The potential of Musha??rakah as an Islamic financial structure for venture capital funding in Malaysia

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by

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In the Name of Allah, the Most Beneficent,
The Most Merciful.

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AUTHOR OF DECLARATION

I hereby declare that the work in this research is my own except for quotations and summaries which have been duly acknowledged.

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ABSTRACT

This thesis investigates the potential of Mushārakah financing in the Malaysian venture capital industry. The thesis address these areas; 1) To investigate how Mushārakah arrangements could be an appropriate form of financial structure for Shari'ah compliant venture capital funding among venture capital companies in Malaysia; 2) To investigate the appropriate exit avenue for a Mushārakah arrangement in the venture capital in Malaysia; 3) To identify the financial advantages (risk, return, corporate governance, exit strategy, ownership and liability) and management value-added (trust and knowledge in managing business) that can be provided by Mushārakah financing in the venture capital setting and 4) To identify the investment criteria that is needed for a Mushārakah fund.

Semi-structured interviews with 18 venture capital companies in Malaysia were undertaken through email, face-to-face meetings and telephone interviews. The responses were examined using content analysis and are coded accordingly into themes. These themes are factors that are required to apply the Mushārakah in the venture capital companies in Malaysia.

The factors reveal interesting elements with regards to the applicability of the Mushārakah in the venture capital companies in Malaysia which are; 1) Mushārakah is appropriate to be applied in the early stage or in the venture capital stage as the case in Malaysia; 2) Ordinary shares, convertible preference shares and redeemable preference shares are appropriate for a Mushārakah fund in terms of Shari'ah compliancy and on obtaining competitive return; 3) Diminishing Mushārakah is more appropriate to be applied in the early stages and viable to be applied as an exit mechanism for companies at the start-up stage; 4) IPO is a viable exit mechanism for the Mushārakah fund due to the return and Shari'ah compliance. The Mushārakah fund is suitable to be applied at the early stages, where the invested companies can exit through share buyback and IPO; 5) The nature of the liability shouldered by the investors can be structured in accordance to Islamic law whereby, in determining liability in Islamic Law it is not the business structure, but the actual *sharikah* contracts between the parties.

This thesis adds to the literature concerning Mushārakah as a financing tool for small businesses and also to the area of Islamic finance. Such study can only create a space of looking into the Mushārakah structure as a huge opportunity for more quality companies to be set up and using new source of funding in industry sectors such as biotechnology, pharmaceuticals, ICT companies, agriculture, fisheries and etc. Stakeholders in the area of Islamic banking and finance and the venture capital industry may further research into the Mushārakah financing as a major potential financing tool in the future. These are included in the recommendation chapter of the thesis.

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GLOSSARY OF TERMS	
'Adl	Justice
Ahadith	Plural of hadith, (see hadith below).
Akhlaqiyyah	The practice of virtue, morality and manners in Islam
Bai Bithaman Ajil	Deferred payment sale whereby the Bank will finance customers who wish to purchase an asset but to defer the payment for the asset for a specific period or to pay by installment.
Dhawat-ul-amthal	Commodities which can be replaced by similar commodities in quality and quantity
Dhawat-ul-qeemah	Commodities which can't be replaced by similar commodities in quality and quantity
Diminishing Mushārakah	An "equity sharing" Islamic financing technique used for financing projects. It uses different types of profit and loss sharing partnerships. Shares are purchased periodically from the financier until the borrower fully owns the asset.
Fiqh	Islamic Jurisprudence
Gharar	Risk, uncertainty and hazard
Hadith (plural, ahadith).	Record of the sayings, deeds or tacit approvals of the Prophet Muhammad (peace be upon him).
Halal	Permitted by Islam
Haram	Prohibited by Islam
Hanafi	One of the four schools of thought in Islam
Hanbali	One of the four schools of thought in Islam
Insanniyyah	Benevolence. Refers to a cluster of moral values such as spending on others, caring for neighbours and relatives, sacrifice for others, including all acts of altruistic character
Ijarah	A medium-term mode of financing, which involves

	purchasing and subsequently transferring of the right of use of the equipment and machinery to the beneficiary for a specific period of time
Istisna	A contract for manufacturing (or construction) whereby the manufacturer (seller) agrees to provide the buyer with goods identified by description after they have been manufactured/constructed in conformity with that description within a pre-determined time-frame and price
Kafil	Guarantor
Maliki	One of the four schools of thought in Islam
Mudhārabah	A mode of business where two or more persons participate: one with capital and the other (or others) with labour and enterprise. The financier shares the profit with the entrepreneur according to mutually agreed terms. In the case of loss, it is borne by the financier alone
Mushārakah	A mode of business in which more than one person join with capital and labour on the basis of profit-and-loss sharing
Riba	Refers to a pre-determined increase on the amount of loan which increases over time. It is equivalent to interest
Riba al-fadl	An increase arising out of an unequal barter exchange of the same commodity with deferred delivery from one party
Riba al-Buyu'I	Riba that occurs on the exchange of goods and involves payments
Riba al-Fadhli	The selling of ribawi items whereby excess is taken in exchange of specific homogeneous items through hand-to-hand purchase
Riba al-Yad	The selling or exchange of different ribawi items in cash but either one of the goods are delivered later
Riba al-Nasi'ah	The selling of different ribawi items on deferred terms, and when the goods arrived and the seller couldn't pay it, then the tenure is added together with the addition in payment

Riba al-Qardhi	A contract on debt or loan for a specified tenure and additional payment on the principal
Sadaqah	Voluntary act of giving alms
Salam	It is a sale where the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot.
Shāfi`ī	One of the four schools of thought in Islam
Sunnah	Refers to the normative behaviour of the Prophet Muhammad (peace be upon him) as evidenced by his utterances, and his tacit approvals
Sukuk	An asset-backed bond which is designed or structured in accordance with Shari'ah and may be traded in the market.
Shura	Consultation
Shirkah-ul-`aqd	Partnership in business affected by mutual contract
Shirkah al-'uqud	Partnership in contracts. (Plural of Shirkah-ul-`aqd)
shirkah al-amlak	Partnership in property
Shirkah al-inan	Two or more persons pool their capital and work together and share the profits
Shirkah al-milk	Joint ownership between two or more partners in a particular property
Shirkah al-mufawadah	Partners combine in every type of shirkah, namely, al-inan, al-wujuh and al-abdan
Shirkah al-wujuh	Partnership in credit. One or more of the partners procure goods on credit and sell them and share/distribute the profit.
shirkat-ul-a'mal	Partners jointly undertake to render some services for their customers, and the fee charged from them is distributed among the partners on an agreed ratio. Also called shirkat-ut-taqabbul or shitkat-us-sana'i` or shirkat-ul-abdan
Shirkat-ul-amwal	Partners invest some capital into a commercial enterprise

Ta'awun	Cooperation. Refers to the God's command to cooperate in all acts of "goodness and piety"
Taqwa	Piety; it is an essential trait of the character of a Muslim. It encompasses a number of values such as honesty, thankfulness to God, remembering God, justice, benevolence, spending in the way of God, etc
Urf	Referring to the custom, or 'knowledge', of a given society, leading to change in the fiqh
Ummah	Refers to the Muslim community irrespective of colour, race, language or nationality.
Wakil	Agent (to act on behalf)
Waqf	Charitable endowment. Appropriations or tying up of a property in perpetuity so that no proprietary rights can be exercised over the corpus but only over the usufruct.
Zakah	The amount payable by a Muslim on his net wealth as a part of his religious obligation, mainly for the benefit of the poor and the needy. It is levied at the rate of 2.5 per cent on all financial assets and stock-in-trade of business; at the rate of 10% on agricultural produce of rain-irrigated cultivation and at 5 % on the produce of artificially irrigated cultivation. It is payable at different rates on livestock reared for sale. The exemption limits are quite low, so that it has a very wide coverage.

Note: This glossary has been complied from a variety of sources including the Islamic Development Bank, the Securities Commission of Malaysia, selected Islamic bank websites and conference volumes.

CHAPTER ONE: INTRODUCTION

1.1 The Importance of the Study

The venture capital industry in an emerging market economy such as Malaysia helps promote entrepreneurship and economic development. This vision is also in line with the Malaysian government's future economic plans, which have been laid out in the Financial Market Master Plan, which was launched in March, 2001. In this plan venture capital is looked upon as an important industry that can also contribute to the development of the Small Medium Enterprise (SME). In addition, the establishment of the Islamic venture capital was laid out in this plan in order to develop the available pool of financial instruments available in Malaysia. Based on Recommendation 7.5 of the Financial Market Master Plan (launched in March, 2001), it is stated that Malaysian venture capitalists should form smart partnerships with venture capitalist in the Organisation of Islamic Countries to establish Islamic funds because it will enhance the pool of available funds in Malaysia.

This gives room for analysing the potential of Mushārakah financing in the venture capital industry. The analysis on the potential of Mushārakah financing can help to overcome the problem of under utilization of equity financing in the Islamic banking and finance industry. It is evident that Mushārakah only account a small percentage in the Islamic banks. The International Association of Islamic banks stated that Mushārakah and Mudhārabah account for less than 20.0 percent of financing undertaken by Islamic banks worldwide.[1] The same scenario can be seen in the venture capital industry in Malaysia. In Malaysia, only two banks have structured Shari'ah compliant funding in the venture capital industry. They are Bank Islam Malaysia Berhad (BIMB) and the Commerce International Merchant Bank (CIMB). 33According to all the four schools in the Islamic Jurisprudence, Mushārakah is the preferred mode of financing due to its non-collateral structure, profit sharing and purely performance structure of financing.

If this is the case, why aren't there many venture capital companies in Malaysia utilizing Mushārakah financing? Therefore, this research aims to address this question or problem statement by analysing the potential of Mushārakah financing among the venture capital companies in Malaysia. Analysing the potential of Mushārakah financing in this research is broken down into several parts as seen below. The research aim is narrowed down into several objectives. The objectives are then used to structure research questions. This research focuses on Mushārakah used for equity financing in the venture capital and not as a mode of financing for debt. Therefore, the research concentrates mainly at the early stages.

1.2 Research Aim

- To investigate the potential of Mushārakah financing in the Malaysian venture capital industry.

1.3 Research Objectives

- To investigate how Mushārakah arrangements could be an appropriate form of financial structure for Shari'ah compliant venture capital funding among

[1] Nasr, Mohamed. (2005). The Demand for Mushārakah in Urban Egypt. Iqbal, Munawar & Wilson, Rodney A. (comp. & ed.) *Islamic Perspectives on Wealth Creation*. (pp.218-230). UK: Edinburgh University Press.

venture capital companies in Malaysia.

- To investigate the appropriate exit avenue for a Mushārakah arrangement in the venture capital in Malaysia.

- To identify the financial advantages (risk, return, corporate governance, exit strategy, ownership and liability) and management value-added (trust and knowledge in managing business) that can be provided by Mushārakah financing in the venture capital setting.

- To identify the investment criteria that is needed for a Mushārakah fund.

1.4 Research Questions

- What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

- Which stage of the business cycle is the Mushārakah best applied?

- What is the appropriate exit mechanism for Mushārakah funds?

- What do venture capitalist look for before investing in a new company?

Mushārakah is the preferred mode of financing among all the four schools in the Islamic Jurisprudence due to its non-collateral structure, profit sharing and purely performance structure of financing. However, Islamic banks mainly utilized fixed income short-term instruments such as Murabahah mark-up financing.[2] A study by Jalaludin (2002) conducted in the Sydney metropolitan area in late 1998 showed that 385 small businesses in that area revealed that 59.5 per cent of respondents expressed

[2] Ahmed, Habib (2005). Operational Structure for Islamic Equity Finance: Lessons from Venture Capital. Retrieved July 11, 2006, from Research Paper No.69, Islamic Research and Training Institute, Islamic Development Bank. Website: www.irtipms.org/OpenSave.asp?pub=212.pdf

a readiness to borrow funds on a profit and loss sharing basis.[3] This shows that there is demand for profit-sharing mode of financing and this includes Mushārakah as well. Mushārakah is such a unique structure and the concept of sharing through a form of partnership seems to make it flexible to be applied in financing through investment of any kind be it land, labour or capital.

This research can only create a space of increasing equity financing in the Islamic finance industry as a huge opportunity for more quality companies to be set up and using new source of funding in areas such as biotechnology industry, pharmaceuticals, ICT companies, agriculture and fisheries. In addition, the Mushārakah financing may not be highly utilized in the Islamic banking industry, but we should not limit the use of Mushārakah in the banking and private debt industry only. A research on the Mushārakah applicability in other areas in finance should be explored. Furthermore, we can study the criteria and assess the existing venture capital and accumulate facts that are useful in developing Mushārakah financing in the venture capital industry.

The venture capital business in Malaysia is growing at a promising rate and with reference to other countries that have shown the success of the venture capital industry to its economy, it only means that Malaysia should also take the step to fully develop the venture capital industry. One way is to engineer new funds with Islamic features that will tap markets from the Middle East and also from other countries that sees its benefit to the society and the economy as a whole.

1.5 Research Design

The research design acts as a flow chart of the stages of research work

[3] Ibid. 226pp.

throughout this study. It also gives a background about each chapter in this research. The first step of any research starts with the literature review. The literature review in this research is broken down into two chapters which are:

- Scope of Venture Capital: A Literature Survey (Chapter Two)
- Scope of Mushārakah Financing: A Literature Review (Chapter Three)

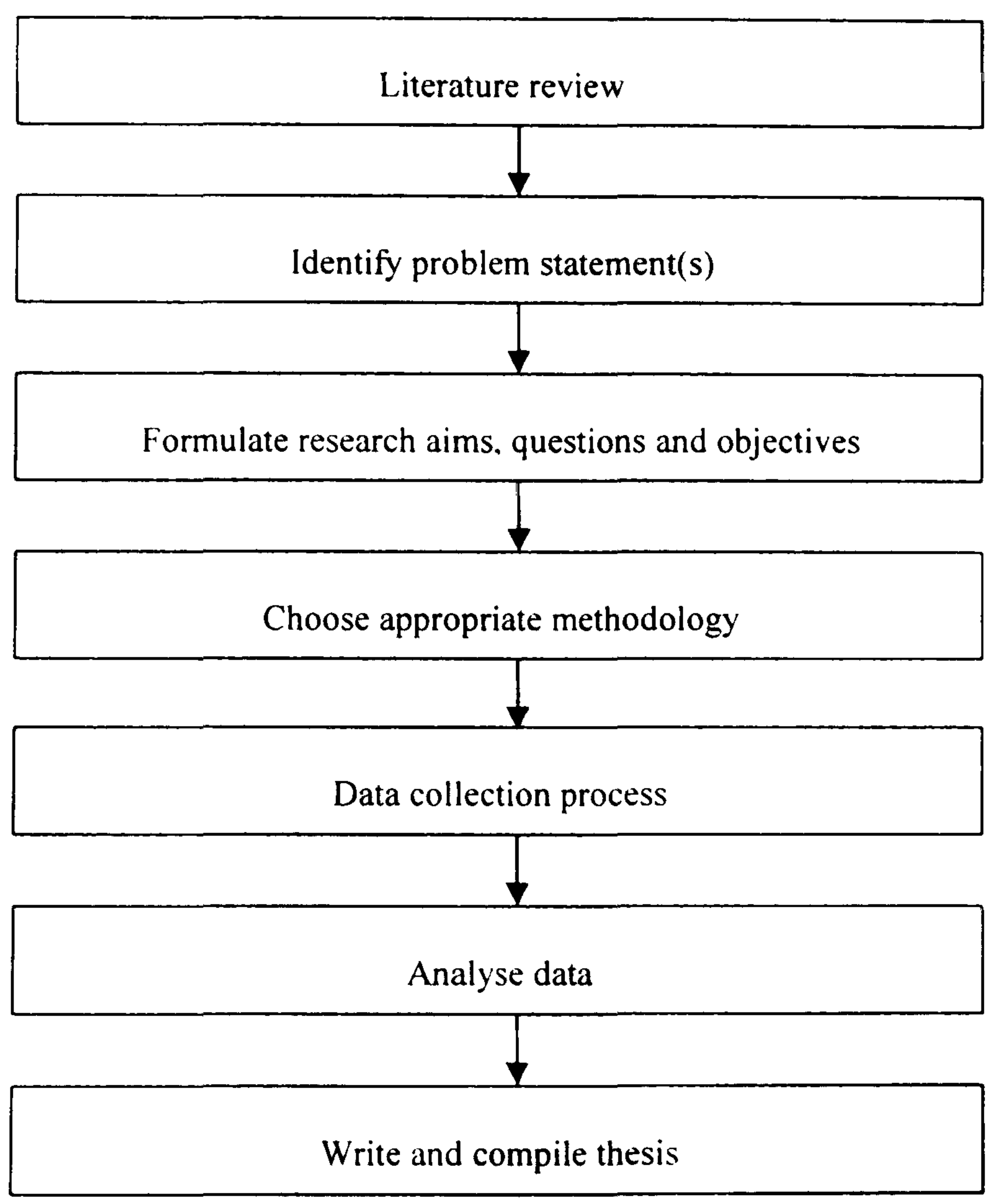
Chapter two focuses on the type of financing applied by the venture capitalist, venture capital process and documents involved in the due diligence process. An overview of the Malaysian venture capital industry is highlighted in this chapter. In addition, chapter two gives some ideas on how the Malaysian venture capitalist selects their business ventures and gives us an insight on why certain criteria are more important than the rest.

Chapter three highlights matters regarding Mushārakah financing, equity financing and profit sharing. A comparison between venture capital, partnership and private equity financing in the conventional setting commences in this chapter to find areas that may be important for Mushārakah financing in the venture capital. In addition, the application of Mushārakah in contemporary financing is also analysed.

Chapter four explains about the research methodology applied in this research. This chapter focuses on the data collection process, interview question preparation, method of data analysis and sampling. The validity and reliability of the method used is also highlighted in this chapter. Chapter five, six, seven and eight are analysis chapters. These chapters analyse and report results obtained from the survey. The survey was a set of twenty semi-structured interview questions given to venture capital companies in Malaysia. The data obtained from the survey are text data and they are analysed using the content analysis method.

Chapter nine is the final chapter of this research. Figure 1.1 shows the research process starting with the literature review. The literature review, identifying problem statements and formulating research aims, questions and objectives are covered in chapters one, two and three. Chapter four covers all aspects on choosing the appropriate research methods and the data collection process for this research. Chapter five, six, seven and eight concentrates on the data analysis and findings from the results obtained through the survey. Finally, chapter nine concludes with a summary of the findings and includes the recommendations for further research in the respective area.

Figure 1.1: Research Process



CHAPTER TWO : VENTURE CAPITAL: A LITERATURE SURVEY

2.1 Introduction

In this chapter, the literature review will focus on the venture capital industry as a whole. A section of the venture capital industry in Malaysia is also included. The definition, background, types of venture capital and types of financial instruments used, the venture capital process. exit strategies and the venture capital impact on economic growth and employment are discussed in this chapter. As stated by Paul Gompers and Josh Lerner that understanding the features of the private equity funds whether management fees, profit-sharing rules or contractual terms have long lasting effects on the behaviour of venture capitalists.[4] Therefore, this literature review becomes a source of reference during the course of the analysis and in structuring the interview questions. This is because we need to understand the venture capital industry and the venture capitalists themselves and to see their views on using Mushārakah. The definition discusses the stages the pros and cons of the venture capital funding. It gives a brief idea on what venture capital is about.

The types of funds used are described since there are many stages in the venture capital and specific funds are used to finance companies in a particular stage. Types of venture capital explain the business entity structure that exists in the modern economic setting today. The type of financial instruments used explains the usage of financial instruments such as common stock. preferred stock and its different types, loan stock and loan warrants. The venture capital process is quite an extensive section as it covers the stages of the venture capital business. In other words how the business

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[4] Gompers, Paul, and Lerner, Josh (2005). *The Venture Capital Cycle*. Cambridge : The MIT Press pp.23

deals are made, the agreements involved and its contents. Exit avenues are another important topic to cover in this literature review. The types of exit avenues are stated and compared. Lastly, the impact of the venture capital towards the economy and employment is discussed and several examples were stated. Examples were mainly taken from the venture capital industry in the United States, United Kingdom, China and Malaysia.

2.2 Definition of Venture Capital

The venture capital industry goes way back to the fifteen century with the activities of the merchant ventures.[5] They were active traders in the Middle East where commercial enterprises were established and sometimes backed with armed authority.[6] Venture capital is money made available for investment in innovative enterprises or research, especially in high technology, in which both the risk of loss and the potential for profit may be considerable. It is also called risk capital.[7] "Venture capital is a specific type of finance provided by certain firms who invest alongside with management in young but rapidly growing companies that are not listed on the stock market. These new and young companies have the potential to become major players in the economy. Venture capital investments generally involve:

- A long timeframe;
- An element of risk;
- A partnership with management; and

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[5] Reid, Gavin C. (1998) *Venture Capital Investment: An Agency Analysis of Practice.* United Kingdom: Routlege. pp.16.
[6] Ibid.16pp.
[7] Venture Capital. (n.d.).Retrieved July 25, 2005, from http://www.answers.com

- Returns that are normally in the form of capital gains rather than dividends."[8]

Gavin C. Reid[9] gave his definition that the venture capital investor (VCI) with the following characteristics:

- The equity stake is a minority one in a high performing, mature small firm that is not currently listed on any formal stock market.
- The investment agreed has a strictly finite life, with an expected duration of a few years.
- The exit route anticipated for the venture capital investor comprises either stock market listing or some other form of change in ownership that would enable the principal to realize their equity stake (for example, a trade sale or a some variant of a buyout).

Looking at the definition above, we can see that the venture capitalist provides money to start-up firms (or in later stages) and small businesses for long-term growth potential. A venture capital has various sizes of investments as it depends on the stage the company is in. Venture capital is a segment of category under private equity. It is called private equity because it invests in private companies as opposed to public listed companies. However, the terms may differ in some countries. As stated in the British Venture Capital Association website, "Some commentators use the term "private equity" to refer only to the buy-out and buy-in investment sector. Others, in Europe but not the USA, use the term "venture capital" to cover all stages, i.e. synonymous with "private equity". In the USA "venture capital" refers only to

[8] Venture Capital. (n.d.).Retrieved November 11, 2006, from http://www.ibbm.org.my/pdf/DP01%20Venture%20Capital.pdf

[9] Reid, Gavin C. (1998) *Venture Capital Investment: An Agency Analysis of Practice*. United Kingdom: Routlege. pp.37.

investments in early stage and expanding companies."[10] To avoid confusion, the term "venture capital" is used throughout this study to describe the seed and expansion stage of the investment and "private equity" to describe the maturity, consolidation and workout stage (refer figure 2.1).

In the private equity there are other categories such as the mezzanine capital and the buyout capital. Mezzanine capital or subordinated debt is another form of venture capital financing or leverage buyout funding. It is normally received at the later stages of the venture capital and can be in a buyout stage if the bank is giving out a loan that is not as much as the leverage buy-out (LBO) fund it is seeking. So the mezzanine fund will make a subordinated loan to the invested company that is below the bank's equity but superior to the equity from the leverage buy-out (LBO) funds. If an entrepreneur wishes to borrow from the mezzanine lender they may be charged higher as compared to the bank. Buyout capital or leverage buy-out (LBO) purchases the company together with the existing management using borrowed money. Figure 2.1 shows the investment stages in the Malaysian venture capital industry.

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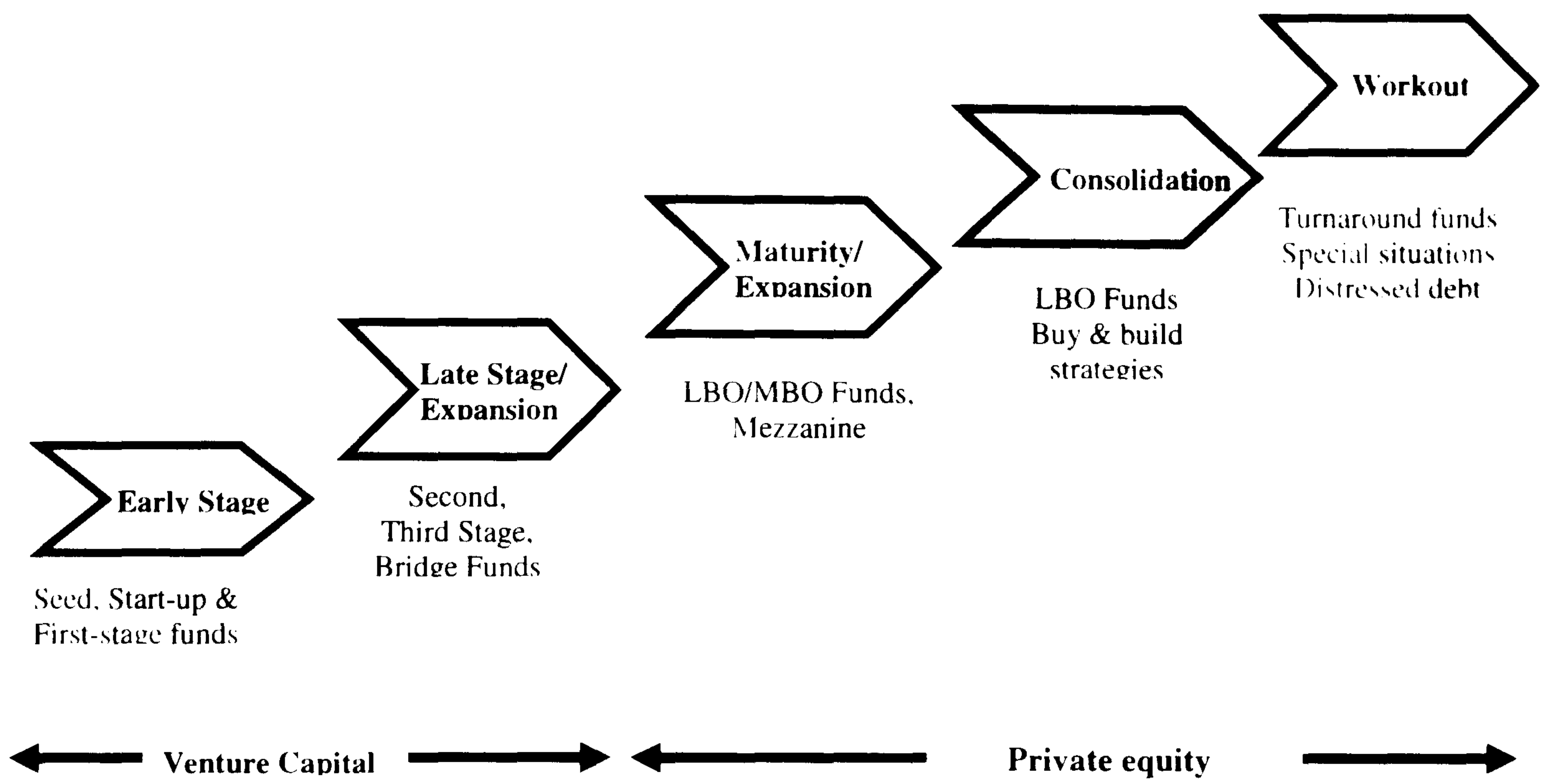
[10] An Introduction to Private Equity. (n.d.).Retrieved January 12, 2007, from http://www.bvca.co.uk/publications/guide/intro.html

Figure 2.1: Different Stages of the Venture Capital Industry in Malaysia



Source: Kwee Bee, Chok. (2004).[11]

In this study we only focus on the venture capital category. In the venture capital there are the start-ups, first, second, third round and bridge funds. The expansion stage consists of maturity, consolidation and workout stage. The venture capital companies have investment stages in which their business investments fall into. These investment stages are discussed in this study as listed below:

- **Early stage** - Focuses on seed / Start-up stage and first round financing. The start-up stage is most risky as potential entrepreneurs only come forward to the venture capital companies with a business proposal. However, in developing countries like Malaysia where the small medium enterprise (SME) are vital for

[11] Kwee Bee, Chok. (2004, April 5). *Collaboration with the Venture Capital Industry*. Presented at the Association Of Merchant Banks Tea Talk.

economic growth and industrial innovation, start-up companies are important to put forward fresh ideas and innovation. Start-up is seen mainly in the technology and communication, manufacturing and biotechnology sectors recently. In this initial stage, the venture is still at the idea stage or may be in the process of being organised. Hence, it requires finance for research and development, which is funded by the entrepreneur's own resources.

- **Late/Expansion stage** – Focuses on second stage, third stage and bridge funds. This is the stage where the proposal materializes. This stage requires skills for market penetration and determining that the idea in the proposal can be of demand in the market. The company is usually in the process of being set up or may have been in business for a short time. However, it has completed the product development stage. Although it requires less capital funding, the company needs greater assistance to initiate commercial manufacturing and sales of its products than a later stage company.

- **Maturity/Expansion stage** – Focuses on LBO/MBO and Mezzanine funds. At this stage the company has already created the product or service and would require them the ability to market the product successfully. The company may need additional funds from the venture capitalists. At this stage the company may be near to break-even. The company is now established and requires capital for further growth and expansion. The company may or may not have made a profit at this stage. This is a period of rapid growth and the company will usually require several rounds of capital injection as it achieves the milestones set in the business plan. Some companies consider giving away their shares at this stage to raise some cash. At this stage some companies consider going public.

- **Consolidation stage** – Focuses on leveraged buy-out funds and buys and builds strategies. "In an independently owned small business, a leveraged buy-out occurs when a non-owner management team buys the company from the original owners. Any of these situations is called a leveraged buy-out or LBO because most of the money is invested into the company as debt."[12]
- **Workout stage** – Focuses on turnaround funds, special situations and distressed debt. The venture capital may come to the rescue when the poor performance of a company results to losses and poor growth. In this case some venture capitalists may change the management before taking the last resort to write it off. In some cases, the business appears to still have potential and other circumstances may have slowed down the growth such as the inefficiency of the management team and lack of skills in marketing a product.

The venture capital has more risk as compared to the buyout. "Investments by a venture capital fund can take the form of either equity participation or a combination of equity participation and debt obligation often with convertible debt instruments that become equity if a certain level of risk is exceeded. In most cases, the venture capitalist becomes part owner or a member of the Board of Directors of the new venture. Most investments are structured as preferred shares whereby the common stock often reserved by covenant for a future buyout, as VC investment criteria usually include a planned exit event (an IPO or acquisition), normally within three to seven years. In case a venture fails, then the entire funding by the venture capitalist

[12] Gladstone, David, & Gladstone, Laura (2002). *Venture Capital Handbook: An Entrepreneur's Guide to Raising Venture Capital.* New Jersey, Prentice Hall. pp.17.

has to be written off." [13] This is to give an idea of how the venture capital operates.

A venture capital provides value added management to the invested company and the entrepreneur whereas the finance companies such as banks do not take part with the entrepreneurs' company operations. Venture capitalists review business operations and advise the entrepreneur. In his case the venture capitalist becomes a partner to the entrepreneur and helps the entrepreneur to achieve their goals and thus achieve the venture capitalists as well. The venture capitalist does not just provide the money but they provide assistance also. The advantages of venture capital funding as compared to other method of financing are:[14]

- **Long-term financial support** – Venture capitalists offer a long-term equity finance that provides a solid capital base for the future growth of businesses. They are also capable of providing additional rounds of funding should it be required to finance growth.
- **A reliable business partner** – Venture capitalist makes the perfect business partner, the one who shares both the risks and rewards of the business. Venture capitalists are rewarded by business success and the capital gain.
- **Sound operational and financial advice** – Venture capitalists have experienced similar situations by other companies. Thus, they are very well informed to provide strategic, operational and financial advice to a company based on their past experiences.
- **Strong network of contacts** – They have an extensive and strong network of

[13] Venture Capital. (n.d.).Retrieved July 25, 2005, from: http://www.answers.com
[14] The Venture Capital Advantage. (n.d.). Retrieved July 25, 2005, from http://www.commerce-ventures.com.my/bizresource_vcadvantage.asp

contacts in various areas that may add value to the company such as providing contacts in international markets, introduction to strategic partners and positioning a new company in the marketplace.

- **Future capital raising** – Companies will also benefit from co-investments with other venture capital firms associated with the venture capitalist if they require additional rounds of financing.
- **Facilitation of Exit** – Venture capitalists can help companies prepare for their initial public offering (IPO) and facilitating in trade sales.
- **To spur further growth in the industry** – The Malaysian government has granted a tax exemption for venture capital management companies on income received from profit-sharing agreements, which would inspire venture capitalists to perform better and play a bigger role in creating and nurturing globally competitive companies. Some of the most common venture capital invested industries are manufacturing, information technology, communications, healthcare, biotechnology, manufacturing and services.

Nevertheless, venture capital is not suitable for all businesses, simply because venture capitalists usually look for:[15]

- **Superior businesses** – Venture capitalists seek companies with superior products or services targeted at fast growing or untapped markets with a strong strategic position. For leveraged management buyouts, they seek companies with high borrowing capacity, stability of earnings and an ability to generate

[15] The Venture Capital Advantage. (n.d.). Retrieved July 25, 2005, from http://www.commerce-ventures.com.my/bizresource_vcadvantage.asp

surplus cash to quickly repay debt.

- **Quality and depth of management** – Venture capitalists must be confident that the company has the quality and depth in the management team to achieve its aspirations. Venture capitalists seldom seek managerial control, as they prefer to add values to the investment such as fund raising, mergers and acquisitions, international marketing and networks.

- **Corporate governance and structure** – Most of the time, the introduction of a venture capitalist is preparatory to a public listing. The venture capitalist must be assured that the investee company has the willingness to adopt modern corporate governance standards such as non-executive directors, including a representative of the venture capitalist. Venture capitalists will stay away from complex corporate structures without clear ownership and where personal and business assets are conveniently merged.

- **Appropriate investment structure** – Other than an attractive business opportunity, venture capitalists will also seek to structure a satisfactory deal to produce the anticipated financial returns to investors.

- **An exit plan** – Venture capitalists look for the clear exit routes for their investment such as public listing or a third party acquisition of the investee or invested company.

In summary, the advantage of a venture capital to summarize all the point above is that it is a value added process and beneficial for the entrepreneur where they get some guidance from the venture capitalists since both have stakes in these investments. It is a partnership of ideas and sharing of responsibilities, risk and return.

2.3 Investment Funds

Venture capital has several investment funds. These funds are not standardized in all venture capital companies in Malaysia. Venture capital funds are allocated for companies in the early stages of the business cycle such as the seed/start-up, development and growth. The private equity funds are allocated for takeovers such as the case of Management Buyout (MBO) and Management Buy-In (MBI). In other words, the private equity funds are catered to that at the later stages of the business cycle.

2.4 Venture Capital Financial Instruments

The type of financing is not standard among the entire venture capitalist and it differs on the basis of many factors depending on how the deal is structured. The types of financing at present are common stock or ordinary shares, preferred stock or preferred shares, convertible debenture and loan warrants. Common stock represents ownership and control within a company. Common stockholders have voting rights. The more stocks you have, your ownership stake in the company becomes greater. Common stockholders get dividend based on the company's earnings but not on a fixed trend. Common stockholders are at the bottom of the priority ladder in the event of liquidation upon bankruptcy because common shareholders have rights to a company's assets only after bondholders, preferred shareholders, and other debt holders have been paid in full. This makes ordinary shares very risky but due to market sentiments it can out perform the other securities in terms of capital gain.

Preferred stocks do represent ownership in a company as well but it does not have voting rights as compared to common stockholders. Preferred stocks' investors are usually getting a fixed dividend forever in a form of perpetuity. This is different than common stock, which has variable dividends that are never guaranteed. In the event of liquidation preferred shareholders are paid first before the common shareholder but only after the company have paid the bondholders. In a venture capital, venture capitalist purchases preferred stock from the invested companies and they get dividend. It means that the venture capitalist gets return first before the common stockholders.

Preferred stock may also be callable, meaning that the company has the option to purchase the shares from shareholders and in this case the invested company may want to purchase them from the venture capital. Preferred stocks are callable in two forms, which are put option and call option. Put option gives the venture capitalist the right to require the invested company to purchase the shares that the venture capitalist owns in the invested company. The call option gives the company the right to own the venture capitalist shares within the invested company but not on the order of the venture capitalist like the put option. These preferred stocks can also be of so many types such as redeemable preference shares, cumulative redeemable preference shares, convertible preference shares and others. Below is the breakdown on the types of preferred stock. These instruments are widely used in Malaysia. They are:

- **Convertible Preferred Stock** – Preferred stock that includes an option for the holder to convert the preferred shares into a fixed number of common shares, usually anytime after a predetermined date.
- **Cumulative Redeemable Convertible Preference Shares** – Shares can be bought back by the invested company from the venture capital by exercising their call-options (invested company) and put-options (venture capitalist) at the redemption date.

- **Redeemable Preference Shares** – "Preference shares, which the issuing company reserves the right to redeem. The shares may, or may not have a specific redemption date or dates."[16]

- **Cumulative Preference Shares** – "When a company fails to pay a dividend, holders of cumulative preference shares are entitled to receive this missed payment when a dividend is next declared. This rule is cumulative and they are also entitled to the current dividend provided sufficient cash is available. These payments receive priority over the claims of ordinary shareholders." [17]

- **Participating Preferred Shares** – "A type of preferred stock that under certain conditions gives holders the right to receive earnings payouts over and above the specified dividend rate."[18]

- **Loan stock** – "Unsecured stock delivered to an entity that has furnished a loan for a company. Loan stock earns interest at a fixed rate."[19]

Another type of instrument used in the venture capital industry is the convertible debenture. This is a type of debenture that can be converted into some other security such as common stocks. The debenture is a loan to the invested company by the venture capitalist. It gives the venture capitalist the option to exchange the bond for a predetermined number of shares in the issuing company. When they are first issued, they are just like regular corporate bonds, but with a slightly lower interest rate. The conversion ratio determines how many shares can be

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[16] Redeemable Preference Shares. (n.d.).Retrieved November 10, 2005, from http://dictionary.itlocus.com/r/redeemable_preference_shares.html
[17] Cumulative Preference Shares. (n.d.). Retrieved November 10, 2005, from http://glossary.itlocus.com/cumulative_preference_shares.html
[18] Participating Preferred Shares. (n.d.). Retrieved November 10, 2005, from: http://financial-dictionary.thefreedictionary.com/
[19] Loan Stock. (n.d.).Retrieved July 5, 2005, from www.investorwords.com

converted from each bond. The convertible debenture works like a stock option whereby its price is tied up with the underlying asset. As the stock price moves up and down or becomes extremely volatile, so does the bond. The convertible debenture is mostly used in the later stage of the venture capital and the business cycle.

The loan with warrants is where the venture capitalist will give loans to the invested companies and in return the loans will have stock option, which are warrants for them to buy stock in your company. Later on, when the loan is paid off, the venture capitalist will still have an option to buy the stocks in the invested company. This is similar to that of a junk bond. Just like the convertible bond, loan with warrants are mostly used in the later stage of the venture capital and the business cycle. Regardless of the types of financial instruments used, the choice depends on several factors. These numbers of factors affect the availability of the various types of financing, and their suitability and cost:[20]

- Accomplishments and performance to date. It is stated that this is a big advantage for the existing small business and that the investors will be impressed by loyal customers, suppliers, channel partners and a business model that yields profits and free cash flow.
- Investor's perceived risk
- Industry and technology
- Venture upside potential
- Venture anticipated growth rate

[20] Spinelli, Stephen, Timmons, Jeffrey A., & Zacharis, Andrew. (2004). *How to Raise Capital: Techniques and Strategies for Financing and Valuing Your Small Business*. New York: McGraw-Hill Professional pp.90.

- Venture age and stage of development
- Investor's required rate of return or internal rate of return
- Amount of capital required and prior valuations of the venture
- Founders' goals regarding growth, control, liquidity and harvesting
- Relative bargaining position
- Investor's required terms and covenants

The author mentioned that existing businesses need both equity and debt to have a sound financial foundation of growth without excessive dilution of the entrepreneur's equity.[21] Short term debts are used for working capital and are repaid by proceeds of its sale. Long term debts are used for working capital and to purchase property or equipment that serve as collateral for the loan.[22] These factors will be very useful in assessing what type of financial instruments will be appropriate for the Mushārakah. On top of that, we can also see at what stage the Mushārakah will appropriately be applied.

2.5 Types of Venture Capital

This section provides some examples of the types of firms in the venture capital industry. There is the private limited partnership, corporate venture capital and angel investors. Private limited partnership gets their source of funding from insurance companies, companies, pension funds and others. The general partners (GP) manage the company and the investors are the limited partners. Limited partners do not take part actively in the management; they invest their money in a specific time

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[21] Ibid.91pp.
[22] Ibid.91pp.

period and wait to reap the returns when the time comes. They have no control on the funds. In this case, the active partner is the general partner who manages the funds and investments. The limited partner is the passive partner. Below are the list of pros and cons of the limited partnership:

Advantages

- LPs provide a legal structure to the establishment of the business. From a capital investment standpoint, limited partners' liability is dependent upon the amount of capital invested. There are no limitations as to the amount of dividends that the general partners may receive from the business. General partners of a LP may be in the form of another person or company.

- As a separate legal entity, LP's may own property, sue, and be sued in LP's name.

Disadvantages

- In a LP there must be at least one general partner and it is the general partner(s) that incur unlimited liability.

- As in any partnership, a LP must draft a partnership agreement, which governs how the business is operated. In a LP the partnership agreement must state a date of termination.

- Since a LP is a legal entity, the formation of a LP requires more legal documentation than in a general partnership.

Next we look at the advantages and disadvantages of a corporation as listed below:-

Advantages

- Limited liability for the people who run the corporation. Shareholders of the corporation are not liable for the debts and obligations of the corporation unless they provide a personal guarantee.

- Corporation has an unlimited life. The corporation will continue to exist even if the shareholders die, exit the business, and if there is change in ownership.
- Easy to raise capital through the issuance of shares.
- Tax advantages.
- Losses from the corporation can't be deducted from the owner's personal income.

Disadvantages

- Subject to two tax returns, one for the business and one for your personal income.
- Complicated registration procedures and high set up fees
- Arduous process in maintaining transparency and corporate governance due to size.

Corporate venture capital acts more like a company but still similar to a partnership. Some large banks have this type of venture capital firm. The corporate venture capital's management would report to the CEO. They are subsidiaries to the corporation. They provide capital for start-ups and other potential businesses. Angel investors are wealthy individuals that provide funds to start-up companies. They would take part actively in the management of the business and add value to the investee or invested companies with their experience. An angel investor also puts funds in another venture capital to invest in potential businesses.

2.6 The Venture Capital Process

The venture capital process is about choosing the best investment and giving capital to the right entrepreneur is a long process. It involves many steps, which a prospective entrepreneur has to adopt when he approaches the venture capitalists. With reference to Paul Gompers and Josh Lerner mentioned that to limit opportunistic behaviour and ensure allocation efficiency a contractual relationship between the two parties is critical.[23] This shows the importance that through such process it can give a clearer picture as to what the business is all about and how the relationship can be built between the entrepreneur and the venture capitalist. Other than that, documents in the agreement between the two parties will bind both parties in their role in this partnership. The venture capital processes[24] are given below in chronological order:

1) Venture fund reviews proposal
2) Meetings with venture capitalist
3) Venture company conducts due diligence
4) Commitment letter
5) Legal closing
6) Working with venture company
7) Exit for venture company

2.6.1 Venture fund reviews proposal

In the first stage of the venture capital process, venture capital companies review the business proposals that they receive. Business plans pour in to the venture capitalist but only a few are selected. Most venture capitalists ask for a business plan to make an assessment of the possible risk and expected return on the venture. Such is

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[23] Gompers, Paul, and Lerner, Josh (2005). *The Venture Capital Cycle.* Cambridge :The MIT Press. pp.66.

[24] Gladstone, David, & Gladstone, Laura (2002). *Venture Capital Handbook: An Entrepreneur's Guide to Raising Venture Capital.* New Jersey, Prentice Hall. pp.356.

the risk averseness of the venture capitalist.

2.6.2 Meetings with Venture Capital Company

In the second stage a meeting with the venture capital company will take place, where the venture capital company and entrepreneur get to meet each other and establish a business relationship. It is also at this level the venture capitalist will make points to see if the entrepreneur is trustworthy, of course it is a long process but first impression counts a lot. Once a proposal has been reviewed, it is subjected to a detailed evaluation or due diligence process.

2.6.3 Venture Company Conducts Due Diligence

Most ventures are new and the entrepreneurs may lack experience. Therefore, a complicated, proper evaluation is neither possible nor desirable. The venture capitalist therefore relies on a subjective evaluation. The venture capitalist evaluates the quality of the entrepreneur before appraising the characteristics of the product, market or technology. Therefore, before making a commitment some due diligence process has to be completed. This is the third stage in the venture capital process. "Due diligence simply means that the investor must conduct background checks on the management team, complete an industry study, and verify the representations in your business proposal".[25] The venture capitalist is reviewing the entrepreneur, their company, and the industry in a thorough study. The venture capitalist is looking for potential in the entrepreneur, management team, product, and the industry and not forgetting the potential of the company to make money. In this due diligence process, venture capitalist would make visits to your company to see how the business is

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[25] Ibid. 211pp.

doing; this would be for existing business and not start-ups. Other than that, individuals or the entrepreneur's track records such as credit checks are investigated to ensure that he/she comes from a good business background. After through investigation and evaluation the venture capitalist would close up the deal with legal documents.

2.6.4 Commitment letter

The fourth stage is on issuing the commitment letter. In some instances the venture capitalist issues out a commitment letter which acts as an intermediate step between oral understanding and legal documents.[26] This step involves writing down in a commitment letter the bargain struck by each side, so that both can agree to it in a semi-binding manner.[27] If neither can agree on the terms in the letter no legal documents can be drawn.[28] Below are the contents of a standard commitment letter, they vary depending on whether it is financed through preferred stock or mezzanine loan. Most of the sample agreements and its contents that are used in this research are mainly obtained from the National Venture Capital Association and from the Venture Capital Handbook: An Entrepreneurs's Guide to Raising Venture Capital by David Gladstone and Laura Gladstone.

2.6.4.1 Terms of investment

The venture will outline to the entrepreneur what they plan to do. Information on buy back and redemption will be laid out in this part of the commitment letter. In this section the venture capitalist will mention the amount of preferred stock that they

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[26] Gladstone, David, & Gladstone, Laura. (2002) *Venture Capital Handbook: An Entrepreneur's Guide To Raising Venture Capital.* New Jersey, Prentice Hall. pp.177.
[27] Ibid.177pp.
[28] Ibid.177pp.

will purchase and at a specified rate. If it is a loan then the interest and the tenure of the principal and interest payment will be laid down. Disbursements of the funds are also stated in this section. The venture capitalist also states how much it will receive at the closing separate stock options to purchase stock in the company. The cost and the exercise price are all listed down. Another item mentioned in this section is the unlocking provision or the right of first refusal of the venture capitalist to exit from the invested company when there is an offer to buy the company. In this case, if the invested company does not agree on the offer, they have to buy back the venture capitalist's funds equity portion on the same amount as those in the offer. In this section there is also the put option whereby anytime after five years the venture capitalist may require the invested company to purchase their stock options and the conditions are specified. For example, the venture capitalist will want the invested company to purchase the resulting stock from the options at the higher of the following:[29]

- $5 million cash
- 120 percent of book value times 20 percent
- Five times net pre-tax earning for the year just ended times 20 percent ownership
- Two times sales for the year just ended times 20 percent ownership
- Ten times cash flow times 20 percent ownership
- Appraised value times 20 percent ownership

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[29] Gladstone, David, & Gladstone, Laura. (2002) *Venture Capital Handbook: An Entrepreneur's Guide To Raising Venture Capital.* New Jersey, Prentice Hall. pp.183.

Other than the put option there is also the call option in this section whereby it states the amount of stock options that the invested company can purchase from the venture capitalist after the investment has been fully paid off. The amount of stock is the same as stated in the put option. Finally, exit options are also mentioned in this section and it gives the right to the venture capitalist to ask the invested company to register for listing. In relations to this, the venture capitalists also have "piggyback" rides where they can sell their shares as well when the invested company has registered for listing.

2.6.4.2 Collateral and security

This section of the letter is subject to mezzanine loan. In this section you see that the venture capitalist has a right on the land and building owned by the invested company. The venture capitalist is also interested in all the invested company's tangible and intangible assets. In this section you will also see that venture capitalist secure their loan to protect themselves in the case the company goes bankrupt. In this case, the venture capitalist is a secured creditor rather than being a general creditor. There is also a clause in this section that states the amount of stock the invested company owns and pledges as collateral for the loan. In the case of a preferred stock, the venture capitalist may ask the invested company to put its common stock in a voting trust with an independent trustee. In this case, the venture capitalist can get control of the company when the business does not turn out as expected. This section of the commitment letter also requires the entrepreneur and his/her spouse to guarantee their investment and this is done so that the entrepreneur does not leave the business. However, if the entrepreneur passes away the insurance policy of the deceased will pay back the venture capitalist's money. It is a requirement by the venture capitalist that the entrepreneur has a life insurance policy. Business insurance is also required by the venture capitalist. If the business is destroyed (for example by an earthquake) the venture capitalists will get back their money.

