required by banks, this financing is not without its downsides. The investee companies may lack of control on its own business as key business decisions should get approval from the venture capitalists. Hence, the investee companies must be prepared to give up some controlling of their businesses in the venture capital financing. The venture capitalists may also pull their investment out of the investee company if the performance of the business is poor (Shan & Bayramov, 2005).

THE APPLICATION OF MUSHARAKAH AND MUDARABAH IN THE CONCEPT OF VENTURE CAPITAL[8]

Having presented the concept of venture capital in its conventional form, the practice seems to be very Islamic in the sense that the application of *musharakah* and *mudarabah* are really practicable. Dr. Mohamed Abdu Moustafa[9] states that venture capital, even in its conventional form, is very close to the Islamic concept of profit and loss sharing (n.a., 2005). Figure 5 illustrates the application of main Islamic contracts in the venture capital concept.

Figure 5: The Application of Islamic Concepts in the Venture Capital



[8] This section briefly discusses the venture capital concept from *fiqh* point of view. It is not a detailed fiqh discussion, it only covers the general idea of the discussion.
[9] College of Business and Economics, UAE University

From the author's viewpoint, the relationship between VC company and its investors can be mainly that of *(joint) mudarabah*[10], or *musharakah*, or *wakalah bij-ujrah* or combination of these three contracts. The relationship is determined by conditions and regulations stipulated between the company and investors and the nature of VC company itself. In the case of relationship between VC company and its investee/the recipient, the main Islamic contract between them is *musharakah* (*al-'inan*[11]), involving the partnership in capital (*al-amwal*[12]) or/and labour/skill (*al-abdan/al-a'mal*[13]) or/and reputation/credit-worthines (*al-wujuh*[14]). It is due to the active participation and contribution of the VC company in the business venture. This view is in line with that of Al-Suwailem (1998). However, again, the exact Islamic contract depends on the nature/method of investment adopted by the VC company and conditions and regulations stipulated between the company and investee.

Wakalah bil-ujrah (agency contract with fee) takes place in the venture capital concept when other external companies/managers, usually experts in the business area undertaken by the investee, are hired to consult and help the investee company. If the VC company operates on fee-based contracts, *wakalah bil-ujrah* will also come into the picture. Other *fiqh* issues involve in the VC concept are limited liability, fixing the life span of VC funds (open-ended or close-ended), investment in controversial instruments, the validity of the concept of legal entity (*shakhsiyyah i'tibariyyah/ma'nawiyyah/qanuniyyah*), the use of discount rate and *et cetera* (Al-Rifai & Khan, 2000). In an agricultural business venture

[10] Joint *mudarabah* or *mudarabah musytarakah* is a type of *mudarabah* where there are many capital providers and single entrepreneur/fund manager. *Mudarabah* can also be either general (*mutlaqah*) or restricted (*muqayyadah*). In the case of two-tier structure, *mudarabah murakkabah* (two-tier *mudarabah*) is involved (Al-Hiti, 1998).

[11] In an '*in an* partnership, the equality of legal capacity, liability, capital and labour contribution by each partner is not necessary (Nyazee, 2002).

[12] It is a partnership in which participation is based on the contribution of capital by all partners (Al-Masri, 1999).

[13] It is a partnership in which participation by the partners is based on labour or skill (Al-Masri, 1999).

[14] It is a partnership based on the creditworthiness of the partners. The ratio of loss is based on the liability borne whereby the ratio of profit could be based on either the liability borne by each partner or mutual agreement between them (Al-Masri, 1999).

between the VC company and its investee, Islamic agricultural partnership such as *al-muzara'ah*[15], *al-mugharasah*[16] and *al-musaqah*[17] may take place.

From the above discussions, it is clear that Islamic partnership contracts can be clearly applied into the conventional venture capital concept in order to make it Shariah-compliant. Although the details of practices of the conventional venture capital companies may not be totally consistent with Islamic principles, these details can be easily customized without compromising the positive aspects of the concept (Al-Suwailem, 1998).

