

CHALLENGES OF VENTURE CAPITAL FUNDING PROCESS IN MALAYSIA

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To my beloved husband and children

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ABSTRACT

Venture capital (VC) plays a significant role to support new-technology-based companies especially in their early stage and has increased tremendously in the Western countries. However, Malaysian VC is still at emerging stage and fails to attract private investors into the industry, although various actions have been taken by the government to promote it. This research aimed to investigate the key challenges of VC industry in Malaysia that hindering its development, with emphasis on the important elements in VC process: establish fund, selection process, structuring of relationships and monitoring of the funded firms, value added activities provided to the funded firms, and exit, and suggested appropriate recommendations for its development. Qualitative research method has been applied since it would provide deeper understanding of the experiences of VC player in Malaysia while research data were collected from interviews and documentation surveys. Respondents were selected from five out of 56 listed VCMC in Malaysia and several government agencies, two PE companies who were previously active in VC and one investee company were also interviewed for validation. The data were analysed using memo and coding technique. Findings from this research clearly suggested various challenges existence in the process of selection of funded firms, monitoring of the funded firms, value added activities provided to the funded firms, exiting from the VC investment and the most crucial, the difficulties in raising funds for VC investment that hindering its development in Malaysia while government's attempts to promote VC have not been a success. However, structuring of relationship with the funded firm is not a kind of challenge within VCs in Malaysia due to small geographical area. This research suggested few measures need to be taken such as the availability of tax incentives and divestment avenues to create a more conducive environment for VC development in Malaysia. Finally, findings from this study would contribute to the academic literature of VC.

ABSTRAK

Modal teroka (VC) memainkan peranan penting untuk menyokong pembangunan syarikat berteknologi baru terutamanya pada peringkat permulaan dan industri ini telah meningkat dengan ketara terutama di negara-negara Barat. Malangnya, ia masih belum berkembang sepenuhnya di Malaysia dan gagal menarik penyertaan dari pelabur swasta walaupun pelbagai tindakan telah diambil oleh pihak kerajaan untuk mempromosikannya. Kajian ini dijalankan untuk mengkaji cabaran utama yang menghalang perkembangan VC di Malaysia, dengan memberi penekanan kepada unsur-unsur penting dalam proses VC: menubuhkan dana, proses pemilihan, penstrukturan hubungan dan pemantauan ke atas firma yang dibiayai, aktiviti nilai tambah yang disediakan kepada firma-firma yang dibiayai, dan keluar dari pelaburan, serta memberi cadangan sesuai untuk pembangunan industri ini. Kaedah penyelidikan kualitatif telah digunakan dalam kajian ini kerana ia dapat memberi pemahaman yang lebih mendalam daripada pengalaman pengamal VC di Malaysia manakala data kajian diperolehi dari temubual separa-berstruktur dan terbuka serta kajian ke atas dokumen berkaitan. Lima responden telah dipilih daripada 56 VCMC yang disenaraikan di Malaysia. Temubual juga diadakan dengan beberapa agensi kerajaan, dua syarikat PE yang sebelum ini aktif dalam VC dan syarikat yang dibiayai, bagi pengesahan. Data yang diperolehi dianalisa dengan menggunakan teknik memo dan pengkodan. Hasil daripada kajian ini jelas mencadangkan pelbagai cabaran terdapat dalam proses pemilihan, pemantauan ke atas firma yang dibiayai, aktiviti nilai tambah yang disediakan kepada firma-firma yang dibiayai, keluar dari pelaburan dan yang paling utama, kesulitan menubuhkan dana pembiayaan yang menghalang pembangunan VC di Malaysia manakala usaha kerajaan untuk menggalakkan VC di Malaysia telah tidak berjaya. Walau bagaimanapun, penstrukturan hubungan dengan firma yang dibiayai bukan merupakan cabaran utama dalam VC di Malaysia disebabkan oleh kawasan geografi yang kecil. Hasil kajian ini juga mencadangkan beberapa langkah yang perlu diambil untuk pembangunan VC di Malaysia seperti mewujudkan insentif cukai dan persekitaran yang lebih kondusif bagi perkembangan industri ini. Akhir sekali, hasil dari kajian ini dapat menyumbang kepada literatur akademik VC.