2.6.4.3 Conditions of the Investment

This section of the letter states the conditions set by the venture capitalist which is important for their investment such as preparing monthly financial statements and reports of important events in the invested company. Calculations of certain ratios are also required by the venture capitalist with regards to inventory, accounts receivable and other collateral. A certified audit from an identified certified public accountant is also required by the venture capitalist and it is mandatory. Financial projections by the invested company are another condition important to the venture capitalist. This is to see how much money the invested company is spending and how much they are making. Another condition obligatory by the venture capitalist is on obtaining information from government bodies such as the tax institutions and the securities commission. The entrepreneur must provide the venture capitalist with this information as it is needed by them to monitor the company. The invested company must confirm that their company is not in any position of default to the banks or mezzanine lenders. When ownership is concerned the venture capitalist does not allow the invested company to give control or to sell the company to anybody else. The venture capitalist does not want to deal with another new management. In relations to ownership, the venture capitalist does not allow transfer of shares without their approval. Other conditions stated in this section of this letter are the number of board meetings to be held with the venture capitalists, location of the business and amount of money to pay the employees, expenses, brokerage fees, legal fees and attorney fees in the business. The amount of money has to get the approval of the venture capitalist and it has limits.

2.6.4.4 Representations

The following representations are enticement for the venture capitalist to make this commitment letter. The commitment letter may be deemed void if any of the representations are not met. The representations listed in the commitment letter are:

- Certification that your company is in good standing
- State the type of business the invested company is in
- Certification that no lawsuit is taken against the invested company
- Certification that the entrepreneur has paid all taxes outstanding
- Net worth of the invested company
- Additional equity intended to be invested into the business by the entrepreneur
- Amount of future investments by other investors
- Information to the venture capitalist on how the money is spent
- Balance sheet figures after money is given
- Providing venture capitalist with a copy of leases
- Representing to the venture capitalist that there are no brokerage fees and indemnify them against it
- Representing that none of the management are involved in crime
- Representing that a bank may give a loan and the entrepreneur must give a copy of the bank commitment letter to them

2.6.4.5 Conditions of Commitment

This section of the letter contains conditions whereby without them the commitment letter will be void. These conditions are:

- Commitment fee
- Closing date
- Legal documents given must be acceptable to the venture capitalist
- Credit check and due diligence review on the company and the industry before closing
- Visitation of the venture capital to the invested company
- Funds that are sought had already been raised and depending on the amount discussed between the entrepreneur and the venture capitalist. For example, if the invested company is not willing to put in the X amount of money in equity, if the venture capitalist is unwilling to put in the Y amount of money, and if the bank is unwilling to put in their Z amount of money, then any of the concurrences can void the commitment letter.[30]

2.6.5 Legal closing

The fifth stage of the venture capital process is on the closing. A closing occurs after the needed legal documents are put into operation between the investor and the invested company after the capital is transferred in exchange for company ownership or debt obligation. There are two types of closing which are closing for loan with options to purchase stock and closing to purchase preferred stock. In this

[30] Gladstone, David, & Gladstone, Laura. (2002) *Venture Capital Handbook: An Entrepreneur's Guide To Raising Venture Capital.* New Jersey, Prentice Hall. pp.201.

study we will focus on the closing to purchase preferred stock. The sections that are covered in the stock purchase agreement[31] as listed below:

- **Purchase and sale** – Lawyers will describe the sale of stock and the price being paid.

- **Affirmative covenants** – This covers all the actions the invested company would take as long as the option to own stock is outstanding. The invested company will do the following (refer table 2.1)

Table 2.1: Contents in Affirmative Covenants

Provide the investor with detailed financial and operating information on a monthly basis
Provide the investor with any documents filed with the Securities and Exchange Commission or other government agencies
Provide an annual budget by a specific date each year
Advise the investors any adverse changes in the company's status
Maintain certain current ratios, working capital amounts, or net worth amounts
Maintain life insurance on certain executives of the company
Maintain property and liability insurance in sufficient amounts
Elect a representative of the venture capital fund to the board of directors, or, if the venture capital is not on the board, notify the representative of the venture capital company when board meetings will occur so that the venture capital representative may attend the meeting as an observer.
Provide access for the venture capitalist to the premises and to the books and records of the company
Keep all equipment and property in good repair and in working order
Comply with all applicable laws and regulations
Maintain its corporate existence and other business existences
Pay all taxes and other levies of taxes against the company
Maintain its corporate existence and other business existences
Give the venture capital firm the right of first refusal on new financings in the future
Notify the venture capitalist if you are in default on any loans or leases

[31] Ibid. 256pp.

- **Negative covenants** – Typical negative covenants include the following as listed in table 2.2 below.

Table 2.2: Contents in Negative Covenants

The company will not invest in other companies or unrelated activities
The company will pay no cash or stock dividends
The company will not expend funds for capital improvements in excess of certain amounts
The company will not pay nor loan to any employee money in excess of a certain amount per year.
The company will pay no brokerage fees and the like in excess of a certain amount
The company will not transact any business with members of the board of directors or management or its officers or affiliated individuals
The company will not dissolve, merge, or dispose of its assets
The company will not change its place of business
The company will sell no additional common stock, convertible debt, or preferred stock.

- **Equity rights** – Covered in this section are the many equity rights of the venture capitalist, including the right to register the shares they own in any public offerings, and the right to require you to register the venture capitalist owned shares free of charge. These equity rights are the primary exit for the venture capitalist.

- **Representations and Warranties** – Representing and warranting to the venture capitalist that certain things are true. Given below are the example of contents in the representations and warranties.

Table 2.3: Contents in Representations and Warranties

Your corporation is in good standing
You are in compliance with all laws
There is certain capitalization of your company
There are no subsidiaries
The financial statements are correct
There have been no materials adverse changes since the last financial statements
There is no litigation going on, or if there is, a description of it is attached as an exhibit
The company is in compliance with all government regulations
There are no defaults on current borrowings
The company is current on all taxes
The company has rights to any patents that it owns

- **Fees and Expenses** – This section explains who will pay all the legal fees; usually it is the seller of the stock.

- **Definitions** – Short definition section.

- **Restrictions** – Restrictions that are placed on the operation of the company. The invested company may have to operate under certain guidelines as long as the venture capitalist owns shares.

- **Voting trust** – Discuss the voting trust in detail. A voting trust may be involved in a sale of stock. The trust is set up at a bank trust department with a bank trust officer as trustee. Your shares and the shares of other managers are put in the trust. The venture capital firm controls the voting trust, but only under certain conditions can the venture capital firm vote the shares in trust.

- **Employment agreement** – The venture capital firm will want to ensure that key employees continue to work for the company, at least for a specific period of time. The venture capitalist will ask the key employees to sign one-way employment contracts ensuring that the key people will be with the company as long as the venture capitalist is an investor. As part of the agreement, the employee may be asked not to reveal confidential company information if he or she is permitted to leave the company. The employment agreement can be turned around to the advantage of the entrepreneur. It can ensure that the entrepreneur's job is secure during a period in which the venture capitalist firm may have an opportunity to take over the company.

- **Consulting contract** – Many venture capital firms play an active role in the management of the company in which they invest. They may help the company establish marketing or financial controls or to address any number of problems that may arise in a new or small, growing company. They will want compensation for the time and attention their consultants take to help the new business get off the ground. Compensation is usually arranged through a contract with the venture capitalist for management consulting services. The agreement states the description of services, terms and amount of payment that will be made by the venture capitalist.

- **Conditions to Closing** – As in the first closing above, there will be a section on indemnification, waivers, and notices. There will be a list of items that must be completed before closing can occur.

2.6.6 Working with the Venture Capital Company

After closing the deal, the final stage of the venture capital process is on working together with the venture capital companies and this is similar to a business partner, whereby all major policy decisions should be discussed with them. It is also at this stage trust is built and harnessed. The venture capital companies have the knowledge and experience and can guide the entrepreneur although the entrepreneur is responsible for the day-to-day operations. At this stage the venture capital company requires monthly reports from the entrepreneur as to monitor on the entrepreneur's progress. It is also important that the entrepreneur would carry out board meetings with the venture capitalist to keep them updated with the business progress. Sometimes a venture capitalist appoints a member into the company's board of director to monitor the business.

In this matter both the entrepreneur and the venture capital company have their own appointed lawyer to close the deal. These legal documents cover what is expected from the entrepreneur and the responsibilities of the venture capital company together with describing the sale of stock and the price being paid. Looking at the legal documents it shows that every aspect of the investment is covered. This is only to ensure the long lasting relationship and having reference on the do's and don'ts in this business relationship since both have their stakes in this investment.

Some examples of the documents are as below which is taken from the National Venture Capital Association. A "template" set of model legal documents for venture capital investments put together by a group of leading venture capital attorneys. The model venture capital financing documents consist of:[32]

- **Term Sheet** – This is a shorter version of the commitment letter.
- **Stock Purchase Agreement** - This forth the basic terms of the purchase and sale of the preferred stock to the investors (such as the purchase price, closing date, conditions to closing) and identifies the other financing documents. The

[32] National Venture Capital Association. (n.d.). Retrieved January 21, 2006 from http://www.nvca.org/model_documents/model_docs.html

main items of negotiation in the Stock Purchase Agreement are therefore the price and number of shares being sold. and the representations and warranties that the company, and sometimes the founders as well, must make to the investors.

- **Certificate of Incorporation** - This is a key document produced in connection with a venture capital portfolio investment. Among other things, the Corporation's Certificate of Incorporation establishes the rights, preferences, privileges and restrictions of each class and series of the Corporation's stock.

- **Investor Rights Agreement** - This agreement can cover many different subjects. The most frequent are information rights, registration rights, contractual "rights of first offer or pre-emptive" rights i.e., the right to purchase securities in subsequent equity financings conducted by the Company), and various post-closing covenants.

- **Voting Agreement** – This document states the voting rights of the investor. It also states the common stockholders' right to vote their stock in relations of the company. Preferred stock usually has the right to vote when the preferred dividend are in default for a specified amount of time. The rights to vote may be allot by the stockholder to another person.

- **Right of First Refusal and Co-Sale Agreement** - The stockholders are granted the invested company's right of first refusal to purchase the shares of the invested company's Preferred Stock or Common Stock owned by them or issued to them in the future.

- **Management Rights Letter** - This is a form of agreement giving an investor purchasing preferred stock the right to attend board meetings and together with other connected rights.

- **Indemnification Agreement** - This agreement can be used for both officers and directors of the corporation. In some cases, a director will serve as a nominee of one or a group of investors (e.g., an individual venture capitalist serving as a nominee of a venture capital fund). Some investors request that they also be covered by the indemnification agreement. Since the indemnification rights provided by this agreement cover liability arising by virtue of "corporate status". This agreement would only work to indemnify investors in a case where the investor is acting as an agent of the corporation.

These agreements are based on the practice in the United States. This is to give an idea on the content of the agreements between the venture capitalist and the invested company. This later on can be compared to that of the features and guidelines listed out in a Mushārakah structure. The agreements listed above may not be the same in Malaysia due to differences in the business law in each country. However, the contents basically cover the same areas in the agreements mentioned above.

2.6.7 Exit Mechanisms

A venture capitalist does not want to keep the invested company in its portfolio forever and depending on the investment focus and strategy of the venture firm, it will seek to exit the investment in the portfolio company. The skill of the venture firm in successfully exiting its investment will determine the success of the exit for the venture capitalist and the entrepreneur. Below are several exit strategies applied in the venture capital industry.

2.6.7.1 Initial Public Offering (IPO)

This is the first sale of stock by a company to the public. A company can raise money by issuing either debt (bonds) or equity. If the company has never issued equity to the public, it is known as an IPO.[33] It is quite time consuming for a company to prepare the company for an IPO. The invested company must have a board of directors, audited financial accounts, lawyers, consultants and etc. The most important is the underwriters who are investment banks or merchant banks responsible for setting up the price for the share of the invested company and set up a prospectus for the potential investors. The process will also be reviewed by the securities commission to see if the regulations are adhered to. The companies and venture capitalists go for listing because they can sell their shares at a higher price as compared to a private placement. IPO would allow the entrepreneur and the venture capitalist to sell the shares at a higher price in the public market. In this strategy a company needs to be transparent, as they have to provide information to their shareholders such as audited annual reports.

2.6.7.2 Management Buyout (MBO)

Managers and/or executives of a company purchase controlling interest in a company from existing shareholders.[34] This method requires a willing seller. Typical reasons for the purchase of a business by its existing management are:[35]

- Certain parts of an organization are no longer seen as a core competence / no core activity by its parent company
- A company is in financial distress and 'needs the cash'

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[33] *Initial Public Offering* (n.d). Retrieved July 26, 2005 from http://www.investopedia.com/university/ipo/ipo.asp
[34] *Management Buyout* (n.d.) Retrieved July 26, 2005 from http://www.investopedia.com/university/ipo/ipo.asp
[35] *Management Buy-Out* (n.d.) Retrieved September 14, 2006 from http://www.valuebasedmanagement.net/methods_management_buy-out.html

- Parts of acquisitions that are not wanted
- In case of a family business: succession issues through retirement of the owner
- The management team stands to gain independence and autonomy, a chance to influence the strategy and future direction of the company and the prospect of a capital gain.

Attractiveness of the Management buy-out approach to a seller:[36]

- Speed – An MBO can be much quicker than a trade sale.
- Strategic considerations – For example the selling party may not wish competitors to acquire control.
- Confidentiality – The selling party may not wish to let competitors have access to sensitive information that would be disclosed during a trade sale process.
- Familiarity - With an MBO the selling party can continue to deal with a management team with whom it has an established relationship.
- Pricing

Some ways to exit through (MBO) is by exiting through puts and calls. The put option gives the venture capitalist the right to buy the company's share and the call option is the right for the company to buy the venture capitalist shares at a predetermined formula. These formula and valuation are based on the price/earnings ratio (P/E), net to asset value (NTA) and cash flow analysis.

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[36] *Management Buy-Out* (n.d.) Retrieved September 14, 2006 from http://www.valuebasedmanagement.net/methods_management_buy-out.html

2.6.7.3 Mergers and Acquisitions

A merger is a combination of two companies to form a new company while an acquisition is the purchasing of one company by another with no new company being formed.[37] Negotiating with the company to merge or acquire depends on how slow or fast the deal can be structured. In some cases due to bureaucracy the process can be very slow. Apart from that, the valuation of the company if it used different formulas and technique may result in a bad deal for the company and the venture capitalist. However, if the acquiring company has a good track record and well established the synergistic benefits would be to the advantage of the invested company and venture capitalist whose stake still exists in the invested company.

2.6.7.4 Management Buy-In (MBI)

Management buy-in happens when group of investors outside of a company purchase a controlling block of shares and keep the existing management.[38] It can also work in a way where new management is brought in by the investors. The investors involved in the MBI believe that the company and its current management are of great value. A few representatives from the group of investors will usually be appointed to the company's board of directors.[39] The investor in this case may add value in terms of marketing the product or services and industry outlook. In some cases, the new investor may be another venture capitalist and it can prepare the company towards listing. Venture capitalists look upon sector experience and skills as being important for an MBI potential candidate to make sure that they understand the business, are

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[37] *IPO Basics: What is An IPO?* (n.d.). Retrieved October 14, 2005, from http://www.investopedia.com/university/ipo/ipo.asp

[38] Ibid

[39] Ibid

reliable, credible and to build a new solid relationship with the new management team.

2.6.7.5 Exit by Puts and Calls

A put is a right given to the venture capitalist to require the entrepreneur to buy the venture capitalist's share in the company at a predetermined formula. A call is a right given to the entrepreneur to purchase the venture capitalist's ownership at a predetermined formula. To name a few are price/earnings ratio, book value and multiple cash flow.

2.6.7.6 Liquidation of the Company

If a business performs poorly, the venture will take a move to liquidate the company and sell off its assets. The land, building, machinery, equipment, and other assets are worth more in liquidation than they are going as a business.[40] Regardless of the exit strategy used the venture capitalist and the entrepreneur wants a higher return of the initial investment. Therefore, any exit strategy that brings them higher return and the highest return would be the best exit strategy. Apart from that, each business is different; an exit plan should take into account the industry, business cycle, management, and more. The introduction of the number of exit strategies applied by the venture capitalist in this section is meant to give an insight on what type of exit strategy is suitable for a Mushārakah fund operated by a venture capital and this is further analysed in the analysis chapters.

[40] Gladstone, David, & Gladstone, Laura (2002). *Venture Capital Handbook: An Entrepreneur's Guide to Raising Venture Capital.* (New Jersey, Prentice Hall). 256pp.

2.7 The Malaysian Venture Capital Industry

The Malaysian venture capital is still at its infancy and gets the support from the Malaysian government. Being an emerging economy the venture capital industry can be a platform for innovating new technology, products and services. Malaysia in the new millennium has moved towards the manufacturing sector and services have gained importance as well. Looking at the United States and the success stories of big conglomerates such as Microsoft Inc. which started from a venture capital financing, it is obvious that such financing has tremendous potential in Malaysia to contribute to the economic growth, employment, technology and knowledge based enterprises. In Malaysia, the venture capital companies normally focus on the early stages.

The venture capital industry started in Malaysia with the establishment of the Malaysian Ventures Berhad in 1984. The number of venture capital companies rose to six in 1990 and thirteen by 1992. The numbers then soared after the establishment of the Multimedia Super Corridor where incubators were set up to nurture small companies in the technology industry. Apart from that, tax incentives for the venture capital industry had contributed to the steady growth of the industry. The end of 1998 the registered numbers of venture capital companies with Bank Negara Malaysia almost doubled to twenty-three. Venture capital financing is gaining increasing recognition as an alternative source of funds in Malaysia, simply because the cost of borrowing is high and the economy is very unpredictable.

Growth in the earlier period was mainly financed by loans from the banking system and the issue of debt instruments by the Malaysian government. In 1970 for example, financing via bank loans and by the public sector (which was mainly through MGS) together accounted for 91 percent of total financing. As a result of the shift in public policy in the 1980s to consolidate its activities and to promote the private sector as the main engine of economic growth, new financing patterns emerged. The share of financing by the public sector declined from 43.1 percent in 1970 to 20.9 percent in 1980 and 11.1 percent in 1990. Much of the financing of private sector activities during the 1980s and 1990s continued to be intermediated through the banking system.

In recent years, as a result of the Malaysian's government efforts to develop the private capital markets, the equity and private debt securities (PDS) markets have expanded significantly to complement and to diversify the risks away from the banking system. The share of financing from the equity market has increased from 1.2 percent in 1980 to 22.8 percent in 1990, while the share of PDS has risen from 5.6 percent in 1990 to 24.8 percent in 1998 and 43.9 percent in 1999. While the share of venture capital, though relatively small, it has however, been rising from 0.1 percent in 1992 to 0.5 percent in 1998. The Malaysian government is a strong supporter of the venture capital industry and it is highlighted in the Financial Sector Master Plan. The venture capital industry has given tremendous growth and investment opportunities to the Malaysian economy. "At the end of 2005, the number of committed funds has risen to RM2.6 billion from RM2.1 billion in 2003. The number of investee companies has also grown by 30 percent since 2003. Statistics also show that the private sector is fast taking over the role of Government as the prime source for these funds. It has become more apparent, that Malaysia is now experiencing a strong acceptance of venture capital, as an alternative vehicle into the mainstream capital market products of debt, equity and derivative instruments."[41]

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[41] Anwar, Zarinah. (2006, August 21). Venture Capital Investors Forum. Retrieved January 10, 2007, from http://www.sc.com.my/eng/html/resources/speech/sp_20060821.html

This clearly shows the importance of venture capital financing in Malaysia. This also gives opportunities for foreign capital to flow into Malaysia's economy. Apart from that, the growth of the venture capital will help in the improvement in employment levels as well, since more small businesses are created and more manpower is needed. Some of the recommendations for the venture capital industry in Malaysia are summarized and listed below.[42]

- To chart the strategic direction for Malaysian venture capital industry and act as single reference point for all government initiatives and incentives
- Coordinate and ensure other elements develop in tandem with the venture capital industry
- To increase availability of venture capital financing as well as stimulate more new ventures especially ICT industry
- To ensure effective utilization of funds, consideration given for management of funds to be outsourced to private sectors/corporations with necessary expertise
- Tax incentives are in the form of tax deductions equivalent to amount of investments made in approved venture capital companies at start-up, seed capital and early stage financing.
- To encourage more companies to list on MESDAQ and build interest and market liquidity and make exit mechanism for venture capital companies more attractive to increase venture capital investment

[42] *Financial Sector Master Plan* (n.d.). Retrieved March 5, 2005, from http://www.bnm.gov.my/index.php?ch=20&pg=32&ac=24

- Malaysian venture capital companies should form smart partnership with venture capital companies in organisation of Islamic countries – help enhance pool of available venture capital funds in Malaysia

The Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ) was launched in 1997 to give a platform for companies in the ICT industry to raise equity capital and to promote the venture capital industry by providing an exit mechanism for their investments. On top of the recommendations listed in the Financial Market Master Plan, the Malaysian Venture Capital Association (MVCA) was also established in 1995 with the objective of promoting and developing the Malaysian venture capital industry. One of the MVCA's recent initiatives is the founding of the Venture Capital Consultative Council (VCCC) which is in collaboration with the National Economic Action Council of the Prime Minister's Department. Table 2.4 shows an overview of the venture capital growth in Malaysia.

Table 2.4: Sources of Financing in the Malaysian Economy.

Sources of Financing for the Economy (% share)							
	Banking System	**Public Sector**	**PDS**	**Equity**	**Industrial Finance Institutions**	**Venture Capital**	**External**
1970	47.9	43.1	0.0	9.0	0.0	0.0	0.0
1980	66.6	20.9	0.2	1.2	0.0	0.0	11.0
1990	56.7	11.1	5.6	22.8	0.5	0.0	3.3
1998	23.0	37.2	24.8	4.7	4.1	0.5	5.7
1999	18.5	15.4	43.9	9.3	2.4	0.1	10.3

Source: Akhtar Aziz, Zeti. (2000)[43]

However, the number of venture capital companies has risen since then. In 2005 the

[43] Aziz, Zeti Akhtar. (2000, March). *Accelerating Economic Growth through Venture Capital.* Speech delivered at the Venture Capital Europe-Asia 2000 Conference. Putra World Trade Center, Kuala Lumpur

Malaysian Venture Capital Development Council was established. The Malaysian Venture Development Council's tasks are:[44]

- To provide vision and direction and assist in the development of the venture capital industry
- To advise the government on overall development of the venture capital industry
- To facilitate greater co-ordination of strategies and initiatives relating to the venture capital industry
- To act as a conduit between policy-makers and practitioners in relation to the development of the venture capital industry

All that is stated in this section clearly shows the Malaysian government encouragement towards the venture capital industry in Malaysia. Though the numbers are increasing and the funds are expanding, the industry is still at its infancy. There is potential for further development and for new innovation in terms of products, services and financial engineering to take place.

2.8 Statistics and Development of the Venture Capital Industry

The venture capital industry in Malaysia expanded further through out the years and hopefully becoming one of the main source of financing in the future. Below are statistics on the venture capital industry in Malaysia that can give us an overview on its development and progress. Table 2.5 and 2.6 shows the key statistics of the venture capital industry in Malaysia by analyzing the amount of investment

[44] Securities Commission Malaysia. Annual Report (2005) Retrieved September 5. 2006..from http://www.sc.com.my

taken by the venture capitalist from the year 2001 up to 2004.

Table 2.5: Snapshots of the Venture Capital Industry (2001-2002)

	As at end 2001	**As at end 2002**
Venture capital funds (RM million)	2497.7	2536
Total Investment (RM million)	968.5	1112.4
No. of venture capital companies/ funds	41	46
No. of venture capital fund management companies	19	20
No. of investee companies	235	297
Total Investment (RM million)	118.7	191.4
No. of investee companies	47	80

Table 2.6: Snapshots of the Venture Capital Industry (2003-2004)

	As at end 2003	**As at end 2004**
Venture capital funds (RM million)	2118.1	2266.0
Total Investment (RM million)	878.7	1058.0
No. of venture capital companies/ funds	43	38
No. of venture capital fund management companies	31	34
No. of investee companies	298	332
Total Investment (RM million)	227.2	289.3
No. of investee companies	115	139

Source for both Table 2.5 and 2.6: Bank Negara Malaysia Annual Report 2004

Based on the Bank Negara Annual Report the number of venture capital companies in Malaysia has risen from forty-one to forty-six at the end of 2002. The Malaysian government has stakes in nineteen, reflecting the important role of the

Malaysian government in promoting growth of the venture capital industry.[45] Among the balance of eleven venture capital companies without Government shareholding, nine are subsidiaries of financial institutions. In terms of participation from non-residents, nine or thirty percent of the thirty venture capital companies have some form of foreign shareholding. From the nine, only one venture capital company has a majority foreign stake. [46]

There were slight increases and decreases in the number of venture capital and venture capital management companies in the year 2003 and 2004. However, the total investment went further up compared to the previous years, which shows the importance of the venture capital financing in Malaysia. Total available funds for venture capital investments grew by 7 percent to RM2.3 billion.[47] Total investments increased slightly by 62.1 million in the end of 2004 amounting to RM289.3 million, which is not an aggressive jolt. Thus shows that the venture capital industry in Malaysia is still moving at a slow pace and contributing to the GDP at a little percentage. In terms of the stages of financing, Table 2.7 shows that 36.6 percent of the investments during 2004 were in the expansion/growth stage.

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[45] Bank Negara Malaysia Annual Report. (2002). Retrieved September 5, 2006, from http://www.bnm.gov.my

[46] Ibid

[47] Bank Negara Malaysia Annual Report. (2004). Retrieved September 5, 2006, from http://www.bnm.gov.my

Table 2.7: Investment by Stages (2004 and 2005)

Investment by Stages (2004)			**Investment by Stages (2005)**	
Business stage	**RM mil**	**% Share**	**RM '000**	**% Share**
Seed capital	16.1	5.6	11,643.1	2.7
Start-up Capital	19.3	6.7	25,116.0	5.8
Early stage	48.9	16.9	107,276.3	24.9
Expansion/Growth	105.8	36.6	61,569.0	14.3
Bridge,Mezzanine, Pre-IPO	67.2	23.2	162,204.8	37.6
Management Buy Out	19.2	6.6	29,664.0	6.9
Management Buy In	...	...	14,700.0	3.4
Cashing out (Secondary Purchase)	0.6	0.2	1,642.0	0.4
Other types of investment	12.1	4.2	17,748	4.1
Total	**289.4**	**100.0**	**431,563.2**	**100.0**

Source: Bank Negara Malaysia Annual Report 2004 and 2005

Meanwhile, investments in the seed capital and start-up stage accounted for only 5.6 and 6.7 percent respectively. The numbers have increased slowly compared to the previous years. Although this stage of financing is considered very risky, the increase in the percentage shows those venture capitalists are slowly becoming less risk averse. In the year 2005 the number reduced and there is an increase in the later stages (Expansion/Growth, Bridge, Mezzanine and Pre-IPO). However, focus is still given to the early stage investment. Several government grants have also been set up for small-and medium scale enterprises that require financing particularly at the early stage. The available government grants include the following:[48]

- The MSC Research and Development Grant Scheme;
- The Industry Research and Development Grant Scheme;
- The Demonstrator Application Grant Scheme;
- The Technology Acquisition Fund;
- The Commercialisation of R&D Fund.

However, the numbers are still small compared to countries like Singapore and China. Bridge, mezzanine, Pre-IPO comes in second place with 23.2 percent in 2004 and 37.6 percent in 2005, which shows that investors are comfortable financing at this stage because risks are not that high and the companies are geared to exit at this stage. In terms of outstanding investments by stages, the expansion/growth, bridge/mezzanine/pre-IPO and start-up capital stages received the bulk of venture capital investments since 2002.[49] This shows both emphases on venture capital financing and also on the private equity financing.

Despite the strong growth in terms of funds mobilized there are several limitations to further expand and develop the venture capital industry in Malaysia.[50] The limitations are:

- Limited sources of funds for venture capital companies due to their inherent high risk and the long-term nature of their investment.

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[48] Aziz, Zeti. Akhtar. (2000, March). *Accelerating Economic Growth through Venture Capital.* Speech delivered at the Venture Capital Europe-Asia 2000 Conference. Putra World Trade Center, Kuala Lumpur.

[49] Bank Negara Malaysia Annual Report. (2004). Retrieved September 5, 2006, from http://www.bnm.gov.my

[50] *Monetary Economics and the Malaysian Financial System.* (n.d.). Retrieved September 5, 2006, from http://www.ibbm.org.my/files/cert_GBQ_DBFS.aspx

- Comprehensive information on the venture capital industry - in particular information on investment opportunities, the nature and performance of venture capital as well as the areas of venture capital funding, is generally lacking. This had caused a general lack of awareness and misconception of the role of venture capital financing.
- Shortage of skilled workers and difficulty in assessing and appraising technology-based projects has also led to reluctance on the part of the venture capital companies to fund and finance technology-related projects.
- Inability of venture capital companies to spread the high risks associated with investment in technology companies past the conceptual stage in the product development life cycle. The long time frame involved in receiving returns from investment in venture capital funds has also discouraged investors from investing in venture capital.

If we look at the first two points, we can see that there is potential for Mushārakah funds. The profit-loss sharing element in the Mushārakah can make it an attractive fund to the entrepreneurs and also to the shareholders. There is no zero-sum game in this matter. The areas that can be a good platform for Mushārakah funds, such as agriculture, manufacturing, technology and biotechnology can also be widened and further developed, through the management sharing that exists in the Mushārakah funds. Though some companies in Malaysia and some Middle Eastern companies have used this method, the numbers are still small. This study further investigates to find the potential to further increase the usage of the Mushārakah funds in the venture capital industry.

2.9 Small and Medium Sized Enterprises (SMEs)

SME or the Small Medium Enterprise plays a significant role in Malaysia's economic growth. The SME can be a breakthrough for innovation and the market of new concepts for any product and service. Some advanced economies have succeeded because SMEs form a fundamental part of the economy, comprising over 98 percent of total establishments and contributing to over 65 percent of employment as well as over 50 percent of the gross domestic product.[51] Although the numbers might be lower in Malaysia, SMEs have the potential to contribute substantially to the economy and can provide a strong foundation for the growth of new industries as well as strengthening existing ones.[52] The government has put a lot of effort in developing the SME. In June 2004, the National SME Development Council was established to coordinate inter-Ministry and Agency efforts on the SME development. Ministry and Agency's task also includes providing a policy strategic framework for the industry's future. The strategies for the SME Development as posed by the National SME Development Council are:

- Strengthening the infrastructure for SME development;
- Building the capacity of domestic SMEs; and
- Enhancing access to financing by SMEs.

Other than that, the Malaysian government has provided a comprehensive set of programmes through the various Ministries and Agencies, which are broadly

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[51] *Developing Malaysian SME's.* (n.d.). Retrieved January 14, 2007, from http://www.smeinfo.com.my/index.php?ch=2&pg=2&lang

[52] Ibid

categorized into "Financial Assistance" and "Business Support Services".[53] The financial assistance is broken down into several categories listed below.[54]

By Types of Financial Assistance

- Soft loans
- Grants
- Equity Financing
- Venture Capital
- Guarantee Scheme
- Tax Incentives

The financial assistance and the business services offered by the government facilitate the financing by the venture capitalist as well. The venture capital is categorized as private sector funding. The venture capitalists are willing to take a stake in a business where they will provide capital, usually in exchange for a minority stake in the invested company. Businesses with potential for listing on the stock exchange are favoured targets for venture capitalists. The money is often provided for long-term expansion projects. This gives room for new funds or financial structure to fund companies at the start-up stage or at the later stage. If the financial structure to fund new companies provides good return, and adds value to the company in terms of management, transparency and corporate governance, it may be of demand in the market. Given that the SME industry in Malaysia is slowly moving upward, there is

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[53] *Government Programmes.* (n.d.).Retrieved January 14, 2007, from http://www.smeinfo.com.my/index.php?ch=2&pg=3&lang
[54] Ibid

no doubt that the market is present to be utilised. Though some companies may have used Mushārakah funds before, the number is relatively small. One may wonder on the reason for not utilizing such Islamic financial instrument.

"Initially the National Small and Medium Enterprise Development Council have approved a comprehensive microfinance institutional framework to promote the development of a sustainable microfinance industry in Malaysia. The development of a sustainable and commercially-driven microfinance industry is important to ensure that micro enterprises have adequate and continuous access to financing. The comprehensive microfinance institutional framework is important as currently, 80 percent of SMEs are micro enterprises. The Council approved the transformation of Bank Simpanan Nasional into a specialised microfinance institution. Bank Simpanan Nasional will be introducing a loan package for micro enterprises, with a maximum loan amount of RM50,000 for up to five years.

The loan will be provided to micro enterprises with viable business activities, at commercial rates with repayment incentives given to good borrowers. Credit cooperatives, are another important provider of microfinance identified and initiatives will be adopted to strengthen the cooperative movement, including through the establishment of Suruhanjaya Koperasi Malaysia. Other institutions that will be offering microfinance are Bank Kerjasama Rakyat Malaysia Berhad and Bank Pertanian Malaysia. In particular, Bank Pertanian Malaysia will provide microfinance for agriculture and agro-based businesses."[55]

The microfinance industry plays a major role in terms of financing for the SMEs. However, banks do not provide management advice to these new businesses.

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[55] *Key Decisions of the Fifth National SME Development Council Meeting.* (n.d.). Retrieved January 16, 2007, from http://www.bnm.gov.my/index.php?ch=8&pg=14&ac=1283

Although most businesses must give a comprehensive proposal as part of the loan application, management value added provided by the venture capital financing can be a useful tool for the entrepreneur of the new company. Their ownership may be at stake, but that is negotiable in the venture capital industry. This gives room for improvement on structuring new funds and improves current existing funds that will give returns for both financier and to the entrepreneur. The usage of the Mushārakah in the venture capital industry is not as widespread as compared to the conventional method of financing. Given if the Mushārakah funds are structured effectively, it may be a demanding tool of financing for both parties.

2.10 Sectors Invested by Venture Capital Companies in Malaysia

The importance of the manufacturing sector is clearly shown when the Industrial Master Plan (IMP) was formulated to further develop the manufacturing sector in Malaysia between 2001 and 2003. Table 2.8 and 2.9 shows the breakdown of the sectors invested in by the Malaysian government.

Table 2.8: Outstanding Venture Capital Investment by Sectors (2001-2003)

Share of investments by sector (%)	**2001**	**2002**	**2003**
Manufacturing	43.7	40.9	34.7
ICT	17.0	19.4	37.1
Life sciences, medical, healthcare, bio-tech etc	4.8	7.7	16.8
Others	34.4	32.0	11.4

Source: Bank Negara Malaysia Annual Report 2004

Table 2.9: Outstanding Venture Capital Investment by Sectors (2004-2005)

	As at end 2004		As at end 2005	
Sector	**RM mil**	**% Share**	**RM '000**	**% Share**
Information and communications technology	446.2	42.2	661,189.2	45.9
Manufacturing	269.2	25.4	292,906.2	20.3
Life sciences	194.7	18.4	270,574.1	18.8
Education	38.4	3.6	59,325.0	4.1
Electricity, power generation, gas and water	17.4	1.6	4,740.0	0.3
Wholesale, retail trade, restaurant and hotels	10.3	1.0	12,024.0	0.8
Financing, insurance, real estate and business services	6.8	0.6	15,963.2	1.1
Construction	0.1	0.0	100	0.0
Transport, storage and communications	0.0	0.0	15,970.0	1.1
Others	74.9	7.1	108,748.4	7.5
Total	**1058.1**	**100.0**	**1,441,540.2**	**100.0**

Source: Bank Negara Malaysia Annual Report 2004 and 2005

It is clear that manufacturing and information technology are the sectors highly invested in by the government and also by the private venture capitalist. Since the inception of the Multimedia Super Corridor, the ICT industry has boomed at quite a good pace in Malaysia. By the year 2003 the investments in ICT surpassed the manufacturing sector by approximately three percent. The ICT industry remains the lead in receiving venture capital funding. In the year 2005 percentage of funding in the ICT sector rose to 45.9 percent. The role of venture capitalist in this sector can further boost the growth and this is highlighted in some of the Malaysian government policies in providing the supporting infrastructure and facilitating the development of technology and knowledge-based enterprises. Some of the initiatives include the following: [56]

- Multimedia Super Corridor initiative, including Cyberjaya and smart schools;
- Setting up of Technology Park Malaysia and incubation centres;
- Acceleration of the university building programme, including technology
- Universities such as the Multimedia University;
- Establishment of research institutes such as MIMOS and Sirim;
- Effective legal framework to protect intellectual property rights, including
- the implementation of Cyberlaws;
- Establishment of MESDAQ to provide a viable exit mechanism;
- Establishment of the Human Resource Development Fund;
- Development of a National Master Plan for E-Commerce:
- Development of a National Information Technology agenda; and last but definitely not least,
- Development of the K-Economy Master Plan.

The life sciences, medicine, healthcare and bio-tech are slowly gaining importance and with the new project of making Malaysia the world leading *halal* food hub, the bio-tech area plays a very significant role.

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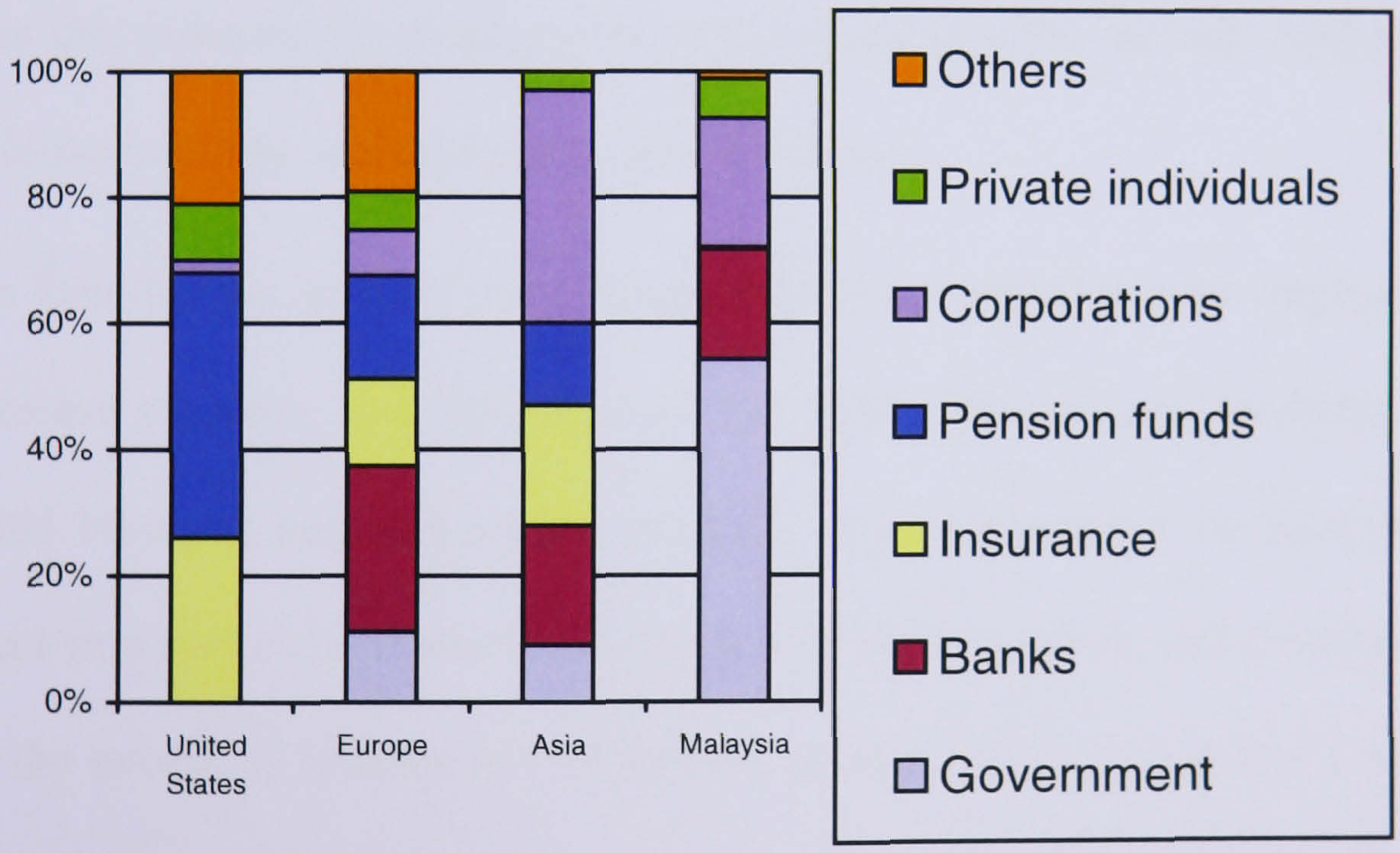
[56] Aziz, Zeti Akhtar. (2000, March). *Accelerating Economic Growth through Venture Capital* Speech. Delivered at *Venture Capital Europe-Asia 2000.* Putra World Trade Center, Kuala Lumpur.

2.11 Sources of Venture Capital in Malaysia

Assessing the type of venture capital that exists in a particular country helps to give a picture of the whole venture capital industry in the country. Figure 3.2 it shows us the source of the venture capital fund in Malaysia. As seen in the graph, most of the source comes from the government and given to venture capital companies and venture capital management companies in Malaysia. This is due to the small venture capital industry in Malaysia. A strong support by the government will help to boost the industry in the future. The second highest source of funding comes from corporations and thirdly the banks. Lastly, there are also angel investors in Malaysia but the numbers are small.

Figure 2.2: Sources of Venture Capital



Source: Kwee Bee, Chok. (2004).[57]

Venture capital companies in Malaysia are mostly corporate venture capital and not a partnership structure such as private limited partnerships in the United

[57] Kwee Bee, Chok. (2004, April 5). *Collaboration with the Venture Capital Industry*. Presented at the Association Of Merchant Banks Tea Talk.

States. Referring to figure 2.2, in the United States the two main sources of funding for the venture capital comes from the pension funds and insurance. In Europe the scenario is totally different whereby the banks and the pension funds are the main source of funding for the venture capital companies. In Asia on the other hand, corporations, banks and insurance are the major sources of funds for the venture capital industry.

2.12 Venture Capital Contribution to the Economy and Employment

The venture capital industry has done wonders in most developed countries particularly the United States and the United Kingdom. In this section we will see the impact of venture capital not only from the points of view of a developed country but also from the perspective of countries classed as emerging markets such as Malaysia. The areas that this industry has managed to nurtured and develop include information technology, biotechnology, manufacturing and education.

Other than that the spirit of entrepreneurship has managed to spur employment and also increase research and development for new concepts and products. The venture capital business has spurred the research and development in most of the sectors present in a particular country. In the U.S.A itself research and development would be in the excess of billions of U.S dollars. Global Insight found that ventured firms, adjusted for size, spend over twice as much on research and development as non-ventured firms.[58] According to Global Insight, even when small ventured firms grow to be among the biggest in their industry, they remain leaders in research and development.

[58] Venture Impact 2004: Venture Capital Benefits to the U.S Economy. Retrieved February 20, 2006, from http://www.nvca.org/pdf/Venture_Impact_2004.pdf

Another interesting point highlighted by Global Insight was that, many of the ventured companies founded during venture capital's infancy 20 to 30 years ago have quickly grown from small private companies to among the largest in the country. In addition to that, it also stated that of the top firms in the U.S.A research and development spending, many were either ventured themselves, such as Microsoft, Cisco, and Intel, or were major acquirers of ventured firms, like Johnson & Johnson and Pitzer.

"Malaysia aspires to be a biotechnology hub and this is clearly evident in the set up of Bio Valley Malaysia, which aims to attract investments worth at least USD10.5 billion within a decade. Bio Valley will consolidate efforts that are currently carried out separately by universities, Government and the private sector. The Government plans to pump in RM 2 billion to form three research institutes in Bio Valley under the country's 2001-2005 development plans. Bio Valley will incorporate three new research institutes in the fields of agricultural biotechnology, molecular biotechnology, pharmaceutical and nutraceutical biotechnology. The Bio Valley project is designed to increase the development of biotechnology intellectual property and to promote the establishment of new companies in this field."[59]

The information above clearly shows us that Malaysia itself is serious in the area of research and development. In the venture capital business itself, biotechnology has made its way into the venture capitalists' portfolio. This comes under the life-science area where it comprises RM194.7 million of the overall venture capital investment. The information and communication technology sector was the highest with an amount RM446.2 million invested by the venture capitalists. These figures

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[59] *Malaysian Biotechnology Information Centre*. (n.d.). Retrieved February 24, 2006 from http://www.bic.org.my/?action=localscenario&do=biotechnology

give us an indication that research and development plays a vital role as new products and concepts are nurtured in this sector.[60]

"The growth of the venture capital industry in Malaysia has been on a positive track. As at end 2005, the number of committed funds has risen to RM2.6 billion from RM2.1 billion in 2003. The number of investee companies has also grown by 30 percent since 2003. Statistics also show that the private sector is fast taking over the role of government as the prime source for these funds. It has become more apparent, that we are now experiencing a strong acceptance of venture capital, as an alternative vehicle into the mainstream capital market products of debt, equity and derivative instruments."[61]

According to the Survey of the Economic and Social Impact of Venture Capital in Europe compiled by the European Venture Capital Association, the companies surveyed in Europe used venture capital funding to achieve significant increases in their budgets for research & development, marketing and training. The survey also highlighted that, for all companies, the initial venture capital investment has been followed by a sharp increase in spending for research and development. Half the seed/start-up companies multiplied their efforts in this area by more than four times, while half the expansion stage companies almost doubled the amount invested. Based on the survey again most of the investment on seed/start-up and expansion are high on computer related technology/products, communications and biotechnology.

In the case of China and quoting from Daily China, China had risen to third in the world in the amount of money it spent on research and development, according to

[60] Bank Negara Malaysia Annual Report. (2005). Retrieved September 5, 2006,.from http://www.bnm.gov.my
[61] Anwar, Zarinah. (2006, August 21). Venture Capital Investors Forum. Retrieved January 10, 2007, from http://www.sc.com.my/eng/html/resources/speech/sp_20060821.html

a recent report by the Organization for Economic Cooperation and Development (OECD). China's expenditure in research and development reached 60 billion US dollars in 2001, only after the United States and Japan whose investment is respectively 282 billion dollars and 104 billion dollars, according to the Beijing-based Economic Daily.[62]

All the information gathered shows that the venture capital plays a vital role in research and development towards innovating new products and concepts in many sectors especially those in the technology, communications and biotechnology sectors. This is yesterday's news for the U.S and Europe (U.K holding the largest venture capital industry) but for developing countries such as Malaysia the economy depends on new ideas and innovation to increase the growth of its economy and increase foreign investments. It is obvious that all developed nations are spending large sums for research and development to sustain their market share and economy in the world. Its impact is very obvious in developed countries such as U.S and U.K which means with right economic planning and infrastructure it can be of success in a an emerging market, such as Malaysia

The venture capital industry in Malaysia may be small but the number of invested companies has risen tremendously for the past three years. The total number of money invested overall has reached billions (ringgit). This is a healthy sign for the nation's economy because innovation of new products in the market would keep the economy stable, particularly if they are in demand in the market and making profit. Furthermore, new companies established through venture capital funding helps to create jobs in the industries that the venture capitalist invest in. The Global Insight

[62] China rises to third in research, development spending. (2003) Retrieved February 24, 2006, from http://www.chinadaily.com.cn/en/doc/2003-11/03/content_277867.htm

mentioned that in the United States, the venture capital contribution to jobs has employed more than 10 million American workers and generated $1.8 trillion in sales in 2003.[63] Based on the statistics obtained from Global Insight, invested companies in biotechnology posted an employment gain of 23 percent and healthcare products grew by 16 percent between 2000 and 2003. Table 2.10 showed the breakdown of employment growth for respective sectors.

