

Venture Capital Action Agenda

Situation Today and Opportunities for Tomorrow

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This paper covers venture capital market development in Pakistan and in the region (India, Thailand and China), and it gives an overview about the role that governments play to promote venture capital and it gives some guidance to the Government of Pakistan to create an appropriate infrastructure to promote venture capital market in Pakistan

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1. INTRODUCTION

Venture capital (VC)¹ has grown significantly during the 1990s and since then it increasingly associated with improved firm performance in terms of survival rates, innovation and growth. Most recently venture capital has taken root and is expanding worldwide, including in the new fast developing markets such as China, India and Thailand.

Thailand

Formal venture capital investing in Thailand was initiated by the USAID programme in 1988 when it formed an investment company to invest in SMEs in Thailand that had strong growth potential. Following this initiative, many foreign VC companies, such as H&Q Asia Pacific, Prudential, City Capital and others were founded in early 1990's.

Since 2000 the Thai Venture Capital industry has benefited from a Baht of 1 billion Venture Capital Small and Medium Enterprise Fund, an US\$250 million Thailand Recovery Fund and an US\$50 million Thai Equity Fund. All these funds are supported by the Government of Thailand.

India

VC investment started in India in 1988 with the formation of Technology Development and Information Company of India Ltd. This followed with a first private VC fund, which was sponsored by Credit Capital Finance Corporation (CFC) and promoted, by Bank of India, Asian Development Bank and the Commonwealth Development Corporation.

In the second quarter of 2005 Venture Capital investment in India rose by 30% with new inflows from the United States, Europe and elsewhere. In a three-month period in the second quarter of 2005, 36 Indian companies raised \$395 million. India expects Venture Capital investment to reach the \$2 billion mark by the end of 2005².

China

The Chinese venture capital industry started in the mid-1980s when the government decided that it should develop various high-technology industries. Due to lack of experience among government officials and venture capitalists, most of the initial efforts in this industry failed³. The China technology Start-up Investment Company, one of the well-known venture capital firms in China, went bankrupt in 1997.

Although most of the early efforts failed, there has been a steady flow of support from the government and the private sector for the development of venture capital industry in China. After years of sluggish development, China's venture capital industry grew

¹ See Annex 1 for an explanation of what Venture Capital is and how it operates.

² See Annex 6 for a matrix listing of venture capital funds in India and in Thailand.

³ The current situation in Pakistan could be compared with Chinese situation of 1980s

rapidly in 1999 and 2000⁴. There are currently over 200 venture capital firms and 300 incubators in China⁵. Beijing, Shanghai and Shenzhen are emerging as the centres of the Chinese venture capital system.

2. VENTURE CAPITAL MARKET IN PAKISTAN

Pakistan has three venture capital firms⁶: Pakistan Venture Capital Limited, PVCL (private, led by an American, located in Karachi⁷; TMT-PKIC Incubation Fund Ventures Limited which is a Pakistani managed and owned firm.) and TRG, which is planned to focus on the IT sector. The other two venture capital companies, EMZ and ABAMCO are also registered with the Security Exchange Commission, but they are still not in operation.

TMT-PKIC registered with the Securities and Exchange Commission of Pakistan (SECP) in June 2005. It has a capital base of Rs. 250 million to invest of which Rs.50 million is its own capital, Rs.75 million was raised from the Pak-Kuwait Investment Company, and the remainder was raised from a consortium of institutions. TMT-PKIC seeks to co-invest in new companies whose management will be co-located with TMT-PKIC in the same building to allow the Venture Capital Fund to engage in hands-on management with respect to its investors along the lines of an incubator.

PVCL was biased toward mature firms in traditional sectors with little evidence of investment in technology-based start-ups. PVCL has recently decided to move away from the venture capital model due to problems with its portfolio and problems created by Pakistan's loan recovery procedures. PVCL is changing its focus to concentrate on fund management and will cease to operate as a venture capital company.