TABLE OF CONTENTS

CHAPTER	TITLE	PAGE
	DECLARATION	ii
	DEDICATION	iii
	ACKNOWLEDGEMENT	iv
	ABSTRACT	v
	ABSTRAK	vi
	TABLE OF CONTENTS	vii
	LIST OF TABLES	xi
	LIST OF FIGURES	xii
	LIST OF ABBREVIATION	xiii
1	INTRODUCTION	1
	1.0 Introduction	1
	1.1 Background of the study	3
	1.2 Statement of the problem	6
	1.3 Objective of the study	10
	1.4 Research questions	11
	1.5 Significant of the study	11

1.6	Scope of the study	12
1.7	Research framework	13
1.8	Conclusion	15
2	LITERATURE REVIEW	16
2.0	Introduction	16
2.1	Definition of VC and the key terms	17
2.2	Characteristics of VC	20
2.2.1	VCs act as a financial intermediary	21
2.2.2	VC is a type of private equity	22
2.2.3	VC takes an active role in monitoring and helping the investee in its portfolio	23
2.2.4	Requirement to exit	24
2.2.5	VC invest to fund the internal growth of companies	24
2.3	VC history and its development in Malaysia	25
2.4	Research framework	32
2.4.1	Selection process of funded firm	34
2.4.2	Structuring relationship and monitoring the firm	36
2.4.3	Value added activities	39
2.4.4	Exit	40
2.5	Factors influence VC development	42
2.5.1	Taxation	43
2.5.2	Corporate governance	43

2.6	Conclusion	44
3	RESEARCH METHODOLOGY	45
3.0	Introduction	45
3.1	Research methodology	46
3.2	Research design	50
3.3	Recruitment of the respondents	54
3.4	Data collection method	54
	3.4.1 Primary data	55
	3.4.2 Secondary data	61
3.5	Data analysis method	62
	3.5.1 Memos	63
	3.5.2 Coding	65
	3.5.2.1 Open coding	66
	3.5.2.2 Axial coding	67
	3.5.2.3 Selective coding	67
3.6	Conclusion	68
4	FINDINGS AND DISCUSSIONS	69
4.0	Introduction	69
4.1	Data collections process	69
	4.1.1 Interview process	70
	4.1.2 Documentation survey	72
4.2	Profile of participating companies	73
4.3	Analysis of the data	74

4.4	Discussion on the findings	75
4.4.1	Challenges in selection process	76
4.4.2	Challenges in structuring of relationships and monitoring of the funded firms	79
4.4.3	Challenges in creating value added activities provided to the funded firms	82
4.4.4	Challenges in exiting the VC	83
4.4.5	Challenges in establishment of fund	86
4.4.6	Suggested factors to influence VC development in Malaysia	89
5	CONCLUSION AND RECOMMENDATIONS	93
5.0	Introduction	93
5.1	Conclusions	94
5.2	Implication of the study	97
5.3	Recommendations based on findings	98
5.4	Suggestions for future research	100
	REFERENCES	102
	Appendices	109

LIST OF TABLES

TABLE NO.	TITLE	PAGE
1.1	Statistics on VC industry in Malaysia (2004 – 2013)	9
2.1	Terms and definitions used in VC study	19
2.2	Investment fund	27
2.3	Investment stage	29
2.4	Number of new listings	31
3.1	Examples of qualitative and quantitative research	46
3.2	Advantage and disadvantage of using memo	65
4.1	Participating companies	73

LIST OF FIGURES

FIGURE NO.	TITLE	PAGE
1.1	The Venture Impact Report 2011	5
1.2	Research Framework	14
2.1	VC and PE in a business lifecycle	18
2.2	The flow of funds in the VC cycle	21
2.3	The fundamental role of VCs as intermediaries	22
2.4	Source of fund in 2013	28
2.5	VC process	34
3.1	Possibilities for qualitative research design	48
3.2	The qualitative research pyramid	49
3.3	Research design for the purpose of this study	51
3.4	Research flowchart	53
4.1	Amended research framework based on complete VC process	86