Table 2.10: Employment Growth at Venture Capital Backed Companies vs. Total Employment Growth by Industry Sector 2000-2003 (U.S.A)

Industry	**VC Employment Growth (%)**	**Total Employment Growth (%)**
Biotechnology	23	5
Business/Financial	4	-1
Communications	5	-18
Computer Hardware and Services	-1	-14
Computer Software	17	-8
Healthcare Products	16	-2
Healthcare Services	10	9
Industrial/Energy	1	-9
Retailing and media	12	-1
Semiconductors	-10	-26
Total	7	-2

Source: Venture Impact 2004[64]

[63] Venture Impact 2004: Venture Capital Benefits to the U.S Economy. Retrieved February 20, 2006 from http://www.nvca.org/pdf/Venture_Impact_2004.pdf
[64] Ibid

Table 2.11: Company and Employment (U.S.A)

Company	Employment
Seagate	10,000
Google	1,600
EBay	6,200
The Home Depot	299,000

Source: Venture Impact 2004[65]

Apart from that, as stated in the Global Insight, ventured firms grow faster than their national industry counterparts, but sectors with a higher concentration of venture capital financing experienced higher employment growth differentials. The best example is the computer software, where venture backed firms employ 88 percent of all computer software workers and ventured backed firms grew by 17 percent, while the industry as a whole declined by nearly 8 percent. Table 2.11 showed the employment at selected venture backed firms in the year 2003. In the case of Malaysia where the venture capital industry is small, it does not stop the job creation process at. It does not surpass the overall employment rate but in future if the numbers of investment by venture capitalist increase it can build up to a good percentage.

2.13 Conclusion

Venture capital is another form of financing that has many advantages to both the investor and the investee. Commonly focusing at the early stages of the business cycle makes it risky but promises high returns. Risk at the early stage is due to the

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[65] Ibid

failure of a business. For example, at the seed stage potential businesses has to offer their business plan with business strategies and financial forecast only. However, this does not make the venture capital the least preferable method of financing chosen by the entrepreneur. The partnership bonded with the venture capitalist is of value-added to the company as compared to obtaining financing from a bank. From the stage where the deal is structured and until the company is ready to exit both parties would be co-operating with each other because both stakes are in the investment and it is bonded with many agreements that gives them very little room to be dishonest to each other.

The above discussion gives us an idea on the features of venture capital, in particular those features which are Shari'ah compliant and deemed useful in comparing with one of the Islamic profit-sharing instrument such as the Mushārakah. Furthermore, there are some similarities between the two. These similarities will give us an insight to analyze and explore the factors needed to structure a Mushārakah model of financing for a venture capital. Apart from that, the venture capital's industry contribution towards research & development and employment is also highlighted in this chapter to note the potential of the venture capital industry in maintaining an economy through the process of innovation and job creation. This intertwines with the spirit of Mushārakah and the concept of business from an Islamic perspective whereby, through entrepreneurship it creates employments for others and the combination of skills and capital that builds potential business investments into respective companies and sectors in the Malaysian economy.

CHAPTER THREE : SCOPE OF MUSHĀRAKAH FINANCING :A LITERATURE REVIEW

3.1 Introduction

This chapter covers the types and features of Mushārakah as a mode of financing. In addition, the application of Mushārakah in contemporary financing is also discussed. Comparisons between Musharakah, Mudharabah and venture capital are covered in this chapter. A literature on the application of Musharakah in Malaysia from the economic and banking perspective is discussed to see the potential of Mushārakah in the venture capital companies in Malaysia. Equity financing is also highlighted in this chapter on its role in the economy and as a mode of financing.

3.2 Definition of Mushārakah

Mushārakah or *shirkah* is a form of partnership where two or more persons combine their capital or labour together to share the profits, management of the business, enjoying similar rights and liabilities. Mushārakah took place during the times of the prophet whereby the Ansar and the Muhajirin joined as partners and traded in the form of Mushārakah, Muzara and Musaqat. According to Dr. Saad Al-Harran, the different classification in Arabic refers to diverse activities such as Muzara in agriculture, Musaqat in gardening and Mushārakah in trade.[66] He also mentioned that the four forms mentioned were developed so that they became independent institutions and the jurists formed detailed rules about them.[67] The term Mushārakah is commonly used in Islamic banking and finance as opposed to *shirkah*. *Shirkah* is more frequently used in Islamic jurisprudence and all these modes of

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[66] Al-Harran, Saad (1995). Leading Issues in Islamic Banking and Finance. Malaysia: Pelanduk Publications. pp.2.
[67] Ibid. 3pp

sharing or partnership are termed as *shirkah* in Islamic Fiqh.[68] In this chapter several studies on *shirkah* and Mushārakah from different authors are set out to get a better understanding on their terms, categories, features and operations.

3.3 Types of Mushārakah

Muhammad Taqi Usmani stated that authors who have written on Islamic banking and finance introduced the term Mushārakah, and it is normally restricted to a particular type of *shirkah*, which is the *shirkatul-amwal.*[69] *Shirkah* can be divided into two categories, which are:

- Shirkat-ul-milk
- Shirkah ul-'aqd

Shirkah al-milk is a joint ownership between two or more partners in a particular property. However, as stated by Muhamad Taqi Usmani, this kind of *shirkah* may come into existence in two different ways. He mentioned that if two or more persons purchase equipment, it will be owned jointly by all of them and the relationship between them with regard to that property is called *shirkat-ul-milk*. "In this case, this relationship came into existence at their own option because they had elected to purchase the equipment jointly. However, there are cases where this kind of *shirkah* operates without any action taken by the parties. In the case of a death of a partner, all the latter's heirs inherit his or her property which comes into their joint ownership as an automatic consequence upon the death of the partner as mentioned above."[70]

The second type of *shirkah* is the *shirkah-ul-'aqd*. It means partnership in a

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[68] Usmani, Muhammad Taqi (2002). *An Introduction to Islamic Finance*. The Netherlands: Kluwer Law International. pp.5.
[69] Ibid. 5pp.
[70] Ibid. 5pp.

business through a mutual contract. *Shirkah-ul-`aqd* is narrowed down into three kinds:

- ***Shirkat-ul-amwal*** is where all the partners invest some capital into a commercial enterprise or a business venture.
- ***Shirkat-ul-a'mal*** is where all the partners jointly undertake to render some services for their customers, and the fee charged from them is distributed among them to an agreed ratio. However, if the income earned goes to a joint pool and it can be distributed between them irrespective of the size of the work of each partner. This partnership is also called *shirkat-ut-taqabbul* or *shitkat-us-sana'i'* or *shirkat-ul-abdan.*
- ***Shirkat-ul-wujooh***. For this type of *shirkah* the partners have no investment at all. They would purchase the commodities at a deferred price and sell them on the spot. The profit earned is distributed between them at an agreed ratio.

The partnership transaction based on Ibn-Taimiyah is divided into two categories that are partnership in property (*shirkah al-amlak*) and partnership in contracts (*shirkah al-'uqud*).71 The partnership on contracts would be highlighted in this paper since it involves the Mushārakah contract and its application in the Malaysian venture capital companies. The five forms of partnership in contracts mentioned by Ibn-Taimiyah are:

- Partnership in capital and labour (*shirkah al-inan*): two or more persons pool their capital and work together and share in the profits.

[71] Islahi, Abdul Azim (1998). *Economic Concepts of Ibn Taimiyah*. Leicester: The Islamic Foundation. pp.156.

- Partnership in labour (*shirkah al-abdan*): artisans or labourers jointly undertake a task and agree to distribute their earnings amongst themselves.

- Partnership in credit (*shirkah al-wujuh*): one or more of the members procure goods on credit and sell them, and they distribute the profits.

- Comprehensive partnership (*shirkah al-mufawadah*): the partners combine in every type of *shirkah*, namely, *al-inan*, *al-wujuh* and *al-abdan*.

- Mudarabah partnership (*shirkah al-mudarabah*): one party and labour by the other party provides capital.

Muhammad Nejatullah Siddiqi has used the term *shirkah* (partnership) in the sense of what the Hanafi jurist's term *shirkat-'inan.*[72] He also stated that the Hanbalī and the Shāfi'ī jurists also use the same term in this sense, while jurists of the Mālikī school use the term *shirkat-mufawada.*[73]

Dr. Saad Al-Harran[74] however, stated that Mushārakah or *shirkah* is of two types, which are:

- *Shirkah al-milk* (non-contractual partnership)

- *Shirkah al-uqood* (contractual partnership)

Shirkah al-milk (non-contractual) means co-ownership that comes into existence when two or more persons get joint-ownership of some asset without having entered into a formal partnership agreement. *Shirkah al-milk* itself is of two characteristics, which are:

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[72] Siddiqi, Muhammad Nejatullah. (1985). *Partnership and Profit-Sharing in Islamic Law*. Leicester: The Islamic Foundation. pp.15.
[73] Ibid. 15pp
[74] Al-Harran, Saad, Zakaria, Mustafa, Khalid, Haniza. (1994). *Islamic Marketing Strategy: Eradicating Rural Poverty in Malaysia.* Malaysia: Pelanduk Publications. pp.30.

- *Ikhtiyariyyah* (voluntary)
- *Jabriyyah* (involuntary)

Shirkah al-uqood (contractual partnership) as stated by Saad Al-Harran can, however, is considered a proper partnership because the parties concerned have willingly entered into a contractual agreement for joint investment and the sharing of profits and risks. The agreement needs not necessarily to be formal and written; it could be informal and oral. The profit can be shared in any equitably agreed proportion and losses must, however, be shared in proportion to the capital contribution.

Shirkah al-uqood has been divided in the *fiqh* books into four kinds: *al-mufawadah* (full authority and obligation); *al-inan* (restricted authority and obligation); *al-abdan* (labour, skill and management); and *al-wujuh* (goodwill, credit-worthiness and contracts). In the case of *mufawadah* the partners are adults, equal in their capital contribution, their ability to undertake responsibility and their share of profits and losses. They have full authority to act on behalf of the others and are jointly and responsible for the liabilities of their partnership business, provided that such liabilities have been incurred in the ordinary course of business. Thus each partner can act as an agent (*wakil*) for the partnership business and stand as guarantor (*kafil*) for the other partners.

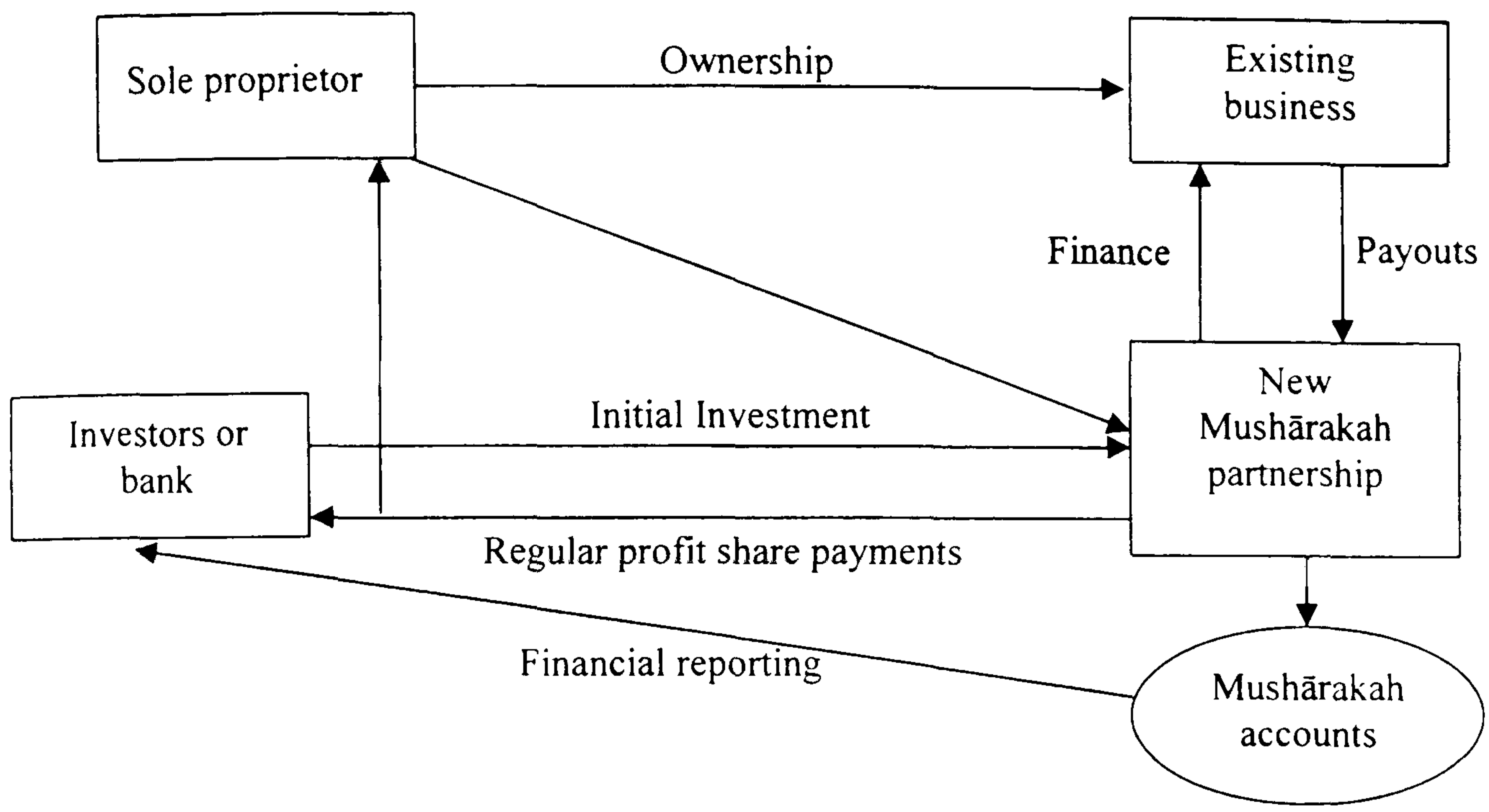
Inan on the other hand implies that all partners need not be adults or have an equal share in the capital. They are not equally responsible for the management of the business. Accordingly their share in profits may be unequal, but this must be clearly specified in the partnership contract. Their share of losses would be in accordance to their capital contributions. The partners act as agents but not as sureties for their colleagues.

Shirkah al-abdan is where the partners contribute their skills and efforts to the management of the business without contributing to the capital. In *shirkah al-wujuh* the partners use their goodwill, their credit-worthiness and their contacts for promoting their business without contributing to the capital. Both these forms for partnership, where the partners do not contribute any capital, would remain confined essentially to small-scale businesses only.

3.3.1 Classic Mushārakah

This type of Mushārakah is when two or more parties' join capital in the form of cash or assets and the shares are distributed (equity participation) based on the capital contribution. Mushārakah is a partnership based on profit and loss sharing. In the Mushārakah financing arrangement, two or more parties will contribute their capital as well as expertise in the joint venture or the partnership. Profit and loss will be shared normally based on the capital contribution. The structure of this type of Mushārakah is shown in Figure 3.1. This type of Mushārakah is normally applied in the banks and the term "classic" is to denote that this Mushārakah becomes the basis of other sub Mushārakah products engineered in the 1990's such as Diminishing Mushārakah. The investors or the bank gives the initial investment to the sole proprietor and both form a Mushārakah partnership and the profit sharing rate will be determined.

Figure 3.1: Permanent Mushārakah Structure



Source: Wilson, Rodney. (2005).[75]

If we look at the Figure 3.1 above, the partnership is between the sole proprietor and the bank. The sole proprietor takes a loan from the bank and engages into a Mushārakah partnership. The loan given by the bank is the initial investment into the existing business set up by the sole proprietor. The profit ratio is then determined by the bank and the sole proprietor. The payments to the bank by the sole proprietor are based on this profit ratio. A Mushārakah account is then set up by the bank to manage the loan given to the sole proprietor. The sole proprietor has to provide financial report of the business to the bank as part of the monitoring process required by the bank.

3.3.2 Diminishing Mushārakah

This type of Mushārakah operates through the buy out of shares by the

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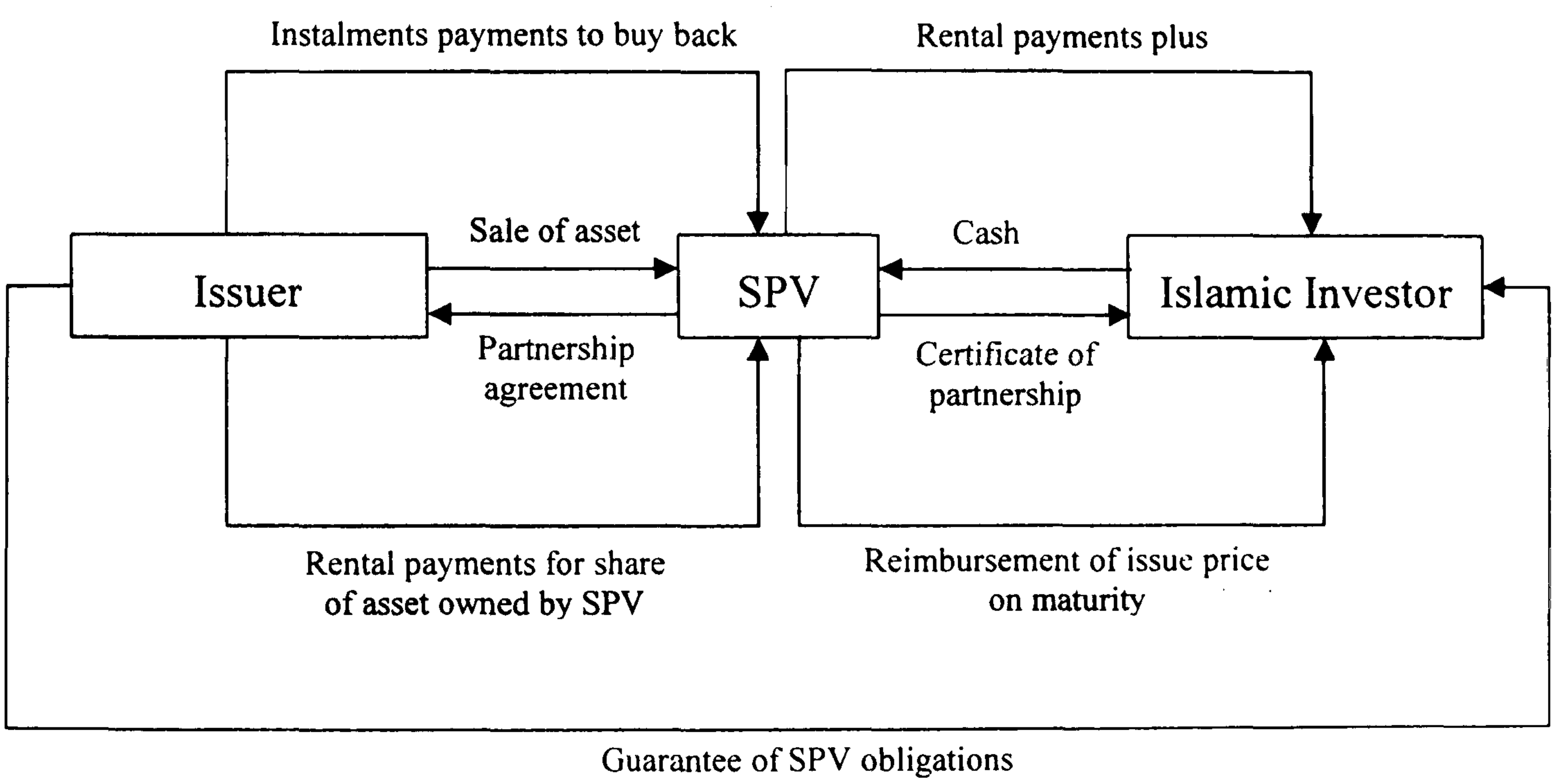
[75] Wilson, Rodney (2005, Spring). *Islamic equity investment and fund management.* Islamic Economics and Finance Module: Durham University.

investors on the joint venture until the company is fully owned by the invested company. However, the buy out must result in a premium to the investors. The profit ratio will reduce as the shares of the parties or companies reduce through the share buyouts. The same concept is also applied in home financing. For example, buyer A takes up a loan from Bank B. During the tenure of the loan the buyer gives out a rent to the tenant of the house and later on uses the rent to pay his loan. While this goes on, slowly the loan diminishes. The structure of this type of Mushārakah is shown in Figure 3.2

Figure 3.2: Diminishing Mushārakah Structure



Source: Wilson, Rodney. (2005).[76]

Looking at diagram two above, the Diminishing Mushārakah is structured as a special purpose vehicle (SPV).The one shown above is used in a *sukuk* structure for real estate finances and securitization of Islamic mortgages. Certificate of partnership is issued out for the partnership formed between the issuer and the Islamic investor.

[76] Wilson, Rodney (2005, Spring). *Innovation in the structuring of Islamic Sukuk securities*. Islamic Economics and Finance Module: Durham University.

The profits are then shared on an agreed ratio between the issuer and the Islamic investor. The client buys the share of the financier at a price, at the time where the sale took place. At maturity of their contract (partnership), the client becomes the sole owner of the asset. The Diminishing Mushārakah is also structured by some banks for home financing. For example, the Amanah Home Finance by the HSBC Amanah Finance is based on the Diminishing Musharakah mode of financing established. The first Islamic PDS issued in Malaysia was in 1990 by Shell MDS Sdn. Bhd. A syndicate of financiers arranged the Bai Bithaman Ajil or BBA transaction of RM75 million for a tenure of five years and another RM50 million for the tenure of eight years. This was followed by another issue structured along the concept of Mushārakah Mutanaqisah by Sarawak Shell Bhd in 1991.[77]

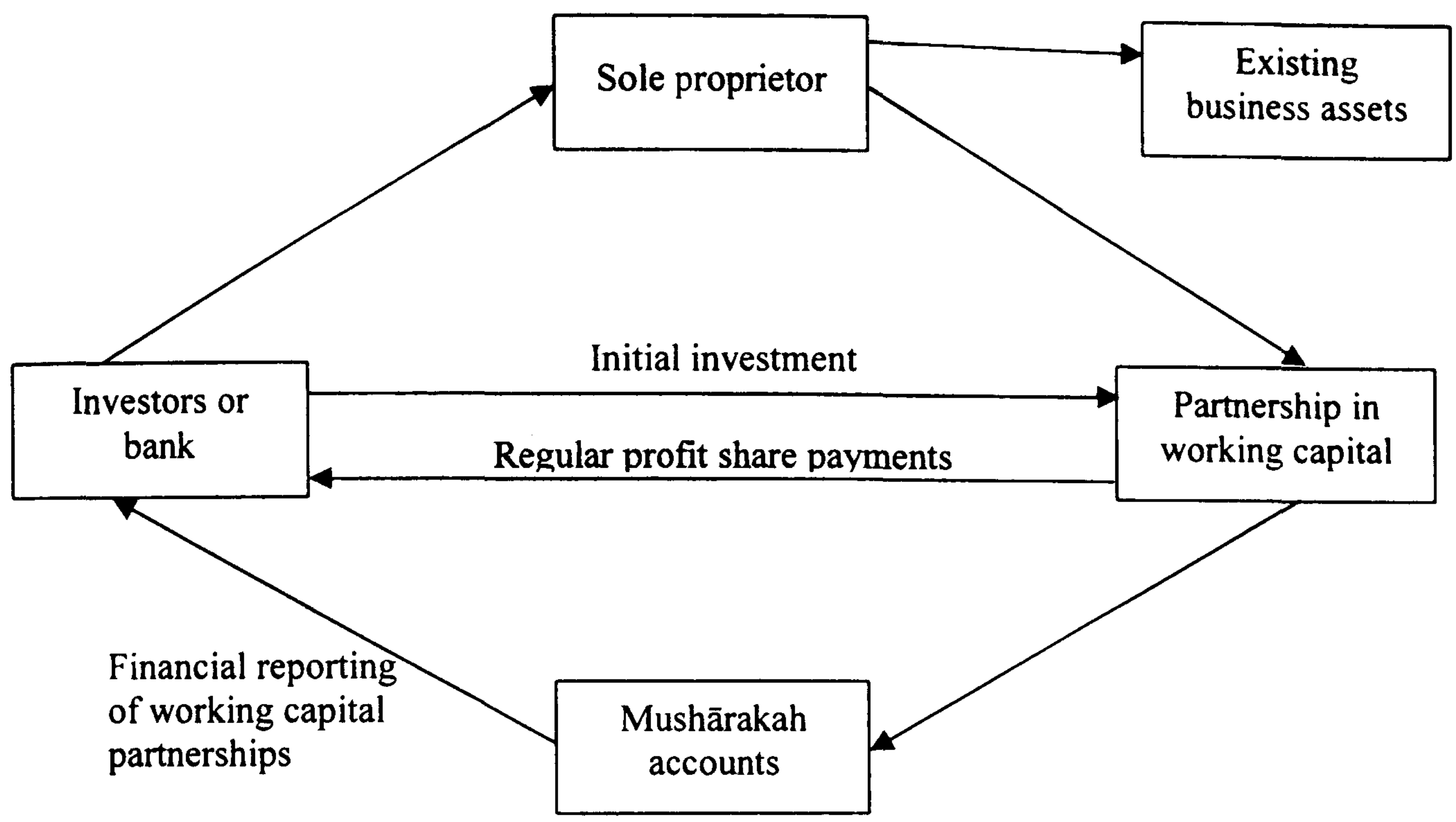
3.3.3 Temporary Mushārakah

Temporary Mushārakah is working capital finance. The Bank invests on a short-term scale, and receives its invested capital plus profit at the end of an agreed period. A temporary Mushārakah can be renewed depending on the agreement of the partners.

The structure of the temporary Mushārakah structure (refer figure 3.3) is different to that of the permanent one in terms of the tenure of investment. In this case the existing business is an established business only that it needs funds to improve its performance. Furthermore, the working capital finance is needed to finance accounts payable and wages. It is not use to finance a long-term investment as seen in the permanent Mushārakah structure.

[77] Mahmood, Nik Ramlah. (2001, September 21).*Seminar on Islamic Private Debt Securities: Exploring New Opportunities in the Capital Market*. Retrieved September 24, 2004, from Securities Commission Malaysia. Website: http://www.sc.com.my/eng/html/resources/speech/sp_20010926.html

Figure 3.3: Temporary Mushārakah Structure



Source: Wilson, Rodney (2005).[78]

The three types of Mushārakah listed give us an idea how Mushārakah operates in the finance industry. In addition, it is also vital to know what type of partnership that is defective from an Islamic perspective. The Hanafī school of thought stated that if two or more partners form a partnership to utilize public properties such as hunting, fishing and grazing it is considered a defective partnership. This is due to the view that partnership requires mutual agency, which is not allowed in the utilization of public property. Each worker is considered to be working for himself. If the partners collaborated in a collective usage of public property, the profits are equally divided among them. However, the other Islamic school of Jurisprudence accept partnerships to utilize public properties as being valid. This is due to their permission of agency (*tawkil*) in utilizing the public property.

[78] Wilson, Rodney (2005, June 2). *Musharakah and Mudharabah*. Presented at FTC Training for the Association of Merchant Banks in Malaysia.

Another type of partnership that is defective according to the Hanafīs is when two or more partners agree that each will lease his property, and share the payments. This is based on their view that agency (*wakalah*) to lease another's property and collect a portion of the rent is not permissible, but if the partners combine their properties for a specific task and jointly lease them then the partnership is considered to be valid. If the owner of a property asks another to lease it on his behalf and share the lease of payments it is also considered a defective partnership.

If a person asks to be partners of a property that has not been received yet, the partnership would be tantamount to selling half the property to the potential partner. Such a sale is not valid prior to receipt and the contract is defective, but if the buyer received the property prior to the initiation of the partnership, then it is valid. If the partner did not know the price before engaging into the partnership, he has the choice to pay half the price and get his share, or void the contract.

3.4 Concept and Features of Mushārakah

In this section the features of the Mushārakah will be discussed based on management, ownership and profit, losses, risk, contract tenure and termination, financial advantages and lastly limited liability. The concept of Mushārakah is based on sharing. Sharing in these matters apply in managing the partnership or joint venture, profit, losses and risk. Mushārakah highlights Shari'ah approved activities on business activities that are *halal* and can be supported in an Islamic economy. In addition, it can be carried out with a non-Muslim as well.

3.4.1 Management

Mushārakah is a mode of financing that is to achieve a win-win situation for both capital providers and entrepreneurs who hold a stake in the company. Sami Al-

Suwailem mentioned that from an Islamic point of view venture capital is based on equity financing (*sharikat al-inan*), and thus falls within the framework of Islamic finance. Secondly, he highlighted that it combines economic viability and Islamic preferably, which makes it a promising option for Islamic financial institutions[79]. Mushārakah involves shared management among the business partners. Shared management will be explained in terms of partners' rights and responsibilities in the business and towards each other.

Firstly, every partner is an agent to the other. Any work done by one partner is deemed to be authorized by other partners but if the partner does purchases for himself/herself it will be on his/her expense and not used for the business. The actual possession of a property from the Mushārakah business is considered as possession of other partners in as much as if a partner purchases half portion of a specific good for himself/herself and half portion for the Mushārakah.[80] Secondly, every partner has the right to actively participate in the Mushārakah business. There are occasions whereby, the partners may agree upon a condition that the management shall be carried out by some partners and the rest become sleeping partners. The sleeping partners in this case are only entitled to the profit only to the extent of his/her investment, and the ratio of profit given to him/her should not exceed the ratio of the investment. Thirdly, every partner enjoys equal rights in the Mushārakah, however, the partner is not to burden the partners with debts.

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[79] Al-Suwailem, Sami. "*A Potential Model of Musharakah*". Retrieved December 21, 2004, from Academic Publication Center, Graduate Studies and Academic Research Vice-deanship, King Abdulaziz University in Jeddah. Website: http://www.kaau.edu.sa/CENTERS SPC page-091.htm

[80] Al-Harran, Saad (1995). *Leading Issues in Islamic Banking and Finance*. Al-Harran, Saad (Ed). *Musharakah Financing: Concept and Application* (pp. 2-24), Malaysia:Pelanduk Publications Sdn. Bhd.

3.4.2 <u>Ownership</u>

Ownership is a crucial element in the venture capital investment. Bovaird stated that venture capital is equity based, more participatory, and longer term for maturity and the participation required of the venture capital investor extends beyond mere provision of capital.[81] Bovaird explains that typically a venture capitalist will seek between 20% and 49.9% of the common shares of the company and the size of the stake must be large enough to influence his fellow shareholders. He also stated that the shared exchanged in return for the financial injection allows the venture capitalist to share in the company's profits, to exercise voting rights in matters relating to the company's management and strategy, and to exercise all of the other rights and privileges that a co-owner or partner might enjoy.

The features of the venture capital in terms of ownership show similar features in the case of the Mushārakah financing. Both parties in this case enjoy similar rights, liabilities, share ownership and the financier or the venture capitalist have control over the business. The proportion of profit to be distributed must be agreed upon at the time of affecting the contract and it will be distributed in proportions settled by the partners in advance and in proportion or percentage. The profit must be based on actual profit earned and not fixed, depending on the success and profitability of the business.

"The Shāfi'ī and Mālikī jurists are also in view that the profit will be distributed in proportion to the amounts of capital invested which means a fixed sum of money because profit cannot be completed for any party. According to Hanafī jurists profit shares must be given as a proportion of the profit and not in a fixed sum

[81] Bovaird, Chris (1990). *Introduction to Venture Capital Finance*. London: Pitman Publishing. pp.7.

of money. Profit obtained from the Mushārakah or *shirkah* does not have to be shared in accordance to capital contributions. The Hanafī and the Hanbalī jurists support this. As for the Shāfi'ī and Mālikī schools, the distribution of profit must reflect the proportion of invested capital."[82]

3.4.3 Losses

Losses however, in a Mushārakah will be distributed in proportion to the capital invested and borne by the owners of the capital. All schools of Islamic jurisprudence universally agree upon this.[83] Therefore, if a partner has invested 70% of the capital, he must suffer 70% of the losses. This is because losses result in the erosion of equity and capital. If the loss is incurred in one period it should be adjusted with the profit obtained in the following periods until all the losses are written off and the capital is restored to its original level.[84] Any distribution of profit that occurs during that period of writing off the losses will be considered as an advance to the partners. In the case of a partner without capital the jurists stated that they are not liable for the losses because they do not have capital and losses imply the erosion of capital.

Therefore, the losses will be answered by the partner with capital. However, they still bear the risk on the investment. This feature of the Mushārakah would only enforce the partner, the investor in the case of a venture capital or the venture capital management company, with the highest capital to work in accordance with its capital and monitor the investments at all times. Apart from that, information on the

[82] Siddiqi, Muhammad Nejatullah. (1985). *Partnership and Profit-Sharing in Islamic Law*. Leicester: The Islamic Foundation. pp.22.
[83] Ibid. 19pp.
[84] Al-Harran, Saad (1995). *Leading Issues in Islamic Banking and Finance*. (Malaysia, Pelanduk Publications), pp.8.

investment or any work carried out would be disseminated accordingly because the profit in a Mushārakah contract does not have to be shared in accordance to capital contributions but this differs among all the four schools in Islamic Jurisprudence.

3.4.4 Forms of Capital in Mushārakah

As stated by Mufti Taqi Usmani most of the Muslim Jurists are of the opinion that the capital invested by each partner must be in a liquid form, such as cash and not commodities.[85] The four schools in Islamic Jurisprudence have different perspectives about this issue. Imam Malik stated that liquidity of capital is not a condition for the validity of Mushārakah. They can use commodities and the partner contributes to the Mushārakah partnerships. His share will determined on the basis of the evaluation of the market price at the time the contract takes place.

Imam Abu Hanifah and Imam Ahmad have a view that such contribution is not accepted in Mushārakah. This is due to reasons such as:

- The commodities contributed by each partner are always distinguishable from one another. For example, if one partner contributes a land and the other partner contributes another land, each one of is owned exclusively by each partner. If the land of a particular partner is sold, the proceeds should go to the owner and the other partner can not share the profit as he/she has no right to claim a share in its price. Looking at the situation above, a partnership can't take place because the capital is distinguishable from one another and it can not be pooled together as compared to monetary capital.
- In the case of redistribution of share capital, if it is in the form of commodities

[85] Usmani, Muhammad Taqi (2005). *An Introduction to Islamic Finance*. Pakistan: Maktaba Ma'ariful Quran, pp.38.

the redistribution can not take place because the commodities may have been sold at that time. If the capital is repaid on the basis of its value and it has increased, there is a possibility that a partner gets all the profit of the business due to the appreciation on the value of the commodity that he/she had invested in and the other partner may get nothing. "If the value of the commodity decreases, there is a possibility that a partner can secure some part of the original price of the commodity of the other partner in addition to his own instrument."[86]

Imam Al-Shafi'i stated that commodities are of two types:

- Dhawat-ul-amthal
- Dhawat-ul-qeemah

Dhawat -ul-amthal is a category of commodities which can be replaced by similar commodities in quality and quantity, such as, wheat, rice and barley. On the other hand *Dhawat-ul-qeemah* are commodities which can not be replaced by similar commodities, such as sheep, lamb and cattle. Each head of sheep can be replaced with another sheep as it has its own characteristics which you can not find in any other sheep head. If a person kills the sheep, he/she is required to pay the price of the sheep to the owner and is not replaced it with a similar sheep.

As mentioned by Muhammad Taqi Usmani, Imam Al-Shafi'i says that the commodities of *dhawat-ul-amthal* may be contributed to the Musharakah as part of the share of capital. On the other hand, commodities of *dhawat-ul-qeemah* can not

[86] Usmani, Muhammad Taqi (2005). *An Introduction to Islamic Finance*. Pakistan: Maktaba Ma'ariful Quran, pp39.

form part of the share capital.[87] The second point as stated by Imam Ahmad and Imam Hanifah is already addressed by Imam Al-Shafi'i, in the sense that the partners can give similar commodities that he had invested to each partner for redistribution of capital. The first point, however, Imam Abu Hanifah says that commodities under the category of *dhawat-ul-amthal* can form parts of share capital because they can be mixed together and become indistinguishable. If the commodity is from the category of *dhawat-ul-qeemah* then it can not form parts of the share capital.

Looking at the different views as stated above the types of capital can be both cash and commodity. In the case of the commodity, it has to be evaluated as per the market price at the time the Mushārakah contract takes place. The market value will determine the share capital of the partner. In terms of the nature of capital in the modern business most venture capital uses monetary form capital and not commodities because evaluation may be costly and cumbersome. Furthermore, capital in cash form can be pooled together.

3.4.5 Termination of Mushārakah

Mushārakah can be terminated at any time and the particular partner has a right to do so. Normally contract tenure is on a long-term basis ranging from 3 to 5 years; however it depends on the companies involved. The distribution of assets of these partners upon the termination is different depending on the form of assets the company has. If the assets are in cash form, it will be distributed on a pro rata basis between the partners.[88] However, if it is not in cash form, the partners will decide on the liquidation or on the distribution of the assets (not in cash form) between them. In

[87] Ibid. 40pp.
[88] Usmani, Muhammad Taqi (2002). *An Introduction to Islamic Finance*. The Netherlands : Kluwer Law International. pp.11.

cases where the assets can not be liquidated and distributed evenly, it will be sold off and the profits are distributed among the partners. If one of the partner dies, his share in the company will either be taken by his heirs or remain in the company depending on the heir's decision. The deceased partner's contract will automatically be terminated, but the contract can remain in the company and again depending on the heir's decision. If any one of the partners becomes insane, the partnership terminates automatically.

There are situations where one partner terminates the contract and the business still remains. If this happens, it can be settled through mutual agreement. The shares owned by the leaving partner will be valued (determined through mutual consent) and distributed among the other partners who want to purchase them. If the partners do not come to an agreed price, the leaving partner can compel the other partners on the liquidation or the distribution of the assets themselves.[89]

However, there is another issue pertaining to this as stated by Mufti Taqi Usmani, "The question arises whether the partners can agree, while entering into the contract of the Mushārakah, on a condition that the liquidation or separation of the business shall not be effected unless all the partners, or the majority of them wants to do so, and that a single partner who wants to come out of the partnership shall have to sell his share to the other partners and shall not force them on liquidation or separation. Most of the traditional books of Islamic *Fiqh* seem to be silent on this question. It appears that there is no bar from the Shari'ah point of view if the partners agree to such a condition right at the beginning of the Mushārakah. This is expressly

[89] Usmani, Muhammad Taqi (2000). *Musharakah*. Retrieved November 21, 2004, from Failaka International Inc. Website: www.failaka.com/Library/Articles/Usmani%20-%20Musharaka.pdf

permitted by some Hanbalī jurists."[90]

3.4.6 Limited Liability

Limited liability is another feature of the Mushārakah. Limited liability in this case is due to the limited losses and profit borne by the shareholders or the partners. They are not held liable for more than the amount that they had invested. This is the same with that of the limited liability feature of the corporation. In the case of Malaysia most of the venture capital is in the form of a corporation. The requirement of the limited liability makes it necessary to regard Mushārakah as an entity separate from the individuality of the shareholders.[91] This common *urf* has given a stable Mushārakah as a financing tool for the shareholders and the parties involved. This is a good point on the Mushārakah or profit-sharing instruments. In the case of the venture capital sometimes we see the combination of the Mushārakah and Mudhārakah whereby all the involved parties contribute the capital but not on the management side. Most of the shareholders do not take part in the management in the venture capital as in the case in Malaysia. This feature of the Mushārakah protects the shareholders and their investment, therefore is a good tool in equity financing and investments.

3.5 The Application of Mushārakah to Contemporary Finance

Although banks do not aggressively use Mushārakah as a mode of financing there are other areas in Islamic Finance that this mode of financing can be used. Some examples are mentioned in this section. For example, Mushārakah can be applied for short-term project financing, partnership financing, joint venture, alternative method

[90] Ibid

[91] Al-Harran, Saad (1995). *Leading Issues in Islamic Banking and Finance*. (Malaysia, Pelanduk Publications), pp.8.

of financing, in the venture capital and Islamic insurance. In Indonesia, Bank Muamalat opened a pilot project where the Bandung Branch was assigned for the implementation of Mudārabah and Mushārakah in the West Java province.[92] Based on this research short term-project are preferred by these small and medium entrepreneurs as they do not want to take greater risks by involving themselves in long-term projects which may also cause liquidity problems. Other than that, the short term projects working capitals are provided by the bank on a profit sharing basis and banks evaluate the project before hand to set the profit-sharing ratio taking into consideration the risks involved.[93] The research also covers the bank's longer-term profit-sharing which is by purchase of contract, with deferred payment on a monthly basis.

The section on the application of Mushārakah and Mudārabah is highlighted in this study to see the potential of Mushārakah in joint ventures and can give some points towards this study of investigating Mushārakah as a mode of financing in the venture capital companies in Malaysia. Ali A. Yasseri mentioned two forms of Mushārakah contracts used by the banks in Iran, which are civil partnership and equity partnership, with civil partnership financing dominating other modes of financing.[94] This article also showed statistics on the composition of financing modes used for credit facilities by the banking system and Mushārakah (civil) and the equity partnership showed quite high percentages as opposed to other modes of financing facilities. This article also stated that the Iranian Civil Code defines civil partnership

[92] Karim, Adiwarman. A, (2002). Incentive-compatible constraints for Islamic banking: some lessons from Bank Muamalat. Iqbal, Munawar & Llewellyn, David T. (comp. & ed.) *Islamic Banking and Finance*. (pp.102). UK: Edward Elgar Publishing.
[93] Ibid. 102pp
[94] Yasseri, Ali. A, (2002). Islamic Banking contracts as enforced in Iran. Iqbal, Munawar & Llewellyn, David T. (comp. & ed.) *Islamic Banking and Finance*. (pp.162) UK: Edward Elgar Publishing.

as a 'mixture of ownership rights of several owners concentrated on a single item, with the share of each partner remaining indistinguishable or indistinct'.[95]

Saad Al-Harran et.al designed an integrated Mushārakah marketing model for socio-economic reformation and reconstruction to help eradicate poverty among fishermen in Terengganu, Malaysia.[96] "In the Mushārakah model, fishermen are viewed as potential assets and as active development agent; unlike in the traditional system where they are assumed as passive, unreliable, lack of motivation and are negative-minded"[97] In the United Kingdom the HSBC Amanah Finance has offered a housing mortgage based on the Diminishing Mushārakah concept. Another bank that followed the footstep of the HSBC Amanah Finance is the Lloyds TSB.[98]

The Mushārakah concept is also applied in the sukuk structure and previously Kuwait Finance House K.S.C. (KFH), Liquidity Management Centre B.S.C. (LMC) and Al Muthanna Investment Company (MIC), the Mandated Lead Arrangers, have officially launched the US$ 125,000,000 Lagoon City Musharaka Sukuk offering in support of the Lagoon City residential and commercial real estate development as part of the broader Kheiran Pearl City project.[99]

3.6 Comparisons between Mushārakah, Mudhārabah and Venture Capital

Further analysis is carried out between the four mode of financing as mentioned above to get an understanding on the operations and application of the Mushārakah. The comparisons are based on these aspects:

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[95] Ibid. 162pp

[96] Al-Harran, Saad, Zakaria, Mustafa, Khalid, Haniza (1994). *Islamic Marketing Strategy: Eradicating Rural Poverty in Malaysia.*. Malaysia: Pelanduk Publications. pp.93.

[97] Ibid. 96pp

[98] Smillie, Susan (2005). *Llyods TSB Expands Islamic Finance scheme.* Retrieved August 8, 2006, from Guardian Unlimited Money Website: http://money.guardian.co.uk/islamicfinance/story/0,,1458776,00.html

[99] *Lagoon City US$ 125,000,000 Musharaka Sukuk Road Show commences in Kuwait.* (n.d.).Retrieved August 18, 2006, from http://www.lmcbahrain.com/newsLagoon.asp

- Nature financing
- Type of financing
- Tenure
- Collateral
- Asset ownership
- Rate of return
- Legal

Mushārakah is a joint venture or a partnership of two or more parties and it is based on the concept of sharing. Sharing in the Mushārakah financing involves four variables:

- Profit
- Loss
- Risk
- Management

The profit ratio is pre-determined and based on actual profit obtained through the ventures. The percentage of the profit ratio and losses for the partners would be divided according to the invested values of the partners. However, the profit ratio may differ depending on the amount of work carried out by the partners as well. One partner may have invested more but does less work and vice versa. Losses on the other hand would be solely based on the invested value. All in all it has to be on a consensus basis and the outcome gives a win-win verdict for partners involved. Since all the partners have stakes in the investment it means they bear the risk of losing their investment in the company, so the risk is spread out.

The Mudhārabah consists of a fund provider and the entrepreneur. whereby the entrepreneur will be the one in charge of executing the business. The fund provider does not share the management of the business with the entrepreneur. The loss is borne by the fund provider or the investor, but the risk is not spread in this case between the two. Indeed, the investor bears the risk that they may lose their investment and the entrepreneur may lose their business and source of profit or income but the entrepreneur does not have shareholding in the business.

Venture capital is the process by which investors fund the early and late stage. of more risk oriented business ventures. A venture capital funding arrangement will typically entail some level of ownership and control of the business and offsetting the high risk the investor takes. Due to the high risk the investor aims for a high return on the investment. However, a comparison of the later stages (private equity) such as expansion, mezzanine, consolidation and workout is also discussed in this section. Table 3.1 shows the differences of the modes of financing listed.

If we look at the operations of the venture capital, we can see that it is a mixture of the concept of Mushārakah and Mudhārabah. The concept of the Mudhārabah looks similar to that of the venture capital in the sense that the shareholders become the provider of the funds and the entrepreneur runs the business, but the venture capitalist still intervenes with the management of the business especially when the company is in a grave position. It also depends on the agreement, as entrepreneur at times do need the venture capitalist to guide them with the business expertise they have. Furthermore, there is no shareholding involved in a Mudhārabah as compared to Mushārakah.

All three are investment based if we are talking about their nature of financing.

If it is investment based it means there is no *riba* involved and it is based solely on investment outcome. The performance on the investment needs to be monitored and valued. From an Islamic perspective this is very much encouraged as one need to take risks when it comes to getting involved in an investment and not getting something out of nothing. The type of financing as shown above in the table focuses on showing its structure in terms of profit, loss and risk sharing. As for the Mushārakah it is clear-cut that all three are present but in the Mudhārabah and the venture capital it may be slightly different. Venture capital focuses on capital gains on their investment and Mushārakah on the profit made by their company. This will be further discussed in the analysis chapters to see how the Mushārakah is applicable in the venture capital setting and how to structure a Mushārakah financing in the private equity area of financing.

In the case of Mudhārabah losses are borne by the fund provider and the profit is shared between the parties involved. This means that in terms of loss and risk sharing it is not spread out as seen in Mushārakah. However, this does not mean that the Mudhārabah is not an efficient financing mechanism. All the Islamic modes of financing are devised to be utilized for specific purposes. Tenure of financing for both Mushārakah and venture capital is on a long-term basis. For the Mudhārabah and financing at the later stages, it depends on the business and its industry. All three mode of financing does not require any collateral except for the later stage financing or at the mezzanine stage where borrowings are involved, then collateral may be condition for such financing. This is an important factor for all three mechanism of financing as compared to the banks.

In terms of asset ownership the Mushārakah applies ordinary shares and the venture capital utilizes both ordinary and preference shares. There is no shareholding involved in a Mudhārabah and the later stage preference shares and debt are utilized. The rate of return for the Mushārakah and Mudhārabah is allocated through its profit sharing ratio whereas for the venture capital and at the later stage, it is allocated through the dividend of their shareholding. The dividends are further discussed in the analysis chapters in terms of its Shari'ah compliancy.

When Islamic jurisprudence is concerned in Malaysia, "separate Islamic legislation and banking regulations operate side-by-side with those for the conventional banking system. The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA), which came into effect on the April 7th, 1983. The IBA provides BNM with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks."[100] Any cases involving Islamic banking and finance products will be covered under the Shari'ah law or the Civil law. Table 3.1 below summarizes the features of each mode of financing as discussed in the paragraphs above.

[100] *BNM Islamic Banking*. (n.d). Retrived August 13, 2006 from http://www.bnm.gov.my/index.php?ch=174&pg=467&ac=367

Table 3.1: Differences between Mushārakah, Venture Capital, Mudhārabah and Private Equity (Management Buy-Out and Buy-In Stage)

Nature of financing	Equity Financing-Investment Based (Mushārakah)	Equity Financing-Investment Based (Venture Capital)	Equity Financing-Investment Based (Mudhārabah)	Equity Financing-Investment Based (late stages)
Type of Financing	Joint Venture – Profit, loss and risk sharing	Joint Venture - Profit Sharing as applied in a Partnership	Joint Venture - Profit Sharing but not risk sharing	Joint Venture - Profit Sharing as applied in a Partnership
Tenure	Long-Term: 3 to 5 years	Long-Term: 3 to 7 years, depending	Depending on the business	Depending on the business
Collateral	No	No	No	No
Asset Ownership	Equity Ownership through ordinary shares	Preference shares, convertibles preference share etc.	No shareholding involved	Preference shares, convertibles preference share, debt etc.
Rate of Return	Profit ratio	Dividend through preference shares	Profit ratio	Dividend through preference shares
Legal	Syariah and Civil[101] law	Civil Law	Syariah and Civil law	Civil Law

3.6.1 Financial Advantages

The financial advantages benefited by the companies or parties involved in the joint venture would be highlighted on the prohibition of interest, risk sharing, clarity of contracts, effective use of capital, prohibition of speculative behaviour and Shari'ah approved activities. The fixed, predetermined rate of return embedded on the maturity or amount of principal is prohibited. The wealth accumulation and distribution should be fair and just and representative of hard work and capital efficient capital utilization. The risk sharing feature gives the venture capital companies and the company the advantage to share some of the risk on the venture and in return both parties get some share of the profits. The clarity of the contract ensures that transparency and

[101] The Civil law in Malaysia has a section that covers issues on Islamic Banking products.

contractual obligations are met, as they are sacred duties (the clarity of the contract is further explained and analysed in the analysis chapters). The involvement in fraud would lead to some type of legal punishment.