So far, there are not tangible results or notable success stories of these funds at the Pakistani venture capital market.

The Enterprise Competitiveness Support Fund will promote and be possibly the most recent venture capital promotion tool through its venture capital window that will focus on business incubation. The CSF will offer funds to private and public-private commercial incubators to be invested on a Venture Capital basis with incubator start-up companies.⁸ These incubators will support the entrepreneurs in the pre-venture

⁴ See annex 5 legal framework of venture capital market in China

⁵ See Annex 7 for a matrix listing of venture capital funds in China

⁶ In September 2000 there was an unsuccessful attempt by the Government of Pakistan to create a \$50 million Venture Capital fund for technology development.

⁷ This company maintains still its registration under the Ministry of Finance.

⁸ The CSF will provide up to 70% of the base capital needed for a private or public-private partnership Incubator Company based on their meeting CSF criteria as spelled out in a form that will be given to all prospective operators. As of now preliminary discussions suggest that the technical department of LUMS is interested to create a hi-tech incubator on this basis.

capital stage, that is, when they want to develop the idea to a viable commercial proposition that could also be financed and supported by a venture capitalist.

3. ROLE OF GOVERNMENT IN VENTURE CAPITAL

Governments can affect the supply of venture capital in several ways. They can stimulate private investment through a range of policies and framework conditions, including through the rules on which types of investors may carry out venture capital investments, the development of an active second-tier market and fiscal policies. Governments can also take a more active role and invest directly in venture capital funds⁹.

4. VENTURE CAPITAL RULES AND REGULATIONS IN PAKISTAN¹⁰

Venture capital firms must register with the Securities and Exchange Commission of Pakistan (SECP)¹¹. The SECP licenses Venture Capital companies and promulgated rules governing such companies in February 2005. Venture Capital companies are allowed to take an equity stake of up to 70% of an investee firm's capital, whereas prior to this they could not invest more than 30%.

4.1 Step One

However, further work should be centred on solutions to overcome the obstacles for the Pakistan's Venture Capital development. The GOP is to undertake an initiative to start discussions, in form of foras, with the private sectors, international experts and the venture capitalists to focus on the following six key instruments:

- Favourable taxation policy for Venture Capital;
- How can government funds learn from international experiences (such as Thailand, India, China, Ireland, Israel etc.) to attract private capital and international funding to energize the growth of Pakistan's innovative economy;
- How to strengthen legal protection of Intellectual Property (IP), resolving IP disputes and enhancing litigation efficiency;
- How to build a comprehensive legal framework for Venture Capital in Pakistan;
- How to promote the development of Pakistan's M&A market and Second Board market, in order to widen exit channels for Venture Capital, and finally,
- How to strengthen the notion of credibility among Pakistani entrepreneurs to enhance information transparency and corporate governance of business start-ups.

4.2 Step Two

⁹ See Annex 2 more details about the government role in venture capital.

¹⁰ See Annex 2 for current rules and regulations governing Venture Capital in Pakistan; See Annex 4 for the rules and regulations governing Venture Capital in India.

¹¹ Until 2005 Venture Capital firms had to register with the Ministry of Finance.

Changes are needed to the existing regulatory and fiscal framework to enable institutional investors to participate in Venture Capital Funds. As of now, the regulatory framework does not allow pension funds or insurance companies to do so. The regulations should lower barriers to entry for would be investors and Venture Capital fund promoters to the greatest possible extent and set out clear cut eligibility criteria based on international best practice¹². In other countries where Venture Capital is successful a major resource for capital mobilization has been pension funds and insurance companies. It is also important to ensure that hi-value individuals can invest in such funds. (See Annex 3 for current Pakistani regulations).