LIST OF ABBREVIATION

CEO	Chief Executive Officer
CMP2	Capital Market Masterplan 2
GDP	Gross Domestic Product
GP	General Partner
ICT	Information and Communication Technology
IPO	Initial Public Offering
IRR	Internal Rate of Return
LP	Limited Partners
MAVCAP	Malaysian Venture Capital Management Bhd
MGS	Malaysian Government Securities
MLSCF	Malaysian Life Science Capital Fund
MTDC	Malaysian Technology Development Corporation Sdn. Bhd.
MVB	Malaysia Venture Berhad
MVCA	Malaysian Venture Capital and Private Equity Association
NVCA	National Venture Capital Association
OSP	Outsource Partners Programme
PDS	Private Debt Securities
PE	Private Equity
PPP	Public Private Partnership
SEAVI	Southeast Asia Venture Investment
SEAVIC	Southeast Asia Venture Investment Company
UK	United Kingdom
US	United States of America
VC	Venture Capital

VCC	Venture Capital Company
VCMC	Venture Capital Management Corporations
VCs	Venture Capitalist(s)

CHAPTER 1

INTRODUCTION

1.0 Introduction

Venture capital (VC) is a leading factor of the development of high technology industry in both developed and developing countries. It is also an important source of institutional support for new-technology-based ventures especially in their early stage (Bartzokas and Mani, 2004). VC industry has become worldwide and increased tremendously, in the past few years. More funds are being raised internationally and invested globally, and many nations are making greater efforts to encourage VC activity to enhance innovation and entrepreneurship (Tan, 2010).

VC investment has developed from a small investment pool in the 1960s and early 1970s to a mainstream asset class that is viable and significant part of the institutional and corporate investment portfolio (Tan, 2010). It is gradually accepted as an important mechanisms of entrepreneurial ecosystem around the globe and continues to develop in most nations in this world especially in developed countries such as United States of America (US), United Kingdom (UK) and Japan. It plays an important role in the West to

enhance the development and growth of innovative practices (Patricof, 1989) and global entrepreneurial communities, resulting in employment creation, economic growth and international competitiveness. Consequently, many giant and famous companies such as Apple, Intel, Microsoft, Compaq, Digital Equipment Corporation, Baidu, Focus Media, Federal Express, Siemen, Nokia, Sun Microsystems and Genentech have benefited from VC financing (Tan, 2010). Based on previous researches, US always on the top rank in this industry. Studies such as Bertoni, Colombo and Grilli (2011); Bruton and Ahlstrom (2003); Bruton, Ahlstrom and Yeh (2004); Groh, Leichtenstein and Lieser (2011) have shown that US mostly ranks ahead of other developed countries in VC industry and always selected as benchmark in most VC's research works.

VC has been widely discussed in many studies. However, most researches on the industry have occurred in the West despite of the industry's growth in other region (Bruton et al., 2004; Wonglimpiyarat, 2013). Likewise, not many studies can be found on Asian VC in general (Bruton and Ahlstrom, 2003; Wonglimpiyarat, 2013), and Malaysian VC in particular. Very limited research has been carried out on VC industry in Malaysia such as Algahtani (2012) who studied the pre-investment criteria in VC; Ismail, Senin and Musibau (2011) have contributed towards the understanding of investment evaluation criteria within VC in Malaysia.

According to Mohammad and Manjit (2006), historically, Malaysian VC industry was dominated by local VC players and trailed behind other developed countries such as Japan, Singapore, Hong Kong, Taiwan and Korea (Groh et al., 2011). Malaysian VC industry is yet to develop despite its potential to be a significant financial instrument in the development of innovation system as well as a tool to promote the country's economy. Although the size of fund under management has increased from 2.27 billion in year 2004 to 5.8 billion in year 2013 (Securities Commission Malaysia), government remains as the major source of funds provider with dearth of investment by private sector.

During her speech at the Kuala Lumpur International Venture Capital Symposium 2011, YBhg. Tan Sri Zarinah Anwar, the chairman of Securities Commission Malaysia has indicated that VC industry's success is typically limited to clusters such as the Silicon Valley in the US, some clusters in Europe, Tel Aviv, Bangalore, Guandong and Zhejiang. Generally, Asian VC firms are still developing and there are many challenges ahead in building a vibrant regional VC industry.