The effective use of capital is when money or assets treated as capital, is used with other productive resources. Islam only recognizes the time value of money when it is behaving as capital as it is utilized efficiently and to it's fullest. Hoarding is discouraged and transactions featuring uncertainties are barred so transparency becomes a crucial issue. By not involving oneself in hoarding and getting involved with transactions that are uncertain, speculation may be eliminated. The financial advantages pointed out through the elements stated above would only give the parties involved a win-win situation, as both are responsible on the venture since they have a stake in it.

3.6.2 Issues in Mushārakah

Issues in Mushārakah arise at the point where it is applied. In the banking sector moral hazard and information asymmetry becomes a concern since the fund provider in this case does not conduct monitoring on the investments or the invested company as done by the venture capital. The nature of a banks operation is mainly to act as a fund provider and not to operate like a venture capital. Since the banks may have shares in these invested companies they may have to appoint a special unit to monitor them. This may incur extra cost to the banks. Other than that the Mushārakah is exposed to increased risk and less liquid since it is asset backed, the bank would require higher liquidity and reserves. This would definitely affect the reserve ratio of the bank, which is not a bad thing only that the calculation is done differently. This extra risk may be transferred to the depositors as well, since the profit from the investment is shared with the depositors.

Another issue is on the valuation of asset for the Mushārakah. It is a long-term financing and its valuation has to be periodically and may be subject to inaccuracy. In the case of Islamic private debt securities and the *sukuk* applying Mushārakah or any other concept such as Mudhārabah, Ijarah and Istisna, it raises issues in the area of accounting and valuation. This is due to differences in relation to the conventional accounting standards. According to the jurists of Malīkī School they have classified trading assets into three categories: [102]

- Assets that are meant for buying and selling
- Assets that are held for sale in the expectation of making profits through price appreciation in the future
- Assets acquired for trade and not personal use

However, in the conventional classification of investment securities, it is classified into two types, which is either dealing (short-term) or investment (long-term).[103] If we look at the classification that is outlined by the Malīkī jurists it is more elaborate on its application while the conventional classification only focuses on the investment on a business perspective only. The difference in terms of classification raises other issues in the area of valuation.

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[102] Abdul Rahman, Abdul Rahim (2002). Accounting Regulatory Issues on Investments in Islamic Bonds. *International Journal of Islamic Financial Services* Vol.4. No.4. Retrieved August 19, 2006, from http://islamic-finance.net/journal.html

[103] Ibid

Another important section that becomes an issue is in the legal area. Based on a case in Abu Dhabi[104] whereby the plaintiff, owner of a piece of land in Abu Dhabi applied to the Dubai Islamic Bank for a loan to be charged against his land. The Dubai Islamic Bank proposed partnership in exchange for money. Then both parties signed a Mushārakah Mutanaqisah contract on May 1st, 1995. A dispute arose when the customer applied to the court to declare the transaction null and void as the sale of land is prohibited under the local law of Abu Dhabi, the bank claimed that the Mushārakah Mutanaqisah is not a sale contract. The bank had earlier paid 2.3 million dirham to the chargee bank of the customer.

The May 1st, 1995 contract was a loan contract amounting to 4,888,000 million dirham at 12% interest payable within 4 years and both parties appealed. The claimant asked the court to review the 12 percent to 9 percent interest payable within eight years. The Dubai Islamic Bank appealed to review the previous judgement and to declare it not a loan but as a Mushārakah Mutanaqisah. The judgement is said to conflict with section 3, 1985 pertaining to the Islamic Financial Institutions. The Court of Appeal held that, although the contract was called Mushārakah Mutanaqisah it was in substance, a sale from the customer to the bank, thus there is a conflict with the local law of Abu Dhabi. It was declared null and void.

If we look at this case, it is evident that there is no merge of information between the Islamic law and the conventional. This becomes even more troublesome should there be fraudulent cases and there is no law to fall back on. The legal aspects for the Islamic financial products and cases pertaining to it need continuous process

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[104] Daud Bakar, Mohd. (2006, July 17) *Workshop on Islamic Banking and Finance: Legal Framework Governing Islamic Financial Services in Global Market.* Presented at the Judicial and Legal Training Institute (ILKAP).

and proper documentation for further reference. If we look at the issues discussed above and compare it with the equity section in the Mushārakah, we can see that it fits the picture more appropriately in contrast to the venture capital which operates similar to that of the profit-loss sharing contract. You can see that a venture capital has both features of the Mushārakah and Mudhārabah in terms of profit-sharing and management sharing.

However, if we are trying to structure a Mushārakah fund in the venture capital there are other factors that needs to be examined because the aim of a venture capital are capital gains whereas in a Mushārakah it concentrates on the company's profit itself. Other than that, in term of losses it is treated differently in the venture capital setting as compared in the Mushārakah. This will be further discussed in the analysis chapters. The issues concerning Mushārakah give us an idea of the factors or areas that need to be covered in the analysis later on.

3.7 Mushārakah in Malaysia

The potential for Mushārakah in Malaysia in the area of venture capital is in its infancy. Although CIMB (Commerce International Merchant Bankers Bhd) had structured the CIMB Muamalat Fund 1 which is a Shari'ah compliant fund, there is still room for other venture capital in Malaysia to take the same step. There has recently been a $50 million venture capital fund launched by the Islamic Development Bank (IDB) that is targeting high tech ventures in Muslim countries. The Census results show that there are 518,996 small medium enterprise (SME) that represents 99.2 percent of total business establishments in Malaysia, while large enterprises (LE) consists of 4136 business establishments in Malaysia.[105] 411,849 micro enterprises make up 74.9 percent of the total SME's and 78.7 percent of the overall business in Malaysia.[106] Based on the Census[107] the majority of SMEs are concentrated mainly in:

- Agriculture
- Manufacturing
- Services

The SME can become an excellent platform to engineer financing through Islamic venture capital or Mushārakah funds for *halal* businesses. The above examples show us that the potential for Mushārakah funds in a venture capital or as a financial institution is huge especially with the emergence of the *halal* food industry and for other industries as well. Malaysia can establish partnerships with other Muslim countries. As mentioned by K. Salman Younis the managing director of Kuwait Finance House (Malaysia) Berhad, "Mushārakah is definitely one of the most effective ways which can be used to help drive the *halal* industry in Malaysia and other countries. However, the success of this form of financing also depends on the Islamic banking community having the expertise in the *halal* business".[108] "Musharakah is one of the four approved Shariah principles together with isti'na, ijarah and mudharabah - that provide certain tax (Malaysian) benefits to the issuer," said Mohamad Safri Shahul Hamid of CIMB Islamic.[109]

In the banking sector Mushārakah is also used as a financing tool in most

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[105] *Status and Performance of Small Medium Enterprise.* (n.d.).Retrieved February 15, 2007, from http://www.bnm.gov.my/files/publication/sme/en/2006/chap_2.pdf
[106] Ibid
[107] Ibid
[108] *The Musharakah Attraction.* (n.d.).Retrieved November 8, 2006, from http://www.halaljournal.com/artman/publish_php/article_1005.php
[109] Ibid

Islamic banks that offers Islamic banking products. However, Mushārakah does not appeal much to the banks due to mismatch of maturities of the assets and liabilities in the bank's balance sheet and as a result liquidity risk emerges. In addition, a moral hazard and information asymmetry issue also makes Mushārakah financing less attractive to be offered by the Islamic banks. Furthermore, banks just provide the funds and do not take part in the management, but in a Mushārakah the parties involved must take part in the management of the business or the investment.

3.8 Equity Financing

Equity financing in the Islamic economy focuses on the profit and loss sharing basis. In addition, it also shares management of the business as well. It has ownership and some control in the business through shareholding. This way it encourages partnership and joint venture to pull capital rather than borrowing. This also creates partnership between the fund suppliers and the fund demanders. However, ownership can become an issue because the pioneer of the business may have to give away huge portions of their share to the investors and have lesser control in the company.This is one important point in equity financing that is needed to be pointed out, because it can be a disadvantage for the Mushārakah especially in the venture capital setting. The disadvantage in this matter would be on the entrepreneurs' side where they have to give up ownership and control of their company to the shareholders. On the other hand interest is not present in this case because the equity finance investors do not have rights to interest which are to be paid at a certain date. They are to be paid in dividends and this depends on the value, growth and profitability of the business. Equity finance investors also get their returns from the capital gains of the shares sold upon exit. Two sources of equity financing would be that of the venture capital and the business angels. Both are used for high growth business especially venture capital whereby the shares will be placed in an exchange upon exit. The role of equity financing is vital in the economy as it becomes an alternative for debt financing.

3.8.1 The Role of Equity Financing

Equity and efficiency are some of the pillars in the Islamic economy. To obtain equity and efficiency we need instruments, Shari'ah guidelines, human resources, and stable political infrastructure. Current instruments that are widely used in the Islamic banking and finance are Murabaha, Mudhārabah, Mushārakah, Muqarada, Ijarah, Salam, Istisna, Sukuk and Bay Bithamin Ajil (BBA). From the instruments listed two of are equity based which is the Mudhārabah and Mushārakah. Both are equity and investment based but the difference is that in the Mudhārabah management is not shared between the fund provider and the entrepreneur. In the Islamic economy the role of equity financing is important due to:

- Stabilizing economy through equity participation
- Foreign Equity Capital
- Promoting Small and Medium Enterprise (SME)
- Lessen poverty rates and instil brotherhood among Muslims

The first point that concerns stabilizing the economy through equity participation such as using profit-loss sharing contracts such as the Mushārakah can ensure fairness between the entrepreneur, investors and the partners involved. The profit-loss sharing and the profit rates determined by the partners are done based on the amount of capital given and how much profit they get depends on the performance and growth of the business. The distribution of profit and return of capital between the partners, entrepreneurs and the investor would be determined by more equitable economic reasons rather than on speculative market forces. Given the fairness of the profit-loss sharing feature it makes equity participation a comfortable avenue for investments and joint venture between partners, investors and entrepreneurs. Equity participation in this case would mean co-operation between businesses within the country itself, other Islamic countries and countries with large Muslim minorities. For instance, an Arabic entrepreneur may seek Malaysian venture capitalist to start up a business.

The Mushārakah may have high risk but it specifies more on resource mobilization, social justice and fair distribution of profit and resources. Although high risk but the profit is earned in a moderate manner and not based on speculation that would only increase the risk and losses of an investment. The degree of losses from risk taking through a profit-loss sharing contract and speculation are totally different. In a profit-loss sharing contract losses are spread out and the idea of shared management would give a cushion to the parties involved in the investment. In other words, what you invest and what you work for is what you obtain. The element of risk must be present. Based on the finance theory in the conventional economy, a higher risk would always lead to a higher return. However, the future remains uncertain, as always, therefore, a higher risk would also mean high losses. This should not be a disadvantage simply because interest overburdens individuals and companies during the recessionary period because interest payment is an obligation. Frequency of the income is far off better although in small amounts, rather than hoping and speculating to receive a bigger sum at one shot. A level of moderateness is very much encouraged in Islam as it opposes extremism of any kind.

The next point is on foreign equity capital. Equity finance gives a good platform for foreign equity capital especially in the developing countries. The exchange of technology, management skills, and financial skills are vital in the developing countries and with this avenue of financing it can help to build their economies through increases in employment and establish small and strong businesses. This is the same technique done by the Mexican government through the "maquiladora" program. "Maquiladora is a Mexican Corporation which operates under a maquila program approved for it by the Mexican Secretariat of Commerce and Industrial Development (SECOFI). A maquila program entitles the company, first, to foreign investment participation in the capital and in management of up to 100% without need of any special authorization.

Second, it entitles the company to special customs treatment, allowing duty free temporary import of machinery, equipment, parts and materials, and administrative equipment such as computers, and communications devices, subject only to posting a bond guaranteeing that such goods will not remain in Mexico permanently. All of a maquiladora's products are exported, either directly, or indirectly, through sale to another maquiladora or exporters. The type of production may be the simple assembly of temporarily imported parts. The manufacture from start to finish of a product uses materials from various countries, including Mexico or any conceivable combination of the various phases involved in manufacturing, or even non-industrial operations, such as data-processing, packaging, and sorting coupons."[110]

The maquiladora gives us an idea to structure an avenue for foreign equity capital in the Mexican economy. This can be done through Mushārakah and equity finance. Apart from discussing foreign equity capital, through equity finance every country has different unique resources that are needed by some other countries.

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[110] Baz, Aureliano Gonzalez. *What is a Maquiladora?* (n.d.). Retrieved November 7, 2006, from:http://www.udel.edu/leipzig/texts2/vox128.htm

Through foreign equity capital such resources can be equally manufactured and shared for the good of mankind. Other than that the tax system can be slowly structured in an Islamic way which will be fair for both parties that are involved. Furthermore, both parties involved share the risk. Through the establishment of the partnerships through joint venture or through venture capital financing it will create an environment of financial policies following the guidelines of the Shari'ah principles and this will further motivate other poorer Muslim countries to participate. The Islamic emphasis on the fulfillment of all contractual obligations would provide the confidence that the foreign investors need. This if executed will leave little room for fraudulent cases. This also helps to boost investment and in the creation of new products and services. These new products and services would later on be exported and thus the particular country work on becoming a country that "supplies" rather than just purchasing foreign goods.

The third point is on promoting SME's (Small and Medium Enterprise). SME's are very important in this case because it can be a major contribution to employment and income. They create new jobs, products and services. Poor Muslim countries have a big supply of labor but lack educational infrastructure for vocational and professional training. Therefore, the SME can be an avenue for people to get employed or be self-employed. In Italy for example, artisans who are often working in a family business are a main factor behind the success of Italian jewelry, gold, silver, leather working, embroidery, glasswork, furniture, pottery, shoemaking, and cloth manufacturing.[111]

Every country has it own unique resources and with the existence of the

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[111] Friedman, Alan. (1987, September 15) Italian Small Business: The Backbone of the Economy Explored. *Financial Times*.

SME's these resources can be explored and utilized to the fullest for domestic use and also for export. Apart from that, current existing sectors available in the country can be further nurtured slowly through research and development. SME's are more labour intensive and in most countries they get help from the government. Equity financing through Mushārakah joint ventures or through venture capitalists can help to assist these small businesses to enter the market. They are there not only as an investor or a fund provider but also to guide the business. New ideas and concepts can be put forward and when produced and marketed successfully would help to increase the economy of a certain country. It may not have an impact such as the larger industries, however with many small businesses it spurs competition and creativity and this helps to increase growth and performance in the company.

Last point is on how equity financing can alleviate poverty in a country. The shared management feature in a Mushārakah is a good tool in strengthening brotherhood among the Muslims and through entrepreneurship. Given the rate of success of the business, it can also be on an international scale. Apart from that, the zakat paid by these small businesses can help to eradicate poverty within the area that the company is operating. If there are many smaller companies in the country then there will be more zakat paid. Another way how the SME can overcome poverty is through the employment opportunities that is offers. Due to more people working it creates other demands and supplies that help shape the economy of a particular area. In response to more money flowing and more transaction at hand plus with fair distribution of wealth through zakat the problem of poverty can be overcome. A good instrument such as the Mushārakah can boost the SME among other Islamic countries.

3.8.2 Comparisons between Equity and Debt

The financial instruments as a mode of financing and its contracts operate with risk and uncertainty when used as a financing medium in any business transaction. Equity is widely and most commonly used which can be deduced from the literature review on venture capital. Debt on the other hand is normally used in the mezzanine and consolidation stage in the Malaysian venture capital industry. The debt contracts as opposed to equity may increase the return on equity of a certain company, due to tax exemption of the interest. However, problems persist should the interest is not be paid and the company may be filed for bankruptcy. Apart from that, regardless of the invested companies' performance, it is still an obligation to pay the debt.

The difference between equity and debt lies in terms of risk allocation, ownership rights, management and incentives. Equity financing is money raised by the business and provided by the venture capitalist in exchange for a share of ownership within a company. In equity financing, the business owners sell shares in their company for an agreed amount of cash. However, debt financing are borrowed funds by the entrepreneur that is needed to be paid up front at a specific period of time, including the interest. Debt financing is normally used in the later stage of the company and can be issued on a long-term or short-term basis.

Equity financing which uses instruments such as ordinary shares puts the investor in a risky position when the business fails. However they get voting rights and manage the company. As for preference shares, shareholders do not get voting rights but receive fixed dividends. Some preference shares may be issued in the form of convertible preference shares, whereby it can be converted into ordinary shares. This type of preference shares is permissible in Islam and approved by Shari'ah. Preference shares help to protect the investors' share in the investment or the invested company should it take a downturn. Upon exiting from the invested company, they get capital gains from their shares. Debt holders on the other hand, would benefit from the situation even though they do not manage the business. If a company uses debt, the return on equity for the company increases as compared to using just equity due to the tax shelter provided by interest and due to the high risk borne by the shareholders for using debt financing, placing them last in the list when company assets are liquidated due to bankruptcy.

When applying debt financing and interest are not paid, it is considered a liability to the company and again assets may be liquidated to pay off the interest. From the financier's side, debt would look more lucrative as compared to equity financing because financiers do not hold high risk and still get fixed return through interest without taking part in the business. From the entrepreneur's side debt would be a burden because it is a financial obligation and a liability to the company. Equity would be more promising to the entrepreneur since ownership are shared together with the financier, especially in the case of a venture capital. In this case, both venture capitalist and the entrepreneur work together to increase the value of the capital provided by the venture capitalist. Table 3.2 summarizes the pros and cons of equity and debt.

Table 3.2: Pros and Cons of Debt and Equity Financing

Debt	**Equity**
Interest repayment	Receive dividends
Need collateral	Do not need collateral
Debt providers are not risk takers. They just want to make sure that the interest are paid	Equity holders are risk takers as they have stakes in an investment that is tied to the investment performance.
Do not have voting rights	Have voting rights
Interest is tax deductible	Dividends are not tax deductible
Loans need to be paid	Equity can be kept for long-term investment
Leverage company's profit	Shareholders share the profit of the company

3.9 Islamic Venture Capital

The structure of an Islamic venture capital is one that is still in discussion. Last year in Bahrain, the Venture Capital Bank (VCBank) was approved and licensed to operate by the Bahrain Monetary Agency on May 5, 2005 and carrying the name of Venture Capital Bank (VCBank) it will be the first venture capital bank that is compliant with Shariah principles.[112] "As part of its management setup, VCBank has put in place a thorough process whereby it engages its Shariah Advisory Board before it commits itself to an investment opportunity through a rigorous compliance system that identifies the nature of the business of each target company and the manner through which financing will be structured around each deal, thus ensuring Shari'ah certification for each investment prior to any commitment."[113]

"VCBank will invest in fundamentally strong undervalued, finance-seeking small to medium enterprises (SME's) with market and revenue growth potential, in addition to a vast array of real estate investment opportunities given the increased demand and appetite for real estate investment products especially in the GCC."[114] From the above mentioned we can see the potential of the structure of the Islamic venture capital. The only difference in this case is that the above follows the operations of a bank whereas in this study we focus more on the mechanics of the venture capital itself as a financier in the small and medium industries. Furthermore, in this study we focus on how the conventional venture capital can stucture a fund that is Sha'riah compliant such as Mushārakah. In comparison between an Islamic bank

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[112] *First Ever Venture Capital Bank Launched in Bahrain.* (n.d.).Retrieved September 14, 2006, from http://www.ameinfo.com/62142.html

[113] Ibid

[114] *First Ever Venture Capital Bank Launched in Bahrain.* (n.d.).Retrieved September 14, 2006, from http://www.ameinfo.com/62142.html

and a conventional bank, the difference between the Islamic venture capital and its conventional one is that it does not engage in *riba* and minimal in *gharar* where the contracts and pricing are concerned.

In addition to that the Islamic venture capital operates within the guidelines of Shari'ah, which is the essence in the Islamic economy itself. Although the venture capital operations may have several similarities compared to that of the Mushārakah or the Mudhārabah this is not the case in all aspects. This can be seen through the principles of the Islamic economy which are:

- Allah (S.W.T) as the sole owner and creator of all
- Abolition of interest
- Profit-sharing under economic cooperation between labour and capital
- The institution of charity
- Instilling moral values through Islamic education.

These economic principles would become a benchmark in evaluating the level of Islamic values instillation and application into the economy.

3.9.1 Allah (S.W.T) as the Sole Owner and Creator of all

All that is created in the universe belongs to Allah (S.W.T) Humans as the vicegerent on earth would only adhere to Allah's rules and laws managing resources with the guidelines given in the Al-Qu'ran and the prophetic tradition (Hadith) of the Prophet Muhammad (S.A.W) If one achieves success and claims that it is purely obtained from his hard work, this would contradict the Islamic belief because Allah (S.W.T) is the sole judge of this world and gives sustenance to his creations. It is with the will of Allah (S.W.T) that makes a person succeed or fail. The Islamic economy is an economy based on the criterion of *Rabbani*, whereby an individual drive towards actions is in the name of Allah S.W.T. This is a moral filter to ensure the moral performance of the Islamic economic system including the Islamic venture capital and the Mushārakah funds. Business transactions are not just to obtain profit only, but it is also an act of *ibadah* to help the society as a whole.

3.9.2 Abolition of Interest

The abolition and forbiddance of *riba* or interest has been stated in the Al-Qu'ran on several occasions. For example,

> *Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitteth trading and forbiddeth usury. He unto whom an admonition from his Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returneth (to usury) – Such are rightful owners of the fire. They will abide therein.*
>
> (Al Qur'an. Al-Baqarah 2: 275)

The definition of interest, the literal meaning of interest or *Al-Riba* as it is used in the Arabic language means to excess or increase. In the Islamic terminology interest means effortless profit which comes free from compensation or that extra earning, obtained that is free of exchange. *Riba* has been described as a loan with the condition that the borrower will pay more than the amount borrowed. In other words *riba* or interest is the cost of borrowed money. The present economy is associated with interest, it becomes an indicator to analyze a country's economy and used as an instrument in their monetary policy, currency and also their financial exchange performance.

3.9.2.1 Riba al-Buyu`I

Riba (Usury) is of two major kinds which are *riba al-Buyu`I* and *riba al-Qardhi. Riba al-Buyu`I* is the type of *riba* that occurs on the exchange of goods and involves payments. This *riba* is divided into three categories:

- ***Riba al-Fadhli*** – Selling of *ribawi* items whereby the excess is taken in exchange of specific homogenous items and through hand-to-hand purchase. For example, the sale of wheat and wheat in different amounts or taking a superior one of the same kind of goods by giving more of the same kind of goods of inferior quality, e.g., dates of superior quality for dates of inferior quality in great amounts. The addition in this transaction is considered as *riba* and it is *haram*. This is stated in a hadith by the Prophet Muhammad (S.A.W) :

  > *Abu Sa'id al-Khudri (Allah be pleased with him) reported, Allah's Messenger (may peace be upon him) as saying: Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, salt by salt, like by like, payment being made hand to hand. He who made an addition to it, or asked for an addition, in fact dealt in usury. The receiver and the giver are equally guilty.*
  >
  > (Sahih Muslim) Book 010, Number 3854

- ***Riba al-Yad*** – The selling or exchange of different *ribawi* items in cash but either one of the goods is delivered later.

- ***Riba al-Nasi`ah*** – The selling of different *ribawi* items on deferred terms, and when the goods arrived at the seller could not pay it, then the tenure is added together with the addition in payment.

3.9.2.2 Riba al-Qardhi

This type of *riba* is a contract on debt or loan for a specified tenure and additional payment on the debt or the loan. This is similar to that of the interest practised in conventional banks. It is vital to know the categories of *riba* to avoid it in any transaction in the Islamic financial system. *Riba* or usury widens the gap between the rich and the poor. The velocity of money increases with interest embedded to the principal of the borrowers. Inflation then comes into the picture when the velocity gets out of control and prices start to increase due to increase of money supply. Goods become more costly and the poor may not afford it. In most cases we see that the rise in prices is faster compared to that of return on wages.

Interest charged by banks and other credit companies has created a loophole in the economic system and with the power of compound interest with higher frequency; the effective rates are higher compared to the nominal rates. Savings then becomes attractive due to the increase in wealth through returns in interest. Money is held and not spent for the prosperity of the *ummah*. In the Islamic economy spending as mentioned here is by doing it in the name of Allah (S.W.T). The effects of *riba* are humongous on the economy. The compounding effect of the interest puts heavy financial burden on the borrower. We should then equip ourselves with knowledge so that we know which transaction is permissible in Islam and whether *riba* is attached to it or not.

3.9.3 Profit-sharing under the Economic Co-operation between Labour and Capital

The next point on the Islamic economy touches on profit-sharing under economic cooperation between labours and capital. This can be achieved through Islamic venture capital with the assistance of the Mushārakah funds. Furthermore, it coincides with the outlook of the Islamic economy, which is to make spending as the basis of resource mobilization in terms of charity, *zakat* and investments. The existence of the Islamic banks has opened the gate for investors to invest based on the

Islamic way. There is no return from the interest embedded to the deposit. Risk is shared between agents and sectors in terms of the magnitude of the businesses. One of the criterions of the Islamic economy is also based on the concept of *Akhlaqiyyah* and *Insanniyyah*. Profit sharing under economic cooperation between labour and capital justifies the concept of *Insanniyyah* whereby profit is obtained not at the expense of others. In the Islamic economy profit and risk are both shared between the buyer and the seller. Several Islamic bank products were introduced on this concept such as the Mudhārabah, Mushārakah, Bai' Bithaman Ajil and etc.

The Islamic financial product do not have high risk as it specifies more on resource mobilization and for social justice. Profit is earned in a moderate manner and not based on speculation that would only increase the risk and losses of an investment. Based on the finance theory in the conventional economy, a higher risk would always lead to a higher return. However, the future remains uncertain, therefore, a higher risk would also mean high losses. Interest overburdens individuals and companies during the recessionary period because interest payment is an obligation. Frequency of the income is far off better although in small amount, rather than hoping and speculating to receive a bigger sum at one go.

3.9.4 The Institution of Charity

The fourth point is on the establishment of charity in the Islamic economy which focuses on the less unfortunate group of people in society. The poor who are employed in the economy are contributors to the growth factor as well and should not be forgotten. Being poor and surviving in an economy that is far from applying the concept of *Insaniyyah* would imply a hard living. The poor can never maintain their standard of living or match up to the cost of living within the country. This is when *zakat* comes into the picture. The *zakat* paid by the small business can further help the poor. If the number of small business emerging through the Islamic private equity or venture capital industry increases, the amount of *zakat* will also increase. It is compulsory for those who can afford to pay to make the payment of *zakat* to the categories identified in the Quran. Apart from the *zakat*, another type of charity would be in the form of *waqaf*, whereby land that is of no use would be donated to the Baitulmal. Houses, mosques and schools are built on these donated lands for the poor and thus would generate social benefit to the economy. The Al-Azhar University, in Egypt under the Fatimid dynasty was built on the concept of *waqaf*.

3.9.5 <u>Instilling Moral Values through Islamic Education</u>

Islamic moral values among the Muslims are vital in ensuring the fiscal transparency in the financial integration in managing the components within the Islamic economy and also within the Islamic venture capital and private equity industry. Islamic studies and the study of the *Al-Qu'ran* and *Hadith* play an important role. Islamic studies taught in colleges and universities are important in order to create Muslim workers and entrepreneurs whereby, they are equipped not only with Islamic revealed knowledge but also on other subjects such as total quality management, cost accounting and other Islamic finance and management related topics.

Looking at the foundations of the Islamic economy we can see what is expected of that in an Islamic venture capital. From the structure of the Islamic venture capital itself we can establish funds that are Shari'ah permissible based on modes such as Mushārakah, Mudhārabah, Diminishing Mushārakah and others which can be applied in the equity and debt financing in the venture capital industry, be it Islamic or conventional.

3.10 Survey of Empirical Study

Based on the literature review, several researches were extracted as a guide for this research. These researches give an idea on what methodology to apply and the sample needed for it. Apart from that, it also helps in identifying the problem statement and formulating research questions for this research. These researches are compared with one another to see areas that can be further improved through this research. The first six researches and articles as stated below are the most important and rated very useful in this research. The remaining five articles which are mainly by Saad Al-Harran are still important and useful for this research. However, the research focused mainly on the application of Mushārakah in the microfinance industry and not in the venture capital industry.

Sami Al-Suwailem mentioned that from an Islamic point of view venture capital is based on equity financing (*sharikat inan*), and thus falls within the framework of Islamic finance. Secondly, he highlighted that it combines economic viability and Islamic guidelines which makes it a promising option for Islamic financial institutions[115]

Masudul Alam Choudhury critically examined the Mushārakah and Mudharabah as modes of mobilizing venture capital in Islam. Masudul Alam Choudhury stated both these instruments would be capable of bringing about extensively co-operative and co-ordinated participation among agents, firms and sectors.[116]

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[115] Al-Suwailem, Sami. "*A Potential Model of Musharakah*". Retrieved December 21, 2004, from Academic Publication Center, Graduate Studies and Academic Research Vice-deanship, King Abdulaziz University in Jeddah. Website: http://www.kaau.edu.sa/CENTERS/SPC/page-091.htm
[116] Choudary, Masudul Alam (2001), Islamic Venture Capital – A Critical examination, *Journal of Economic Studies*, Volume 28 Number 1. pp.14-33.

The two articles stated above gave a good idea on how to start this research. However, these articles do not cover extensively on how the profit-loss sharing instruments are applied in the venture capital industry. A comparison of the venture capital and the profit-sharing loss instruments mainly Mushārakah and Mudhārabah were carried out to analyse in terms of Shari'ah compliancy. These two articles give an idea on the advantages and disadvantages of applying the Mushārakah in the venture capital industry.

Tariq Al-Rifai and Aamir Khan in their article on "The Role of Venture Capital in Contemporary Islamic Finance" stated the type of funding available in the venture capital industry and analysed how it can fit into a Shari'ah compliant structure. Shari'ah views on equities and fundamental Shari'ah principles are also discussed. Structuring issues are also mentioned pertaining to the instruments used in the venture capital to see their level of Shari'ah compliancy.[117]

Saqib Rashid in his paper "Islamic Finance and Venture Capital: A Practical Approach" attempts to increase the awareness of the prevailing US-based venture capital model as an acceptable Islamic investment vehicle by providing a critical analysis of this mode of financing in the context of Islamic economic principles. An analysis of the venture capital from the Shari'ah perspective is written and has become an excellent source of reference for this study. As stated by Saqib Rashid, the article he had written makes a case that establishing a venture capital industry is essential not only for further evolution of the Islamic finance industry, but also for the

[117] Al-Rifai, Tariq, & Khan, Aamir (2000). *The Role of Venture Capital in Contemporary Islamic Finance*. Retrieved December 21, 2004, from Failaka International Inc. Website: http://www.failaka.com/Library/Articles/VC%20in%20Islamic%20Finance.pdf

long-term health of the ailing economies of the Muslim world. [118]

The researches by Saqib Rashid, Tariq Al-Rifai and Amir Khan provide a critical analysis of the venture capital in the context of Islamic economic principles. The instruments used in the venture capital were analysed to see their level of Shari'ah compliancy. This helps this research in analyzing the instruments appropriate for Mushārakah financing in the venture capital.

Habib Ahmed examines the operational structure of the financial institution and its implication towards managing risks pertaining to financing.[119] He analyzed the organizational structures for debt and equity financing through analyzing credit, liquid and operational risks. His research showed that the organizational structure of the venture capital firm is an appropriate model for minimizing the risks involved in equity financing.

Tariqullah Khan analysed the capability of redeemable financial instrument as a means to provide a comprehensive financing mechanism.[120] He argues that redeemable financial instruments are also expected to promote self-financing and ensure growth. He mentioned that sale-based finance can be made subordinate to the profit and loss sharing (PLS) instrument and can enhance cash flow of Islamizing enterprise.

Habib Ahmed and Tariqullah Khan researched more extensively on the financial advantages of profit-loss sharing contracts in the Islamic banking and

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[118] Rashid, Saqib. (2005). Islamic Perspectives on Wealth Creation. Iqbal, Munawar & Wilson, Rodney. (Eds.), *Islamic Finance and Venture Capital* (pp. 228-248), Edinburgh: Edinburgh University Press.

[119] Ahmed, Habib (2005). *Operational Structure for Islamic Equity Finance: Lessons from Venture Capital.* Retrieved July 11, 2006, from Research Paper No.69, Islamic Research and Training Institute, Islamic Development Bank. Website: www.irtipms.org/OpenSave.asp?pub=212.pdf

[120] Khan, Tariqullah (1995). *Redeemable Islamic Financial Instruments and Capital Participation in Enterprises.* Retrieved June 20, 2005, from Research Paper No.29. Islamic Research and Training Institute, Islamic Development Bank. Website: www.irtipms.org/OpenSave.asp?pub=32.pdf

finance industry. Habib Ahmed used the venture capital operations as an appropriate model for minimizing the risks involved in equity financing in banks. This will give a guideline on how to manage risk in Mushārakah financing in the venture capital. In Tariqullah Khan's research which stated that profit and loss sharing (PLS) instrument can enhance the cash flow of Islamizing enterprise only shows the financial advantage of the Mushārakah financing.

Mustafa Gamal –Eldin Abdalla discusses problems arising in the microfinance enterprise and investigates the suitability of Mushārakah financing for small enterprises.[121] He stated that the Mushārakah financing protects against the depletion of resources due to inflation. Other issues related to Mushārakah financing such as monitoring, trust, tax, and transaction cost were discussed.

Saad Al-Harran suggested Mushārakah as a financial tool to help the poor and utilize this fund effectively by looking at the present Malaysian economic system. He also mentioned that the system of profit sharing would be able not only to bring about greater efficiency in the allocation of resources but also reduce the concentration of wealth and power. He added that the proposed bank for the poor in Malaysia would then become a strong force for socio-economic change and development.[122]

Saad Al-Harran examines the framework for Mushārakah and analyses the conditions of present day Mushārakah, which are partnership regulated by the government, limited company and co-operative societies. The analysis on equity financing is also highlighted whereby it can meet the needs between consumers and

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[121] Abdalla, Mustafa Gamal-Eldin (1999). Partnership (Musharakah): A New Option for Financing Small Enterprise? *Arab Law Quarterly*, Vol.14 No.3, 257-267.

[122] Al-Harran, Saad, Zakaria, Mustafa, Khalid, Haniza. (1994). *Islamic Marketing Strategy: Eradicating Rural Poverty in Malaysia.* Malaysia: Pelanduk Publications. pp.93.

government as stated by Al-Harran.[123] Saad Al-Harran also suggested establishing Rural Investment Companies in the rural areas to serve the needs of poor fishermen in Malaysia, through the introduction of a new concept of Islamic finance such as the Mushārakah financing. In this case the poor fishermen will be partners with the banks, sharing the profit and losses. Secondly, he mentioned that partnership financing can help make the poor fishermen financially independent, decent human beings and entrepreneurs through time. He commented that a partnership team work has to be created in the banks to identify bankable projects and make them ready for financing and the Islamic bank must achieve high returns to distribute to its shareholders and at the same time maximize social benefit.

Saad Al-Harran cited that one of the objectives of Islamic banks is to supply funds based on profit-sharing principles[124] He mentioned the importance of the PLS funds and it can permeate sound feasibility studies projects and that it will put great responsibility on the Islamic Banks to ensure that the business succeeds. He stated on the structure of the Islamic Investment Companies as a suggestion in assisting the banks with the investments taken.

The first six empirical studies stated above covered the analysis of the venture capital from an Islamic perspective and how it can be structured in an Islamic way especially as a Mushārakah contract. Instruments used in the venture capital were also analysed in terms of Shari'ah compliancy. However, these articles and researches do not analyse the appropriate exit strategy or at which business stage the Mushārakah best applied, which is important in this research. In addition, it does not analyse the

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[123] Al-Harran, Saad (1995). *Leading Issues in Islamic Banking and Finance*. Al-Harran, Saad (Ed). *Musharakah Financing: Concept and Application* (pp. 2-24). Malaysia:Pelanduk Publications Sdn. Bhd.
[124] Ibid. 26pp.

profit distribution and risk mitigation of Mushārakah financing in the venture capital industry. The critical analysis is on the basis of Shari 'ah compliancy only. The applicability of the Mushārakah financing in the venture capital industry is not analysed extensively, which gives an opportunity for this research to do so in terms of financial advantages (risk, return, corporate governance, exit strategy, ownership, liability, legal) and management value-added (trust and knowledge in managing business).

Most of Al-Harran's articles focused on the application of the Mushārakah in microfinance and he also mentioned about equity financing. This gives room to explore how Mushārakah funds can be established in the venture capital. The principles and features of Mushārakah applied in the microfinance area can be of good reference to study on the application of Mushārakah financing in the venture capital business in Malaysia.

All the articles and research papers give us the idea to look into more depth and to investigate factors that are needed to apply Mushārakah in the venture capital business in Malaysia, and to analyse the various aspects of Mushārakah and the venture capital in terms of risk and return, corporate governance, liability, exit strategy, trust and transparency. In addition, these researches also analyses the differences and similarities between the two types of financing. Selection criteria for an investment are also covered in this research.

3.11 Conclusion

The list of subtopics covered in this chapter gives an overview of the Mushārakah in terms of its concepts and principles and to fully understand how it can be applied in the venture capital setting. Apart from that, one needs to know from past experience where the Mushārakah was applied in contemporary finance in various

Muslim countries. This will give an idea on the pros and cons of its applicability in the venture capital. The application of Mushārakah (mainly in banks) in Malaysia is also highlighted as to give an idea on the applicability of the potential Mushārakah financing in the venture capital and examining if Malaysia has the infrastructure for it. The discussion on equity financing was also covered in this chapter. This is to highlight the importance of equity financing, which is the basis of Mushārakah financing and to compare it with debt financing. This chapter is of importance for setting up the interview questions and to study the Mushārakah from a religious and economic standpoint. The collections of empirical studies give excellent guidelines in building the research in terms of choosing the appropriate research methodology, structuring interview questions and to find a platform to explore the potential of Mushārakah for venture capital funding in Malaysia.

CHAPTER FOUR: RESEARCH METHODOLOGY

4.1 Introduction

This chapter focuses on the methodology applied for this research. The research method chosen for this research is the qualitative method. The qualitative research method is another type of research that is different from that of its quantitative counterpart in terms of the area of study, the type of data obtained and its analysis. In sociology, the work of the 'Chicago school' in the 1920's and the 1930's established the importance of qualitative inquiry for the study of human group life.[125] It is also stated that in future qualitative research would be employed in other social and behavioural science disciplines including education, history, political science, business, medicine, nursing, social works and communication.[126] However, this all depends on the area of the research topic and also on the amount of the sample there is to analyze. A comparison between qualitative research and quantitative research is demonstrated below. The qualitative research differs from quantitative research in the following ways:[127]

- The data is usually gathered using less structured research instruments
- The findings are more in-depth since they make greater use of open-ended questions
- The results provide much more detail on behaviour, attitudes and motivation

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[125] Denzin, Norman, K. & Lincoln, Yvonna, S. (2003) 'The Discipline and Practice of Qualitative Research' in Norman K. Denzin & Yvonna S. Lincoln (eds), *The Landscape of Qualitative Research: theories and issues.* (pp. 1). London: Sage Publications Ltd.
[126] Ibid. 1pp.
[127] *Qualitative Research. Techniques* (n.d.). Retrieved July 7, 2006, from http://www.ryerson.ca/~mjoppe/ResearchProcess/QualitativeResearch.htm

- The research is more intensive and more flexible, allowing the researcher to probe since she has greater latitude to do so
- The results are based on smaller sample sizes and are often not representative of the population,
- The research can usually not be replicated or repeated, given it low reliability

Quoting from David Silverman from his comparisons between quantitative and qualitative research, he mentioned that in choosing a method it depends on what we are trying to find out.[128] Furthermore, for both types of research they have various models. The analysis of the results is much more subjective. Therefore, depending on what one is studying and to choose models that are appropriate for the study, David Silverman listed several questions where qualitative research is concern for a specific research:

- What exactly am I trying to find out? Different questions require different methods to answer them.
- What kind of focus on my topic do I want to achieve? Do I want to study this phenomenon or situation in detail? Or am I mainly interested in making standardized and systematic comparisons and in accounting for variance?
- How have other researches dealt with this topic? To what extent do I wish to align my project with this literature?

[128] Silverman, David. (2004) *Doing Qualitative Research: A Practical Handbook Issues*. London: Sage Publications Ltd. pp. 6

- What practical considerations should sway my choice? For instance, how long might my study take and do I have the resources to study it this way? Can I get access to the single case I want to study in depth? Are quantitative samples and data readily available?
- Will we learn more about this topic using quantitative or qualitative methods? What will be the knowledge payoff of each method?
- What seems to work best for me? Am I committed to a particular research model which implies a particular methodology? Do I have a gut feeling about what a good piece of research looks like?

Based on these questions I have decided to choose the qualitative research method for this study. This is supported by the fact that there is a high level of interaction and direct communication with respondents. The qualitative research method used is the content analysis and the data collection strategy used to collect data for analysis is through a survey. Under the survey strategy I used the semi-structured interview questions to obtain the data. Face-to-face meetings email and telephone interview were carried out. Qualitative research produced large amount of text data and later was transcribed. There are many transcripts that are later analysed and categorized for the analysis. Although qualitative research can be used as part of formal or conclusive research, it is most commonly encountered when conducting exploratory research, which is what is done in this research. Qualitative research techniques are part of primary research.[129]

[129] *Qualitative Research. Techniques* (n.d.). Retrieved July 7, 2006, from http://www.ryerson.ca/~mjoppe/ResearchProcess/QualitativeResearch.htm

4.2 The Rationale for Using Qualitative Methods

Qualitative research seems to promise that we will avoid or downplay statistical techniques and the mechanics of the kinds of quantitative methods used in survey or epidemiology.[130] To choose such methods definitely depends on what the researcher intend to study. As stated by Silverman, that in choosing a method everything depends upon what we are trying to find out and that no method of research, quantitative or qualitative, is intrinsically better than any other. [131] In this study qualitative method are chosen based on these reasons:

- Inline with the research aims, questions and objectives
- Infancy of the area of study
- Small sample size
- Scarce information on the area of study
- To obtain more information about the area of study and also to study the attitudes and behaviour of the interviewees where applicable

The method used for this qualitative research would be the semi-structured interview technique. Interview as a research method can be a very powerful tool as stated by three authors listed below:[132]

- 'The purpose of interviewing is to find out what is in and on a person's mind..., to access the perspective of the person being interviewed.... to find out from them things that we cannot directly observe' (Patton, 1990:278)

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[130] Silverman, David. (2004) *Doing Qualitative Research: A Practical Handbook. Issues* London: Sage Publications Ltd. pp.6
[131] Ibid. 6pp.
[132] Arksey, Hillary & Knight, Peter (1999). *Interviewing for Social Scientists.* London :Sage Publications.pp.32.

- Qualitative interviewing is a way of uncovering and exploring the meanings that underpin people's lives, routines, behaviours, feelings etc. (Rubin and Rubin, 1995)
- These interviews focus on the informants' understanding rather than checking the accuracy of the interviews' account, which is the case with survey interviews and questionnaires; 'it allows both parties to explore the meaning of the questions and the answers involved, which is not so central, and not so often present, in other research procedures' (Brenner et al., 1985: 3)

The points stated above supports the method used in this study. Through interviews and connecting it with qualitative research we are obtaining primary data as opposed to analysing secondary data that we use in quantitative analysis. Firstly, interviewing is chosen in this study as it is not only based on the research questions, aim and objectives, but it is also with this method that we are able to obtain and find factors important for the implementation of Mushārakah in the venture capital company. In addition to that, interviewing is also a systematic collection of data, through asking questions and carefully listening to, and recording or noting the answers[133]. Interviews provide:[134]

- Access to a range of experiences, situations and knowledge that would otherwise be hidden. Interviewees may describe private or sensitive behaviours, events that happened in the past or key locations inaccessible

[133] RAR Technical Guide. (n.d.).Retrieved August 9, 2005, from http://www.who.int/docstore/hiv/Core/Chapter_9.4.html#introduction..
[134] Ibid

to outsiders.

- Information on the meanings and definitions that people give to events and behaviour. This is particularly useful for understanding what individuals think 'risk' behaviours are.

Secondly, based on the two points stated above, interviews are vital in this study as we want to know the perceptions of the venture capitalist towards using or applying Mushārakah in the venture capital. Although this is not the main research aim, but it is still important to know since they are the ones who will be offering the product to the entrepreneur.

Thirdly, in this study the purpose of using the semi-structured interview that is part of the technique under interviewing is an appropriate tool because the nature of the research is exploratory. "Interviews allows for understanding and meaning to be explored in depth. Qualitative interviews examine the concept of thought, feeling and action and can be a way of exploring relationships between different aspects of situation. Interviewing is a powerful way of helping people to make explicit things that have hitherto been implicit – to articulate their tacit perceptions, feelings and understanding"[135] If we look at the paragraph above it is similar to that undertaken in this study, whereby from the interview questions answers that are obtained from the interviewees are categorized and put into themes. The next step is to find a relationship between the themes and at the same time one can also articulate their perceptions and feelings on a certain subject.

Lastly, the industry or the sample size used in this study is of small size within

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[135] Arksey, Hillary & Knight, Peter (1999). *Interviewing for Social Scientists*. London :Sage Publications.pp.9.

the range of ten to thirty, therefore, to apply the self-administered questionnaires or quantitative statistics methods would be not suitable as those two would require large samples for testing. In this study, interviews are necessary because there is not much information about the industry and we cannot generalize the venture capital industry being the same throughout the whole world. In addition, the richness of response between the interviewer and the interviewee can be a rich source of data, simply because some interviewees give more information than the one asked for. In the section below we have stated reasons for applying the semi-structure interview in depth.

4.3 The Advantages and Disadvantages of the Methods Applied

An interview is a data collection technique involving verbal communication between the interviewer and the interviewee. It is used in both exploratory and descriptive study. There are three approaches to interviewing which are structured, semi-structured and unstructured. Structured interviews enable the interviewer to ask the same questions to the respondents in a same way. It is very much like a questionnaire, which is heavy with closed ended questions and these questions are pre-coded to make it easier for data entry later on. However, in most structured interviews and questionnaire the final question is usually in open-ended format, for example, "What are your comments..." whereby, it helps to gather as much information as possible.

Semi-structured interview involves a series of open-ended questions in categories that the researcher wants to study. Open-ended questions must be detailed and straight to the point to minimize as much confusion as possible. Valid and reliable answers will be obtained, which is important for your analysis in the next stage. It is important that questions are pre-tested to avoid irrelevant questions that would give answers that are not contributing to the overall study. The advantage of using this approach is that the interviewer and the interviewee can discuss the points in more detail. The data obtained is extensive. The disadvantage is that the interviewees may sometime give longwinded answers and it would take time in transcribing the data later on. This approach is useful for exploratory study such as this study and it is not possible to draw up a list of pre-coded data because little is known about the research area and information is scarce.

Unstructured interviews have very little or no structure. A limited number of topics are discussed but are covered in great detail. Questions vary from one interview to another, which means that this method of interviewing is flexible. The researcher must have good communications skills to be able to interact with the interviewee and discuss the issues in depth. This approach may be useful at the early stages of the interview or the research process whereby; the researcher has very limited knowledge on the topic involved. Irrelevant questions can be eliminated easily. The drawback of this approach is that it lacks consistency and coding becomes a difficulty.

Among the three approaches the semi-structured interview is preferred to obtain data from the venture capitalists. The answers obtained vary from respondents and questions are all standard eliminating biasness at any cause. Various answers would only enrich the databank obtained for this study, which is later on analysed using the comparative analysis method, which we will discuss later. The common format for each interview makes it easier to code, analyse and compare data. The interviewer can ensure that interviews do not over-run, and have control over the interview session. The questions set are descriptive and interviewees have to explain in order answer.