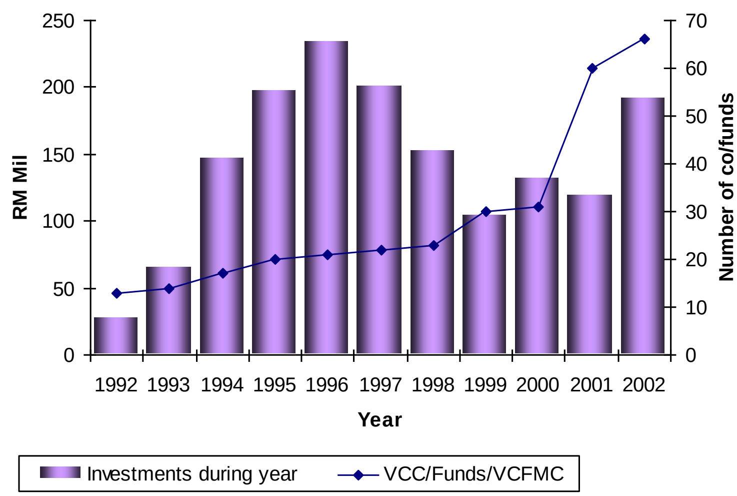
MALAYSIAN ISLAMIC VENTURE CAPITAL: THE NEXT DEVELOPMENT

The positive impact of venture capital on economic growth and entrepreneurship attracts Malaysian government to further develop the Malaysian venture capital industry in order foster the development of knowledge- and technology-intensive enterprises. However, the development of Malaysian venture capital industry has lagged behind the more developed countries like Japan, Singapore, Hong Kong, Taiwan and Korea (Fong, 2003). Malaysian venture capital industry began with the establishment of its 1st venture capital firm in 1984 i.e. Malaysian Ventures Berhad (BNM,). The Malaysian government started to have concern on the venture capital industry through the setting up of Malaysian Technology Development Corporation ('MTDC') in 1992. MTDC was established as a venture capital company which focused on providing technology financing to seed and early stage technology-based enterprises. A number of venture capital companies and funds emerged during the period prior to 1997, but the pace of Malaysian venture capital development really took off after the Asian Financial Crisis as the government turned to

[15] It is a type of agricultural partnership with land contributed by one party and work by another. The land is cultivated and the yield is shared between them (Al-Masri, 1999; Al-Zuhaili, 1997).
[16] It is a type of agricultural partnership where the land and plants are contributed by one party and the work of planting is provided by another party with a portion of plants being given to him (Al-Masri, 1999; Al-Zuhaili, 1997).
[17] It is a type of agricultural partnership whereby the trees and land are contributed by one party and their care (watering) is undertaken by another with their fruit being divided between the parties (Al-Masri, 1999; Al-Zuhaili, 1997).

its domestic activities, particularly SME, to be the backbone of future growth (Aziz, 2000; BNM, 1999 & 2002; Fong, 2003). See Figure 6.

Figure 6: Progress of the Malaysian Venture Capital Industry



Source: BNM's Annual Report, 2002

Malaysian government is very positive in promoting venture capital as a new source of financing for the Malaysian economy and providing the supporting infrastructure, particularly for the technology and knowledge-based enterprises. Several main measures have been taken to enhance the industry such as the establishment of Technology Park Malaysia and incubation centres; establishment of the effective legal framework to protect intellectual property rights e.g. Cyberlaws; setting up MESDAQ in Bursa Malaysia as a viable exit mechanism[18]; the formulation of a National Action Plan for Industrial Technology Development; the establishment of the Malaysian Technology Development Corporation and the Malaysian Technology Forum; the introduction of special tax incentives for the industry whereby VCCs; the development of National Master Plan for E-Commerce and K-Economy Master Plan (Aziz, 2000; BNM, 1999).

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[18] Process where venture capitalists liquidate their investments by selling the shares back to the management, selling the shares to a third party in a private transaction or liquidating the investment in the public share market through initial public offering (BNM, 2000).