Thus, this research aim to investigate the key challenges facing by VC companies in developing countries, concentration in Malaysia with particular emphasis on the important elements in VC process: selection process, structuring of relationships and monitoring of the funded firms, value added activities provided to the funded firms, and exit the investment (Bruton et al., 2004) and suggested appropriate recommendations that would help the development of VC industry in Malaysia. The study began with reviews of the background of the VC industry in Malaysia. Interviews with several venture capitalists (VCs), and some administrative data collections from various sources were carried out and used as research resources.

1.1 Background of the study

VC industry is globalizing and becomes one of the most important source of financing to enhance entrepreneurship. Over the years, the industry has seen a lot of changes where early VCs has developed from traditional to modern capital venturing (Cornelius, 2005). It has evolved from being a novelty to a level where it is now considered as a vital for economic development and plays a significant economic role in

most Western countries and some Asian countries such as Singapore, Hong Kong and Japan. It is expected to play an even more significant role in the future (Bruton et al., 2004; Wonglimpiyarat, 2013).

VC industry in US has taken almost 20 years to reach its current position which was supported by cutting edge technology. Now it plays significant role towards positive impact on US economy and job creations far outweighs its relative size. Figure 1.1 shows the VC impact to total US economy from year 2008 to 2010. It was highlighted that while investments in venture-backed companies accounted for less than 0.2 percent of US gross domestic product (GDP) each year, these companies employed 11 percent of the total US private sector workforce and generated revenue equal to 21 percent. Throughout its history, US VC investment has built entire industry sector by funding ground breaking innovations, from biotechnology to information technology, and to clean technology. Along the years, thousands of start-ups have been brought to life.

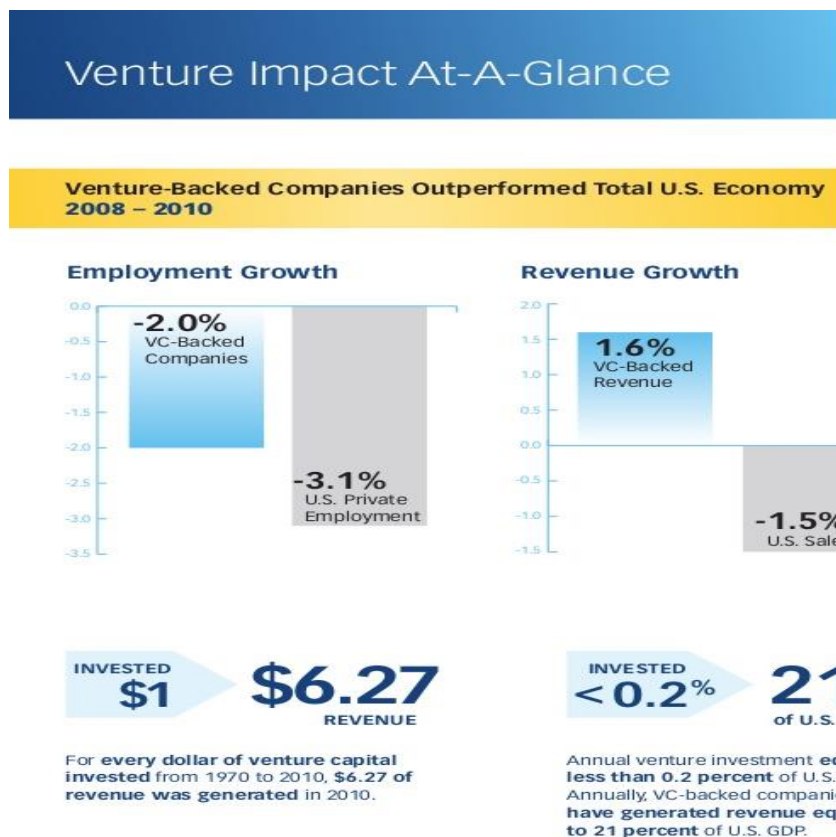


Figure 1.1: The Venture Impact Report 2011
Source: National Venture Capital Association (2011)

The fundamental forces of change arising from globalization, advances in technology and greater reliance on knowledge for value creation is shaping the new economy. As the economy transforms into one in which service and productivity will drive growth, different sources of financing are required to complement traditional financing sources to accommodate the substantial financing requirement of new activities and industries, whereby the risk should be borne by those most able to absorb them. These alternative mode of financing include among others, VC and private equity (PE). VC financing has tremendous potential in Malaysia to contribute to the growth of technology and knowledge based enterprise.