Face-to-face interviews, email interviews and telephone interviews were used in this research. Face-to-face interviews were applied in the pilot test phase and the interviewees gave positive responses on the development on the questions asked. If the interviewees do not understand the questions, then this is the time to do some rewording and adding more important questions, which is relevant to your research questions and objectives. Questions, which are irrelevant, will be eliminated. For the full survey, face-to-face interviews and email interviews were frequently used because of the difficulty to schedule for an interview with the potential respondents. Face-to-face or personal interviews are very labour intensive but are flexible in the sense that the interviewer can correct any misunderstanding of the questions on the spot to provide clarity. New ideas can also be discussed with the interviewee and can be a bonus to the thesis. In general and in summary, the advantages and disadvantages of the face-to-face interview are given below.[136]

Table 4.1: Advantages and Disadvantages of face-to-face Interview

Advantages	Can allow for in-depth knowledge sharing Helps to develop the bigger picture Helps with analysis of results Good for networking (e.g. you may be referred to other people to interview).
Disadvantages	Can be time consuming May be difficult to arrange an interview time Can be difficult to compare and analyse information

The advantages listed above have helped in the analysis in answering the

[136] Finley, Alan (n.d.). Introduction to Basic Research Methods Handout. Retrieved December 25, 2006, from IntraOnline Website: www.itrainonline.org/itrainonline/mmtk/mmtk_basic_research_methods_handout.doc.

research questions. Other than that, during the pilot test irrelevant questions were eliminated and familiar terms were applied so that to increase the understanding of the interviewer on the interview questions and also on the scope of what is researched.

The face-to-face interviews is time consuming and hard to schedule an appointment. However, if the interview process is administered with proper timing to avoid restlessness with the interviewee, it may be time consuming. The main disadvantage as for face-to-face interviews are concerned is on scheduling an appointment, usually due to the interviewees' busy schedule. In this study the interviewees are mainly people in high position such as the Chief Executive Officer, Director, Managing Director and General Manager of the company. Therefore, to have an appointment with them may be very hard. In some cases, the interviewer is left with no response from them. Looking at this disadvantage there is one method that had helped in increasing the response rate of the data collection that is the email interview.

"Sample listings that include e-mail addresses obviously open that avenue for data collection. While e-mail is not yet a reasonable option for general population surveys, there are many populations (employees, students, members of professional organizations) for which e-mail addresses are nearly universal and are easily available. In those cases, using the Internet as the main or at least, data collection mode may be a good idea."[137] This leads us to the next method of data collection, which is the email interview.

Using the e-mail interview approach as a method for data collection potentially offers researchers many advantages such as "ready data" whereby you can

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[137] Fowler Jr., Floyd J. (2002). *Survey Research Methods*. California: Sage Publications, Inc. pp. 60.

save time from transcribing the data, low costs and it is convenient to the respondents. Although email interview is informal by nature[138], it is not a structured interview and there are no face-to-face meetings, or no facial expressions and body language that can be seen and observed by the interviewer, respondents can take their time to answer the questions as compared to a face-to-face interview where respondents tend to feel tired after the first twenty minutes. The data obtained are just as good compared to that obtained from the face-to-face interview. The ones obtained from the email interview were more direct and straight to the point. This will make it easier to transcribe the data and also to code them later on. Although one can obtain more information and new ideas from a face-to-face interview, it does not mean it is not possible in an email interview as well. This all depends on the interviewee. Email interviews are also particularly useful when the respondents to be interviewed are widely geographically distributed. Furthermore, the participant can remain anonymous and they can speak freely without constraint, limitations or feeling uncomfortable of being video taped. In this case the Internet through the email is used not just to obtain data but also as a tool for communicating and as a place for communicating.

Telephone interviews can be an efficient way of collecting data. Telephone interview is preferred by busy professional respondents, and is appropriate for interview questions that provide straightforward answers. However, there are cases whereby companies move or relocate and the number ceased operation. Telephone interviews are helpful when the respondents to be interviewed are widely

[138] Wakkee, Ingrid, Englis, Paula D. & During, Wim. (2007) 'Using emails as a source of qualitative data.' in Neergaard, Helle & Ulhoi, John Parm (eds), *Handbook of Qualitative Research Methods in Entrepreneurship.* (pp.333). Edward Elgar Publishing.

geographically distributed. One of the main disadvantages of a telephone interview is that it is difficult to include illustrations and not appropriate for surveys, which involves likert scales. The length of a telephone interview is also limited, although this depends on the subject area. One needs to make prior appointments for a telephone interview and send the interview material and the cover letter for the respondent to look at in advance of the interview. The cover letter should include the background of the research and length of interview.

Comparing the telephone interview with that to the email interview, the answers obtained from this type of interview are straightforward. Although, the interviewer has to write down the answers or record them by using software in the computer, it is still a good way to obtain data. Recording in this case is better than writing it down. To write down the answers one must be able to filter the irrelevant points stated by the interviewee, and only write down keywords. This is very much similar to that of a face-to-face interview without using any recording device and the interviewee must write down the answers. In addition to that, the interviewer must go through the answers with the interviewee again for clarification. Then, the interviewee must revise the answers straight away after the interview. This is important because if the interviewee revises the answer after a couple of days from the interview, he or she may forget what the keywords are associated with in relation to the questions asked. Telephone interviewing has several advantages and disadvantages:

<u>Table 4.2: Advantages and Disadvantages of Telephone Interview</u>

Advantages	It is well suited to random and structured sampling, far more so than clipboarding (which is known as 'intercept interviewing', where people are stopped in malls, going to football games, leaving churches, and so on. The major problem is that the people at those places are only representative of people who go to such places at such times)

	Telephone interviewing is ahead of its main rival, the questionnaire, because it is quicker
	Telephone interviewing usually has a higher response rate than do questionnaires, especially where people have had a letter saying that they will be called and outlining the purpose of the coming call.
	The interviewer can help respondents who have difficulties with any question, and this may not be possible with questionnaires.
	Literacy, which is necessary for questionnaire response, is not a limiting factor in telephone interview.
	The conventions of phone use work for the interviewer, since people feel a pressure to answer the phone (but not to respond to an intercept interviewer), it is normal for the initiator to terminate the call, and there is an expectation that the person answering the phone will then participate actively in the conversation (Frey, 1989)
	It has the advantage over questionnaires that the interviewer can encourage reluctant phone subscribers to participate. The author mentioned that the interviewer can explain the importance of the research and how helpful the interviewees' opinions are, plus to call back at a better time. The interviewer can also explain to the interviewee about the research and that it doesn't take that long to be interviewed.
	Interviewer reliability should be high, since a supervisor can monitor calls and spot cases where the interview diverges from the script.
	The researcher can quickly see how the work is progressing by reviewing the completed response forms as they are passed on by the interviewers.
Disadvantages	Respondents will not be prepared to spend a long time answering questions. There is a consensus (Frey, 1989) that the questions need to be fixed-response ones, since open-ended questions are harder to manage over the phone than face-to-face and answers tend to be less complex and shorter.
	The interviewer has little guarantee that the respondent's mind is really on the questions and not distracted by TV, children, pets, or the dinner that is burning. Phone surveys take more interviewer time than do questionnaires, involve phoning outside of normal work hours, and require repeated attempts to contact the right person at some numbers.
	They demand a lot of concentration and energy to keep to the script and to sound right.

	Interview training is necessary and interviewer supervision is common
	Each call is more expensive than the cost of sending out each questionnaire.
	The data produced will be of the quality that comes from all survey methods

Source: Arksey, Hillary & Knight, Peter (1999)[139]

In this research there were not many telephone interviews. One of the respondents just called and straightaway asked if the interview could be done on the spot. Such things can happen if prospective respondent is busy. This only shows that researchers should be ready at all times, when telephone interviews are concerned. Other than that, it shows that point number three under advantages persists, and that the response rate is better compared to that of scheduling a meeting for a face-to-face interview.

Another method of data collection is through focus groups. "Focus groups are used especially in marketing and media research."[140] "Focus groups are used as a method on their own or in combination with other methods – surveys, observations, single interviews and so on."[141] Group interviews are useful when limited resources prevent a researcher to conduct a face-to face interview with the respondent. However, one must be able to identify a number of individuals who share a common background. For example a group interview of CEO's from the banking sector. The disadvantage of this method is that it will be difficult for the researcher to get a suitable time for all the respondents to be able to meet up at a specific time. Assistance is needed to record and take notes on the group interview. However, I do

[139] Arksey, Hillary & Knight, Peter (1999). *Interviewing for Social Scientists.* London :Sage Publications. pp.79.
[140] Flick, Uwe. (2002). *An Introduction to Qualitative Research.* London: SAGE Publications Ltd. pp. 120.
[141] Ibid. pp. 120.

not use this method in this study, as it is not appropriate, since we want a one-to-one interaction to obtain the information needed.

In this study most of the time the interview would just interview only one interviewee, but there are situations whereby there are more than one interviewee. This is not arranged like that of the joint interviews. "Joint interviewing involves one researcher speaking with two people simultaneously to gain both perspectives on the same phenomenon."[142] This type of interview would be better off if it had been planned before hand rather than having it on the spot and give the interviews to the interviewee in advance. It is also important to call the interviewee(s) before going to the interview although the appointment had been scheduled. Furthermore, it is important to give a detailed background on what you are working on in your thesis, so that the interviewee has a clear idea what to be discussed together with his or her partner. Listed are some advantages and disadvantages of joint interviews:

Table 4.3: Advantages and Disadvantages of Joint Interviews

Advantages	May establish rapport and an atmosphere of confidence more easily
	Can obtain two versions of events rather than one, which may, or may not, produce a coherent joint account. The distinct form of information and knowledge are likely to corroborate and supplement each other but at the same time may contain points of divergence. Inconsistencies between perspectives are likely to be missed if one partner is left out of the study and his or her views are inferred from the other's data.
	The story that emerges may be more complete as interviewees fill in each other's gaps and memory lapses.
	The information obtained may be more trustworthy as bias in one account may counterbalance that in the other

[142] Arksey, Hillary & Knight, Peter (1999). *Interviewing for Social Scientists*. London :Sage Publications. pp.75.

	Researchers may gain insights into the interactions and nature (power) relationship between couples through observation of verbal and non-verbal modes of communication; for example, it may be possible to witness how couples support, negotiate and influence each other, as well as manage disagreements and areas of tension.
Disadvantages	One informant may dominate, to the extent of silencing the partner: the literature (McKee and O'Brien, 1983; Jordan et.al., 1992) suggests that men are likely to be more vocal and overbearing.[143]
	The risk of stirring up antagonisms and conflicts of interest
	If the research topic is especially sensitive, or there is any likelihood of provoking fiction, individuals may not be willing to disclose detailed, honest information in front of their partner and instead provide a more acceptable, 'public' response (Cornwell, 1984).[144]
	Partners may collude to withhold information from the interviewer
	Interviewees may not concentrate as well when two people are present.

Source: Arksey, Hillary & Knight, Peter (1999)[145]

This method of interviewing was not part of the methodology in this study; it was by chance that the initial interviewee (the CEO, Director, General Manager or Manager of the company) had scheduled another interviewee to assist them. This does not affect the interview process and also the data analysis at all. In fact, in this study it has helped to give more ideas as "two heads are better than one" and this is seen under point two of the advantages of joint interviews.

In conclusion, though the data collection method used is not standardized, the results obtained were good enough to analyse and has increased the response rate. The

[143] McKee, L. and O'Brien, M. (1983) 'Interviewing men: taking gender seriously', in E. Gamarnikow, D. Morgan, J. Purvis and D. Taylorson (eds), *The Public and the Private*. London: Heinemann. pp.147-61.

[144] Cornwell, J. (1984). Hard Earned Lives: Accounts of Health and Illness from East London. London: Tavistock Publications.

[145] Arksey, Hillary & Knight, Peter (1999). *Interviewing for Social Scientists*. London :Sage Publications. pp.76.

same interview questions formats (semi-structured interview) were applied throughout the survey. Indeed, all the methods have its pros and cons, but all the methods used are suitable to that of obtaining the data for this study. In other words the interviewees had managed to answer and provide the information needed. All of them provide text data and were later analysed and coded. Below in Table 4.4 is a summary of the pros and cons of all methods used pertaining to this study:

Table 4.4: Summary on Pros and Cons of Different types of Interview Methods

	Response rate	Quality of data	Feedback on research/thesis	Technical errors
Scale	**Slow/Fair/Fast**	**Bad/Fair/Good**	**Less/Fair/Many**	**Less/Fair/Many**
Face-to-face interview	Fair	Good	Many	Fair
Email interview	Fast	Good	Many	Less
Telephone interview	Fast	Good	Fair	Fair

As stated in the paragraphs above, the response rate for the email interview and the telephone is faster compared to that of the face-to-face interview. Although there were more interviews carried out through face-to-face, the response rate with of an email would take about four days for the interviewer to reply back with the answers. In the case of the face-to-face interview one has to make an appointment a week before, and this depends on the availability of the interviewee.

In terms of the quality of the data, all of the data collection methods used provided data that are useful for analysis, and content analysis is carried out on them. Useful in this case means that information is obtained and that the quality of the audio is good. For example. look at the conversation below:

Interviewer: "What is the biggest risk in the venture capital business?"

Interviewee: "Venture capital meaning early stage...poor management"

Although several interviewees would give different types of risk, this is the answer that we want for the analysis. It answers the question. Some of the interviewees may not give the exact term. However, we can do that in the coding process. Feedback and ideas on the research are obtained through face-to-face meetings and email interviews. In this research the interviewees were generous in giving a helping hand in giving all the information needed and also to reword some of the interview questions from the practitioners' point of view. It needs to be reworded based on terms that they are familiar with. In the telephone interview, since we only had one, it is unfair to put a judgment here. However, discussion did take place and several questions and answers were exchanged with relations to the subject area.

In terms of technical errors both the face-to-face interview and the telephone interview pose more errors as compared to the email interview. In the face-to-face interview where transcribing data is concerned, there are cases whereby, the pronunciation of the interviewee is not that clear. This can be due to many reasons, in this study there are cases where the digital recorder was placed below an air-conditioned vessel and it produces a slight hollow sound when the audio is played in the computer. There is also a case whereby the interview was carried out at a café, and the noise interrupted the interview process and made some words unclear.

For the telephone interview, although it is not taped, the same thing persists. The noise from the television or other source of obstruction can interrupt the interview process. However, for the telephone interview we can ask the interviewer to repeat again but this is not in the case of the face-to-face interview. As for the email interview, the data are considered "ready data". It only needs to be coded and no transcribing is necessary. In cases where the interviewee is not well versed in the area researched then we may not be able to get answers from them. This can also happen in a face-to-face interview and even after explaining, we cannot demand an answer straightaway, or expect the interviewee to at least say something. There have been cases also whereby, the potential interviewee replied back and mentioned that he is not the right person to be interviewed, because he is not well versed in the area studied (Mushārakah). All in all the methods used were useful and the differences in data collection methods are made flexible so that it does not constrain the interviewee.

4.4 The Preparation of Interview Questions

The preparation of interview questions is not an easy task. Interview questions must cater to research questions, aims and objectives. One must also make sure that it is the right method to use for the topic chosen in order to get the data wanted. Semi-structured interviews are applied in this study. It involves a series of open-ended questions based on the topic areas, which are:

- Overview of Venture Capital Industry
- Risk and return
- Corporate Governance, Liability and Ownership
- Trust

The topic areas and the interview questions were structured in accordance to the literature review process with guidance from articles in the journals. Answers from the interview will be analysed through content analysis. This is really a systematic way of identifying all the main categories and developing them into themes. The next section gives the lists of interview questions according to the topic areas as stated above.

4.4.1 Overview of Venture Capital Industry

Interviewees are asked general questions or "warm up" questions about Shari 'ah compliant financial instruments. This is to avoid interviewees getting a shock on the type of Shari 'ah compliant financing that they are not familiar with. Questions are based on comparisons between partnership and venture capital in order to get information on the venture capital industry in Malaysia and to see how much the interviewees know about Mushārakah and Shari 'ah compliant financial instruments. The interview questions in this section are:

- Is venture capital funding in Malaysia based on partnerships of any kind?
- What are the criteria that you look for before investing into a company?
- What are the factors deemed important if a venture capital wants to structure funds to be Shari'ah compliant, for an example like the CIMB Muamalat Fund.
- What are the limitations of using such funds?

4.4.2 Risk and Return

Interviewees are asked questions pertaining to profit sharing, profit distribution and risks in venture capital. From these questions, we can analyse on applying the profit-sharing concept of Mushārakah and it would also give ideas on how to manage risks in Mushārakah financing in a venture capital setting. The interview questions in this category are:

- How are capital gains distributed between the shareholders of the venture capital and the invested company?
- Is it distributed based on the invested value? Please elaborate.

- Between, the Net to asset value (NTA), P/E ratio and the cash flow analysis, which is your preferred method of valuation? Please explain.
- What happens when investments perform poorly or the business ceases trading?
- What is the biggest risk in the venture capital business?
- How do you ensure that you maintain a degree of control over the business to protect your investment?
- Is risk management the prime responsibility of the venture capitalist or the entrepreneur?

4.4.3 Corporate Governance, Liability and Ownership

Interviewees are asked questions with regards to their ownership interest and liability incurred in the venture capital. Interviewees are also asked questions on the rights and responsibilities in a venture capital and compare it with the Mushārakah. Other than that, one can also study the preferred way on how liability is managed and compare it with the Mushārakah. The questions in this section also covers, the instruments used for investment and the exit mechanisms that are common among the venture capital companies in Malaysia. The interview questions in this category are:

- What are the rights and responsibilities of the company and the venture capitalist in this partnership?
- Is the venture capitalist liable for any action undertaken by the entrepreneur?
- Is it possible to use just ordinary shares? Please explain.
- Would it be a good strategy to exit if the investee slowly buys out it shares bit by bit until the investee wholly owns the business?

- What is you preferred exit strategy? Please explain.
- What other exit avenue do you use?

4.4.4 Trust

The venture capitalist perception on trust is highlighted here. This is to find out the importance of trust in a venture capital and a partnership, which is vital in a Mushārakah contract/financing. The questions on developing trust are highlighted as well. The question on the monitoring process is also covered. The interview questions in this category are:

- How would you define trust?
- How can you strengthen trust between the VCC and the entrepreneur?
- How do you monitor the companies?

While preparing the interview questions there are several guidelines that need to be adhered to. This is to ensure that the interview questions are understandable and clear to the interviewee. An unclear interview may result in poor data quality and reduces its reliability and validity in answering the research question. Below are some guidelines that apply to all structured, semi-structured and unstructured interviews:[146]

- **Vocabulary** – The question must be clearly understandable and appropriate for the particular group being interviewed. If words or phrases are too complicated or theoretical this can lead to confusion.
- **Prejudicial language** – Avoid language that can be interpreted as

[146] Arksey, Hillary & Knight, Peter (1999). *Interviewing for Social Scientists*. London :Sage Publications. pp.93.

containing assumption that may reinforce particular beliefs and prejudices.

- **Ambiguity** - Certain words can be interpreted in different ways, and it is important to make sure that interviewees understand the correct meaning from the point of view of the study.
- **Imprecision** – Terms or phrases such as 'average', 'a great deal' or 'regularly' are vague, and likely to hold different meanings for each of us.
- **Leading questions** – It is not desirable to use questions that suggest or 'lead' interviewees towards a particular answer.
- **Double-barrelled questions** – Questions that ask two in one, like 'Do your hobbies include swimming and cycling?', should be avoided for two reasons. First it would be unclear whether an answer of yes or no applied to the first part, or to both parts; secondly, the answer might be both yes and no, making it difficult for the interviewee to answer.
- **Assumptive questions** – Try to refrain from using questions assumptions. For instance, the question 'Do you go to work in your car' contains two assumptions: one, that the interviewee works, and two, that he or she drives a car. As it stands, the question overlooks the fact that not everyone engages in these two activities.
- **Hypothetical questions** – It is best to avoid using hypothetical questions as they are unlikely to generate any useful data. For instance, there is no guarantee that people's response describing what they would do if they were confronted with a particular event or situation are an accurate guide to their behaviour in reality.
- **Personal or sensitive questions** – Pose these kinds of questions at the end of the interview when you have built up relationship and trust. Some

researchers use vignettes whereby it is a short story generated by the researcher and focusing on hypothetical characters in particular situations.

- **Knowledge** – Do not assume any specialist, or even general knowledge on the part of the interviewee. Whilst they may be willing to answer questions you need to make sure that members of the group you are targeting also have the ability to answer them.
- **Memory recall** – Bear in mind that asking people to recall events from the past may not produce totally correct answers, not because people are telling untruths but simply because they have forgotten.

Looking at the points above, points number one, three, six and ten are very important to follow. In terms of vocabulary, in this study there are several Arabic terms used. Therefore, one must highlight this in the letter and give a brief introduction about the study. For instance, it is good to highlight the concept of Mushārakah in the cover letter and also about the research because this can give the interviewer an idea of what you are working on and also how they can approach your interview questions. This also relates to point three which is on ambiguity of the questions. For example in this research, the word 'profit' may not result the same meaning from a venture capitalists' perspective because profit for them is on the 'capital gains'. Therefore, it is important to address the term capital gain in your interview questions and not 'profit'.

In point six, it is not good to put two questions into one. These are called double-barrelled questions. This may result in difficulty for the interviewee to answer. However, if there is one in your interview question, do put aside some time for the interviewee to slowly answer them and guide them through it. If possible remind them at which point they are at, and the interviewer should also take notes. Lastly, in this research, the interviewee can not assume that the practitioners (the interviewee) already know Islamic banking and finance. Indeed, they get their experiences first hand, but that does not necessarily mean that they know the area that we are studying about. This is highlighted in point number ten. It is very important to follow this because structuring questions that interviewees can not answer would only result in poor data.

4.5 The Preparation for Conducting Interviews

Devising an interview schedule and the content of the interview involves several elements:

- What questions to ask (structuring the questions)
- Phrasing the questions
- Depth of topics to be included (depending on what you are studying)
- Question order
- Timing

The interview schedule will obviously depend on the purpose and focus on the research. The questions must be understood, familiar and answerable. Interviews are time consuming for the interviewee as well as the interviewer. Therefore, the interview should be kept to the minimum time possible. It is important to provide the interview questions in advance to the interviewer as it would give them and idea on what you are studying and how they can answer your interview questions.

It is important to phrase the question with clarity as to avoid rephrasing. There are times when the interviewer may not understand a certain question. This is when the interviewer needs to rephrase the question if the interviewees do not understand the question but bear in mind that the interviewer must rephrase at least the same way should another interviewee does not understand a particular question. Also avoid rephrasing because if there are too many questions that need rephrasing it shows that your interview questions contains questions or terms that are ambiguous.

The depths of topic to be concluded in this matter would mean, categorizing the interview questions into sections to organize it. This will give a flow to answering the interview questions and also would be easier for the interviewer to understand the questions rather than jumbling them all together and may cause confusion to the interviewer. Not only that, it will be useful for the researcher in terms of analysis of the data. In terms of question order, the interviewer should not jump into complicated questions at the starting point of the interview as it may discourage the interviewee from participating. The introduction section of the interview questions in this research should be something that interviewees will be able to answer without difficulty and providing them with an idea of the study. This will help them to relax and encourage them to open up.

On the timing of the interview, the interviewer should make sure that the key issues have been addressed and resist the temptation to get diverted for each question. The recommended times for an interview should be from 20 minutes to 40 minutes which means that for each question, the interviewer must allocate a specific amount of time, though this highly depends on the amount of questions one has and also on the level of difficulty for each question. Sometimes, there are signs of restlessness after the first twenty minutes where the interviewee will rub their eyes and yawn. In this case, the interviewer should speed up the interview process but still focus on covering the area studied. The interviewer should always concentrate on what the interviewees are saying and clarifying what they mean. However, when such cases do not occur, avoid intervening during an interview as it disrupts the whole interview process. The more time spent on active listening and the less time the interviewer spends talking, the less directive the interview will be.

4.5.1 Establishing Rapport

Before starting the interview the interviewer should spend some time to explain again the reason for the interview including the aim of the research project and what will happen to the interview data. The interview session should be in a relaxed informal manner so that the interview appears more like a discussion or conversation. The interviewer must be aware of the effect of body language in indicating restlessness, encouraging the interviewee to talk and maintaining a friendly atmosphere. By establishing rapport with the interviewer we can establish trust with them. This means that they are not afraid to pass out information to you and would expect that certain information should not be published and only used for the thesis.

To establish the trust and rapport to build a good relationship with the interviewee, the interviewer must ensure several elements at every stage of the interview. The stages of the interview are the opening, middle and closing stages. At the opening stage, the interviewer must take into consideration on how to communicate appropriately with the interviewee. In this study the interviewee are among professionals with high professional status such as the Chief Executive Officer (CEO), Director, General Manager and Manager. The interviewer can not be too casual with them in terms of conversation and appearance. There are some protocols to adhere to. The interview is considered formal in this case. However, this depends on the cultural norms of a certain country.

Next in the opening stage, the interviewer must explain on the contents of the letter with regards to research, anonymity of the interviewers, and timing of the interview and on whether a recording device is allowed to be used. The interviewer must show clarity on the aims and objectives of this research. This is the most important part in building trust and rapport. We need to make it clear that we are here for good intentions. In terms of their anonymity, the interviewer needs to ask the interviewee if their names can be publish in the thesis or in any other publications. Lastly, when the timing is concerned, it is important to inform the interviewer on the length of the interview and how long it will take. After going through all this at least the interviewer will know the dos and don'ts of a particular interview session and would thus create a friendly and polite atmosphere during the course of the interview.

In the middle stage of the interview, it is advisable that the interviewer does not interrupt or intervene and let the interviewee do the talking. At this stage, taking notes is important regardless if the interview is recorded or not. This will make the interviewer and the interviewee more alert. Hillary Arksey and Peter Knight had given an excellent guideline in this matter. They mentioned that during the interview the interviewer should:

- Listen, make eye contact, and say encouraging things that help to make the interview develop in ways that encourage the informant to disclose more
- Be sensitive to signs of emotional reaction
- Avoid conveying a sense of urgency or impatience

As mentioned above one should not intervene while the interviewer is talking. Having the skill of listening and being attentive is the best way to communicate in an interview. To sit in a professional manner is important as body language shows signs of laziness and discomfort. This can psychology affect the interview process as it gives a negative impression of the interviewer to the interviewee.

Other than that, when body language is concerned, the interviewer must also be sensitive to emotional reaction and body language signs of the interviewee that may show restlessness, tire, sleepy or discomfort. It is of courtesy to ask on your part for a short break of five minutes or so if the interviewer would allow. Lastly, in the middle stage of the interview, the interviewer must plan his or her interview professionally. If they have more than one interview in one day, schedule them as such so that one does not have to rush. This is to avoid a sense of urgency and also from closing the interview abruptly. Other than that, avoid showing impatience, especially when the interviewee gives long-winded answers and talks slowly.

On closing the interview, again say encouraging and thankful words on how the information is fruitful to you and your research. Given if the interview is successful, the interviewer may intend to be more generous and give more information such as handouts or pamphlets that may be useful for you. There are some cases whereby they may ask for the results or the findings of the research. It is a good way to network, and the interviewer may leave his or her contact details with the interviewer.

4.5.2 <u>Recording Data</u>

Interviewers have a choice of whether to take notes of responses during the interview or to tape record the interview. Both ways are just fine. It is advisable to ask permission from the interviewee should if he/she would allow the usage of a recording device. The interviewer can concentrate on listening and responding to the interviewee and is not distracted by writing down what has been said. Tape recording ensures that the whole interview is captured and provides complete data for analysis and can easily be reviewed again. The ideal tape recorder or an mp3 player with a recording feature should be small, handy and produces good quality audio. The size of the recording device matters as it makes the interviewees feel less self-conscious.

However, these days tape recorder are no longer useful and would be considered rather obsolete simply because the mp3 player can record up to 18 hours non-stop and it can be easily stored and transferred to storage devices. It is important to avoid areas such as the restaurant or areas near the roadside because the noise will affect the sound of the conversation that is taking place. This will be a problem during the transcribing process. The interviewees' office is the best place for an interview to take place because there are minimal obstructions.

Though it is easier to record using digital recording devices, some interviewees do not like the interview to be recorded. Therefore, the interviewer needs to take notes in this case. The interviewer should have a specific keyword for the answers to the interview questions. It may be hard for the interviewer to write all the answers down. The interview has to be revised immediately after the interview if not the interviewer may forget important notes related to the keywords. To learn the short hand as practiced by secretaries may be handy, but it is better if the interviewer already knows this in advance.

There are other methods of recording that can be used in a qualitative research but specifically for this research we used audio recording. Videotaping is not necessary because it may dissuade frankness on the interviewees' part. Furthermore, being high status professionals there are certain protocols that need to adhere to. The interviewers can not simply video tape and most definitely permission is needed.

Videotaping is not commonly used to record interviews apart from focus groups.[147] It is questionable whether interviewees are comfortable with video recording or not. Both methods of recording (audio tape and note taking) have its advantages and disadvantages. The interviewer must ensure which method gives the best quality for the data and is in accordance with the research aims, questions and objectives. Other than that, the interviewer must be efficient and trying his or her best to obtain the data required for both methods. In this study most of the face-to-face interviews are audio taped and only one required for note taking. Audio recording can record the whole interview session, while note taking focuses on key words. Audio recording requires transcribing while note taking provide 'ready' data.

The location and recording device is important when audio recording is concern as compared to note taking. If we compare these two elements we can see that note taking is the cheapest method by far. The size of the recording device also matters. Video recording is also another way to record data but not in this research due to protocols and the interviewees may not be comfortable being video taped. Furthermore, video recording is more appropriate for focus groups. Getting the data from the audio is sufficient enough in this study. Therefore, video recording is not necessary.

4.6 The Sample Selection of the Research

In this research the sampling technique is not the same as compared to that of a quantitative research. In a quantitative research one would select a small subset of a population to represent a whole population. But this is not the case of a qualitative

[147] Arksey, Hillary & Knight, Peter (1999). *Interviewing for Social Scientists*. London :Sage Publications. pp.106.

research whereby a small group can provide data extensively only that it is in a form of text. However, this depends on the objectives of the research and the research aims. Below in table 4.5 are the list of companies that were interviewed. The anonymity of the interviewee is taken into consideration, and names are not mentioned.

The number of venture capital companies interviewed was 18. 10 of the venture capital companies were interviewed through face-to-face meetings, 7 through email interviews and 1 by telephone interview. The individuals interviewed were Chief Executive Officers, Managing Directors, Investment Directors, Directors, Investment Vice President, and General Managers of the venture capital companies. These are the individuals that manage the funds and the investments. There are 33 venture capital management corporations (VCMC's) and 43 venture capital corporations (VCC's) in the list of registered venture capital companies in the Securities Commission Malaysia as of the year 2005. The VCMC's are the ones responsible to manage the funds and the VCC's are just special purpose vehicles. It is only a trust fund. This is the updated list at the time when the data collection process was commenced. The total VCC's and VCMC's are 76 altogether (as of 2005), but one was excluded from the VCC list and another one from the VCMC list. The one excluded is the BIMB Venture Capital Berhad and BIMB Musyarakah Satu Sdn. Bhd because they are not relevant to the analysis as they have the Mushārakah funds. The EPF Private Equity is also included in the list of VCC's and VCMC's analysed and as a replacement for venture capital companies that did not respond to the survey. In Table 4.5 are the lists of all the companies interviewed. The interviewees are kept anonymous.

Table 4.5: List of Venture Capital Companies Interviewed

Interview	Venture Capital Company	Fund Size of Venture Capital Company (RM)
1	Kumpulan Modal Perdana Sdn. Bhd.	RM100 mil - 199 mil
2	Mayban Ventures Sdn Bhd	RM200 mil - 299 mil
3	Commerce Asset Ventures Sdn. Bhd	RM200 mil - 299 mil
4	CIMB Private Equity Sdn. Bhd.	RM345 mil
5	Malaysian Technology Development Corporation	> RM 300 mil
6	Intelligent Capital Sdn Bhd.	< RM49 mil
7	DTA Ventures Management Sdn. Bhd.	< RM49 mil
8	Bumiputera and Technology Venture Capital	RM39 mil[148]
9	Ingenious Haus Sdn Bhd	N/A
10	Employment's Provident Fund Private Equity	RM1 bil
11	Walden International Malaysia	RM50 mil – 99 mil
12	Renong Ventures Sdn. Bhd	N/A
13	Mezzanine Capital (Malaysia) Sdn. Bhd.	< RM49 mil
14	Malaysian Venture Capital Management Bhd.	> RM 300 mil
15	Global and General Equities Sdn. Bhd	N/A
16	Netval Management Sdn Bhd	< RM49 mil
17	Amanah Ventures Sdn. Bhd	RM50 mil – 99 mil
18	Firstfloor Capital Sdn. Bhd.	< RM49 mil

Note: The fund size were taken from various sources, which are:

1) Kwee Bee, Chok. (2004, April 5). *Collaboration with the Venture Capital Industry*. Presented at the Association Of Merchant Banks Tea Talk.
2) Bumiputera and Technology Venture Capital website
3) Bernama: Banking and Finance Special Page
4) Securities Commission of Malaysia

The type of sampling applied in this study is the purposive sampling, which is a sub-category of the non-probability sampling. Non-probability sampling is normally

[148] Bumiputera and Technology Venture Capital (n.d.) Retrieved August 8, 2007, from http://www.btvc.com.my/

applied for qualitative research. "One justification for non-probability sampling techniques stems from the idea that the research process is one of 'discovery' rather than the testing of hypotheses."[149] In continuation with the statement above on non-probability sampling and comparing it with probability sampling Descombe also mentioned, "A different set of criteria come into play, in terms of how and why people or events get included in the study. The crucial and defining characteristic of non-probability sampling, whatever form it takes, is that the choice of people or events to be included in the sample is definitely not a random selection."[150]

Looking at both the author's points on non-probability sampling and its purpose in qualitative research, we see it appropriate for this study due to the fact that the amount of samples is not that large. Furthermore, in this study the venture capital companies interviewed are likely to produce the most valuable data. In this matter size is not an issue, what matters is that the research method and sampling technique used should be able to answer the research question and achieve the research objectives.

4.7 The Pilot Test on the Sample Selected

The pilot test is conducted using the first draft of the interview questions. The pilot test was carried out on five venture capitalists to check on the relevance of the interview question, appropriate timing of the interview and enhancing transcribing skills. In terms of the interview questions, after the pilot study had been conducted, we found that some questions need rewording based on the standard term used in the venture capital industry. For example, "How are profit distributed in your company?"

[149] Denscombe, Martyn. (1998). *The Good Research Guide for small-scale social research projects.* Buckingham: Open University Press. pp.25.
[150] Ibid. 15pp.

is not understood by the interviewee because profit in the venture capital industry is the capital gain obtained from the investments of the companies in the portfolio. Other than that, practitioners may not understand the theoretical terms obtained from the textbooks. In addition to that, some questions were added and some not relevant questions were eliminated. The questions that are not relevant would be those that are not related to the industry at all. For example, for the question "How are losses treated in your company?" is not relevant because in a venture capital losses are in terms of lower capital gains and not in terms of losses as seen in the balance sheet.

Based on the Mushārakah financing losses are shared due to the amount invested by each partner involved in the partnership or investment but it is not the case in a venture capital. Therefore, asking the venture capitalists this question would only make them confused and the information would not be obtained on a consistent basis. Several questions were also added to assist in answering the research questions and achieving research objectives and aim. These questions were selected based on the answers obtained from the pilot study so that it would be consistent with the forthcoming interviews since new questions were added. In the appendix section we have attached the revised interview questions for the full survey. Furthermore, after the analysis is done from the pilot test the results gave ideas on asking further questions that can expand the research.

In terms of timing, each interview session takes up to one hour to complete and this is ample time for the interviewee. If it goes beyond an hour the interviewee would tend to be restless and would lose focus on the interview. One should not spend so much time on one particular question as the interviewee may be tired to answer the rest and therefore, would give shorter answers as compared to the rest of the interview questions. It is best to arrange interviews in the morning before lunch time as the interviewee is not tired as compared to after office hours. However. scheduling an appropriate time for an interview depends on the availability of the interviewee and when it would be an appropriate time for them.

When transcribing is concerned, the pilot test will help to improve the transcribing skill for the researcher. In this study the transcribing process is not so complicated as compared to a psychology experiment where video and audio recording is concerned. In this study the transcribing process is limited to the semi-structured interview questions that has been arranged and given to the interviewee in advance. In this case, if the interviewee had read the questions before hand and had the answers ready before the interview, the answers given would be structured and would flow smoothly.

On the other hand, if the interviewee were to read the questions on the spot and not have an idea on what the interview is all about, the answers would tend to be long winded and not to the point. Should this happen the interviewer must act and respond accordingly to bring the interviewee back to the topic discussed. The long-winded answers can be troublesome in the transcribing process as the interviewee may repeat the same answers many times. Expressions are also transcribed even though it doesn't contribute much to the analysis. Furthermore, the analysis carried out on the conversation in this study is not based on observations of expressions and behaviour.

4.8 The Method of Analysis for the Sample Selected

The analysis in a qualitative research is far more different as compared to quantitative. In a qualitative research data is in the form of text, therefore it requires an analysis that can extract the text into smaller themes and the category to be analysed. The qualitative research focuses on subjective data that is not easily coded into numbers. "The emphasis is on words and feelings rather than numbers. Qualitative research tends to work with fewer subjects or respondents (cases) but analyses each case to a deeper level. It is particularly useful when management needs to answer questions relating to motivation and emotions such as consumer needs and perceptions, subjective opinions, brand images, brand personality and testing of advertisements. It follows that qualitative analysis is a set of techniques specifically developed to analyse qualitative data like content analysis, text analysis, and conceptual analysis. In general the qualitative data analysis in this research goes through the following stages as listed below.

- Familiarization of the data through review, reading and listening.
- Transcribing recorded material
- Organizing data for easy retrieval and identification
- Coding
- Re-coding
- Developing categories
- Identifying themes
- Exploration of relationship between categories
- Refinement of themes and categories
- Report writing, including excerpts from original data if appropriate (e.g. Quotes from interview)

One way to analyse this huge texts is through content analysis. The key to content analysis is to analyse responses from interviews (regardless of the type) and the researcher should be looking at how and why the respondents differ in their answers or views. "Content analysis has the potential to disclose many 'hidden' aspects of what is being communicated through the written text."[151] In reference to the statements above, this method works well with semi-structured interviews and in-depth interviews. There are several advantages and disadvantages of using content analysis in a research. The advantages and disadvantages include the following:

Table 4.6: Advantages and Disadvantages of using Content Analysis

Advantages	Looks directly at communication via texts or transcripts, and hence gets at the central aspect of social interaction
	Can allow for both quantitative and qualitative operations
	Can provide valuable historical/cultural insights over time through analysis of texts
	Allows a closeness to text which can alternate between specific categories and relationships and also statistically analyses the coded form of the text
	Can be used to interpret text for purposes such as the development of expert systems (since knowledge and rules can both be coded in terms of explicit statements about the relationships among concepts)
	It is an unobtrusive means of analysing interactions
	Provides insight into complex models of human thought and language use
	When done well, is considered as a relatively "exact" research method (based on hard facts, as opposed to Discourse Analysis).
Disadvantages	Can be extremely time consuming
	Is subject to increased error, particularly when relational analysis is used to attain a higher level of interpretation
	Is often devoid of theoretical base, or attempts too liberally to draw meaningful inferences about the relationships and impacts implied in a study

[151] Denscombe, Martyn. (1998). *The Good Research Guide for small-scale social research projects.* Buckingham: Open University Press. pp.168.

	Is inherently reductive, particularly when dealing with complex texts
	Tends too often to simply consist of word counts
	Often disregards the context that produced the text, as well as the state of things after the text is produced
	Can be difficult to automate or computerize

Source: Palmquist, Mike[152]

It is important to note that content analysis can be time consuming because long answers by the respondents have to be read again and reviewed many times. There are many ways a respondent can express their points and views on an issue. Therefore, the researcher does not want to miss the point and code it in a different category. Another disadvantage that may affect the analysis would be on interpretation error. However, any answer given by the respondents and is proven to be valuable, needs to be used in the analysis.

The process of content analysis is as given below:

- Organize data
- Coding – starts with initial coding and then to focused coding
- Identify themes and category

The data are organized based on the date, venue and time of interview. Each interview is numbered such as 'Interview 1' and 'Interview 2' to retain anonymity of the interviewees. Coding is one of the important elements in the analysis, because it requires consistency. We do not want to use different categories or factors for the same issue. The definition of coding is labelling a piece of text or a statement, to

[152] Palmquist, Mike. *Content Analysis*. (n.d.). Retrieved February 10, 2006, from http://www.gslis.utexas.edu/~palmquis/courses/content.html

make sense of it by summarizing it. The analysis starts with initial coding. At this stage. the answers by the respondent are broken down into a general category. Later one. these general categories are narrowed down into smaller categories that are done through focused coding, and then it will be narrowed down again into a main theme. Below is an example of content analysis carried out in this research.

Table 4.7: Example of Content Analysis

Category	**Overview of Venture Capital Industry**
Question 1	**Are the venture capital companies in Malaysia based on partnership of any kind?**
Focused Coding	
1	Most venture capital companies are companies with limited liability
2	Partnership and collaboration exists through shareholding of interested parties in the investments
3	Possible form of limited partnership
Theme	**Venture capital companies are partnership based on shareholding and some venture capitals in Malaysia are based on limited partnership.**

Table 4.8: Example on Focused Coding

Focus coding 1 : Most venture capital companies are companies with limited liability	
Interview	**Initial Coded Answers**
Interview 5	Venture capital is set up as a company
Interview 6	Venture capitalist set up as "Sdn. Bhd. (Sendirian Berhad) or "Bhd. (Berhad)
Interview 11	Venture capital do not follow the limited partnership or general partnership structure
Interview 13	Company with limited liability
Interview 18	Limited liability company

In some circumstances, the initial coding is good enough to qualify as a focused coding. Table 4.7 shows an example on how the coding is done. There are two sections 'Focused Coding' and 'Theme' which states that we had narrowed down the initial coding to focus coding or categories. The initial coding as shown in table 4.8 is simplified from the long interview responses obtained. The example given is on the interview question number one in the "Overview of Venture Capital" section of the semi-structured interview questions.

4.9 The Validity and Reliability of Method Used

The validity and reliability becomes an issue when the interviewee may not understand the question asked and this can happen several times. Therefore, the interviewer must ensure that he/she is consistent throughout the interview and in the data collection process. However, this does not affect the data and make it less reliable unless the interviewer is not consistent at all. In other words, validity covers the credibility, objectivity and quality of the data obtained and its contribution towards the study in the analysis. The reliability covers the accuracy of the method used and also the quality of data obtained and its assistance in answering the research questions plus achieving the research aims and objectives. In the case of the interviewing process for this thesis, interview questions are tested first to see its validity in the sense that it answers the research questions and the research aims.

Validity can be enhanced by:[153]

- Interviewing techniques that build rapport, trust and openness and which give informants scope to express the way they see things.
- Schedules that contain questions drawn from the literature and from pilot work with respondents.
- A set of questions that fully covers the issues raised by the research question – key aspects are not ignored.
- Not asking questions that are irrelevant to the research topic – a waste of scarce interview time.
- Prompts that encourage informants to illustrate, expand and clarify their initial responses, talking in detail and about specifics
- A sample that is fit for the purpose of the research. If the work is preliminary, opportunity samples and snowballing are acceptable. If the aim is to make claims about a group, or to give a rounded account of an event, sampling needs to ensure that all points of view are appreciated. Big samples, preferably selected at random, are needed if you want to claim that your findings are very likely to hold good for the population.

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[153] Arksey, Hillary & Knight, Peter (1999). *Interviewing for Social Scientists.* London: Sage Publications. pp.52

- Thinking about the possible effects of interview times and settings. Ideally, respondents should be interviewed more than once, with the setting changing.
- Interviews that is long enough. Interviewers often find themselves pressed for time.

Looking at the points listed above, the first four slowly improves the interview questions especially during the pilot test and also the interview rapport between the interviewer and the interviewee. For example, if the interviewee feels restless after thirty minutes, the interviewer should try to slowly speed up the process, because sometimes the interviewee may tend to give long-winded answers and can take a lot of time to answer a question. Through the pilot test the consistency will build up in terms of timing and clarity of the questions asked. John Heritage pointed out that there are two kinds of conversation analysis going on today: 'The first examines the social institution of interaction as an entity in its own right; the second studies the management of social institutions (such as corporation, classroom, medicine, etc) in interaction.'[154] Anssi Peräkylä defined the first type of conversation as an ordinary conversation: informal talking among friends, family members, or the like. The latter one focuses on verbal interaction between professionals and clients or amongst professionals.[155] In this research we focus on the second type of conversation.

However, we do not apply conversation analysis in this research. The claim of superior reliability in face-to-face interviews, email interviews and telephone interviews needs to be justified and the key aspects of reliability involved selection of

[154] Drew, P. and Heritage, J. (1992) 'Introduction: Analyzing Talk at Work', in P. Drew and J. Heritage (eds), *Talk at Work: Interaction in Institutional Settings*. (pp. 3-65). Cambridge: Cambridge University Press.

[155] Peräkylä, Anssi. (2005) 'Reliability and Validity in research based on naturally occurring social interaction' in David Silverman (eds), *Qualitative Research: Theory, Method and Practise*. (pp. 284). London: Sage Publications Ltd.

what is recorded, the technical quality of recordings and the adequacy of data obtained and transcripts.[156] Anssi Peräkylä in this matter focuses more on transcribing. The amount of conversation recorded in an interview contains large amount of data. There are cases whereby the interviewee gives more information compared to what that had been asked. This can give the researcher an advantage as it can expand the content of the research and help to focus on relevant issues.

The technical quality of the recordings would involve the clarity of the volume and pronunciation of the interviewee. This also depends on the device used and location for the recording process. As stated above the best location for an interview and for good quality recording would be the office room as compared to a café or a restaurant. Even so, digital recorders or tape recorders should be put further away from the air-conditioning as the sound makes the recording less clear. The inconveniences of the recording process can be minimized through careful planning and also through the pilot test. The adequacy of data comes into question when we compare between having the interview face-to-face and through the email and telephone. In the case of the face-to-face interview we need to transcribe the data and for the other two transcribing is not needed at all.

Transcribing needs careful attention as one does not want to miss any important information or data. All three methods of interview has its pros and cons, but the most important element in this case is to ensure if these methods are able to give you reliable data and that they are valid methods for the purpose of this research. The email and telephone interview provides answers that are straight to the point and in some cases the interviewee also provides additional data. The answers from the

[156] Ibid. 288pp.

email and telephone interview are more structured as compared to that of the face-to face interview. Indeed one can obtain more information from a face-to-face interview, but not all the data is relevant to the research. However, all three methods in this research have provided the researcher with the data needed. In other words, all the data obtained is adequate for the research.

One last issue remains, which involves transcribing the data obtained from the face-to-face interview. Transcribing is a very delicate process and needs good quality audio. It also needs experience. However, 'simplified' transcripts can make the reception of the analysis easier, especially if the audience is not specialized in conversation analysis.[157] This is the case in this research whereby the conversation that takes place is not that complicated as compared to other social science researches where audio and video recording takes place and unstructured interview questions are used. Therefore, the transcripts are simplified and more straightforward. In this research the reliability of the method used which is semi-structured interviews and the reliability of the data obtained are all based on the selection of what is recorded, the technical quality of recordings and the adequacy of data obtained and transcripts.

4.10 Limitations and Difficulties

The limitations of this research lie mainly in the resources. Currently, there are very few books about the venture capital industry in Malaysia. This is required to give an overview of the venture capital industry in Malaysia and would put forward more ideas on how to improve it by comparing with other venture capital industries. The information obtained from the Bank Negara Malaysia (Central Bank) is adequate for

[157] Ibid. 289pp.

the research, however it only highlight performance of the industry and provide statistical information. The venture capital process is not highlighted in an annual report. Obtaining information on due diligence, valuation, monitoring and structuring the investment in the venture capital companies in Malaysia is important to promote the venture capital funding to the public.

The difficulties faced in conducting this research would be on scheduling the interviews with the CEO, general managers and managers of the venture capital companies. It takes some time to get an appointment with them due to their busy schedule. Other than that, the information provided by the Securities Commission does not state the key managers (those managing the funds) in the venture capital companies. The Securities Commission provided a list of directors in the venture capital corporation list, but they may not be involved with managing the fund. This appears to be even more cumbersome if the venture capital company does not have a website.

4.11 Conclusion

This chapter explained the research methodology used in this research. When research methodology is concerned, we are looking at the method of collecting data and on how to analyse it. This is important because in qualitative research there are many methods and choosing one that is in line with your research in terms of data collection and analysis is vital. This covers the validity and reliability of the method used and also on the data obtained. On the data collection, we had carried out a survey using the semi-structured interview questions and using face-to-face interview, email interview and telephone interview as methods of data collection. The analysis for the qualitative data, the content analysis was applied.

The methods chosen for data collection and analysis are based mainly on the research questions and the sample available for the research. To double check if the method is appropriate is through the analysis of the data. If it generates findings and manages to answer the research questions then the method is valid and reliable for your research. The survey carried out using the semi-structured interview using face-to-face interview, email interview and telephone interview. Face-to-face interview were recorded and transcribed. The email interview provided 'ready' data and in the telephone interview we had to take notes.