Venture Capital needs success stories in Pakistan and to educate financial institutions and those controlling pension funds and similar capital sources about venture capital investment, its risks and how such risk can be mitigated. Specific action needs to be taken on the following:

- Relaxation of rules that prevent Pension Funds, Insurance Companies and other institutions from investing in Venture Capital Funds due to the risks involved;
- Provision of a permanent exemption from capital gain taxes on venture investments;
- Creation of equity guaranties for domestic institutional investors
- Creation of a Government backed seed fund perhaps transforming current loan programs into capital ones that could seed private venture capital as has been done in India and Thailand;
- Creation of national and provincial level business angel networks linked to emerging venture capital funds;
- Develop a company law based on international best practise;
- Changes in the rules and regulations of the Karachi Stock Exchange or creation of a NASDAQ equivalent to ease listing for smaller firms and their eventual IPOs; and
- Creation over time of a regional stock exchange with a NASDAQ window for small start-up companies.

Lastly, co-financing ventures with international investors would further help impart experience to Government and private sector to move them to speed up the progress towards the creation a sustainable venture capital market in Pakistan.

¹² See Annex 5 for international best practice criteria for Venture Capital registration eligibility.

5. ANNEX 1

1. FUNCTIONING OF VENTURE CAPITAL MARKETS

Venture Capital

Venture Capital is an equity or equity featured capital seeking investment in new ideas, new companies, new production, new process or new services that offer the potential of high returns on investment.

Types of VCs

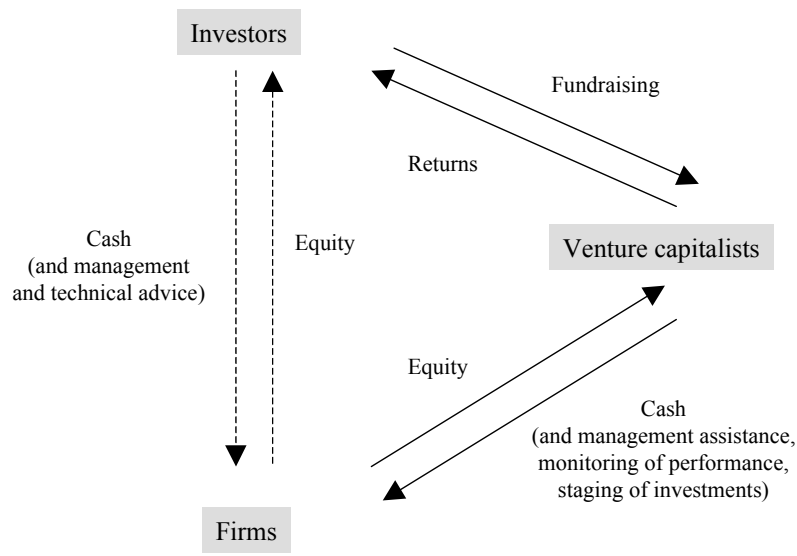
Generally there are three types of organised or institutional venture capital funds: Venture capital funds set up by angel investors; venture capital subsidiaries of corporations; and private venture capital firms/funds. Venture capital subsidiaries are established by major corporations, commercial bank holding companies and other financial institutions.

Venture capital is a special type of finance targeted mostly to young and innovative firms that need capital to fund product development or growth, and must, by the nature of their business, obtain capital largely in the form of equity. In fact, heavy reliance on intangible assets, uncertain operating environments and negative cash flows make it unlikely that these firms can access bank loans or use other debt financing instruments. Young, technology-intensive companies with little track record may find it particularly difficult to raise capital, as they have few tangible assets, which investors or bankers may regard as potential collateral. Consequently, without venture capital, many of these firms would be capital-constrained and fail to survive.

Firms could receive venture financing in two ways (Table 1) venture capital can be supplied *directly* from investors such as individuals (“business angels”) and corporations or *indirectly* from specialised venture capital funds. The latter act as financial intermediaries between investors (such as individuals, corporations, pension funds, banks and insurance companies) and portfolio firms.