Tan Sri Dr. Zeti Akhtar Aziz, the governor of Bank Negara Malaysia in her speech, *Accelerating Economic Growth Through Venture Capital* (2000) in the *Venture Capital Europe-Asia 2000* conference stated that over the decades, Malaysia has achieved economic transformation on several faces including from commodity based economy to one in which the manufacturing sector with higher value added products dominates and the latest economic transformation in the services industry. She added that VC's role is important to fill in the financing gap especially in the new technology based industry which is considered as high risk investment by other conventional financial institutions.

Although VC has the potential to play significant role in the new economy transformation, Malaysian VC has yet to develop. There are many challenges ahead in building a vibrant regional VC industry in Malaysia. Unfortunately to date, very limited research has been carried out on Malaysian VC industry in general and it is hardly to find any studies on the challenges of this industry in Malaysia. Therefore, in general this research attempted an in-depth study on the key challenges facing by VC firms in Malaysia with particular emphasis on the important elements in VC process: selection process, structuring of relationships and monitoring of the funded firms, value added activities provided to the funded firms, and VC investment exit and suggested appropriate recommendations that will help the development of VC industry in Malaysia. In the researcher's point of view, all the characteristics were important to provide clearer picture and better understanding on the Malaysian VC industry as whole.

1.2 Statement of the problem

Generally Malaysian VC industry was dominated by local VC players and lagged behind developed countries such as Japan, Singapore, Hong Kong, Taiwan and Korea

(Mohammad and Manjit, 2006) and still at emergence stage despite the fact that this industry has the potential to be one of the key contributor towards the economic growth.

Although the financing pattern in Malaysia has also evolved over the years in line with the transformation of Malaysian economy, the growth was mainly contributed by loan from the banking system and the issue of debt instruments by the government. Historically banking and public sectors have dominated the quantum of total financing in Malaysia, though new financing emerged in 1980s to promote private sector as the main engine of economic growth which resulted declined in public sector financing to 20.9 percent and 11.1 percent in 1980 and 1990 respectively. While the share of VC still relatively small, it has however been rising from 0.1 percent in 1992 to 0.5 percent in 1998. Government is aware of the important roles of VC in funding the new growth areas, thus effort have been directed to develop this industry (extracted from Tan Sri Dr. Zeti Akhtar Aziz's speech in the Venture Capital Europe-Asia 2000 conference). Unfortunately, this industry does not yet have the critical mass needed to achieve self-sustaining growth.

In spite of various actions taken by the government to promote VC industry in Malaysia such as by announcing tax incentives to VC companies and provide more fund to government-backed VCs, this industry is still at emerging stage and fails to attract more private VCs to enter the industry as cited below:

“The venture capital and private equity industry in Malaysia is at a crossroads. Despite having received RM3 billion in government aid, according to practitioners, the industry will be devoid of any privately backed organizations within five years if further action is not taken” (Hussain, 2010).

Studies demonstrate that in most countries with an innovation policy, there is increasing importance of government backing for setting-up of VC industries. Malaysian government had recognized the important role of VC industry in financing the emerging high-growth companies and therefore provide significant funding and tax incentives to promote the growth of this industry. Hence, table 1.1 has shown high growth of Malaysian VC industry with committed fund rising at 14 percent in year 2005 compared to year 2004 or increased from RM2.27 billion to RM2.59 billion, due to the strong commitment from the government. The percentage continued to grow in year 2006 and 2008 where the highest percentage of fund raised was shown in year 2008, which represent 38.5 percent if compared to year 2007. However, year 2011 has shown a significant drop on the rising fund of RM5.46 billion compared to RM5.96 billion in year 2010. Although the fund raised in VC industry has continued to increase in year 2012, the percentage is very small and it was mostly contributed by the government. Again, year 2013 has shown a decrease on the percentage if compared to year 2012.

