

## Latest trends in venture capital in Islamic banking



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Venture capital is a mode of equity financing in which an investor or capital provider actively participates in the venture company being financed. Venture capital is mainly provided for early-stage and high-potential growth companies in the interest of generating a high return through an eventual buyout or initial public offering.

In general, there are three types of venture capital financing, namely early-stage, seed-capital and start-up financing: **Early-stage** refers to financing in the form of working capital, additional capital or interim funding with the ultimate expectation for the venture company to be listed on the stock exchange; **Seed-capital** refers to financing for the purpose of research, assessment and development of an initial concept of the product; and **Start-up** refers to financing for product development, initial marketing and promotion activities.

Venture capital can be a tool for economic development in developing regions. It is a preferred option for new companies with limited operating history that are too small to raise capital in the public markets and have not reached the point where they are able to obtain financing from banks. It contributes to the economy in that: it supports technology advancement with the development of new cutting edge technology which would not otherwise be realisable; and contributes to increased job opportunities and innovation (for instance, Google, Amazon, Apple Computer, Intel, FedEx and Microsoft took off as a result of venture capital financing by investors).

### Common structures in Islamic venture capital

There are three common structures used in Islamic venture capital, namely, *Mudaraba*, *Musharaka* and *Wakala*. Generally, venture capital is a mode of financing that is ideal for Islamic finance through the application of participatory financing modes, with the *Mudaraba* concept being the most common. In the *Mudaraba* model, financing will involve a partnership/investment contract under which the investors (or *Rabb-ul-maal*) will provide financing, whereas the manager/entrepreneur will run the business venture and will be responsible for the management and work. According to the *Mudaraba* principle, the parties will have to agree upfront on the profit ratio arising from the business venture. Loss in the venture will have to be borne solely by the investors except if the loss is due to the negligence, fraud or mismanagement by the entrepreneur.

The other common structure used is the *Musharaka* model whereby the financing will involve a partnership between two or more parties to finance a business venture whereby all parties have to contrib-

ute capital, either in cash or in kind. Profits are to be shared between the *Musharaka* partners according to a pre-agreed ratio. In the event of a loss, the loss shall be shared according to the capital contribution.

Apart from *Mudaraba* and *Musharaka*, the *Wakala* structure is also widely used in Islamic venture capital. In *Wakala* structure, an investor (as the principal) authorises the asset manager (as its agent) to act on his behalf, based on agreed terms and conditions. A *Wakala* contract confers the powers and rights to the agent to act on behalf of the principal as long as the principal is alive.

In order to ensure that the business and operation of the Islamic venture capital company complies with *Shariah* principles and requirements, a *Shariah* advisor should be appointed to advise and provide guidance on all matters related to the proposed investment structures and the business activities of the Islamic venture capital company.

### Latest trends in Islamic venture capital

According to Darawati Hussain, the former Chairman of the Malaysian Venture Capital and Private Equity Association, Islamic venture capital in Malaysia is attracting strong interest from local and foreign investors. Currently, together with a sound amount of funds in *Sukuk* and unit trusts, Islamic venture capital asset class comprises approximately RM 1 billion (approximately US\$318,890 million) out of a total RM 5.4 billion (approximately US\$1.8 billion) venture capital industry in Malaysia. However, global Islamic venture capital assets still remain only less than 1 percent of the total conventional venture capital assets.

The followings are some interesting points to note on the latest trends in Islamic venture capital:

- (1) There is high interest and strong demand from investors to deploy their funds in venture capital in Malaysia as it is considered a niche market facilitated by developed Islamic finance infrastructure, demographic and economic fundamentals and government support.
- (2) As there are too many small private equity and venture capital funds, consolidation will continue in the Middle East and North Africa (MENA) and South-East Asia (SEA) venture capital markets.
- (3) Venture capital financing, which traditionally focused on the information and communications technology sector, is shifting to other areas such as life and health sciences, electricity and power generation, education services, trading activities, transportation and micro-finance.
- (4) Islamic venture capital financing is becoming more sophisticated and institutionalised, and it is starting to reflect global standards together with professionally managed *Shariah*-compliant asset allocations.

The Malaysian experience can be an excellent example to other countries, as the government has always played a major role in supporting Islamic venture capital firms to establish their base in the country.

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