Albeit the Malaysian venture capital industry is gaining popularity as an alternative source of funds for investment, the industry faces several difficulties. Some of them are limited sources of funds for venture capital companies due to their high risk and long-term nature of their investment, lack of comprehensive information on the Malaysian venture capital industry, shortage of trained workers and complexity in evaluating and appraising technology-oriented investments which accordingly cause a reluctance on the part of the VC firms to finance the investments (BNM, 2000).

In Malaysia, as at end-2004, the sectors which received most of the VC investment were the ICT sector (42.2% of total), the manufacturing sector (25.4%) and the life sciences sector (18.4%). The three sectors accounted for RM910.1 million or 86.0% of total funds invested (BNM, 2004). And until the end of 2004, there were only 38 VCCs[19] and 34 VCMCs[20] in Malaysia with 332 investee companies. Only RM 1.058 billion was invested in investee companies out of RM 2.266 billion of venture capital funds, while more than half of the total was kept in other assets, namely fixed deposits and cash. This was due to the difficulty of finding the appropriate investment (BNM, 2004; SC, 2003). See Figure 7 for more details. These facts reveal that the potential of venture capital was very much underutilized in the country.

[19] Venture Capital Companies
[20] Venture Capital Management Companies

Figure 7: Key Statistics on the Malaysian Venture Capital Industry

	As at end-2003	As at end-2004
Venture capital funds (RM million)	2,118.1	2,266.0
Total investment (RM million)[1]	878.7	1,058.0
Local sources (RM million)	769.0	887.7
Foreign sources (RM million)	109.6	170.3
No. of venture capital companies/funds	43[2]	38
No. of venture capital fund management companies	31[2]	34
No. of investee companies	298	332
	During 2003	**During 2004**
Total investment (RM million)	227.2	289.3
Local sources (RM million)	192.5	248.4
Foreign sources (RM million)	34.8	40.9
No. of investee companies	115	139

Source: BNM's Annual Report, 2004

With regard to the development and performance of Islamic venture capital industry in Malaysia, the author found no public data available for analysis. The institutions which offer the Islamic venture capitals are still limited e.g. BIMB Venture Capital Sdn Bhd and PUNB[21] (Permodalan Usahawan Nasional Berhad), in number and size of funds. Malaysian Islamic financial institutions should put more effort to expand the Islamic venture capital industry in Malaysia. BNM also recommends that Malaysian VC companies should form smart partnership with VC companies in Organisation of Islamic Countries (OIC) to help enhance the pool of available Islamic VC funds in Malaysia (n.a., 2005)

Additionally, with the establishment of more Islamic venture capital firms, the investment portfolio of Islamic individual and institutional investors becomes wider and they are willing to diversify at least small portions of their portfolio into higher risk investments e.g. venture capital. This development will also promote more Muslim entrepreneurs to indulge into more risky and technology-oriented ventures as the cost of capital is cheaper

[21] Perdanan Usahawan Nasional Berhad has established PUND Venture Capital Bhd to organize Islamic venture capital investment for Bumiputra entrepreneurs.

with the Islamic venture capital concept. Hence, the development of the Malaysian Islamic financial system should not overlook the vast potential role that Islamic venture capital firms could play. The heavy dependence of Government to promote Islamic venture capital will only decelerate the development of a comprehensive Malaysian Islamic financial system.

CONCLUSION

Islamic venture capital has the large potential to be a viable alternative of Islamic investment and source of financing for investors and entrepreneurs, particularly in Malaysia as the government is very supportive and gives recognition to the significance and importance of the industry to the Malaysian economy. Islamic banking and financial institutions should step ahead beyond their "comfortable" methods of sale-based and *ijarah*-based financings to their customers and get involved into their customers' businesses as active partners. Furthermore, the application of Islamic partnership concepts in Islamic venture capital will add to the enhancement of Islamic equity-based instruments in comparison to the sale-based and *ijarah*-based instruments that are more widely practiced by the Malaysian Islamic financial institutions. Hence, more Islamic venture capital funds and investments should be set up in the effort to promote more profit-and-loss sharing schemes in the Malaysian Islamic financial system. It is regrettable for the Muslim entrepreneurs, particularly in Malaysia, if they have to opt for conventional financing since the appropriate source of Islamic financing is not available for them.

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