Looking at all the aspects covered in this research methodology one must also remember to carry out a pilot test before the full fledge survey is carried out. The pilot test will filter out all interview questions that are irrelevant and also to reword the interview questions so that it will be understandable by the interviewee. All the methods chosen for data collection and analysis have its pros and cons and the researcher must know what is appropriate for his or her research. Regardless on whether the data is qualitative or quantitative in nature this depends on the research aims and objectives.

CHAPTER FIVE: POTENTIAL AND LIMITATIONS OF SHARI'AH COMPLIANT INSTRUMENTS IN VENTURE CAPITAL

5.1 Introduction

The interview questions consisted of twenty questions and are segmented into the following sections - 1) Overview of Venture Capital, 2) Risk and return 3) Corporate Governance, Liability and Ownership and 4) Trust. The table consisting of the respondents' answers, which had already been carried out, and the content analysis from the interview questions are attached in the appendix. The themes obtained from the respondents are further elaborated, discussed and reported in chapter five, chapter six, chapter seven and chapter eight. All these four chapters form part of the analysis chapters.

The focused coding or category and the themes are analysed and discussed in relations to the research question. Chapter five covers the overview of venture capital segment of the interview question which mainly covers the venture capital structure, potential and limitations of Shari'ah compliant instruments including Mushārakah in Malaysia. Chapter six covers the profit distribution, profit sharing and risk mitigation in the venture capital and compared to the Mushārakah. Chapter seven covers about corporate governance, liability, instruments applied in the venture capital and exit mechanisms. Chapter eight discusses about the issues on trust between the entrepreneur and the venture capital companies. In this chapter Mushārakah funds is similar to that of the funds existing in the venture capital only that it is an Islamic financial instrument and Shari'ah compliant.

Based on this analysis we can see what is expected of a specific fund to be efficient in terms of Shari'ah compliance, return, governance, transparency, exit strategy, financial structure and risk mitigation for both the venture capitalist and the entrepreneur. Then, we can compare with that of the features of the Mushārakah and see how the Mushārakah can fit into the venture capital company. The themes are regarded as the factors needed to structure the Mushārakah fund based on the answers obtained from the interviews. The themes are derived from the focused coding and are further elaborated and discussed in all the analysis chapters The focused coding are derived from the initial coding. Initial coded answers are compiled in the appendix. Full answers from the interviewee are also used in the analysis.

5.2 Venture Capital Structure

The section of chapter five analyzes the business structure that is formed within a venture capital company in Malaysia and to compare it with the Mushārakah thus, answering research question number one which is:

What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

The interview question and the focused coding/categories are as shown in the table 5.1 below. The theme is derived from the focused coding in table 5.2, 5.3 and 5.4. The focused coding from table 5.2, 5.3 and 5.4 was established from the initial coding obtained from the interviewees. The results are shown below:

Table 5.1: Results for Question 1(Overview of Venture Capital Industry)

Question 1	**Are the venture capital companies in Malaysia based on partnership of any kind?**
Focused Coding	
1	Most venture capital companies are companies with limited liability
2	Partnership and collaboration exists through shareholding of interested parties in the investments.
3	Possible form of limited partnership
Theme	Venture capital companies are with limited liability and partnership based on shareholding. Some venture capitals in Malaysia are structured on limited partnership.

Table 5.2 Focused Coding Number 1 for Question 1 (Overview of Venture Capital Industry)

Most venture capital companies are companies with limited liability	
Interview 5	Venture capital do not follow the limited partnership or general partnership structure
Interview 6	Company with limited liability
Interview 11	Venture capital is set up as a company
Interview 13	Venture capitalist set up as "Sdn. Bhd. (Sendirian Berhad) or "Bhd. (Berhad)
Interview 18	Limited liability company

Table 5.3 Focused Coding Number 2 for Question 1 (Overview of Venture Capital Industry)

Partnership and collaboration exists through shareholding of interested parties in the investments.	
Interview 1	The partnership element is almost everywhere in the venture capital. There is a lot of partnership involved, but what would that partnership be, it will be in relation to shareholder agreement, management agreement, and also participation (those who participate in the fund as an investor) agreement.
Interview 2	Partnership dimension is standard in Malaysia.
Interview 3 and 4	Partnership exists through shareholding
Interview 7	Partnership contributions to the development of the venture capital.
Interview 8	Partnership through shareholding
Interview 9	Partnership between investors of the fund and the venture capital company
Interview 10	Risk and rewards based on shareholding.
Interview 12	Venture capitalist collaborates with their investors and the investee companies.
Interview 14	Partnership synonymous with venture capital as there are a lot of collaboration
Interview 15	Partnership through shareholding
Interview 16	Shareholding relationship determined by interested parties

Table 5.4 Focused Coding Number 3 for Question 1 (Overview of Venture Capital Industry)

Possible form of limited partnership	
Interview 17	Limited partnership

In relations to the theme in Table 5.1, the essence of partnership exists in the venture capital through shareholding and most venture capitalist in Malaysia is a company with limited liability and not structured as a limited partnership. As stated by the respondent in interview 5 "It is basically a company because we don't have the limited partnership (LP) and general partnership (GP) structure." The same points are stated by respondents from interview 6, 11 and 13. However, the partnership exists through shareholding. As stated by respondent in interview 3, "..You know how venture capital and private equity works. You go into the shareholding of the company so you are in a partnership with new shareholders or current shareholders in a company, so it is partnership" Respondent from interview 14 mentioned the same point "..In a venture capital without some form of partnership there will not be a venture capital. Very often when you study the US market generally you see four or five venture capitalist's behind an investment. They raise a lot of funding; they get two or three investors, two or three different venture capitalist to put money for that particular round of funding so in that context partnership is synonymous with venture capital, a lot of collaboration"

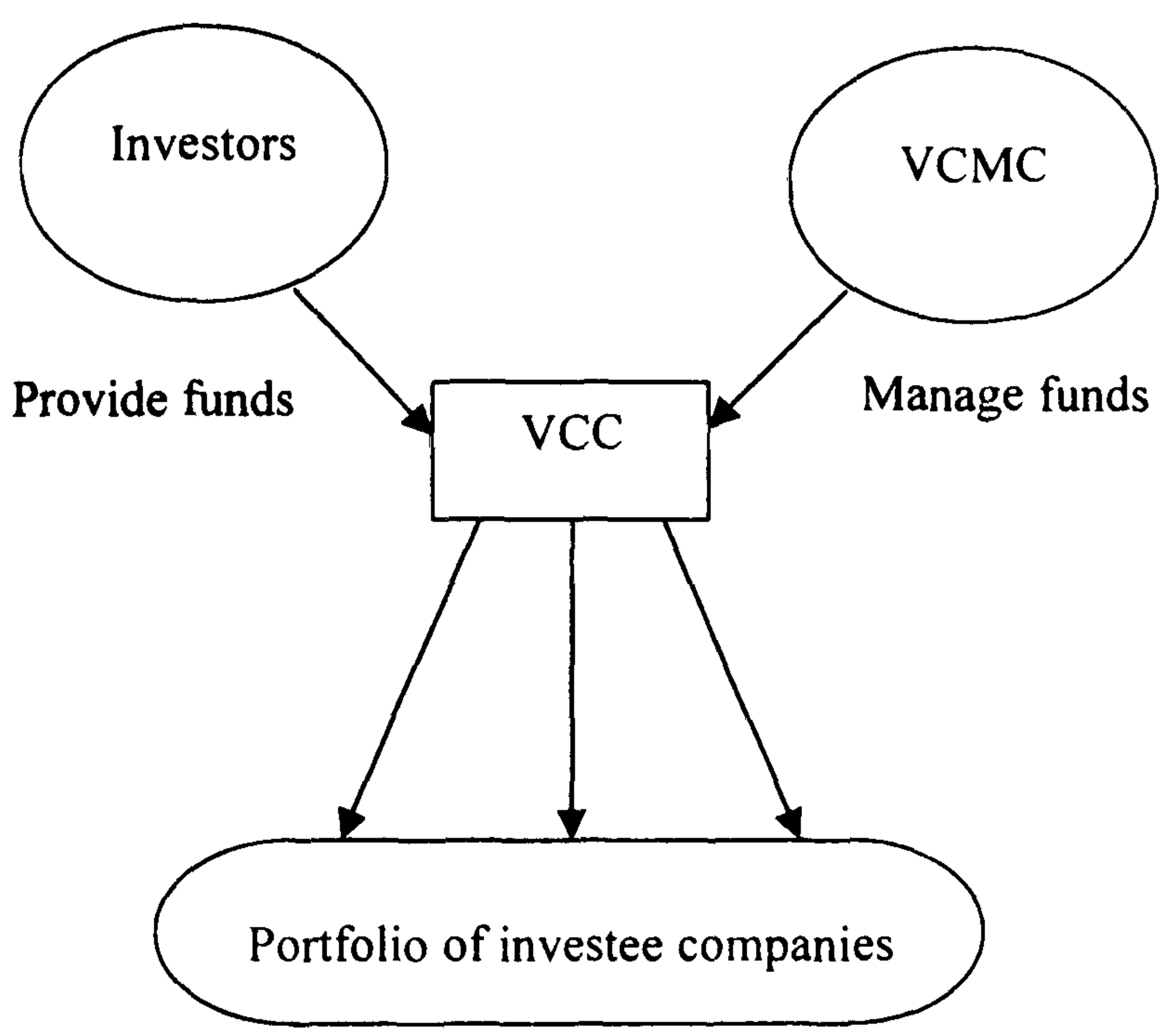
Looking at the responses from interview 3 and 14, this is parallel to that of the *Shirkah-ul-Amwal* where all partners invest some capital into a commercial venture. Respondent from interview 1 stated another important point, "The partnership element is almost everywhere in the venture capital industry. There is a lot of partnership involved, but what would that partnership be, will be in relations to the shareholder's agreement, management agreement, and also participation (those who participate in the fund as an investor) agreement."

Even though most venture capitalists in Malaysia are companies with limited liability, The Employment Providence Fund Malaysia's private equity section is structured on a limited partnership structure. However, all the venture capitalist listed and registered in the Securities Commission are all companies with limited liability and with the abbreviations such as "Sdn.Bhd (Sendirian Berhad)" and "Bhd. (Berhad)" at the end of the company name. "Sdn.Bhd (Sendirian Berhad)" means private limited companies and "Bhd. (Berhad)" means semi-government companies. The guidelines for registration of the venture capital corporations and venture capital management corporations under item two provided by the Securities Commission Malaysia is listed below:

> 1.1) Venture Capital Corporations (VCC) and Venture Capital Management Corporations (VCMC) are given "exempt dealer" status pursuant to the Securities Industry (Exempt Dealer) Order (No. 2) 2002, subject to registration and compliance requirements.
>
> 1.2) Venture Capital Corporations (VCC) and Venture Capital Management Corporations (VCMC) refer to corporations that deal, or manage investment, in securities of venture companies. In order to qualify for the "exempt dealer" status, the corporations shall register with the Securities Commission (SC) as a VCC or VCMC, as the case may be, and comply with the provisions of these Guidelines.

In point 1.2 of the Securities Commission Malaysia's guideline as show above, it is stated that venture capital corporations and venture capital management corporations in Malaysia are corporations that deal and manage investments in securities of venture companies. Corporation has limited liability and shareholders only bear losses up to the amount of what they have invested only. The diagram below shows the relationship of the venture capital corporations (VCC) and venture capital management corporations (VCMC), investors and the invested company.

Figure 5.1: Structure of Venture Capital in Malaysia.



VCC stands for Venture Capital Corporations and VCMC for Venture Capital Management Corporations. As seen above VCC and VCMC are corporations that deal, or manage investment, in securities of venture companies. The VCMC is the one that manages the fund and the VCC is the fund company (to hold the investment fund). Being an entrepreneur the individuals and their team run the company and share in the profit and the losses. The portfolio comprises of number of businesses taken in as investments by the VCMC.

After analysing the interview results obtained and in relations to the theme above (Table 5.1), this raises an interesting question on the applicability of

Mushārakah in the venture capital companies in Malaysia because Mushārakah has unlimited liability. Unlimited liability in this case is that upon liquidation, all the exceeding liabilities will be divided pro rata among the partners. If the partners agree that no partner incurred debts during the period of the business, then the exceeding liabilities would be borne by the rest of the partners who has incurred debt during the period of the business. However, if we look at the partnership structure of the Mushārakah the partners' losses are determined by the amount of their invested value.

This leads us to one factor that is important in applying the Mushārakah in a venture capital company which is on the type of agreement that exists between the venture capital companies and the invested companies. As stated by respondent from interview 1, "..The partnership element is almost everywhere in the venture capital. There is a lot of partnership involved, but what would that partnership be, it will be in relation to shareholder agreement, management agreement, and also participation (those who participate in the fund as an investor) agreement.."

Respondent from interview 16 stated another point, "..The scope and the depth of the shareholding relationship are to be determined by the interested parties.." Looking at these two answers from interview 1 and 16, this leads us to the flexibility of the Islamic Law in structuring a contract and to be applied in Mushārakah fund in a venture capital. In an article by Engku Rabiah Adawiah, the author stated that liabilities remains the same under Islamic Law up to the amount of their capital contribution and that there are no separate contracts on the basis of pure business structures be it partnership or companies.

The author also stated that paramount in determining liability in Islamic Law is not the business structure, but the actual *sharikah* contracts between the parties. The author added that if the parties want limited liability, they can choose *sharikah al'inan* or Mudhārabah and if they want unlimited liability, they can choose *sharikah al mufawadah*.[158] This shows that in a Mushārakah the partners have the options to choose and negotiate on opting to limited liability or unlimited liability. Furthermore, in a *shirkah* and Mushārakah no partner is liable for the other partners' financial liability unless that responsibility is given permission by the other partners on behalf of the partnership. Though any partner can become an agent for all other partners for all kinds of business transactions in the partnership (not outside), no partner is financially liable for the transactions that are made personally by other partners.[159]

From the results obtained, we can see two structures available here, which is the limited liability company and the limited partnership. Therefore, regardless of the business structure as stated in the paragraph above that in determining liability in Islamic Law is not the business structure, but the actual *sharikah* contracts between the parties. This way, it will give a win-win situation for both parties. In relations to research question number one, the factor that is important in this case is the contract structured for the investment deal in the case of applying Mushārakah in the venture capital companies in Malaysia. This is an advantage of applying Mushārakah in the venture capital company whereby the flexibility of the Islamic Law gives partners the options to choose and negotiate on opting to limited liability or unlimited liability. However, the business structure there is in the venture capital companies in Malaysia would not hinder the applicability of the Mushārakah because for both structure (corporation and limited partnership) the shareholders are protected but for the limited

[158] Adawiah, Engku Rabiah, (2002, June). *Development of Partnership Structure and Limited Liability Regime: An Islamic Law perspective*. Presented at the International Conference on Law and Commerce, Kuala Lumpur.
[159] Siddiqi, Muhammad Nejatullah (1985). *Partnership and Profit-sharing in Islamic Law*. Leicester:The Islamic Foundation. pp.49.

partnership the general partners are exposed to more risk.

5.3 Criteria for Venture Capital Investment

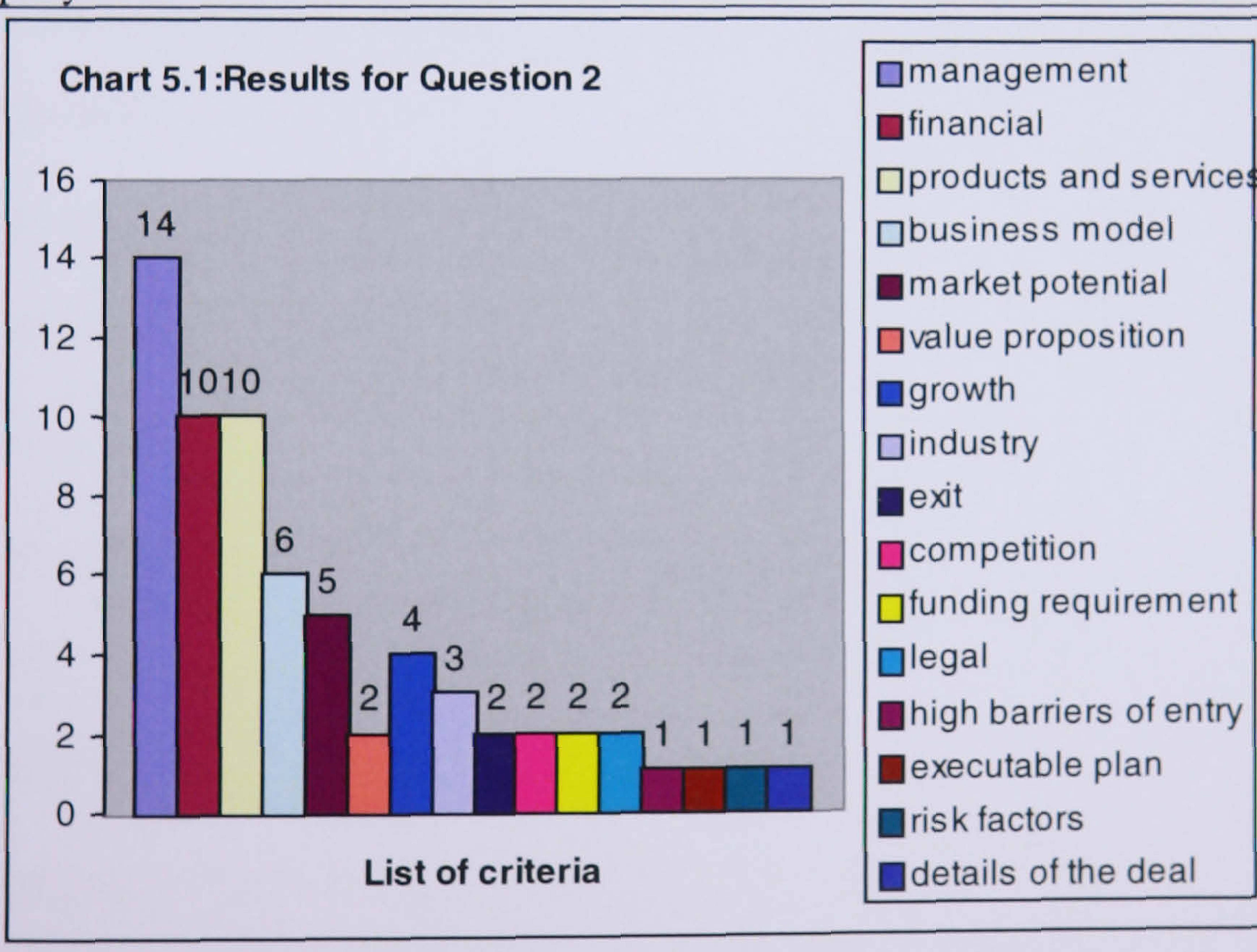
This section looks into the criteria which the venture capital companies seek for before making any decision to invest in a company. For a Mushārakah to operate well, it is vital that these criteria are used as a benchmark. These criteria help in overcoming adverse selection issues. This interview question assists in answering research question number four which is:

What do venture capitalist look for before investing in a new company?

The interview question and the results obtained are given below in Table 5.5.

Table 5.5: Results for Question 2 (Overview of Venture Capital Industry)

Question 2: What are the criteria that you look for before investing into a company?



As seen from the graph most respondents stated that management is an important criterion before selecting an investment. 14 respondents out of 18 interviews stated that management is one of the criteria they look for before investing. 10 respondents mentioned that financial is an important criterion and 10 mentioned that products and services is vital in selecting an investment. 6 respondents stated that business model is important in selecting an investment and 5 mentioned market potential. Therefore, in answering research question number four we can see the criteria that is vital to the venture capital companies in Malaysia in selecting their investments. This also shows that to apply Mushārakah financing in the venture capital companies in Malaysia, these criteria (refer table 5.5) should be a guideline to select an investment. The criteria obtained are listed below according to its level of importance based on the majority (refer Table 5.5):

1) Management

2) Financial

3) Products and services

4) Business model

5) Market potential

6) Growth

7) Industry

8) Others (exit, competition, funding requirement and the rest in table 5.5)

Since management is the most important criterion obtained from the results of the interviews, the discussion goes further to evaluate the elements within the management scope that are of importance to the venture capital companies in Malaysia. In Malaysia's, most of the venture capital companies are investing in the early stage, expansion stage and at the bridge, mezzanine and pre-IPO stage. The early stage comprises of 24.9 percent of the overall investments as of the year 2005, based on the Bank Negara Malaysia annual report in 2005. 14.3 percent are concentrated at the expansion and growth stage and 37.6 percent of the overall investments in 2005 (by stages) are in the bridge, mezzanine and pre-IPO stage. Most of the venture capital investments are in the information and communications technology, life sciences and manufacturing.

As stated by respondent from interview 2, "There are four areas that we look at. One, it is the people, the very most important criteria. Look at the people whether they have the experience, the qualification, the drive, and the skill set the mindset, to drive a company to another level.." Respondent from interview 8 mentioned, "The list is non-exhaustive. Generally, the fundamentals of the company which may comprise of the following, people; their track record, educational background and working experience, etc..." Respondent from interview 14 stated, "..Obviously like any other investment we look at the people whether they have the right skills, whether they have the maturity, chemistry because those are very important.."

Respondent from interview 17 mentioned a series of questions pertaining to the management criteria. They are:

- Is the management committed to enhance the value of the company?
- Does the management team have the right mix of experiences and skills (technical, financial, and managerial)?
- What is the track record of the management team?
- Does the entrepreneur involved have past achievement that demonstrated his/her capability to accomplish?

It is evident from this survey that experience, skills, track record and the right attitude and motivation are the elements that these venture capital companies (in Malaysia) are looking for. Apart from that, it gives us an insight of the additional criteria that may be needed by a venture capitalist using a Mushārakah fund. Venture capital companies back only good management teams and in fact, the most important reason a venture capitalist will invest in a business is belief in its management team. [160] It is important that the management is experienced, qualified and has the skills and the drive to bring the company to another level.

The financial information and valuation criterion appears to be the second highest after management. Financial evaluation of invested companies takes into consideration the previous performance of the companies in assessing its financial robustness and solvency. Respondent from interview 17 listed several vital questions pertaining to the financial criterion, they are:

- What is the company's financial track record?
- Are the company's financial projections reasonable? What are the assumptions behind the projections?
- What do financial analysis (i.e ratio analysis and sensitivity analysis) of the company indicate?

This may apply to companies seeking funds at the later stages as stated by the respondent from interview 6, "...if you do like later stage companies like private equity, Pre-IPO, mezzanine that kind of thing, it is a much more financial operate, much, much financial transactions. The company is much more established, the company is already doing business, it is no longer guess work, and it is more of a

[160] Gladstone, David, & Gladstone, Laura (2002). *Venture Capital Handbook: An Entrepreneur's Guide to Raising Venture Capital*. New Jersey: Prentice Hall. pp.40.

financial transaction. What price I can buy in at, what price can I sell it at, how can I add a little value to the company to make it happen. The answer to that question is what your mandate is. If your mandate is at the early stage, mezzanine or later stage, then it will differ." In Malaysia, the Bank Negara annual report of 2005 shows that most investments are at the early stage and at the bridge, mezzanine and pre-IPO stage. 24.9 percent are concentrated at the early stage and 37.6 percent of the overall investments by stages are concentrated in the bridge, mezzanine and pre-IPO stage. 14.3 percent goes to the expansion and growth stage. Therefore it is evident that financial becomes one of the main criterions in selecting a business/investment among venture capital companies in Malaysia because most of the investment are at the later stage.

Financial criteria are also an important factor in term of the venture capital companies' valuation on the invested companies and to see if they are able to obtain return from the investment. Apart from that, it is important in determining the value of the invested company and the venture capital companies' portfolios. This is stated by the respondent from interview 7 who stated that they need 5-10 years financial information to gage the potential rates of return. In addition to that respondent from interview 14 also mentioned a similar point, "...And then of course you look at the financial evaluation for dollar of investment. Mavcap generally does equity investment. For X dollar we take 1% of equity, we use different instruments such as ordinary shares, redeemable cumulative convertible preference shares (RCCPS) and sometimes we forward some debt instrument as a bridge loan of some sort. Valuation is an important factor so we put in a million dollars are we going to get 10% of the company or are we going to get 50% of the company. Let's say with a million dollars you get 10% so we're looking at post money valuation of 10 million..so are you getting fair value for 10 million? Obviously you want to get a decent IRR for your investment.." Respondent from interview 3 mentioned, "We look at few, first of all we look at the historical balance sheet of the company maybe 4 years before what happened to the company and then we look at the projection forward where it will be 3 to 5 years.."

The third important criterion is on product and services. It focuses on the competitive edge of what is offered by the entrepreneurs as compared to what exists in the market. As stated by the respondents in interview 14, "..But if you go to a company that articulate their proposition and most of their product offering and that is easier to determine if they have a unique proposition or not. The proposition could be a strong market proposition, strong technical proposition, or it could be an opportunistic proposition where there is a fundamental shift in the market and they are creating a new market because of fundamental shift." The respondent from interview 17 listed a few questions pertaining to the product and service criterion. They are:

- Is the product/service unique? What are its breakthrough qualities (i.e the technology used)?
- Has the company completed or is undertaking any research and development projects?
- Does the company own any intellectual properties?
- Does the company have a sustainable competitive advantage?
- Is there any threat of substitution of its product/service?

The questions listed above, show that uniqueness, research and development, and marketability if the product and services are vital. In Malaysia, several government grants have also been set up for small-and medium scale enterprises that require financing particularly at the early stage. The available government grants include the following:[161]

- The MSC Research and Development Grant Scheme;
- The Industry Research and Development Grant Scheme;
- The Demonstrator Application Grant Scheme;
- The Technology Acquisition Fund;
- The Commercialisation of R&D Fund.

These government grants are to encourage more entrepreneurs to innovate and engage into research and development to create a product or service that has competitive edge and can create a market.

The fourth important criterion would be the business plan presented to the venture capitalist. A business plan could be several hundred pages long and have sections on the financial plan, marketing plan, production plan, and the personnel needed to carry out the plans.[162] The respondent from interview 17 had listed several questions pertaining to the business model criteria. They are:

- What are the revenue generating mechanisms (i.e. product sales, service fees, subscription fees, etc.)?
- What are the revenue drivers?
- Is the business model sustainable? Is there a clear path to profitability?

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[161] Aziz, Zeti Akhtar. (2000, March 28). *Accelerating Economic Growth through Venture Capital* Speech presented at. Venture Capital Europe-Asia 2000. Putra World Trade Center, Kuala Lumpur.
[162] Gladstone, David, & Gladstone, Laura (2002). *Venture Capital Handbook: An Entrepreneur's Guide to Raising Venture Capital.*. New Jersey: Prentice Hall. pp.62.

The business plan gives an idea to the venture capital companies on how the invested company is going to tackle the market, how they are going to materialize in the business plan and if the invested company can meet their target.

Market potential, growth and industry is also one of the highest rated criteria and as seen above, venture capital companies in Malaysia are looking for growth and opportunities, therefore, they are looking for products that can create a market and not just another product that is a substitution to the existing ones in the market. This is stated clearly by the respondent from interview 7, "Product potential, the sector in which the business is in. (i.e ICT, Communications and Networking, Biotechnology, Semiconductor etc.)". The respondent from interview 11 mentioned about the market size and potential as part of their investment selection criteria. Respondent from interview 5, mentioned that their main criteria is the return on investment and that their target is at least 30 percent per annum.

In Malaysia, information technology and manufacturing are the sectors highly invested in by the government and also by the private venture capitalist. Since the establishment of the Multimedia Super Corridor, the ICT industry has boomed at quite a good pace in Malaysia. Furthermore, some venture capital companies like the Malaysian Technology Development Corporation who investments are in life sciences and biotechnology, and are mandated by the government, invest at the early stage. Therefore, growth is an important criterion when selecting an investment. There are many venture capital companies in Malaysia that is mandated by the Government and focuses on early stage, for example, Malaysian Venture Capital Management Bhd. (MAVCAP) is the company mandated by the Finance Ministry and the Malaysian Development Corporation (MDC) for information, communication and technology (ICT) ventures as well as Malaysian Technology Development Corporation (MTDC) for non ICT. Sources of venture capital in Malaysia as at the end of 2005 are mostly by the government.

Therefore, it is evident that market potential, growth and industry are one of the main criterions for selecting an investment. The information technology industry is a fast paced market, product and services becomes obsolete in a short period of time. Therefore, the product and services must be able to stand the test of time. The rest of the criteria which are, value proposition, exit, competition, funding requirement, legal, high barriers of entry, executable plan, risk factors, details of the deal are the rest of the criteria of the venture capital companies from this survey. By knowing these criteria, it gives an idea what is needed of an investment and the same criteria should be the same for Shari'ah compliant funds, and in particular Mushārakah financing. Selection criteria are vital for investment success and solid business relationship between the venture capital companies and the invested companies.

5.4 Facilitating Factors for Shari'ah Compliant Venture Capital Investments

This segment analyzes the factors pertaining to the applicability of Mushārakah financing in the venture capital companies in Malaysia. This question assists in answering research question number one which is:

What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

In this analysis, research question number one is needed to see the potential of Mushārakah and its expectation among the venture capital companies in Malaysia. Given below is the interview question and theme derived.

Table 5.6: Results for Question 3 (Overview of Venture Capital Industry)

Question 3	**What are the factors deemed important if a venture capital wants to structure funds to be Shari'ah compliant, for an example like the CIMB Muamalat Fund.**
Focused Coding	
1	**Shari'ah compliance matters** • Shari'ah compliance business, portfolio, operations and activities • No riba and interest • Type of instrument • Spirit and objective of the investment must be clear • Shari'ah advisor • Profit sharing • Financial and legal matters
2	**Profitability and potential return** • Return • Pay good dividend • Long-term • Growing & consistent
3	**Risk management** • Risk mitigation
4	**Demand by clients** • Willingness to adhere to structure • Demand
Theme	**Shari'ah compliance matters, profitability and potential return, risk management and demand by clients are vital to structure funds to be Shari'ah compliant**

Table 5.7 Focused Coding Number 1 for Question 3 (Overview of Venture Capital Industry)

Shari'ah compliance matters	
Interview 7	Shari'ah compliant business Exclusion of interest Type of investment
Interview 8	Business must be *halal* No interest element Spirit and objective of the investment must be clear
Interview 12	Look at the returns and nature of business
Interview 13	No interest
Interview 14	What type of business investing in
Interview 15	Satisfaction of the Shari'ah law
Interview 17	Shari'ah advisor appointed Shari'ah compliance operations and activities No riba Investment portfolio accordance with Shari'ah Profit sharing Legal
Interview 18	Instruments used Return must be in capital gain and not interest Interest attached to the preference shares at the early stage, depends on the stage Profit sharing element

Table 5.8 Focused Coding Number 2 for Question 3 (Overview of Venture Capital Industry)

Profitability and potential return	
Interview 12	Look at the returns and nature of business
Interview 13	Good return Pay good dividend Long-term Growing and consistent
Interview 17	Financial

Table 5.9 Focused Coding Number 3 for Question 3 (Overview of Venture Capital Industry)

Risk management	
Interview 8	Risk mitigation

Table 5.10 Focused Coding Number 4 for Question 3 (Overview of Venture Capital Industry)

Demand by clients	
Interview 6	Demand
Interview 10	Willingness of the party to adhere to the structure

Four categories were extracted from the entire list given by the respondents. They are Shari'ah compliance matters, profitability and potential return, risk management and demand and knowledge on Shari'ah compliant instruments. In relations to the research question, the four categories are factors needed to be taken into consideration to apply Mushārakah financing or funds in the venture capital companies in Malaysia. The Shari'ah compliance matters highlight the compliancy of the investment in the venture capital companies and the processes involved in structuring the investment deal. Based on the results obtained, the respondents (refer table 5.7) mentioned on appointing Shari'ah advisors, concentrating on Shari'ah compliance business, operations, activities, instruments and that return must be in capital gain and not interest. The investment and financial instruments used must be free from *riba* and the venture must be based on profit-sharing.

For a Mushārakah financing the screening process definitely needs a Shari'ah scholar that may sit in the board of directors or appointed as one of the managers. This is mentioned by the respondent from Interview 17, "..One of the factors deemed important to structure a Shari'ah compliant venture capital fund is to appoint a Shari'ah advisor approved by the Securities Commission Malaysia to advise the venture capital company and to ensure the operations and activities of the venture capital company comply with Shari'ah principles, which include prohibition of *riba*, Mudhārabah (profit-sharing), Mushārakah (joint venture), etc. The Shari'ah Advisory Council of the Securities Commisison Malaysia also plays an important role in advising the Commission on structuring the guidelines for the Islamic capital market, which include the setting up of Shari'ah compliant venture capital funds." Therefore, we can see that the Shari'ah advisors/scholars play a vital role in:

- Analysing the type of investment to ensure it is halal
- Analysing the contracts and agreements (avoid gharar)
- Analysing the pricing of the investment and how it is structured
- Analysing that it is interest free
- Shari'ah compliance review for pre-IPO securities
- Analysing that the instruments used are Shari'ah compliant

In terms of contract and agreement, it can not be hundred percent free from *gharar*. This is stated in the Resolutions of the Securities Commission Malaysia Shari'ah Advisory Council, whereby *gharar* and *ghubn* are two negative elements that can unfavourably affect a contract. However, if it occurs in a small amount, Islamic Jurisprudence considers it to be normal and does not affect the contract's goodwill. In Malaysia, to further promote the Islamic Capital Market, Shari'ah compliance review for pre-IPO has been implemented. Previously, the compliance reviews were subject to listed companies on the Bursa Malaysia. The contract written should be as precise as possible, transparent and understood by the invested company. In relation to contract and agreement, a lawyer that is well verse in Shari'ah law should be of assistance to ensure that the agreement are done based on Islamic law. This was stated by the respondent from interview 17, whereby financial and legal matters are important factors if venture capital companies want to structure Shari'ah compliant funds.

The second point under Shari'ah compliant matters, would be on ensuring that the investment made and the instrument used by the venture capital companies are Shari'ah compliant. Five respondents mentioned the point on Shari'ah compliant investment area and two mentioned on using Shari'ah compliant instruments (refer Table 5.7). The respondent from Interview 17 mentioned a very important point, "...companies invested are not to be involved in the following core activities:

- Financial services based on riba (interest)
- Gambling
- Manufacture or sale of non-halal products or related products
- Conventional insurance
- Entertainment activities that are non-permissible according to Shari'ah
- Manufacture or sale of tobacco-based products or related products
- Other activities deemed non-permissible according to Shari'ah principles

The investment areas listed above are those that are not Shari'ah compliant. Other than identifying non- Shari'ah compliant investment areas, the instruments used must be also be Shari'ah compliant. This was mentioned by the respondent from Interview 18, "...investment in the form of using instrument that are Shari'ah compliant. In this case ordinary shares are Shari'ah compliant and not loan stock or Cumulative Preference Shares (CPS). Then the return from the investment will be Shari'ah compliant also whereby you get the capital gains not interest based. It depends on the stage of the maturity of the investments that you went in. If it is early stage normally, you invest in the form of preference shares that preference shares will be attached to it interest to the CPS that that won't be Shari'ah complaint. So it depends, mature companies you go in as ordinary shareholders then you get your returns through capital gains."

The answer given by the respondent from interview 18 shows that the instrument used must be free from *riba* in terms of financing and the return from the investment. Three respondents from interview, 13, 17 and 18 from the survey mentioned this point. Based on the answer given from the respondent from interview 18, two points can be highlighted here. As mentioned above, cumulative preference shares are not Shari'ah compliant and that the type of instrument used depend on the stage of investments. Therefore, venture capital companies can not be limited to using ordinary shares only if Mushārakah financing in the venture capital companies in Malaysia. This will be further discussed in chapter seven of the thesis.

In terms of profit and return on the investment, respondent from interview 13 mentioned it as an important factor if a venture capital company wants to structure funds to be Shari'ah compliant. It shows that Mushārakah is applied in the venture capital companies have to be competitive with the conventional product and market. It should be as attractive as compared to the other funds available in the market. This raises question for us on the potential rate of return and dividend payment that is obtained through a Mushārakah fund. Other than return, the respondent from interview 13 also mentioned that the Shari'ah compliant fund must pay good dividend, growing and consistent return.

The next factor would be on risk mitigation and this was mentioned by the respondent from interview 8, "..the spirit and objective of the investment must be clear i.e. to take the investee company to the next level and both investor and investee fully aware of the risks involved and both must find ways on how to mitigate them." Based on the response given above, the parties involved in Shari'ah compliant fund or a Mushārakah fund must know the risks involve in using them. Demand by clients also plays a major role for an Islamic financial fund to work. In fact, the respondent from interview 6 mentioned this as one of the factors needed to structure Shari'ah compliant funds. Another interesting point by the respondent is related to willingness to adhere to the structure (Islamic financial instruments). This was mentioned by the respondent from interview 10. This means that there must be understanding between the venture capital companies and the invested company and both should have knowledge on the instrument. In addition, there should be mutual interest in the investment and co-operate with each other.

In relations to the four factors stated above on establishing Shari'ah compliant funds (Mushārakah in this case) the Malaysian government must have the infrastructure for building up the Islamic banking and finance industry in Malaysia as this will assist in structuring Mushārakah funds in the venture capital companies. Given below are some of the key statistics which shows that Malaysia is the largest Islamic banking and finance market. [163]

- Islamic banking assets: RM113.5 billion (US$30.9 billion).
- Takaful assets: RM6.2 billion (US$1.7 billion).
- Largest Islamic private debt securities (IPDS) market: 45.5 percent (RM125

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[163] *Malaysia: Leading Islamic Finance*. (n.d.). Retrieved May 18, 2006 from http://www.pwc.com/extweb/indissue.nsf/docid/1d681d874f24fda7ca25720a00158bfd

billion or US$34 billion) of domestic corporate bonds.

- Active Islamic money market channelling about RM30 billion - RM40 billion monthly.
- Critical mass of diversified players - Islamic banks, investment banks, takaful companies, development financial institutions, savings institution, fund management companies, stock brokers and unit trusts.

There is one interesting point from the information above where, Malaysia holds the largest market for Islamic private debt securities. However, in the case of equity financing, the number is still small. Other than having the largest market, Malaysia further develops the Islamic banking and finance industry. These developments[164] are listed below:

- Pioneering many global Islamic banking and finance initiatives
- Robust regulatory framework - Malaysia has a comprehensive regulatory and supervisory framework that caters to the unique characteristics of Islamic finance. Stronger standards have been set for corporate governance, transparency, disclosure, accountability, market discipline, risk management and customer protection.
- Shariah Framework - Operate in an environment that offers conducive and effective legal and Shariah framework. The Islamic Banking Act 1983 and Takaful Act 1984 were enacted to govern the conduct of Islamic banking institutions and takaful operators respectively.

[164] *Malaysia: Leading Islamic Finance*. (n.d.). Retrieved May 18, 2006 from http://www.pwc.com/extweb/indissue.nsf/docid/1d681d874f24fda7ca25720a00158bfd

- Liberal Foreign Exchange Regime
- Resources - This includes the establishment of the Institute of Islamic Banking and Finance Malaysia (IBFIM), International Centre for Leadership in Finance (ICLIF) and the International Centre for Education in Islamic Finance (INCEIF)
- A wide range of tax exemptions across the Islamic finance spectrum. Other than that, there will also be a tax review on special purpose vehicles for Islamic financing.

Looking at the information listed above, we can see that Malaysia has the infrastructure to structure Mushārakah funds in the venture capital companies. The last point which states on tax review for special purpose vehicles for Islamic financing would be a good platform to start such funds.

All four factors which are Shari'ah compliance matters, profitability and potential return, risk management and demand on Islamic funds/financing play a crucial part in structuring Islamic funds in the venture capital companies in Malaysia. From here we can see that if a venture capital company wants to apply Mushārakah financing, these are some factors that are needed to be taken into consideration. Appointing Shari'ah advisor in the venture capital companies in Malaysia is one of the factors, and in the case of Malaysia, the Shari'ah Advisory Council of the Securities Commission in Malaysia is responsible in ensuring the Shari'ah compliancy of the investment, instruments used and contracts/agreement. Other than that, on a legal side, a lawyer that is well verse in Shari'ah law should be of assistance to ensure that the agreement are done based on Islamic law.

5.5 Limitations of Shari'ah Compliant Instruments

This section of chapter five gives an idea on the limitations on Shari'ah compliant funds in the venture capital setting. The analysis of Question 4 from the Overview of Venture Capital Industry section of the interview assists in answering research question number one, which is:

What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

The interview question and the results obtained are in Table 5.11 up to Table 5.14.

Table 5.11: Results for Question 4 (Overview of Venture Capital Industry)

Question 4	**What are the limitations of using such funds?**
Focused Coding	
1	**Limitation on Shari'ah instrument** • Slow and cumbersome • Reinvestments of capital gains may be limited to Shari'ah approved investment products • Ability to recover • Limitations when the fund is small • Specific expiry date • Interest income from conventional fixed deposits or other interest bearing financial instruments • Limited to the instruments used • Most of the funds in the market are not Shari'ah compliant
2	**Knowledge of Investment** • No limitation • Lack of comprehension in the spirit of Mushārakah • Parties agreeing to use the concept • Lack of knowledge • Still new in Malaysia
3	**Expectations and confidence** • Investors openness to invest in such funds • Expectations
Theme	Limitation on Shari'ah instrument, knowledge of investment, expectation and confidence are limitations to applying Shari'ah compliant funds in

	venture capital companies in Malaysia.

Table 5.12: Focused Coding Number 1 for Question 4 (Overview of Venture Capital Industry)

Limitation on Shari'ah instrument	
Interview 6	Slow and cumbersome as they are making up the rules as they go along Later stage more flexibility
Interview 7	Reinvestments of capital gains may be limited to Shari'ah approved investment products that may not yield the highest return
Interview 12	Ability to recover
Interview 13	Limitations when the fund is small Specific expiry date
Interview 17	Interest income from conventional fixed deposits or other interest bearing financial instruments
Interview 18	Limited to the instruments used Most of the funds in the market are not shari'ah compliant

Table 5.13: Focused Coding Number 2 for Question 4 (Overview of Venture Capital Industry)

Knowledge of Investment	
Interview 8	Lack of comprehension in the spirit of Mushārakah
Interview 10	Parties agreeing to use the concept
Interview 18	Lack of knowledge Still new in Malaysia

Table 5.14: Focused Coding Number 3 for Question 4 (Overview of Venture Capital Industry)

Expectations and confidence	
Interview 9	Are they (investors) open to invest in such funds

In answering the research question number one above, these area of limitation such as limitation on using Shari'ah compliant instrument, knowledge on the instrument, expectation and confidence of the venture capital companies on the Islamic instruments, are important to take into consideration on applying the

Mushārakah in the venture capital companies in Malaysia. The limitation on Shari'ah instrument gives us an insight on the issues pertaining to the limitations of applying Islamic financial instruments in the venture capital setting. It gives an insight of the disadvantages of the Mushārakah financing in the venture capital setting. The knowledge on the product would mean how well versed the investors and entrepreneurs are about Shari'ah compliant instruments. The focused coding on expectations and confidence as seen in Table 5.14 shows if investors are open to invest in Shari'ah compliant funds.

Looking at the limitation on Shari'ah compliant instrument, the areas of limitation touches on the process of structuring the Shari'ah compliant instrument, reinvestment of capital gains, return, expiry date and the size of fund of Shari'ah compliant instrument. Respondent from interview 6 stated that the process that involves using Islamic financing instruments (venture capital setting) is slow and cumbersome as they are making up the rules as they go along. This shows that the process involves in ensuring Shari'ah compliancy on structuring a Shari'ah compliant fund is not efficient, especially at the early stage. Respondent from interview 6 also mentioned that for private equity funds at a much later stage, there is a lot of flexibility as compared to the early stage. At the later stage, the companies are already established, therefore, the process of Shari'ah compliancy is focused on the processes involved to go for listing. In Malaysia, the Shari'ah compliance review process have been extended to include securities at pre-IPO stage and is under the responsibility of the Securities Commission Malaysia.

Another point under this category would be on the limitations of Shari'ah approved investments when it comes to reinvesting the capital gains due to the small market. This was mentioned by respondents from interview 7, 17 and 18. The Islamic capital market in Malaysia is relatively small as compared to the conventional market. There is not much choice for the venture capital companies in this case to reinvest their capital gains using Islamic securities. In terms of return, the ability to recover the investment is of concern and this was mentioned by the respondent from interview 12. In other words, if a Mushārakah financing is applied in a venture capital company it should be able to meet the target return of the investor. However, this depends on many things, how skilful the entrepreneur is in handling the business, the overall industry performance, the stage of the venture capital and the performance of MESDAQ.

The respondents from interview 13 mentioned the expiry date of using Islamic financial instruments in this case. Compared to venture capital as in equity investments it exists in perpetuity and a Mushārakah venture has a limited duration. This also means that for a limited duration the amount of fund is small and that the return from investment may be low. It is not valid to say that the Mushārakah is not profitable if applied. For example, some companies in Malaysia such as Bank Islam Malaysia Berhad and Perbadanan Usahawan Malaysia Berhad (PUNB) have already implemented and established a Mushārakah structure as a form of financing in a venture capital setting.

The knowledge on Shari'ah compliant instrument would mean how well the investors know the product and how open they are in applying the product. In reference to Table 5.13, the respondent from interview 18 mentioned that the application of Shari'ah compliant fund in the venture capital is still new in Malaysia. Therefore, to apply Shari'ah compliant fund in the venture capital companies in Malaysia, the investors, managers and the people involved in the investment must have knowledge on Shari'ah compliant instruments. The expectations and confidence also links to knowledge in Islamic banking and finance. The investors would be confident if they know the product well. This was highlighted by the respondent from interview 9, whereby it stated whether the investors are open to invest in such funds. Investors and entrepreneurs would not invest in funds that they have very little knowledge of.

5.6 Conclusion

The response obtained from this interview question gives an idea on the factors needed for Mushārakah financing in the venture capital companies in Malaysia If a venture capital company in Malaysia wants to structure Mushārakah financing they must take into consideration these area of limitation such as limitation on using Shari'ah compliant instrument, knowledge on the instrument, expectation and confidence of the venture capital companies on the Islamic instruments. This also shows that Malaysia must have the infrastructure for Mushārakah fund to take place. The process of structuring the Shari'ah compliant instrument must be efficient and fast, bigger market and more Shari'ah compliant instrument for reinvestment of capital gains. Knowledge on Shari'ah compliant instrument among the investor, entrepreneur and the manager is also another important point to ensure confidence of the parties involved.

CHAPTER SIX : PROFIT SHARING, VALUATION AND RISK MITIGATION IN VENTURE CAPITAL

6.1 Introduction

The interview questions from the section on risk and return provide us an idea on the profit distribution, valuation and risk mitigation of the venture capital industry in Malaysia. The responses obtained in these key areas will be a good benchmark on analysing the applicability of Mushārakah funds in the venture capital companies in Malaysia. This chapter analyses all the interview questions under the section of risk and return.