Table 1.1: Statistics on VC industry in Malaysia (2004 – 2013)
Source: Securities Commission Malaysia

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
No. VCC	38	48	49	52	56	59	58	56	59	61
No. VCMC	34	39	42	46	53	55	55	52	53	58
No of VC Professionals	195	156	184	132	248	313	160	131	124	103
Funds under management (RM' billion)	2.27	2.59	3.3	3.3	4.57	5.35	5.96	5.46	5.70	5.80
Total investment (RM' billion)	1.06	1.44	1.16	1.78	1.93	2.59	3.39	3.59	2.76	3.43
No. investee companies	332	380	461	433	450	445	389	409	466	356

This statistical data is good to support statement made by Hussain (2010) that VC industry in Malaysia is at a crossroads and will be devoid of any privately backed organizations if no further action is taken since the small increased in percentage of the fund under management from year 2011 to year 2013 as shown in table 1.1 was mostly due to additional fund raised by the government to promote this industry. The above data has also shown significant decrease on the number of VC professionals within five years that is from 313 VC professionals in year 2009 to only 103 VC professionals in year 2013, thus provide the signal that VC industry becomes less attractive among professionals. According to Wonglimpiyarat (2007), although government intervention is important in developing countries to fill in the funding gap for entrepreneurs to compete in technology-based industries, the government programmes should not be a replacement for private equity financing.

As an industry operating in a developing economy such as Malaysia, various challenges thrive both from inside and outside the industry. There are many challenges ahead in building a vibrant regional VC industry and it is imperative to investigate these challenges and suggest appropriate recommendations that would help the development of VC industry especially in developing economy. Previous researchers including Ribeiro and Carvalho (2008); Schwartz (1994); Sheela and Jitrapanun (2008) have explored the operations of VC industry in similar developing countries and revealed various challenges including ineffective legal environment and bureaucratic tendencies that prevent the development of VC industry in these countries.

Nevertheless, many researchers have failed to recognize the key challenges of VC in the important elements of VC process: selection process, structuring of relationships and monitoring of the funded firms, value added activities provided to the funded firms, and exit and not any research found on VC industry in Malaysia. Therefore, in the researcher's opinion it is crucial to understand the key challenges faced by Malaysian VC industry which reduce the chances of its development in Malaysia.

1.3 Objective of the study

The study is designed to learn about the key challenges facing by VC that hindering its development in Malaysia, although various actions have been taken by the government to promote this industry. Specifically, the objectives of this study are as follows:

- 1) To identify the key challenges of VC industry in Malaysia.
- 2) To suggest appropriate recommendations that would help the development of VC industry in Malaysia.

1.4 Research questions

In order to serve the specific objectives of this study, the following specific questions have been developed:

- 1) In what way is VC process hindering VC industry development in Malaysia?
- 2) What are the factors that influence VC industry development?

1.5 Significant of the study

This study seeks to fill some of the voids in the literature regarding challenges in VC industry. Previous research has found the impact of institutional elements that shape VC industry which create challenges to its development. Therefore, to complement this finding, this study attempts to further analyse the key challenges existence within the element of VC process that hindering its development in Malaysia.

The review of the literature in the contexts of VC industry in Malaysia, may suggest clear directions for future research and it is hoped to benefit the academic world by giving insights on the theory of VC.

1.6 Scope of the study

Typically research on VC industry emphasizes on how the actors (fund providers, VCs and entrepreneurs) develop business together and it is crucial to clearly define the actors and relationships involve in order to have clear understanding in the VC process.

Thus, this research focused on selected VC companies within Malaysia with various size of investments. For the purpose of this study, target correspondents were initially identified from Security Commission Malaysia (2014). Five VCs were purposely selected for in-depth interviews with the top management, which represented approximately nine percent of research population of 56 firms. In addition, few government agencies, two PE companies who were previously active on VC activities and one entrepreneur were also interviewed for additional insights on the VC's role to support entrepreneurship and to corroborate the information provided by VCs, thus helped to validate the results and provided some additional insights. According to Sapienza (1992), it is almost impossible in one framework to encompass all phases of financing from investee and investor sides of view. Hence, this research focused only on VCs side.

1.7 Research framework

This research are made of five chapters with other subchapters within. Figure 1.2 below presents the outline of the entire chapters of this study.