Venture capitalists however provide more than money to their portfolio companies. These additional contributions include management assistance, intensive monitoring of performance, staging of investments, and reputational capital (*i.e.* the venture capitalist’s ability to give the portfolio company credibility with third parties), and play a crucial role in the survival of these companies, at least in the short-run. They help to reduce informational problems and mitigate agency conflicts between entrepreneurial firms and outside investors.

Table 1: The ways that firms receive venture capital



1.1 Business angels

Business angels are generally wealthy individuals with substantial business experience that invest directly in unquoted small companies. Individual investors in the informal markets tend to be more focused on early-stage financing than institutional investors and they provide more managerial and business advice through their greater personal involvement. There seems to be a virtuous circle with angel investment: the more successful entrepreneurs that exist, the more potential angels there will be. Although data are scarce (partly because these individuals are hard to identify and are often reluctant to reveal exact information), it is believed that total funding by business angels is several times greater than all other forms of private equity finance.

1.2 Corporate investors

Large companies are increasingly investing in entrepreneurial ventures in spin-offs or other start-ups, especially in the United States. For instance, Microsoft acquired shares in 44 firms for USD 13 billion in 1999, and Intel in 35 firms for USD 5 billion. Much of the corporate interest is driven by recent encouraging developments in venture capital markets and the desire of larger companies to outsource innovative activity. This strategic collaboration could be beneficial for all parties. By financing and co-operating with small innovative firms, larger firms can gain access to new technologies; small firms in return can benefit from the expertise of large corporations in their respective field.

6. ANNEX 2.

THE ROLE OF GOVERNMENTS IN PROMOTING VENTURE CAPITAL

Government as Venture Capitalist

Many governments in the OECD area are playing an active role as venture capitalists with the aim of enhancing innovation and increasing employment. Direct equity investments by governments are the high-profilest way of providing financial resources to small businesses or venture capital firms.

Government equity programmes are generally based on the assumption that there is insufficient liquidity available for particular classes of investment and the government must fill the void. These are often targeted to helping forms that are in a very early stage of development where the risk profile is too high to attract private capital. One approach is for a government to invest in private sector venture capital firms, which in turn provide equity to small enterprises. Alternatively, a government may create its own venture capital fund.

However, the efficiency of such programmes is subject to debate, whether government can identify firms in which investments will yield high private and/or social returns or can encourage private sector parties who can do so. One can argue that government schemes are misplaced, they can displace or retard the development of the private sector venture capital market, subsidise unviable firms or ventures, and even depress levels of entrepreneurship. In contrast, one can claim that government interventions can attract investors to riskier ventures, which result in job and wealth creation that would not otherwise have occurred, that they can be targeted to areas which are in need of job creation but which are unable to offer attractive financial returns in the near-term and that they can have a leveraging effect on private sector risk capital. However, indeed the governments can play a useful venture capital role, if such scheme properly designed. This could be particularly important in cases where venture capital investment is very concentrated in terms of sector or region where firms need only small amount of financing that venture capital funds may be reluctant to provide.

However, pursuing one-dimensional supply-side policies may only have minor effects on the venture capital market. Demand side factors, including the existence of promising ideas and high-potential entrepreneurs or firms suitable for investment are also important.

Governments in many OECD countries are setting up policies to promote entrepreneurship and risk-taking, facilitate firm start-up and expansion, and provide mechanisms for easy entry and exit on capital markets. The United States, for example, exhibits many of the factors that foster entrepreneurship and venture investing. These include a secondary stock market (NASDAQ) allowing easy entry and exit for investors, favourable capital gains tax treatment, availability of and favourable tax treatment of stock options, rules allowing pension funds and institutions to invest in venture capital, and an extensive business angel network. As a result, US growth companies have benefited from the continuum of finance provided by business angels in the early stage, then venture capital from the private equity

market, then an initial public opening, and subsequent access to institutional and private investors. Other countries in the OECD are trying to replicate this success, but many may have not yet put together the complete package.