6.2 Profit Distribution in Venture Capital

The interview question 1 and 2 (Risk and Return) under the section of risk and return (refer table 6.1) is to analyze and discuss the profit distribution method within venture capital companies in Malaysia and to study the applicability of Mushārakah financing in the venture capital setting. This associate in answering research question number one which is:

What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

Table 6.1: Results for Question 1 (Risk and Return)

Question 1	**How are profit distributed in your company?**
Focused Coding	
1	Shareholders of an invested company: dividends or sale of shares
2	Shareholders of venture capital: through redemption of preference shares, dividends and liquidation of funds
Theme	**Capital gains are distributed through dividend, sale of shares, and redemption of preference shares.**

Table 6.2: Focused Coding Number 1 for Question 1 (Risk and Return)

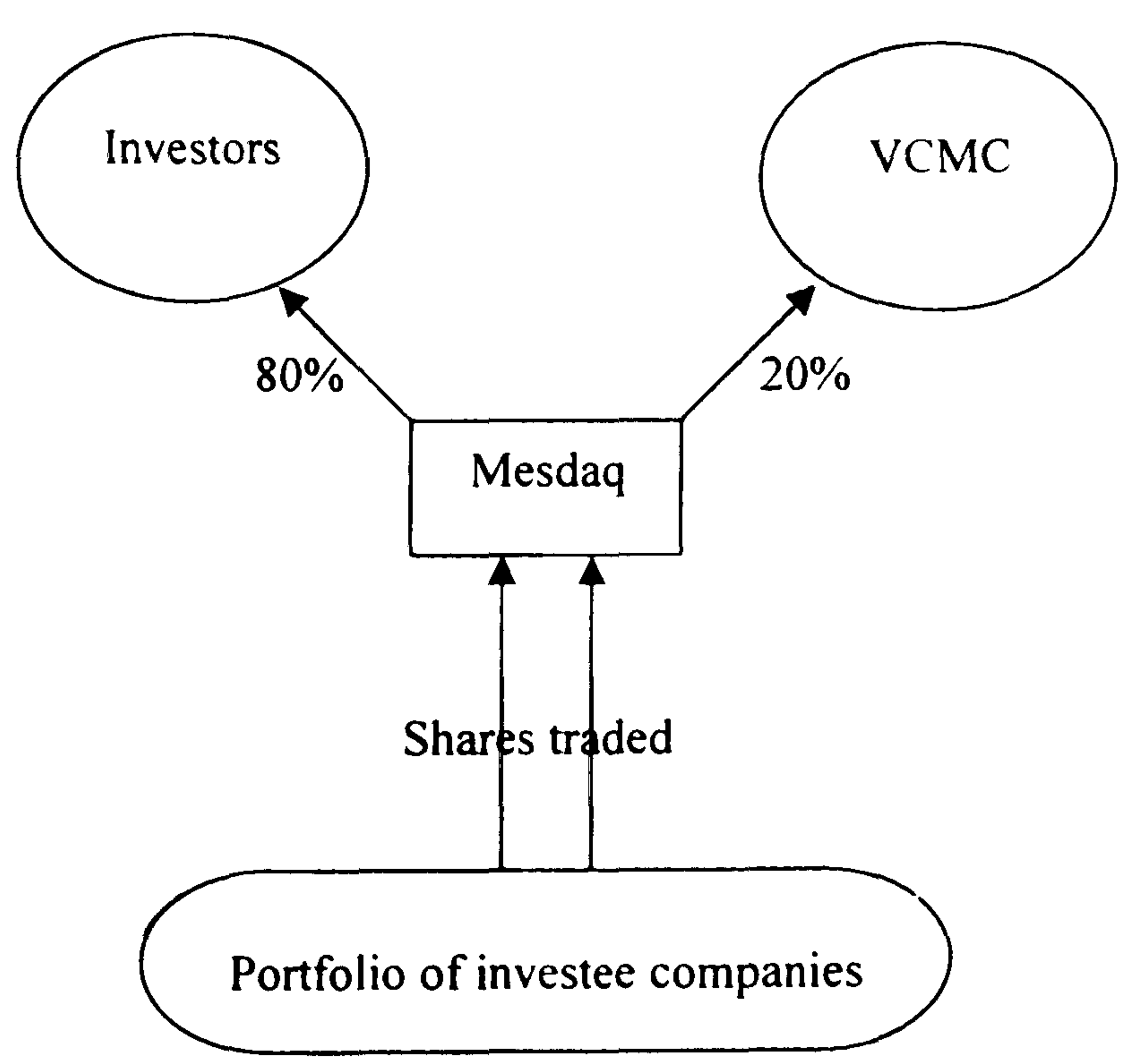
Shareholders of an invested company obtain profit through dividends and sale of shares	
Interview 10	Distribute income and profit
Interview 11	Interim dividends
Interview 17	Venture capitalist and invested company via dividend payout

Table 6.3: Focused Coding Number 2 for Question 1 (Risk and Return)

Shareholders of venture capital: through redemption of preference shares, dividends and liquidation of funds	
Interview 1	Redemption and uses redeemable preference shares and ordinary shares
Interview 2	Specified profit ratio
Interview 3	Depends on the percentage of shareholding and won't go less than 20 percent
Interview 4	Capital gains distributed between shareholders
Interview 5	Capital gains distributed between shareholders
Interview 6	Subscription agreement outline relationship between the fund company and the investment and how gains are going to be distributed Double dip
Interview 7	Not distributable unless reinvest capital gains Upon exit shareholders cash out, proceeds are divided proportionately according to shareholding
Interview 8	No standard formula
Interview 9	Profit sharing with the investor not invested company
Interview 10	Capital gains distributed between shareholders
Interview 11	Upon exit shareholders cash out, proceeds are divided proportionately according to shareholding
Interview 12	Pay the principle out to the business and dividend Interest accrued throughout the tenure of the loan order
Interview 13	Upon exit shareholders cash out, proceeds are divided proportionately according to shareholding
Interview 15	No standard formula
Interview 16	Shareholders of venture capital: through redemption of preference shares, dividends and liquidation of funds
Interview 18	Distributed between the shareholder and the VCMC

The categories obtained from interview question 1 (Risk and Return) shows how profit is distributed in the venture capital companies in Malaysia and how the profit ratio is determined. The focused coding are a sub-category from all the answers obtained from the interview for question 1 (Risk and Return). Looking at the theme in Table 6.1 and the respondents' answers in Table 6.2 and 6.3 it shows that profit-sharing is applied by the distribution of capital gains to the shareholders through dividend, sale of shares, and redemption of preference shares. Capital gains belong to the shareholders and the profit-sharing is among the investor, venture capital company and not the invested company. From here we can see the differences on how the profit-sharing principle is applied and on the instrument used. Financial instrument plays an important role in this case. Figure 6.1 below is an illustration of how capital gains are distributed in a venture capital company in Malaysia. This figure is similar to that to figure 5.1 the difference is on the illustration on the profit-sharing as seen below.

Figure 6.1: Profit-sharing in a Venture Capital



The VCMC is the venture capital management corporation and manages the funds. The portfolio as seen above is the list of invested companies. The shares are traded at the MESDAQ[165] market and the percentage shown above would be the percentage of profit sharing between the investors and the VCMC. This is a common structure in Malaysia. As stated by the respondent from Interview 18, "..Normally, common structure that they use in Malaysia, you have investor who is also a shareholder of a fund company and that fund company would be the venture capital company. So the VCMC will be the manager of this fund company and they would have a profit-sharing with the VCC (fund company). Normally, it would be 80:20 ratio, 80 percent to the investor and 20 percent to the VCMC." The ratio as seen in Figure 6.1 above is the normal rate that is shared between the VCMC and the investors as stated by the respondent in interview 18. Therefore, there is an element of profit-sharing in the venture capital and this will give a good platform to apply Mushārakah funds.

In the case of Mushārakah, we need to use Shari'ah compliant instrument. In addition, Shari'ah compliant instruments does not penalize the entrepreneurs of the invested company by obliging them to return the initial investment if their business is not of success. The conditions that come with applying financial instruments need further examination as some are not Shari'ah permissible such as cumulative preference shares and the "double dip" advantage that the venture capital can obtain from the investment. This may be of disadvantage to the invested company. Therefore, in answering research question one, instruments used in the venture capital companies plays a crucial part in applying Mushārakah funds in the venture capital

[165] The MESDAQ market is part of the Bursa Malaysia. It is intended to support the growth of high technology companies with potential.

companies in Malaysia. Financial instruments must be Shari'ah compliant and ensure a fair and transparent profit-sharing principle.

Looking at the structure of profit-sharing between the VCMC and the investor in the figure 6.1 above, we can see that there is no profit-sharing with the invested companies in terms of capital gains. Comparing with Mushārakah financing profit-sharing is between the financier and the entrepreneur. The VCMC in this case is the manager of investment funds and not the entrepreneur of the business. However, this leads to another type of venture capital which is the business angel. As stated by the respondent from interview 18, "..Angels they don't need the fund company, you have the invested company, angel here means the investor, the individual they invest directly but we help manage fund on their behalf, monitoring and sometimes you don't get any fees for managing the companies but in the end say if the investment makes money say in this case you put in 5 mil you get back 10 million so the 5 million then you share also between the individual."

This is an interesting point that arises from the analysis is on the similarities of the Mushārakah with that of the angel investor. The angel investor is an individual who invests in a business venture and provide important capital for start-up or expansion. In this type of investing money is directly given to the invested company and the angel investor may share the responsibility of managing the company together with the entrepreneur. The angel investor(s) would be the management company in this case and sits on the board of directors in the invested company and may demand higher returns due to the risk they bear. In summary, the instrument used is one of factors that are important for the applicability of the Mushārakah fund in the venture capital setting in Malaysia.

Question 2 (Risk and Return) examine the basis of the amount to be distributed. In this analysis we want to see if the capital gains are distributed based on the invested value of each shareholder. The results obtained are given in table 6.4 below.

Table 6.4: Results for Question 2 (Risk and Return)

Question 2	**Is it distributed based on the invested value?**
Focused Coding	
1	Proceed of divestment
2	Profit upon exit
3	Principal loan and shareholding
4	Negotiation on the investment deal
5	Depend on the instrument used
Theme	**Basis for profit distribution depends on proceeds of divestment, profit upon exit, principal loan and shareholding, negotiation on the investment deal and depend on the instrument used.**

Table 6.5: Focused Coding Number 1 for Question 2 (Risk and Return)

Proceed of divestment	
Interview 7	Based on proceeds of divestment

Table 6.6: Focused Coding Number 2 for Question 2 (Risk and Return)

Profit upon exit	
Interview 9	Based on profit of the venture upon exit

Table 6.7: Focused Coding Number 3 for Question 2 (Risk and Return)

Principal loan and shareholding	
Interview 1	Profit distribution is based on invested value
Interview 5	Based on the shareholding
Interview 10	Distributed based on shareholding
Interview 12	Based principal loan

Interview 14	Distributed between shareholder and the VCMC
Interview 16	Shareholding proportion
Interview 17	Yes, distributed based on the invested value plus the return on investment of the company
Interview 18	Distributed between shareholder and the VCMC

Table 6.8: Focused Coding Number 4 for Question 2 (Risk and Return)

Negotiation on the investment deal	
Interview 2	Depends on the pre-money and the post money valuation Depends on negotiation with the invested company
Interview 6	Subscription agreement outline the relationship between, the parties involved and the investment
Interview 11	Discretion of the fund manager
Interview 12	Based principal loan
Interview 13	No fixed one How you cut the deal
Interview 15	Depends on the structured agreed

Table 6.9: Focused Coding Number 5 for Question 2 (Risk and Return)

Depend on the instrument used	
Interview 3	Internal rate of return is not Islamic
Interview 13	Preference shares
Interview 15	Invested value translated to investment instrument

Based on the responses obtained, the basis for profit distribution is:

- Proceed of divestment
- Profit upon exit
- Principal loan and shareholding
- Negotiation on the investment deal
- Depend on the instrument used

In answering research question number one, we need to take these five categories obtained above that shows the basis of determining the profit ratio for the distribution of capital gains or profit among the parties involved in the investment deal. Therefore, to apply the Mushārakah fund and referring to the five categories listed above, the instruments used, exit strategy, investment deal and agreements must be Shari'ah compliant. The profit distribution of the venture capital is similar to Mushārakah and it is based on invested value. Looking at question 1 and 2 (Risk and Return) the venture capital in Malaysia gives a good platform to apply Mushārakah funds due to the concept of profit-sharing that is practised among the shareholders and the venture capital management corporation (VCMC).

6.3 Valuation Methods for Venture Capital Investments

This section of chapter six discusses about the valuation methods that are used by the venture capital companies in Malaysia. In addition, it is also to analyse which valuation method that is appropriate for a Mushārakah fund. The tables provided (table 6.11 to 6.14) shows respondents' reasons for using the preferred valuation method of their choice. This helps in answering research question number one which is:

What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

Table 6.10: Results for Question 3 (Risk and Return)

Question 3: Between the Net to Asset Value (NTA), P/E ratio, Cash Flow Analysis, which is your preferred method of valuation? Please explain.

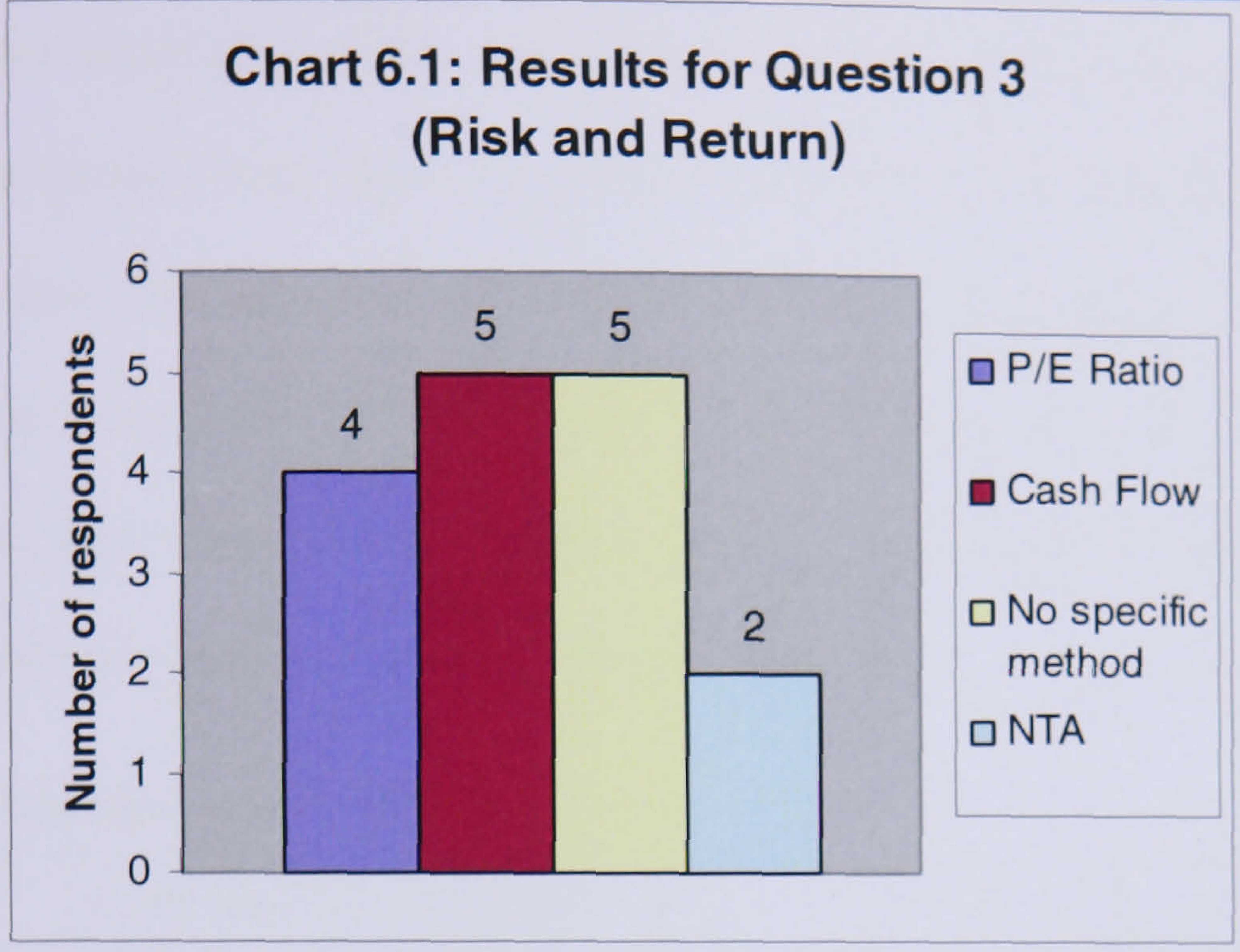


Table 6.10 above shows the statistic breakdown of the responses obtained. Most respondents (venture capital companies) prefer to use cash flow analysis and most respondents also mentioned that there is no specific method for valuing investments. Second highest is the P/E ratio and two respondents preferred to use net to asset ratio (NTA) to value their investments. The list of detailed answers given by the respondents and include together reasons for using a particular method is given in the tables listed below (table 6.11 to 6.14).

Table 6.11: Respondents' answers on using cash flow analysis

Interview 10	Cash flow considers actual value of the company Appropriate for project based investment
Interview 12	Cash flow applied for complicated cases
Interview 13	Cash flow (reality check and calculate value back in cash)
Interview 17	DCF for more than 10 years
Interview 18	Cash flow

The highest method of valuation is the cash flow method. Five out of thirteen respondents preferred this method. Based on all the responses as seen in table 6.11, cash flow analysis is more appropriately applied in the later stages whereby, the company is more established (have steady cash flows) and that applying the cash it can consider the actual value of the company (interview 10) and calculate value back in cash (interview 13). The respondent from interview 18 mentioned "Cash flow analysis because it represent the true value of the company. You want to see how much the value, how much the company is going to make next 5 years. Normally what managers do to value is using the cash flow and P/E."

Table 6.12: Respondents' answers on using P/E ratio

Interview 6	Early stage not applicable P/E matters in the private investment in public companies (PIPES)
Interview 7	Multiple earnings method, company should be completing product development in 2 to 3 years time
Interview 14	Realistically use P/E Ratio Early stage, benchmark with listed companies
Interview 17	Normally P/E and NTA

As seen in Table 6.12 above two respondents (Interview 6 and 14) mentioned that P/E ratio or any other method of valuation is not applicable in the early stage. As mentioned by the respondent in interview 6, that P/E is mainly used in "pipes" which is private investment in public companies. The respondent from interview 6 also mentioned that a lot of companies in Malaysia are involved in this type of investment. This involves companies in the later stages. Respondent from interview 14 mentioned that it is realistic to use P/E ratio as compared to the other two methods of valuation. The respondent also mentioned, "...Cash flow unless you are talking about a matured business. It doesn't give you a real return because at the seed early stage cash flow is hypothetical. So you cannot rely on the cash flow. We have it for planning obviously we try to rationalize the cash flow. In terms of valuation we don't use cash flow. You have to use P/E and that also forward P/E. It can't be based on actual."

From this response we can see that cash flow analysis and the NTA is more appropriate to be applied at the later stages whereby, the business and the product has already developed. Therefore, to apply such method makes more sense and in the seed stage it is more applicable to apply the P/E ratio. This is the same point stated by the respondent from interview 7, whereby the respondent mentioned that the invested company should be completing product development in 2 to 3 years time; therefore it is more appropriate to apply the P/E ratio at the seed-stage.

Table 6.13: Respondents' answers on having no preferred method of valuation

Interview 6	Mandate
Interview 8	No standard formula and depends on negotiation
Interview 9	No preference Combination of valuation
Interview 11	No preferred method One or more can be used and compared
Interview 15	Difference in valuation methods used for different industries
Interview 17	No specific methods it depends on the industry and current market conditions, quality and reliability of the data given and the stage of development of the company

Table 6.13 shows lists of individual without any preferred valuation method for their investments. Based on the responses from interviews 6, 8, 15 and 17 we can see the reasons for using such valuation method. For example, respondent from interview 8 mentioned that the method of valuation depends on the negotiation. Respondent from interview 15 stated that it different industries may use different methods. Some respondents may use more than one method of valuation and use many for comparison basis (interview 9 and 11). Firstly, it depends on the mandate of

the investment. Secondly, it depends on the negotiation between the investor, VCMC and the invested company. Thirdly, the industry and the market of a specific investment play a crucial part, because different industry may subject to different valuation method. Lastly, the stage of the development of the company is also of importance because as seen from the responses from table 6.11 and 6.12 some respondents mentioned that at the early stage the invested company do not have assets just yet and the business is not established, therefore applying such valuation method may not be appropriate.

Table 6.14: Respondents' answers on using net to asset ratio

Interview 12	NTA (basis principle)
Interview 17	Normally P/E and NTA applicable to listed companies

The net to asset value as mentioned by the respondent from interview 17, involves deriving the value of a business by reference to the value of its net asset. It is likely to be appropriate for a business whose value derives mainly from the underlying value of its assets rather than its earnings, such as property holding companies and investment businesses. The respondent from interview 17 stated, "..NTA is only applicable to mature companies, listed companies. You can apply it to manufacturing companies also and capital intensive company. Early stage companies you don't have any asset, then NTA is not giving you a good value of the company. Normally what managers do to value is using the cash flow and P/E. NTA if it is a mature company that it is applicable also."

Respondent from interview 14 mentioned, "NTA valuation is not the best method for young companies. NTA may be one of the methods you use for a matured company. For young companies they have very little assets. The company starts with a high NTA and within months it reduces. Young companies they don't have revenue so month and month they are burning money and they have low revenue so their NTA decline." It is evident from these two responses that the NTA is more appropriate for later stage companies where they have already acquire some assets, then only the net worth of these companies can be calculated.

If a venture capital company has a Mushārakah fund, it has to abide by the Islamic accounting standards. Furthermore, from an Islamic perspective, there should not be price manipulation and price control in a transaction that results in party being victimised. Pricing as a result from valuation is subject to a lot of uncertainty and ambiguities such as in the case of the cash flow analysis where it depends on future cash flows.

In the venture capital industry where risk plays a major role in determining profit it is vital that there should be a valuation method that can reflect the true value of the invested company. The importance of this discussion is to ensure that the valuation is to avoid *ghubn* and *gharar*. Not only that, the concept of *'iwad* whereby the price that the consumer or in this case the parties involved in the investment had paid should justify the return they are about to get from the purchase. The profit margin must be in line with *'iwad.* According to Ibn al-'Arabi "Every increase, which is without *'iwad* or an equal counter value is riba"[166] The zakat can also act as a benchmark. "In Islamic accounting, wealth and profits are both bases on which zakat (Islamic tax) is assessed on individuals and organizations. It becomes especially important because interest is forbidden in Islam and thus a predetermined fixed return on capital is prohibited."[167] The income and profit obtained by the venture capitalist

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[166] Azhar, Saiful. (2005). Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking & Finance, Investments, Takaful and Financial Planning. (pp.30-33). Kuala Lumpur: Dinamas.
[167] Islamic Accounting Web.(n.d.). Retrieve March 20, 2006, from http://www.iiu.edu.my/iaw/phdcontents.htm

and the entrepreneur are subject to zakat and financial statements must abide with Islamic principles.

In relations to the research question number one, finding the best method of valuation and abiding by the Islamic accounting standards is vital to avoid manipulation and price control in structuring the investment deal. Therefore, the importance of this discussion and the research question is to ensure that the valuation is to avoid *ghubn* and *gharar*. The profit margin must be in line with *'iwad.* Based on choosing a specific method of valuation for a Mushārakah fund depends on mandate of the investment, negotiation between the investor, VCMC and the invested company, industry and the market and the stage of the development of the company.

6.4 Facilitating Investments in Venture Capital

Facilitating investments in a venture capital is vital for the shareholders, managers and the entrepreneur. The value-adding process is important to nurture the company, however, in cases where the investments perform poorly, from this interview questions we can see that the venture capital companies will try their best to retain the investments and not just write-off. This is linked to answering research questions number one which is:

What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

This is important as value adding is another important factor to apply Mushārakah in the venture capital companies in Malaysia. At the seed and start-up stage business are bound to make losses and some do not even survive. Table 6.15 below provide the results for question 4 (Risk and Return). For the initial coded answers please refer to the appendix.

Table 6.15: Results for Question 4 (Risk and Return)

Question 4	**What happens when investments perform poorly or the business ceases trading?**
Focused Coding	
1	Sell-off and write-off
2	Management takeover
3	Modify business plan
4	Right to call back the put option
5	Takeover, mergers and acquisition
6	Pump in additional capital
7	Sacking
8	Help management
9	Restructure the way the business is managed
10	Depends on the agreement between the parties. If there is position for legal recourse, then legal action will be initiated
11	Sell shares back to the promoters or to a third party
12	Analyse poor performance
13	Salvage value
14	Criminal case option is to seek legal redress
Theme	**Writing off an investment is the last resort**

For initial coded answers please refer to Appendix 2.

This is an answer from the respondent from interview 5, "Start-up there are losses but nowadays even though the company is not making profit there is still value in a company there are some revenue. People still want to invest because there is still potential. We are not really that concern on how losses are treated in the company. As a venture capital we look at prospect. So maybe in the initial year, maybe down the road but then later you make profit."

The respondent from interview 2 stated that, "We categorise our investments as good, average, and bad investment. So bad investment normally we can turnaround if not we sell it off to a strategic partner or you just cut loss and just write-off because certain company if they are not going anywhere doesn't mean that that is the end of the company." Based on the answer the venture capital company would not just simply write-off or sell off the business. Partly, the venture capital is responsible in ensuring that the business succeeds. None of the choices are easy and the venture capital may have to put additional money for the business.

The venture capitalists writing-off the investment are the last resort as stated by the respondents. Most of the respondents mentioned that they would help and assist with the management of the invested company if they are facing a difficult phase. Some of the options that can be taken by the venture capital companies are shown in table 6.15. The venture capitalist would also look for ways to minimise loss, restructure the business and change the management of the invested company. In this case, we can see that although the venture capital companies and the invested company do not share losses the venture capital companies still assists the entrepreneur through the tough times as they hold the risk of losing their investments as well. The structure of the venture capital itself is not a partnership.

However, the value-adding process through, helping management of the invested company, restructure the way the business is managed and analysing poor performance is also of importance for a Mushārakah fund to operate efficiently. In relations to research question number one, value-adding process is an important factor to apply a Mushārakah fund in the venture capital companies in Malaysia and that writing off the investment is the last resort that the venture capital companies take action of.

6.5 Risk Mitigation in Venture Capital

This segment is focused on identifying the risk in venture capital companies in Malaysia and how they are controlled and managed by the venture capital companies and the entrepreneur. This segment also highlights the risks exposed to the venture capitalist and the entrepreneur. The responses would give an idea on the risks that a Mushārakah fund may be exposed to and most importantly how it can be addressed and controlled. This is linked to research question number one. The risk sharing will be analyzed in a more in depth manner and for both Mushārakah and the venture capital companies. The research question is shown below:

What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

In relations to the research question number one, one factor that is crucial in applying Mushārakah financing in the venture capital in Malaysia is the risk management process. We start by distinguishing the risks present in the venture capital in interview question 5 and followed by question 6 which focuses on how it is controlled and managed. Question 7 continues with the venture capital companies and the entrepreneurs' responsibility in the risk management process. The advantages and the disadvantages in this case focus on the area of risk and return. The highlight is mainly on the risk management process. Table 6.16 shows the results for question 5 (Risk and Return). The focused coding(s) are categorized based on the respondents' answers.

Table 6.16: Results for Question 5 (Risk and Return)

Question 5	**What is the biggest risk in the venture capital business?**
Focused Coding	
1	Management
2	Market
3	Return
Theme	**Risks concerning the management, market and return are the biggest risk in the venture capital companies.**

Table 6.17: Focused Coding 1 for Question 5 (Risk and Return)

Management	
Interview 6	Poor management
Interview 8	How you manage your company
Interview 9	Entrepreneurs losing focus and distracted by other products and services
Interview 10	Trusting the entrepreneur
Interview 13	People
Interview 14	People
Interview 15	Integrity of the promoter Jumping on the bandwagon when investing
Interview 16	Experience Competency and credibility of promoters Key team members
Interview 17	Competency of the management team which manage the venture capital fund Investing into a company with poor management
Interview 18	Governance

Table 6.18: Focused Coding 2 for Question 5 (Risk and Return)

Market	
Interview 7	Product/Service deployment did not receive the expected market response resulting in lower revenue
Interview 8	Competitor
Interview 9	Changes in technology, government policies and market trend
Interview 12	Business viability Not really viable why pursue
Interview 17	Depends also on the sector

Table 6.19: Focused Coding 3 for Question 5 (Risk and Return)

Return	
Interview 7	Not achieving the expected return/capital gains
Interview 10	Nearly 6 out of 10 investments under performs and need 1 or 2 home run deals to repay back the fund with
Interview 15	Industry itself very risky, failure rate at least 80%

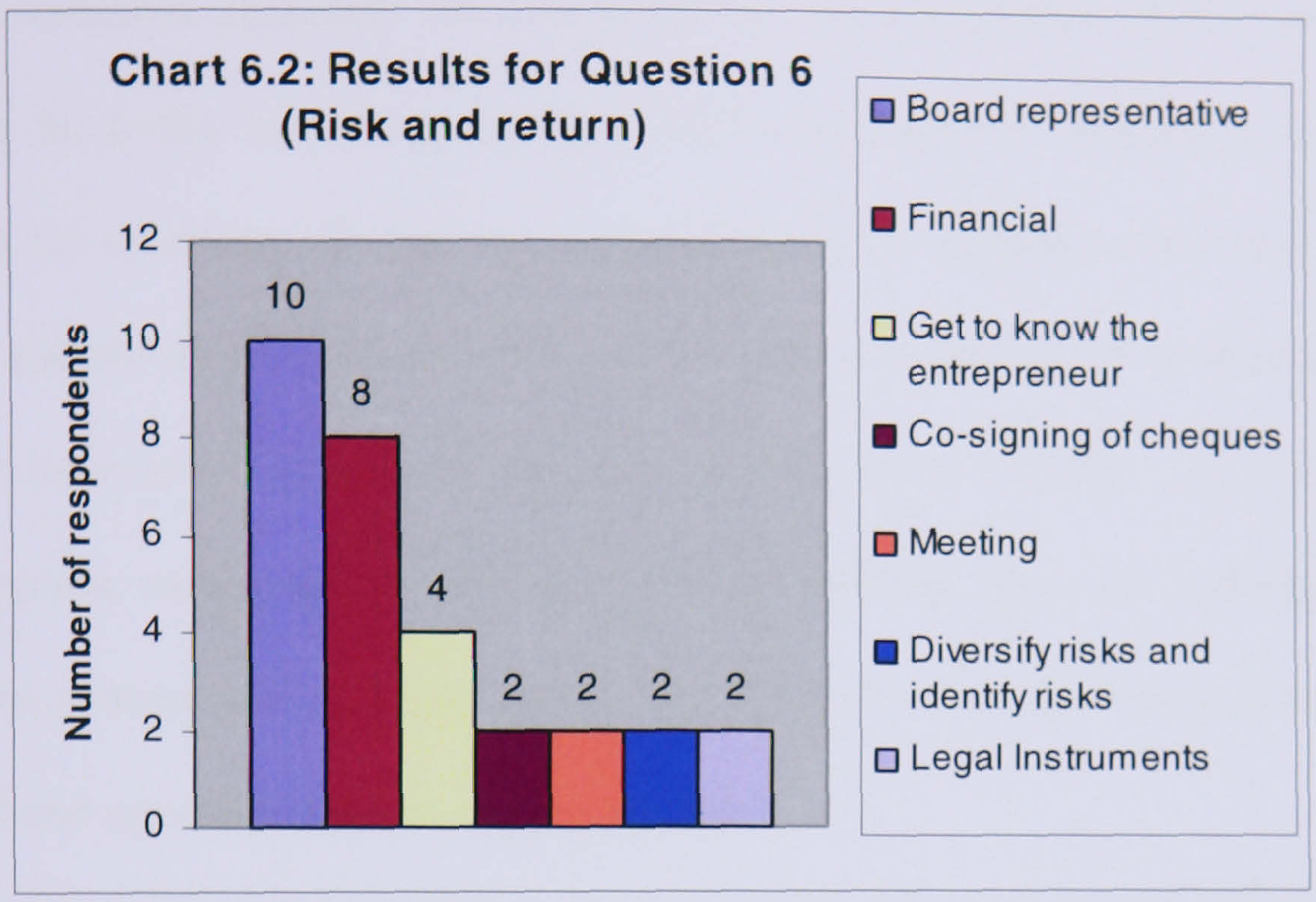
The venture capital business is considered as a financing method that highlights transparency at the early stage of the business cycle. Board directors are appointed and invested companies are monitored. The thoughts that the venture capital and the Mushārakah are exposed to such high risk especially at the start-up level makes it very much encouraged in Islamic finance. This encourages guided risk taking with knowledge in managing a business. From table 6.16 above, the biggest risk in the venture capital companies are concerning the management, market and return. Identifying the risk would only lead us to analyse further the risk mitigation of the venture capital and that of the Mushārakah. This leads us to answer research question number one whereby managing the risk involved in the management, market and return is an important factor in applying Mushārakah in the venture capital companies in Malaysia.

When management is concerned the venture capital companies are looking for entrepreneurs that are trustworthy, experienced, competent and credible (refer table 6.17). This is in line with that of question 2 (Overview of Venture Capital Industry) whereby, management is said by most of the respondents are one of their important criteria before undertaking an investment. In terms of market which is the business climate for the marketability of the product or services focuses on the competitors, business viability, changes in technology, government policies and market trend. This shows that business risk is one of the biggest risks in that of the venture capital industry especially when technology is concerned. Based on the Bank Negara Malaysia annual report 2005, the sector that comprises the highest investment in the venture capital industry is the information and communication technology sector. The information and communication technology is a fast pace technology and when the market dynamics changes the product and service may be irrelevant and out of place. In terms of return, venture capital companies are concerned of not obtaining the return on investment as the industry itself is very risky and the failure rate is at least 80 percent in Malaysia (refer table 6.19, interview 15).

Previously, the risks in the venture capital are identified through question 5 (Risk and Return). In question 6 (Risk and Return) it shows how risks in a venture capital are managed and this is a good benchmark to that how risk mitigation should be applied in a Mushārakah fund in a venture capital setting. Table 6.20 provides the results for question 6 (Risk and Return). This interview question gives an idea on managing risk in a Mushārakah fund.

Table 6.20: Results for Question 6 (Risk and Return)

Question 6: How do you ensure that you maintain a degree of control over the business to protect your investment?



The results from table 6.20 shows that 10 respondents out of the total interviews stated that appointing a board representative can ensure a degree of control over the business and protect the investment. Next, monitoring the financials in the invested company is the second highest mode of control over the investment. The third highest is on getting to know the entrepreneur and lastly, co-signing of cheques between the venture capital companies and the invested company, regular meetings, legal instruments, diversify and identify risks are other ways of maintaining control in the business and investment.

Board representative are appointed in the invested company and to monitor their progress. This is mentioned by the respondent from interview 3, "whenever we invest we always demand a board seat at least we can be there, we won't probably be hands on, but we would like to know and monitor with what is going on. That is one of the best ways, other than that we always get the quarterly reports, management reports from our invested companies. So monitoring would be the answer." Other than monitoring the invested companies, the board representation is also to guide and nurture the invested company as mentioned by the respondent from interview 5, "...also we have the nurturing division, where we put our people as the board members in the company. So that we can monitor these companies and nurture these companies and we try to hook up with our, we have our technology incubation...." In relations to interview 3 and 7, we can also see that under reports, which consist of quarterly reports, management reports, review of monthly financial performance are crucial to the venture capital companies in this case. This is to give an update in terms of financial and operations to the venture capital.

In reference to the selection criteria and the biggest risk in the venture capital, the word management appears to be mentioned the most. From this interview question management is another key area needed to be mitigated to ensure control and to protect the investment. As stated by the respondent from interview 6, "In the shareholders agreement we have a list of issues, which need our control. The best way actually is just spend time with them. The earlier the stage company the more time out should invest in them. In Mc. Kinsey's survey the best company spend a lot of time with their investsee. So you always know what's happening." In getting to know the entrepreneur the venture capital company spends more time with them.

In interview 14, the respondent mentioned, "...These are all and obviously we use our soft skills, this is probably the most important skill. The most in control is the soft skills. When you invest the person it's important you build a relationship with the investee or the promoters of the investee so that you can shape certain outcomes as you see necessary and if you build a decent relationship with them they will take head about what you have to say and you could influence them..." From this interview it also shows that the relationship between the entrepreneur and the venture capital companies is crucial and that soft skills play a major role.

The rest of the variables such as co-signing cheques, meetings, diversifying risk and legal instrument are some other methods used by some venture capital companies in Malaysia. Co-signing of cheques is to ensure financial control and financial update. Meetings are done formally and informally to monitor the progress of the investee and to build strong relationship with them. Diversifying risks as mentioned in interview 1, whereby the respondent mentioned, "Diversify the risk. In relation to the type of company you invest in and the quantum of investment. For example, in Malaysia we will limit say a particular investment we will only invest 1 million it has to be approved by the investment committee, but above 2 million it has to be approved by the board committee. Having said that, putting in 1 or 2 million when you have 30 million fund meaning you are looking around for 15 to 30 companies, so you're spreading out your risk"

This is an important point because the venture capital industry in Malaysia is relatively small. Therefore, venture capital companies must be selective and must mitigate risk as efficient as possible to further expand the industry to a larger scale. From this term and condition which is put in contract by this venture capital company, it basically shows what is requested by most venture capital companies in Malaysia in ensuring control and protect their investments. Therefore, in answering research question number one, risk mitigation through board representative, updated financial reports, getting to know the entrepreneur, regular meetings, diversify and identify risks and legal instruments are factors that are needed to implement Mushārakah in the venture capital company in Malaysia.

Table 6.21: Results for Question 7 (Risk and Return)

Question 7	Is risk management the prime responsibility of the venture capitalist or the entrepreneur?
Focused Coding	
1	Venture capitalist holds the biggest responsibility (risk management of company and investment).
2	Daily operation is the entrepreneurs' responsibility and risk assessment of the investee company.
3	Both venture capital and invested company are responsible for risk management
Theme	**Venture capitalist holds the biggest responsibility for risk management of company and investment. Daily operation is the entrepreneurs' responsibility and risk assessment of the investee company.**

Table 6.22: Focused Coding 1 for Question 7 (Risk and Return)

Venture capitalist holds the biggest responsibility for risk management of company and investment.	
Interview 1	Venture capitalist holds the biggest responsibility
Interview 3	Venture capitalist holds the biggest responsibility
Interview 4	Venture capital ensure that the investment performs, minimize its own investment risks
Interview 5	Long-term basis or a strategic basis is the Board of Directors responsibility
Interview 7	The venture capitalist will want to ensure that the executions of plans are in line
Interview 9	Venture capitalist holds the biggest responsibility
Interview 12	Venture capital ensure that the investment performs, minimize its own investment risks
Interview 13	Normally the risk management of the business is undertaken by the key managers
Interview 14	Venture capital ensure that the investment performs, minimize its own investment risks
Interview 16	Venture capital ensure that the investment performs, minimize its own investment risks Normally the risk management of the business is undertaken by the key managers Risk management of the company is done through Board of Directors (Promoters and VC are represented)
Interview 17	Venture capital ensure that the investment performs, minimize its own investment risks
Interview 18	VC is responsible to do the internal control assessment on the invested company, whether they have good accounting policy and procedures.

Table 6.23: Focused Coding 2 for Question 7 (Risk and Return)

Daily operation is the entrepreneurs' responsibility and risk assessment of the investee company	
Interview 2	Daily operations is the entrepreneurs responsibility
Interview 5	Daily operations is the entrepreneurs responsibility
Interview 6	Entrepreneur holds biggest responsibility for company and investment
Interview 11	Entrepreneur must be aware of the venture capitalist as the minority stakeholder
Interview 12	Daily operations is the entrepreneurs responsibility
Interview 14	Entrepreneur is responsible for the operations and strategic role of the company
Interview 15	Day to day running at the hands of the entrepreneur
Interview 17	Entrepreneur responsible for the risks assessment of the investee company
Interview 18	Check and balance is on the entrepreneurs' side and investor

Table 6.24: Focused Coding 3 for Question 7 (Risk and Return)

Both venture capital and invested company are responsible for risk management	
Interview 2	Both venture capitalist and entrepreneur holds the risk together
Interview 4	Shared risk
Interview 5	Shared risk
Interview 7	Both have critical role to play in managing the operational risks of the company
Interview 11	Joint responsibility, but entrepreneur must be aware of the venture capitalist as the minority stakeholder
Interview 15	General accepted risk tolerance would be set together by both parties
Interview 17	Both

This question is to examine the risk management environment in the venture capital company and the role of the venture capital company and the entrepreneur in managing them. Based on the responses obtained, seven venture capital companies (refer table 6.24), stated that the venture capital companies in Malaysia and the entrepreneur collaborate on risk management. On the other hand, twelve venture capital companies from the survey (refer table 6.22) mentioned that the venture capital companies hold the biggest responsibility when risk management is concern. This result shows that a venture capital company plays a major role in the risk management of the investments and also the investee companies. The entrepreneur in this case (refer table 6.23) manages the risk pertaining to the daily operations of the business and responsible for the risk assessment, operations and strategic role of the company. Comparing to Mushārakah risk are shared between the parties involved in the apitalist and the entrepreneur. Below are several exit strategies applied in the venture capital industry.

Initial Public Offering (IPO)

This is the first sale of stock by a company to the public. A company can rais risk collaboration between the venture capital company and the entrepreneur.

6.6 Conclusion

The importance of this analysis and the research question is that the risks of the venture capital industry are identified and to discuss the role of the entrepreneur and venture capital companies in risk mitigation. From here we can see that, to apply Musharakah in the venture capital companies in Malaysia the risk mitigation process is vital and this is stated in the theme (refer table 6.21) whereby, venture capitalist holds the biggest responsibility (risk management of company and investment). Daily operation is the entrepreneurs' responsibility and for risk assessment of the investee/invested company.

CHAPTER SEVEN : STRUCTURE AND EXIT STRATEGIES IN VENTURE CAPITAL

7.1 Introduction

In this chapter the analysis consists of rights and responsibilities of the venture capital companies and the investee companies that persists in a venture capital and can be a good reference to the Mushārakah. It also covers the exit strategies in a venture capital company and to analyse the appropriate exit strategy for a Mushārakah fund. This chapter further investigates on the appropriate financial instruments for the Mushārakah fund. All the questions in the section of corporate governance, liability and ownership in the interview question are analysed in this chapter.

7.2 Rights and Responsibilities of Venture Capital Company and Entrepreneur

This section of chapter seven examines on the rights and responsibilities of the venture capital companies and the entrepreneur in the investment. It focuses on moral hazard issues and how the venture capitalists manage them. Both questions assist in answering research question number one which is:

What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

The interview question and the categories obtained are given in Table 7.1.

Table 7.1: Results for Question 1 (Corporate Governance, Liability and Ownership)

Question 1	**What are the rights and responsibilities of the company and the venture capitalist in this partnership?**
Focused Coding	
1	Rights of the venture capital companies
2	Responsibilities of the venture capital companies
3	Rights and responsibilities of invested company
Theme	**Venture capital company holds the biggest responsibility (risk management of company and investment. Daily operation is the entrepreneurs' responsibility and risk assessment of the investee company.**

Table 7.2: Focused Coding 1 for Question 1 (Corporate Governance, Liability and Ownership)

Rights of the venture capital companies	
Interview 11	Venture capital has rights as shareholders.
Interview 12	Right to recover interest.
Interview 15	Venture capitalist provides funds and entitled to profit.
Interview 17	Voting rights - Voting rights of the VCC (Venture capital company) on certain items (i.e. remuneration or allowance of any kind for directors, significant change in business or the assignment of business to or from third parties, declaration of any cash dividends or distributions). Right of first offer and first refusal - Holders of preference shares have the right of first offer to purchase and right of first refusal not to purchase any equity securities offered by the investee company. Rights and responsibilities in decision making process - VCC should participate actively as shareholder in ensuring that it is informed of, takes an interest in, an advising and assisting the decision making process of the invested company. Rights and responsibilities of the board - The VCC should ensure that the board of the invested company is structured and appointments are made in the best interest of the investment and the invested company. Rights and responsibilities on information and communications - The management of the investee company should ensure that the company's information is accurately compiled, clear and unambiguous, kept secure and confidential, and provided in a timely and appropriate manner. Right to exercise put option

Table 7.3: Focused Coding 2 for Question 1 (Corporate Governance, Liability and Ownership)

Responsibilities of the venture capital companies	
Interview 1	Live up to the expectations of the entrepreneur. Transparency of agreement. Some companies manage on their own and some come back for opinion.
Interview 2	Transparency of agreement.
Interview 5	Venture capitalist's responsibility is to disburse money on time.
Interview 6	Early stage the venture capital should provide money, market opening and assistance.
Interview 7	Mutual understanding of the deliverables and compliance of the agreements entered into. Venture capitalist look into periodic compliance like monthly reporting, yearly accounts.
Interview 8	Being shareholder, often try to value add their presence by opening doors for business opportunities and sharing expertise.
Interview 9	Focus on business plan and flexible to market & economic changes.
Interview 10	To maximize shareholder wealth.
Interview 11	Responsibility to meet the target. VC's responsibility is to ensure that investee move in the direction mutually agreed upon and assist them.
Interview 12	Running the business as agreed upon. Profit.
Interview 17	Responsibilities to other shareholders - The VCC should ensure that the board of the investee company is structured and appointments are made in the best interest of the investment and the investee company. Responsibilities for risk assessment.

The rights given by the respondents are self exploratory and that these rights exist to protect each party of their investments. These rights are important in venture capital agreement and a Mushārakah fund. Furthermore, it enhances transparency in the agreements and is made clear to the parties involved. The agreements cover the rights and responsibilities of both parties. All of the responsibilities of the venture capital company and the invested company, stated by the respondents mentioned in the interview such as, transparency, corporate governance, achieving target returns and risk management nurtures small business to practise this at the early stages of the business and continued at the later stage. Apart from that, the responsibilities listed indicate what is promised by each party and that they have to execute it.

As stated by the respondent from interview 2, "Normally put option or whatever so it's quite transparent in a way because from day one the entrepreneur knows what is expected out of him. If as planned then we have the right and if it doesn't materialize as planned the entrepreneur knows what are the consequences and the responsibility is only spelled out based on the budget, they have to submit the budget, periodical budget, management account, so everything is spelled out." This response shows that the agreement binds all the rights and responsibilities of both parties. The rights and responsibilities that the venture capital companies have is part of their value adding process towards the invested companies. For example, venture capital companies responsibility is to ensure that the investee company move in the direction mutually agreed upon and assist them (refer table 7.3, focused coding 2, interview 11).

The venture capital companies that are registered with the Securities Commission Malaysia must provide period reporting to the Securities Commission of Malaysia such as, annual activity report[168] for venture capital corporations (VCCs) and venture capital management corporations VCMCs:

- Submitted to the SC within 30 days from each year-end
- Information on the funds, actual investments in local and international venture

[168] Securities Commission Malaysia.(n.d.). Retrieved April 10, 2007, from www.sc.com.my/eng/html/licensing/vencapregkit.html

companies (by business stage and by industry sectors) and information on the VCC's/VCMC's portfolio of venture companies

- Encouraged to provide input on the company's performance during the year, problems and constraints encountered, futures plans for development and views on the local and international venture capital industries
- Audited financial statements to be submitted within 3 months from the close of each financial year end

This is to ensure good performance, governance and transparency of the venture capital companies. The information on the invested company is required as well. This goes inline with the rights and responsibilities on information and communications whereby, the venture capital company must ensure the management of the investee/invested company provide the company's information that is accurately compiled, clear and unambiguous, kept secure and confidential, and provided in a timely and appropriate manner (refer table 7.2, interview 17). In relations to the responsibilities of the invested companies, table 7.4 below provides the list of rights and responsibilities of the invested companies as stated by the respondents.

Table 7.4: Focused Coding 3 for Question 1 (Corporate Governance, Liability and Ownership)

Rights and Responsibilities Invested Company	
Interview 7	Daily operations would be the responsibility of the invested company
Interview 8	Daily operations would be the responsibility of the invested company
Interview 11	Investee has the right to manage their companies without interference from the venture capital
Interview 14	The invested company should deliver on what they had committed for.
Interview 15	Investee is responsible for making the company profitable.
Interview 17	Responsibilities for risks assessment - The management of the investee company should be responsible for the risks assessment of the company, which includes determining risks appetite, identifying specific risks, and assessing the effectiveness of control over specific risks.

Table 7.4 shows that invested companies focus towards their company operations and responsible for making the business profitable, materializing what is in the business plan and managing risk in the business (refer table 7.4). In addition, the invested companies have the right to manage their own companies business without the interference of the venture capital companies.

From this analysis it is evident that to implement Mushārakah in a venture capital company the agreement must be transparent on the rights and responsibilities of the venture capital companies and the invested company as shown in table 7.1 up to table 7.4. Knowing the rights and responsibilities of involved parties would only ensure fair distribution of profit, loss, management and risk. The rights and responsibilities of the partners in a Mushārakah are given below.

Table 7.5: Rights and responsibilities of Mushārakah partners

Rights	Responsibilities
1) Right to borrow or lend	1) Prohibition of interest
2) Right to make transactions on credit	2) To ensure *halal* investment/business
3) Right to give capital to a third party on a Mudhārabah basis	3) Circulation of wealth through Zakat payment
4) Right to give capital to a third party on a Shirkah basis	4) Transparency of all contract and agreement and business transaction
5) Right to bring in new partners to the partnership	5) Efficient and following as stated in the agreement
6) Right to enter into another new partnership in a private capacity	6) To assist each other during tough times and
	7) Not to burden other partners with debt

Looking at table 7.5, the rights and responsibilities of the Mushārakah would be the responsibility of the Securities Commission Shari'ah Advisory Council, lawyers (well verse with Shari'ah law and Islamic contracts), venture capital company and invested company. The Mushārakah is flexible in listing out the rights and responsibilities of the parties involved and not consider too much the structure of the business entity.