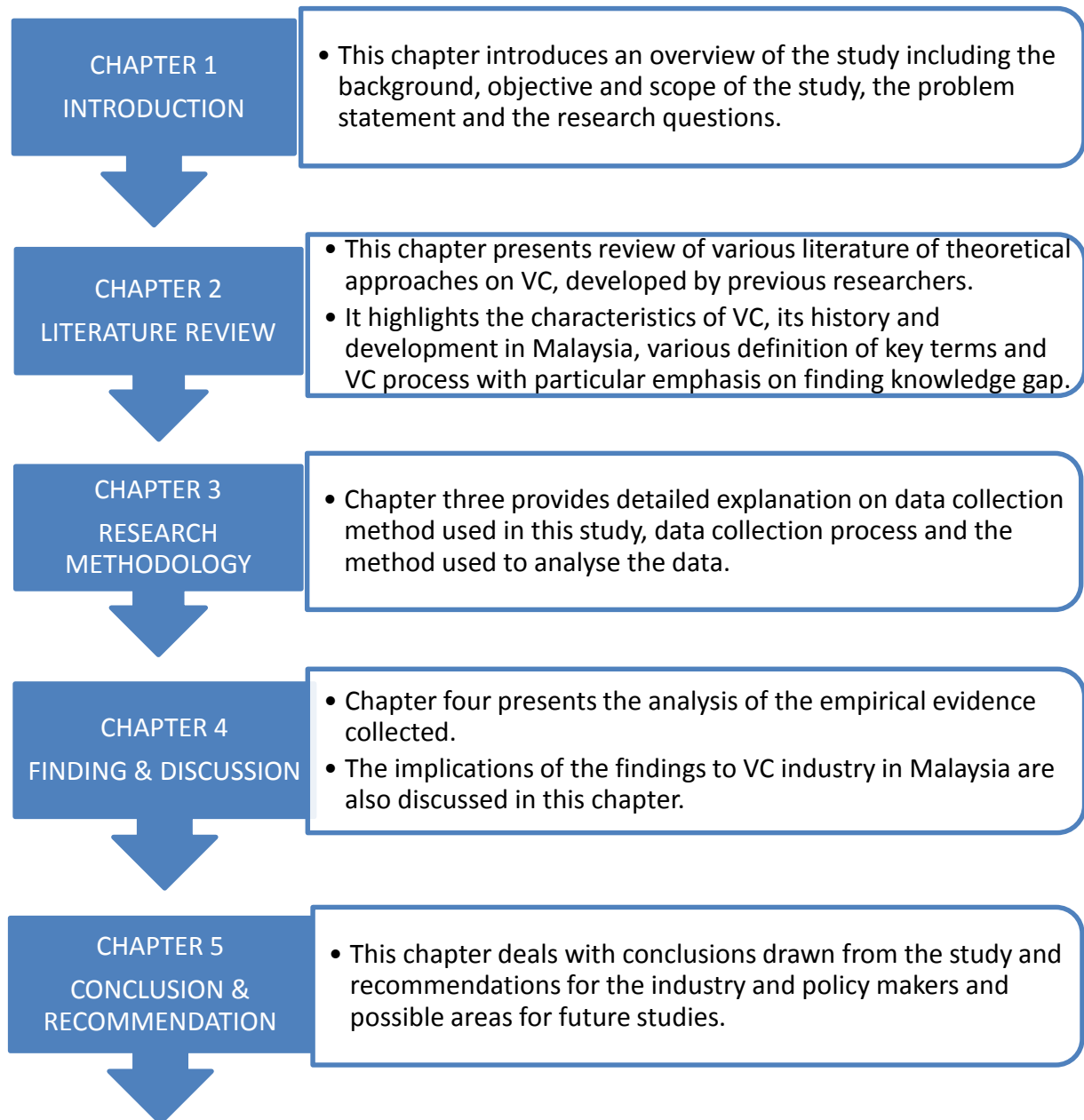


Figure 1.2: Research outline

1.8 Conclusion

This research began by introducing an overview of the dissertation, such as the background of the study, the objective of the study, the scope of the study, the problem statement and the research questions. Chapter two presented the literature review of theoretical approaches and various definitions on VC, its history and development in Malaysia, and its terminology that have been found or developed by previous researchers. Chapter three described the research methodology applied in this study for data collection and method used to analyse the data. The data analysis and discussion on the findings from the research which were based on the constructed framework derived in chapter two, could be found in details in chapter four while the final chapter provided some conclusions and recommendations of the study.

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