The Government can also take a more active role in cases of “funding gaps”, where access to financing is a major business constraint, where investors are not willing to provide funds in small amounts or where regional imbalances are too pronounced. But the demand side is also important, including the availability of promising ideas and entrepreneurs suitable for investment, which can be affected by appropriate framework conditions conducive to creativity, innovation, risk-taking and entrepreneurship. The latter are particularly crucial, as international venture capital flows may increasingly dissociate domestic supply from domestic demand, and change the relative importance of the underlying factors.

7. ANNEX 3

TERMS AND CONDITIONS OF OPERATION FOR VENTURE CAPITAL FUNDS/COMPANIES IN PAKISTAN

- A venture capital fund shall not expose more than 40% of its equity to any single venture;
- Disclose in its accounts all investments in companies and group of companies exceeding 10% of paid-up capital of venture capital fund;
- Ensure that the maximum exposure of the venture capital fund to its directors, affiliated companies in which any of the directors and their family members including spouse, lineal ascendants and descendants and brothers and sisters hold controlling interest, shall not exceed 10% of the overall portfolio of venture capital;
- Not except any investment from any investors, which is less than one million rupees.

8. ANNEX. 4

INVESTMENT CRITERIA FOR A FOREIGN VENTURE CAPITAL INVESTOR IN INDIA

All investments to be made by foreign venture capital investors shall be subject to the following conditions: -

- It shall disclose to the Board its investment strategy.
- While it can invest its total funds committed in one venture capital fund it shall however not invest more than 25% of the funds committed for investments to India in one Venture Capital Undertaking.
- It shall make investments in the Venture Capital Undertaking as at least 75% of the investible funds shall be invested in unlisted equity shares or equity linked instruments.
- Not more than 25% of the investible funds may be invested by way of:

- Subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed subject to lock-in period of one year.

Tax benefits

In terms of section 10(23 F) of IT Act income by exemptions way of dividend and long term capital gains received by approved VC Companies/Funds from investment made by way of equity shares in a VC undertaking are exempt from tax.

IT rules amended on 18th July 1995 introduced a rule 2(D) that allowed tax exemption under the aforementioned section provided, among others,

(1) An application is made to Director of IT (Exemptions) by the VCC or VCF

(2) VCF/VCC is registered with SEBI.

(3) Not less than 80% of the fund corpus/paid up capital is invested by year 3.

(4) The VCC/VCF does not invest more than 5% of paid up capital/fund corpus in one VC undertaking.

(5) VCC/VCF does not invest more than 40% in equity capital of one VC undertaking.

9. ANNEX.5

LEGAL FRAMEWORK FOR VENTURE CAPITAL IN CHINA

Innovative Provisions and Legislative Breakthroughs: 2003 VC Regulation

1) Non-legal Person Venture Capital Enterprise

2) Three Capital Repatriation Methods

3) Elimination of Restriction on Investment of more than 50% of Net Assets

4) Reduction of Investment Threshold

5) Contribution, Capital Reduction, Contribution Transfer, and Investment Repatriation
6) Venture Capital Management Enterprise

7) Taxation

Innovative Provisions and Legislative Breakthroughs: 2003 VC Regulation

1) Non-legal Person Venture Capital Enterprise

Form:

- a. Investors jointly and severally liable
- b. Only principal investors bear unlimited liability.

Remaining investors liable is limited to the extent of their invested capital The non-legal person enterprise may be established under the Law of Chinese- foreign Cooperative Enterprise of PRC, however, there is little practical experience

2) Capital repatriation methods

Exit from overseas capital market

Share transfer to a third party in PRC

Share redemption by the invested enterprise

3) Elimination of Restriction on Investment of no more than 50% of Net Assets

2003 VC Regulation permits VC enterprise to invest all of its capital

4) Reduction of investment threshold

Amount of registered capital:

2001 Tentative Rules: US\$25,000,000 (minimum capital commitment of each of foreign investor is US\$1,000,000)

2003 VC Regulation: Non-legal Person VC Enterprise: US\$1,000,000

Company VC Enterprise: US\$500,000

Capital contributed by Foreign Investors may be less than 25% of total committed capital

Principal Investor Qualifications Reduced: qualitative requirements of Investor may be met by such investor's affiliates

Investment Ratio of Principal Investor:

Non-legal Person VC Enterprise: not less than 1% of the VC Enterprise's total committed capital and paid-in capital (decreased from 3% under 2001 Tentative Rules)

©¥Company VC Enterprise: not less than 30% of the VC Enterprises total committed capital and paid-in capital

5) Capital Contribution Reduction, Transfer of Registered Capital, and Repatriation of Capital

Capital Contribution: Distinction between paid-in capital and committed capital

©¥Non-legal Person VC Enterprise: Elimination of requirement for the first instalment of not less than 15% of the registered capital to be paid within 3 months after issuance of business license

©¥Injection by instalments permitted: 3 years; 5 years? Capital Reduction:

©¥Non-legal Person VC Enterprise: consent of majority of investors, Principal Investor and MOFCOM required? Transfer of Registered Capital:

©¥Transfer by Principal Investor: consent by more than 50% of investors, revised contract and articles to be submitted to approval authority for approval

©¥Transfer by other Investors: in accordance with contract revised contract and articles to be submitted to approval authority for filing

Repatriation of Capital: no prior approval necessary, only filing required

6. Venture capital management enterprise

Internal management

Non-legal Person VC Enterprise: Joint management committee

Company VC Enterprise: Board of Directors

Exterior management

The overseas company permitted to manage the Chinese VC enterprise as management enterprise

7. Taxation

V.3 Challenges and Opportunities for Improvement

1) Restrictions on Company VC Enterprise

Company VC Enterprises are limited by the existing company system and provisions of company laws of PRC, and unable to adopt innovative provisions regarding taxation and capital repatriation of limited partnership VC enterprises

3) Resolution of VC enterprise taxation issues within the existing tax legislation framework

Avoidance of Double Taxation: as a limited liability partnership no tax to be paid on realization of investment, tax is to be paid on distributed profit and return on investment

Taxes on Capital Increase: issues concerning taxation on profits made from investor disposal of equities

3) Redemption of equity interest in VC enterprise

Requirements and Procedures to be clarified

4 Procedural differences between filing, examination and approval

Standards for filing, examination and approval procedures remain unclear

5) Coordination and supervision over the enforcement of law by different governmental departments

9. ANNEX 6

Some of the Venture Capital Funds and Companies in India and Thailand

1. INDIA

- APIDC Venture Capital Limited
- Canbank Venture Capital Fund Limited
- Gujarat Venture Capital Fund 1997
- Industrial Venture Capital Limited
- Auto Ancillary Fund
- Gujarat Venture Capital Fund 1995
- Karnataka Information Technology Venture Capital Fund
- India Auto Ancillary Fund
- Information Technology Fund
- Tamilnadu Infotech Fund
- Orissa Venture Capital Fund
- Uttar Pradesh Venture Capital Fund
- SICOM Venture Capital Fund
- Punjab Infotech Venture Fund
- National Venture Fund for Software and Information Technology Industry

2. THAILAND

- Asian Direct Capital Management
- Business Venture Promotion

- CDC Capital Partners
- Darby Asia Investors (HK) Ltd.
- Finansa Co., Ltd.
- H & Q (Thailand) Ltd.
- NAVIS Capital (Thailand) Ltd.
- PAMA Group Inc.
- Rasa Holding
- Thai Strategic Capital Co., Ltd.
- Vnet Capital Co., Ltd.
- JAIC Asia Holdings Pte. Ltd.

3. CHINA

Additional Chinese venture capital funds some of the key funds include:

- Beijing Venture Capital
- Centek Venture
- Legend
- New Margin
- TEDA
- Shanghai VC
- Shenzen VC