Table 7.6: Results for Question 2 (Corporate Governance, Liability and Ownership)

Question 2	**Is the venture capital liable for any action undertaken by the entrepreneur?**
Focused Coding	
1	In this case it depends if the venture capitalist and the entrepreneur cohort or not.
2	The venture capital is not liable for any action undertaken by the entrepreneur
3	The venture capital is liable for any action undertaken by the entrepreneur
Theme	**Overall the venture capitalist mentioned that they are not liable in this case.**

Table 7.7: Focused Coding 1 for Question 2 (Corporate Governance, Liability and Ownership)

In this case it depends if the venture capitalist and the entrepreneur cohort or not.	
Interview 1	Cohort
Interview 13	Depends on the shareholding agreement Depends on the percentage invested
Interview 16	It depends on the legal framework agreed upon and are specific for each investment

Table 7.8: Focused Coding 2 for Question 2 (Corporate Governance, Liability and Ownership)

The venture capital is not liable for any action undertaken by the entrepreneur	
Interview 2	Venture capitalists are not liable.
Interview 4	Shareholder not liable but exposed to the problem.
Interview 5	Not applicable in Malaysia. It's on company basis. Venture capitalists protect themselves through RCPS (redeemable convertible preference shares).
Interview 6	No, we're the one who get defraud.
Interview 7 and 9	No.
Interview 14	Fiduciary, manipulation venture capital is not liable.
Interview 17	There is a clause on indemnity in the agreements to indemnify the venture capital company

Table 7.9: Focused Coding 3 for Question 2 (Corporate Governance, Liability and Ownership)

The venture capital is liable for any action undertaken by the entrepreneur	
Interview 3	Liable Insurance policies
Interview 8	Depending on the circumstances, the venture capitalist may be viable
Interview 10	Yes.
Interview 12	Yes.
Interview 15	The venture capitalist would face the same liabilities as any company director and shareholder
Interview 18	To a certain extend Yes, when invested companies don't pay the employees provident fund. Liable due to board seat. Liability that a director holds.

In relations to interview question 2 (Corporate Governance, Liability and Ownership), most of the venture capital companies mentioned that they are not liable for any actions taken by the entrepreneur. Respondent from interview 17 mentioned that there is a clause on indemnity in the agreements to indemnify the venture capital company against all claims, fines, losses, damages, costs, expenses and liabilities incurred in respect of any non-compliance by the investee company with regards to any law, guidelines or directives. If there is no indemtion, then the venture capital company would be liable.

In this case, there are areas where the venture capital companies are liable and this is stated by the interviewees. For example, respondent from interview 8 mentioned that the venture capital company is liable if the company fails to pay its Employment Provident Funds Malaysia contribution and all directors including the one representing the venture capital will be personally responsible. The interviewee also mentioned that as far as possible the venture capital company will negotiate for indemnity from the invested company or not to be a director of a company. Lastly, the interviewee stated that in lieu it is important to form a Directors Working Group Committee comprising the venture capitalist and directors of the company where any decision to be made needs to have the approval from the group committee.

In addition, respondent from interview 1 also highlighted that depending if the venture capital company and the entrepreneur cohort or not when it comes to being liable on the actions taken by each party. This also depends on the shareholding agreement and investment amount. Furthermore, corporate governance plays a vital role and everything has to be transparent and on a consensual basis before an entrepreneur wishes to carry out any transactions with another party or a financier. Looking at the responses above it shows that the venture capital company is protected from being taken advantage from unscrupulous entrepreneurs.

This all depends on the situation and how the deal and the agreement are structured. Respondent from interview 16 highlighted that legal framework may be different for each investment. This takes us back to the flexibility of the Islamic Law as stated above in structuring a contract and to be applied in Mushārakah fund in a venture capital. To apply the Mushārakah fund in the venture capital company in Malaysia, contracts need to be transparent and there is also a need for more Shari'ah lawyers to handle Islamic contracts as there may be many agreements involved which includes the rights and responsibilities of the venture capital company and the entrepreneur. As seen in table 7.8 under interview 17, the results show that in the venture capital the agreements are crucial to ensure a fair investment deal if the Mushārakah fund is applied.

7.3 Financial Instruments for a Mushārakah Fund

This section highlights on examining the appropriate financial instruments for the Mushārakah fund through analysing Interview question 3 (Corporate Governance, Liability and Ownership). It assists in answering research question number one and number two which are:

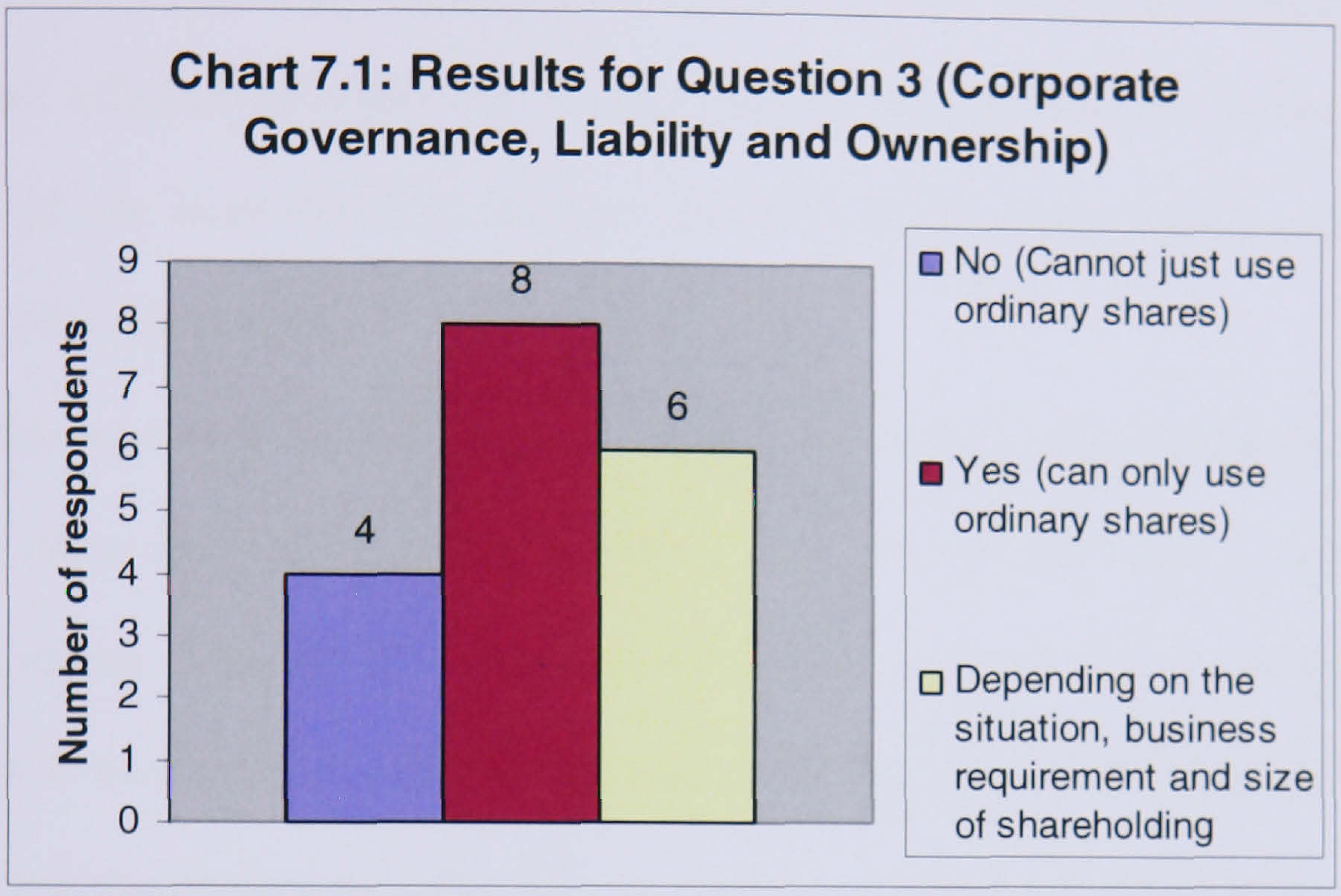
1) What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

2) Which stage of the business cycle is Mushārakah best applied?

Interview question 3 (Corporate Governance, Liability and Ownership) and the results are given in table 7.10.

Table 7.10: Results for Question 3 (Corporate Governance, Liability and Ownership)

Question 3: Would you agree to just use ordinary shares?
Theme: Venture capital companies can just use ordinary shares. However, preference shares have to be used for venture capital exit avenue and to minimize risk exposure.



In relations to research question number one and to apply the Musharakah financing in a venture capital company in Malaysia, ordinary shares can be the only instrument used to structure an investment deal as seen from the results obtained from the survey. However, preference shares have to be used for venture capital exit and to minimize risk exposure. Ordinary shares are Shari'ah compliant. Most interviewees responded that venture capital companies can just use ordinary shares for their investment. Four interviewees out of eighteen mentioned that it is not possible to use just ordinary shares and two other stated that it depends on the situation, business requirement and the size of shareholding. Finding the right instrument for an investment deal is another important factor that ensures that both parties get their fair return from the investment at the end of the day. It is vital to look for an instrument that gives fair profit-sharing for shareholders, venture capital company and the invested company. As stated by the respondent from interview 4, "..We look at how we structure the management and when we look at that, instruments become very important. Because instruments are governed by Shari'ah issues and governed by how we actually return capital to our investors. How do we exit, and how do we structure the most tax efficient structure. So all this we look into before we decide which instrument we use. I can use all instruments that are available but it depends on which is the most efficient structure."

In the case of a Mushārakah, we need to use instruments that are Shari'ah compliant. Other than using ordinary shares, venture capitalists use a variety of preference shares. Through the instruments used we can also see at which stage Mushārakah is best applied and assist in answering research question number three. Table 7.11 lists the reasons given by the respondents on using ordinary shares.

Table 7.11: Reasons for using ordinary shares only.

Interview 2	For ordinary shares if we are comfortable with the valuation and we know the company is going somewhere then we use ordinary shares
Interview 6	Not in venture capital in an LBO fine.
Interview 8	It is possible. The decision largely depend on factors such as how soon the company can be listed, any dividend
Interview 13	Yes, It is how you cut the deal.
Interview 14	We take a bit of OS the bulk of our investment is in shareholders advance. We find the RCPS very cumbersome too. Shareholders advance is a little bit easier to manage because it can be convertible anyway. Not different from RCPS except one does not need to go through some sort of a capital reduction, and so much legal maneuvers. The OS is to get a foothold into the company and to have our shareholders rights and structure a lot on shareholders advance based on future performance then we convert and work out on some sort of formula.
Interview 16	The investment instrument is determined based on the risk profile and the exit options of the investment.
Interview 17	Ordinary shares are entitled to all income and capital after the rights of all other classes of capital.
Interview 18	Mature companies go in as shareholders.

Using the appropriate instruments depends highly on the investment stage. As mentioned by respondent from interview 6, that ordinary shares may be more appropriate in the leverage buy-out (LBO) rather than in venture capital. LBO is at the private equity stage, which is at the later stage (in the case of Malaysia). Another respondent from interview 16 mentioned that the investment instrument is determined based on the risk profile and the exit options of the investment. Convertible preferred equity is more likely to be used with seed and early stage investments, and with firms in the internet and communications sectors.

Common equity is used more often for expansion stage investments. This goes in line with the answer by respondent from interview 10, whereby preference shares provide a risk management element. Preference shares protect investors by giving them the right to claim assets first upon liquidation as compared to ordinary shareholders. In the case of a Mushārakah, the convertible preferred equity is permissible and at the early stage the investors do not have a high percentage ownership using the convertible preference share. The best exit strategy in this case, would be the IPO or the Diminishing Mushārakah. In both this exit avenue the preference shares would be converted to ordinary shares at a higher price where capital gains will be obtained by the investors. Even for mature companies as stated by respondent from interview 18, that one can go in as ordinary shareholders and get returns through capital gains. Definitely at the later stage it will be less cumbersome to apply the Mushārakah and for the venture capital, therefore, having just the ordinary shares for ownership is not so risky.

Furthermore, venture capitalist can take a bit of the ordinary shares in the shareholders advance. It is easier to manage and can make them convertible, it is not much different from redeemable convertible preference shares except that one does not need to go through capital reduction and so much legal manoeuvres, this was stated by the respondent from interview 14.

Table 7.12 lists reasons given by the respondents on using preference shares.

Table 7.12: Reasons for using preference shares.

Interview 1	They can convert or not having a preference shares as an extra. Upon liquidation get to claim before the ordinary shareholder.
Interview 2	Start up stage we use preference shares. Using preference shares the exit avenue will be better, there will be redemption there will be conversion.
Interview 3	Preference shares can be exercised later on through redeemable or cumulative preference shares. It depends on the business, it depends on the requirement, it depends on how big the shareholding of the company is.
Interview 5	Invest in RCPS, the reason being in case of liquidation, it comes before ordinary shares and for conversion before listing.
Interview 7	The norm would be for the investee to issue a Cumulative Convertible Redeemable Preference Shares (CCRPS) to the investor. Maybe a condition precedent set by the investor for the venture company to obtain the necessary funding. Additional returns that the investor will get are based on the premium part of the CCRPS and also the dividend payment. Other instruments are created to address risks pose by some investments.
Interview 9	Preference share is preferred to minimize risk exposure.
Interview 10	Hybrid is preferred. It provides a risk management through preference shares.
Interview 11	VC prefers to use convertible redeemable preference shares which can be converted into ordinary shares upon listing and the shares can be redeemed by the investee company.
Interview 12	Prefer preference shares or loan more secured creditor.

Convertible preferred equity is more likely to be used with seed and early stage investments, and with firms in the internet and communications sectors (in the Malaysia venture capital industry). Preference shares provide a risk management element and more appropriate in the early stages. Ordinary shares on the other hand, are more appropriate in the later stages. Ordinary shareholders can get returns through capital gains in mature companies at the later stage and venture capitalists can take a bit of the ordinary shares in shareholders advance. Ordinary shares are easier to manage and can make them convertible and do not need to go through capital reduction and many legal manoeuvres. In relation to research question number two, we can see that Mushārakah can be applied in any stage, but would be less cumbersome if applied at a later stage where ordinary shares are used as an investment instrument. The issue in this matter is on the financial instruments used. Preference shares are likely to be used in early stages and ordinary shares in the later stages.

In a venture capital preference shares can be exercised later through redeemable cumulative preference shares and redeemable preference shares. Preference shares have to be used for venture capital exit avenues where redemption and conversion takes place. Preference shares give their holders a right to a fixed dividend but do not have voting rights. Preference shares may be issued with the right of conversion into ordinary shares, where they are called convertibles. Listed below are some examples of the forms of preference shares in Malaysia's capital market:

- **Convertible Preferred Shares** - Preferred stock that includes an option for the holder to convert the preferred shares into a fixed number of common shares, usually anytime after a predetermined date.

- **Cumulative Redeemable Convertible Preference Shares** - Shares can be bought back by the invested company from the venture capital by exercising their call-options (invested company) and put-options (venture capitalist) at the redemption date.

- **Redeemable Preference Shares** - "Preference shares, which the issuing company reserves the right to redeem. The shares may, or may not have a specific redemption date or dates."[169]

- **Cumulative Preference Shares** - "When a company fails to pay a dividend, holders of cumulative preference shares are entitled to receive this missed payment when a dividend is next declared. This rule is cumulative and they are also entitled to the current dividend provided sufficient cash is available. These payments receive priority over the claims of ordinary shareholders." [170]
- **Participating Preferred Shares** - "A type of preferred stock that under certain conditions gives holders the right to receive earnings payouts over and above the specified dividend rate."[171]
- **Loan stock** - "Unsecured stock delivered to an entity that has furnished a loan for a company. Loan stock earns interest at a fixed rate."[172]

As of 14th July 1999, the Syariah Advisory Council (SAC) of the Securities Commission in Malaysia resolved that the basic preference shares (non-cumulative) are permissible based on *tanazul.*[173] *Tanazul* means to drop claims to right.[174] The Companies Act 1965 has defined preference share as a share that does not give a right to the shareholders to vote at its general meeting or any right to participate in any distribution of the company that has stated the amount, whether through dividends or redemption, dissolution or otherwise.[175] "The SAC has carried out studies on non-

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[169] Redeemable Preference Shares. (n.d.). Retrieved November 10, 2005, from http://dictionary.itlocus.com/r/redeemable_preference_shares.html.
[170] Cumulative Preference Shares. (n.d.).Retrieved November 10, 2005, from http://glossary.itlocus.com/cumulative_preference_shares.html
[171] *Participating Preferred Shares* (n.d.).Retrieved November 10, 2005, from http://financial-dictionary.thefreedictionary.com/
[172] *Loan Stock* (n.d.). Retrieved November 10, 2005, from www.investorwords.com
[173] Resolutions of the Securities Commission Syariah Advisory Council, (2002). Kuala Lumpur: Securities Commission. pp.71.
[174] Ibid. 71pp.
[175] Companies Act 1965, section 4.

cumulative preference shares. It refers to preference shares whose period of holding by the investor is permanent and similar to ordinary shares except that dividends are fixed and not accumulative. It has similar features of an ordinary share that has no maturity date and dividend payment is not cumulative. A non-cumulative preference share is included in the equity with fixed dividends."[176]

"The SAC ruled that non-cumulative preference shares are permissible based on *tanazul* where the right to profit of the ordinary shareholder is given willingly to a preference shareholder. *Tanazul* is agreed upon at an annual general meeting of a company, which decides to issue preference shares in an effort to raise new capital. As it is agreed at the meeting to issue preference shares, this means that ordinary shareholders have agreed to give priority to preference shareholders in dividing the profits, in accordance with *tanazul*. In the context of preference share *tanazul* means surrendering the rights to a share of profit based on partnership, by giving priority to preference share holders."[177]

Based on the Shari'ah Advisory Council's (SAC) explanation, we can see that convertible preference shares and redeemable preference shares operate similarly to that of the non-cumulative preference shares, whereby it is permissible based on *tanazul*. In this case, the venture capital buys the convertible preference shares from the invested company surrendering the rights to a share of profit based on partnership, by giving priority to preference share holders. Participating and cumulative preference shares of any kind are not mentioned as Shari'ah permissible. As stated by the SAC non-cumulative is permissible but did not mention cumulative. However, it is

[176] Resolutions of the Securities Commission Syariah Advisory Council. (2002). Kuala Lumpur: Securities Commission. pp.72.
[177] Ibid. 72pp.

convertible. In a venture capital setting participating preferred shares somehow allows the investor to receive profit twice from the face value of their investments and hold their equity ownership in a company. If this is the matter, then the investors do not actually accept risk or practicing correctly the risk-sharing concept as in the Mushārakah contract. This may not be fair for the entrepreneur.

To summarize, we can see that convertible preference shares and redeemable preference shares operate similarly to that of the non-cumulative preference shares, whereby it is permissible based on *tanazul*. Apart from that, using the appropriate instruments depend highly on the investment stage and that ordinary shares may be more appropriate in the leverage buy-out (LBO) private equity stage rather than in venture capital stage. Therefore, in answering the research question, the Mushārakah financing mode can be applied at any stage, and that it only depends on the instruments that is appropriate for each investment stage on whether it is Shari'ah compliant or not and that it gives fair business environment for the parties involved. However, there are several instruments that are Shari'ah compliant which are convertible preference shares and redeemable preference shares which can be opt to structure an investment in a Mushārakah fund.

7.4 Potential Exit Strategies for a Mushārakah Fund

This section analyses questions 4, 5 and 6 (Corporate Governance, Liability and Ownership) to study the appropriate exit mechanism for a Mushārakah fund. It assists in answering the research questions below which are:

1) What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

2) Which stage of the business cycle is Mushārakah best applied?

3) What is the appropriate exit mechanism for Mushārakah fund?

Table 7.13: Results for Question 4 (Corporate Governance, Liability and Ownership)

Question 4	**Would it be a good strategy to exit if the investee slowly buys out it shares bit by bit until the investee wholly owns the business?**
Focused Coding	
1	Can be applied if able to obtain target return
2	Can be applied if invested company has large amount of cash
3	Can be applied if it can provide a win-win situation for the parties involved
4	Depending on the objective and value extracted by the venture capital company
Theme	**Can be applied in a venture capital as long as able to obtain target return, invested company has large amount of cash, can provide a win-win situation and depending on the objective and value extracted by the venture capital company.**

Table 7.14: Focused Coding 1 for Question 4 (Corporate Governance, Liability and Ownership).

Able to obtain target return	
Interview 2	As long as it meets target return
Interview 4	As long as you get return
Interview 18	That's where the put option is. Investee can buy back their own shares provided they give the required return to the investors.

Table 7.15: Focused Coding 2 for Question 4 (Corporate Governance, Liability and Ownership).

Invested company has large amount of cash	
Interview 13	Call option. Large amount of cash (listed shares)
Interview 17	It is a good strategy as long as the investee company has extra cash which cannot get a good return. Buying back the shares to add value to the invested company.

Table 7.16: Focused Coding 3 for Question 4 (Corporate Governance, Liability and Ownership).

It can provide a win-win situation for the parties involved	
Interview 8	It is good if it is a win-win situation

Table 7.17: Focused Coding 4 for Question 4 (Corporate Governance, Liability and Ownership).

Depending on the objective and value extracted by the venture capital company	
Interview 15	Depends on the objective and value extracted by the venture capitalist.

Table 7.18: Focused Coding 5 for Question 4 (Corporate Governance, Liability and Ownership).

Other reasons for stating that buying out shares periodically is a good strategy.	
Interview 1	Good for developmental venture capital and applicable in certain type of venture capital.
Interview 2	Depends on a case to case basis.
Interview 3	Third payment scheme, whatever the company owes can be paid in instalments but must have prior agreement to that.
Interview 7	Yes, the price of the shares are usually pre-determined, it won't be a disadvantage to the investor
Interview 9	Depends on a case to case basis.
Interview 10	Usually the two parties will enter into an agreement of buyback options. Cost plus a certain percentage of gain.

Table 7.19: Focused Coding 6 for Question 4 (Corporate Governance, Liability and Ownership).

Reasons for stating that buying out shares periodically is not a good strategy.	
Interview 2	Profit limited as compared to an IPO.
Interview 3	Preferred IPO market, it doesn't cause anybody any money.
Interview 5	Start up level is appropriate but late stage not appropriate.
Interview 6	Happens when business is not successful. If the business is successful venture capital won't let the entrepreneur to buy out cheaply. Buying out with the highest price in the market is fine.
Interview 11	Not exactly. The existing cash should be reinvested for profit. Applying buyback will devalue the company
Interview 14	If there is potential that a company is doing so well buyback is not practical
Interview 16	No, preference shares could be redeemed but don't offer good return to venture capital.

Question 4 (Corporate Governance, Liability and Ownership) in this section analyses the potential of Diminishing Mushārakah as a potential exit strategy. In this question

we are analyzing an appropriate exit mechanism for a Mushārakah fund. In addition, exit strategies are also linked with the stages of investment and this is discussed also in this analysis pertaining to the Mushārakah applicability in the venture capital setting in Malaysia. Buying out shares periodically is the same with that of the Diminishing Mushārakah. If we look at table 7.13, buying out shares can be applied in the venture capital based on these reasons:

- Able to obtain target return. (Interview 2, 4 and 18)
- Invested company has large amount of cash. (Interview 13 and 17)
- It can provide a win-win situation for the parties involved. (Interview 8)
- Depending on the objective and value extracted by the venture capitalist. (Interview 15)

Referring to table 7.18 above, other reasons for stating that buying out shares periodically is a good strategy to exit because it is appropriate for certain types of venture capital and the one mentioned by the respondent in Interview 1 would be for of a developmental type of venture capital. Respondent from interview 3 and 10 mentioned that buyback are a good strategy but the parties involved must get into an agreement before that. Respondent from interview 7 stated that buyback is a good strategy as the price of shares is pre-determined and would not be a disadvantage to the investor. In answering research question number one, it is important to have a practical exit mechanism that gives attractive return and a win-win investment deal for the Musharakah fund.

In relations to research question two and three, this shows that to apply Diminishing Mushārakah as an exit strategy for a Mushārakah fund can be done as long as the venture capital company can obtain the target return and that the invested company has large amount of cash. Other than that, it can provide a win-win situation for the parties involved and depending on the venture capital company's objective and value extracted by them. Other important areas to look into would be on the agreement, and as mentioned by respondents from interview 3 and 10 (refer table 7.18, focused coding 5), the investors, managers and the entrepreneur must get into an agreement before that. There are several other points highlighted by the respondents that should be taken into consideration. There are several respondents that stated that buying out shares periodically to exit is not a good strategy.

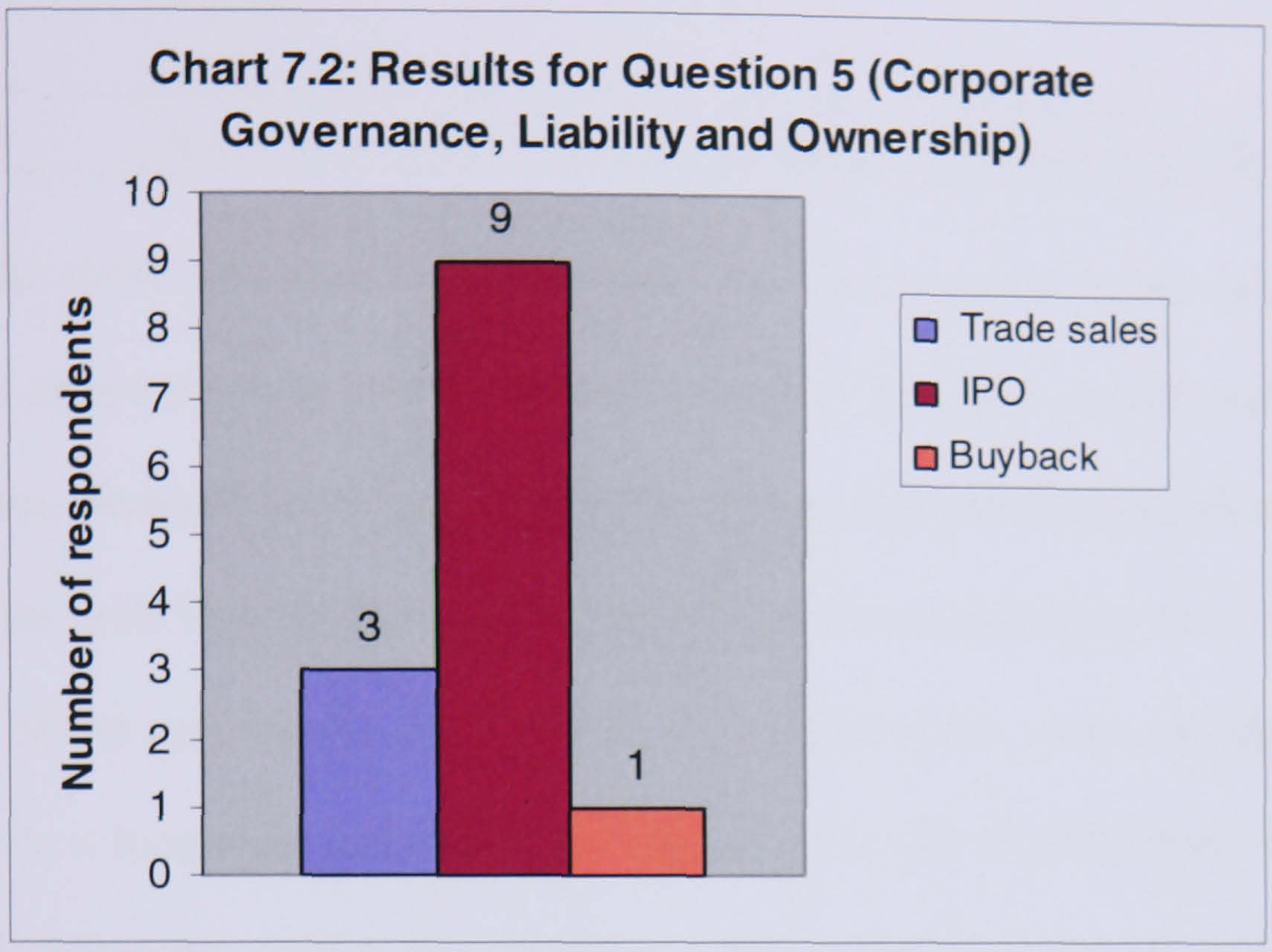
Respondent from interview 6 (refer table 7.19, focused coding 6) mentioned that successful companies do not buyback their shares. This is only the case when the invested company is not doing so well, and they buyout their shares to add value to the company. Other than that, the respondent also mentioned that venture capital companies would not let the entrepreneur to buy out cheaply. Respondent from interview 11, stated that buying back the shares may devalue the company. This same point was raised by respondent from interview 14. However, if the entrepreneur wants to buyout at the highest market price the venture capital company would be fine with it (refer table 7.19, focused coding 6, interview 6). Based on these responses it shows the downside of share buyback by the invested company, whereby profit is limited and this is stated by the respondent from interview 2, that IPO is preferred as an exit mechanism as compared to buying back shares because the profit is limited (refer table 7.19, focused coding 6).

The analysis goes further to see the application Diminishing Mushārakah at the respective stages. This is to see at which stage it is best to apply this method of exit strategy. The respondent from interview 5 mentioned that, "..At the start-up level maybe this is appropriate because the entrepreneur would have not much money to buy it out right. So they need time to buy it bit by bit. As they show their maturity and their skill in running the business, they can buy back from the venture capital at a higher level but, for late stage companies, where the venture capital themselves are quite sure of the value and can basically be realized in short-term and medium-term, maybe the venture capital themselves wouldn't want to do this because they want to get a cut of the profit...". Based on the response in interview 5, due to the high level of risk at the start-up stage it is more appropriate to apply share buyback at this stage.

The share buyback is used in this analysis as a benchmark to analyse the applicability of the Diminishing Mushārakah as an exit strategy. In answering research question number one, it is important to have a practical exit mechanism that gives attractive return and a win-win investment deal for the Mushārakah fund. In relations to research questions number two and three, it is appropriate and viable for the Diminishing Mushārakah to be applied as an exit mechanism for companies at the start-up stage because in the later stages invested companies have higher value and venture capital companies prefer to exit using other exit mechanism that would provide them higher return. This gives an idea on analysing other exit strategies for the Mushārakah fund at the later stage. This leads to question 5 (Corporate Governance, Liability Ownership). Table 7.20 below shows the results obtained from the survey.

Table 7.20: Results for Question 5 (Corporate Governance, Liability and Ownership).

Question 5: What is your preferred exit strategy?



IPO is mostly the preferred exit strategy based on this survey. Three respondent preferred trade sale. One respondent mentioned share buyback from the promoter as the preferred exit strategy, which is similar to that of Diminishing Mushārakah.

In relations to Question 5 (Corporate Governance, Liability and Ownership) most of respondents answered IPO due to the reasons stated (refer table 7.21).

Table 7.21: Reasons for choosing IPO as a preferred exit strategy.

Interview 7	It enables the venture capital company to own shares which are tradable and that there is dividend received.
Interview 9	IPO for maximum return.
Interview 10	IPO. Provides a proper channel of exiting.
Interview 11	One that gives higher returns so it can either be IPO, trade sale or M&A.
Interview 13	IPO. Strong dividend policy.
Interview 14	IPO or second best revert into public vehicle because you command a higher P/E in the market.

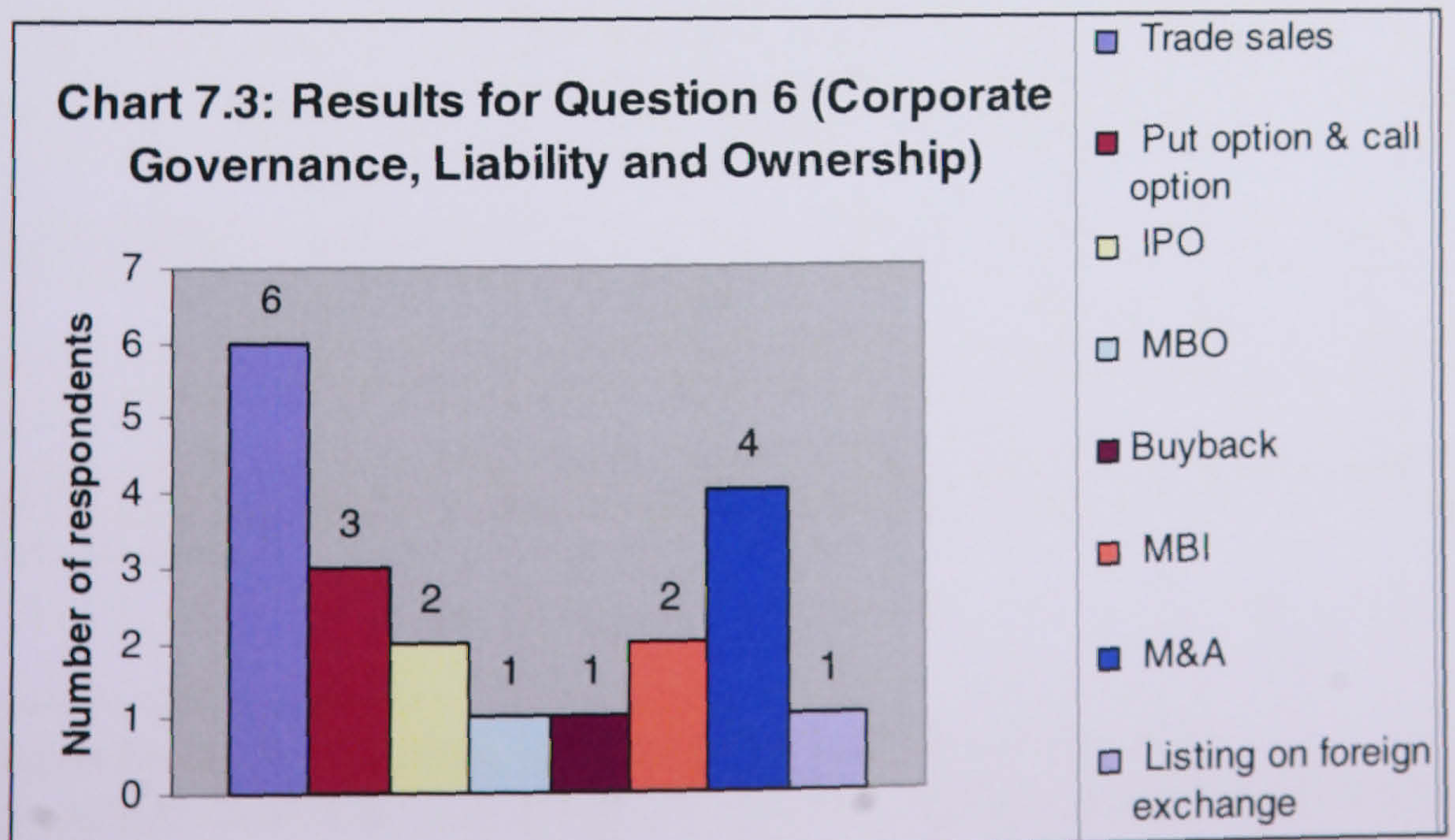
Interview 15	Short term investment the choice would be put option and long term investment the choice would be an IPO.
Interview 16	IPO. Tap into the market for future capital rising and have market liquidity. Beneficial for both shareholders and the company
Interview 17	IPO. Public market pays more for a company than almost any other source. Higher return.
Interview 18	If you go in at an early stage then your exit strategy would be the IPO

Based on the above this shows that to choose an exit strategy for a Mushārakah fund the reasons above must be taken into consideration. The IPO is preferred based on higher return, dividend received, market liquidity and proper channel of exiting and beneficial for both shareholders and the company. The exit strategy also depends on the tenure of the investment. In a short-term investment the choice would be a put option and in a long-term investment the choice would be an IPO (refer table 7.21). Table 7.22 shows the results for Question 6 (Corporate Governance, Liability and Ownership).

Table 7.22: Results for Question 6 (Corporate Governance, Liability and Ownership).

Question 6: What other exit avenue do you use?

Chart 7.3: Results for Question 6 (Corporate Governance, Liability and Ownership)



This chart shows other preferred exit methods applied by the venture capital companies in the survey. The number of respondents is given in the chart. Trade sales is the highest followed by mergers and acquisition. Buyback and management buy-in comes in third and fourth place. Below are examples of exit avenues in the Malaysian venture capital industry and in relations to the results provided in table 7.22.

7.4.1 Initial Public Offering (IPO)

The establishment of the MESDAQ in (Malaysian Exchange of Securities Dealing & Automated Quotation) provides a viable exit mechanism for the investee companies in Malaysia. The objective of the MESDAQ is to provide a platform for high-growth companies to raise capital and promote technology industries and assist in developing a science and technology base for Malaysia through indigenous research development.[178] Table 7.23 shows the statistics of IPO listings through the MESDAQ market in Malaysia. Based on the statistics given in table 7.23 we can see the number of listings and this shows the important role of the MESDAQ market for the venture capital companies and the invested companies.

Table 7.23: Total Number of Listed Companies (as at 13 April 2007)

Year	Main Board	Second Board	MESDAQ Market	Total
2007	645	245	130	1020
2006	649	250	128	1027
2005	646	268	107	1021
2004	622	278	63	963
2003	598	276	32	906
2002	562	294	12	868

Source: Bursa Malaysia[179]

[178] Bursa Malaysia Listing Requirements. (n.d.) Retrieved April 16, 2007, from http://www.bursamalaysia.com/website/bm/rules_and_regulations/listing_requirements/downloads/LR_MM28Dec06.pdf

[179] Bursa Malaysia Listing Statistics.(n.d.) Retrieved April 16, 2007, from http://www.klse.com.my/website/bm/listed_companies/ipos/listing_statistics.html

7.4.2 Management Buy-out (MBO)

This type of exit takes place when the managers and/or executives of a company purchase controlling interest in a company from existing shareholders.[180] As mentioned by the respondent interview 18, "..if ordinary shares are the only instruments used in the investment deal then MBO would be the suitable exit strategy." Some other ways to exit through (MBO) is by exiting through puts and calls. Preference shares can be redeemed by the invested company after a specific year(s) (depending on what has been agreed with the venture capitalist). The put option gives the venture capitalist the right to buy the company's share and the call option is the right for the company to buy the venture capitalist shares at a predetermined formula. The advantages of a management buyout are that the entrepreneur is not tied up with reporting to the regulators and would probably be less costly as compared to an IPO.

7.4.3 Management Buy-In (MBI)

Management buy-in is an exit mechanism where a group of investors outside of a company purchases a controlling block of shares and keeps the existing management.[181] The investors involved in the MBI believe that the company and its current management are of great value. A few representatives from the group of investors will usually be appointed to the company's board of directors.[182] The investor in this case may add value in terms of marketing the product, services and industry outlook. In some cases, the new investor may be another venture capitalist and it can

[180] Investopedia.com. (n.d.) Retrieved October 14, 2005, from http://www.investopedia.com/university/ipo/ipo.asp, 10/14/05.
[181] Management Buy-in MBI.(n.d.) Retrieved October 14, 2005, from http://www.investopedia.com/university/ipo/ipo.asp,
[182] Ibid

prepare the company towards listing.

7.4.4 Trade Sale

Trade sale involves selling shares to another potential buyer or another venture capital company. In some cases, the earnings obtained through trade sale are higher compared to that of the IPO. The potential buyer could expand the business into other countries and the net worth will increase. The respondent from interview 16 mentioned that in Asia, the person who always makes the highest price is a strategic buyer because he knows how to take the exit and make more value out of it. He also mentioned the best example about NAVIS's[183] sale of Drypers[184]. He stated that if they had gone for listing maybe they could have got 10 times earnings but a Swedish paper company looked at Drypers and they say they could cut cost and expand the brand plus invest more money to take the brand to Thailand, Indonesia and they paid 16 times. In reference to table 7.22 we can see that other than IPO the venture capital companies in Malaysia from the survey preferred trade sales as an exit mechanism. It shows that these two exit mechanism provide high return.

It is hard to say if the Diminishing Mushārakah can give a high return as compared to the IPO or the trade sale as preferred by the respondents. Buying back shares periodically and applying Diminishing Mushārakah as an exit mechanism is viable as long as the target returns is achieved and provide a platform for parties to maintain a win-win situation in the investment deal. The advantage of a share buyback or the Diminishing Mushārakah for that matter, over the IPO is that the

[183] Navis Capital Partners was founded in 1998. They make private equity investments in buyouts, recapitalisations and financial restructurings in Asia.
[184] Associated Hygienic Products Manufacturers of the Drypers range of baby diapers, training pants, and baby wipes.

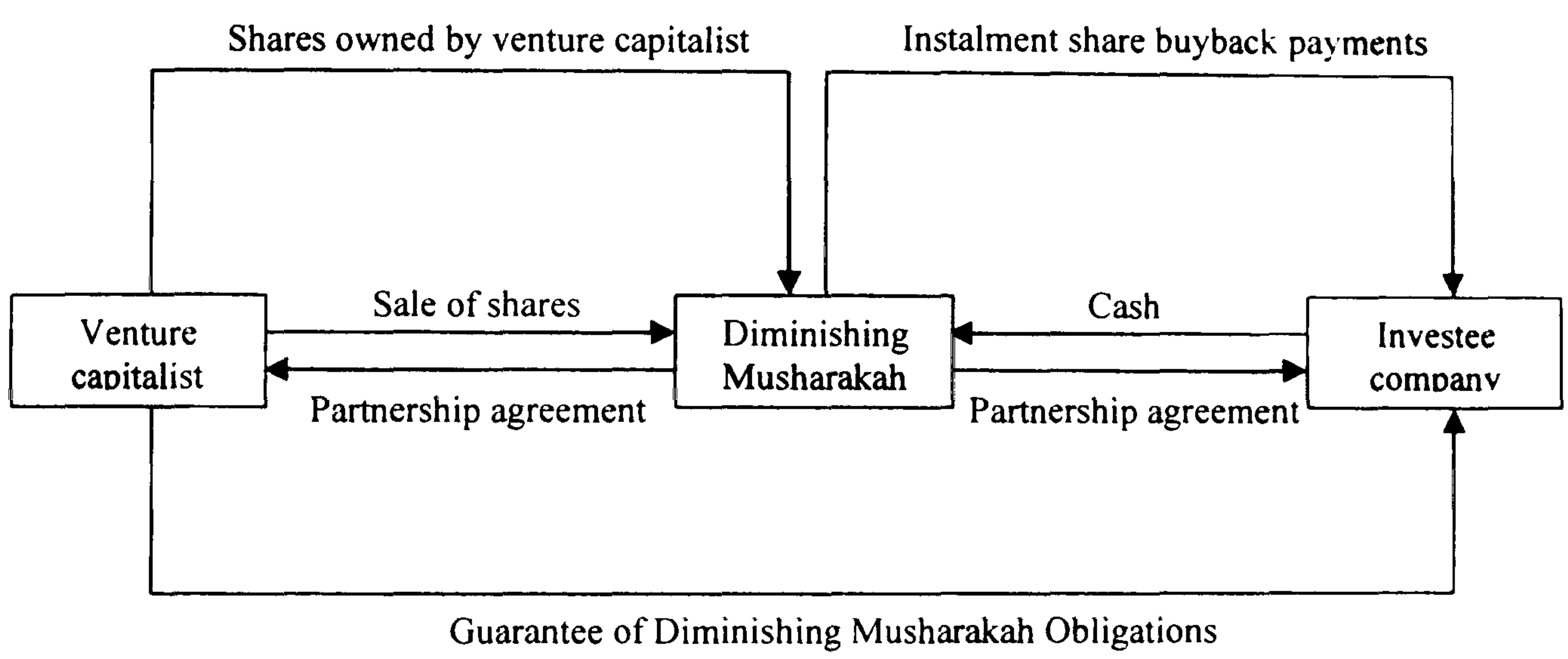
entrepreneur is not tied up with reporting to the regulators and would probably be less costly. The chart on exit mechanisms seen in table 7.20 and 7.22, show potential exit mechanisms for a Mushārakah fund. In relations to the IPO listing, the Shari'ah Advisory Council (SAC) of the Securities Commission Malaysia currently conducts Shari'ah compliance reviews process at the pre-IPO stage. In terms of Shari'ah compliance matters there is a regulator in Malaysia that can provide guidelines and consultations. For the other exit mechanisms the process is not as stringent as compared to that of an IPO.

7.5 Conclusion

Therefore, in answering research question number two and three the IPO is the viable exit mechanism for the Mushārakah fund due to the return and Shari'ah compliance. The Mushārakah fund is suitable to be applied at the early stages, where the invested companies can exit through share buyback and IPO. In relations to research question number one, another factor that is important to apply Mushārakah in the venture capital company in Malaysia is to have a viable exit mechanism that gives an attractive return, a win-win investment deal and Shari'ah compliant which is the IPO, share buyback and Diminishing Mushārakah. The lists of exit mechanisms in table 7.22 also gives an idea on other exit mechanisms appropriate for the Mushārakah funds but it needs to be Shari'ah compliant.

Another important factor that needs discussion in this matter is on the transaction that takes place between the venture capital company and the entrepreneur/investee company. When contract transactions are concerned, from the Shari'ah standpoint one transaction can not be made a condition on another. In this case the entrepreneur will purchase their unit of shares from the venture capital company. Therefore this transaction may be in the form of a separate and independent promise by the entrepreneur. This is the same as explained in the case of house financing using the Diminishing Mushārakah as written by Mufti Taqi Usmani.[185] He mentioned that instead of making these transactions conditional towards each other, which is not allowed according to Shari'ah Law, there should be a one sided promise from the client. Firstly, is to take the share of the financier on lease and pay the rent, and secondly, to purchase different units of the share of the financier of the house at different stages.[186] Figure 7.1 shows how it works in the venture capital scene.

Figure 7.1: Diminishing Mushārakah Exit Mechanism



The venture capital company goes into a partnership agreement with the investee company and the agreement will include the amount of shares that the investee may buyback from the venture capitalist in instalments. Using Diminishing Mushārakah as an exit strategy the price per unit of the share can not be fixed in the promise of the entrepreneur to purchase from the venture capital company, because if the business is a success or not, the entrepreneur has to pay that amount. By right, the price is evaluated based on actual profit, the invested company's value and performance. As mentioned by Mufti Taqi Usmani, if the price is fixed before hand at the time of

[185] Usmani, Muhammad Taqi (2005). *An Introduction to Islamic Finance*. Pakistan: Maktaba Ma'ariful Quran, pp.90.
[186] Ibid. 90pp.

entering the Mushārakah, it will practically mean that the client has ensured the principal invested by the financier with or without profit and this is prohibited in the case of Mushārakah.[187]

Mufti Taqi Usmani also stated that one option that the financier can opt to pricing the share is that the financier agrees to sell the units on the basis of valuation of the business at the time of purchase of each unit of the shares. If the value of the business has increased, the price will be higher and if it has decreased the price will be less.[188] The enforceability of the promise is also discussed by Mufti Taqi Usmani. He stated that there are number of Muslim jurists who lecture that promises are enforceable, and the court of law can compel the promisor to fulfil his promise especially in the context of commercial activities. He also mentioned that some Mālikī and Hanafi jurists can be cited, in particular, who have declared that the promises can be enforced through courts of law in cases of need.

[187] Usmani, Muhammad Taqi (2005). *An Introduction to Islamic Finance*. Pakistan: Maktaba Ma'ariful Quran, pp.92.
[188] Ibid 92pp.

CHAPTER EIGHT:TRUST AND MONITORING METHODS IN VENTURE CAPITAL

8.1 Introduction

This chapter covers on the definition of trust from a venture capital perspective and ways to support it. This is definitely one element that is vital in the Mushārakah fund as it is a partnership based on trust. These answers from the interviewees will give an insight into trust and how it is important in the venture capital industry and also for the Mushārakah fund in the venture capital. Monitoring methods are analyzed as well.

8.2 Definitions of Trust

Interview questions 1 and 2 (Trust) analyzes on defining and reinforcing trust and its importance for a Mushārakah fund. By defining trust we can see what is expected from an entrepreneur. Both interview questions assist in answering the research question below which is:

What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?

Table 8.1: Results for Question 1 (Trust)

Question 1	**How would you define trust?**
Focused Coding	
1	Expectation
2	Comfort and relationship
3	Personality
4	Transparency and corporate governance
Theme	**Trust is defined based on; expectation, comfort and relationship, personality of the entrepreneur, transparency and corporate governance.**

Table 8.2: Focused Coding 1 for Question 1 (Trust).

Expectation	
Interview 1	What he says is what he does.
Interview 2	Believe in the entrepreneur to charter the best course for the company and delivering it
Interview 3	Skills to make business work
Interview 6	Finding the entrepreneurs ability and match it with what he is asking for
Interview 11	Believe in the entrepreneur to charter the best course for the company and delivering it
Interview 12	The ability to love a common goal in pursuing the business
Interview 16	Confidently depend on other party to carry out its obligation
Interview 18	Experience

Table 8.3: Focused Coding 2 for Question 1 (Trust).

Comfort and relationship	
Interview 2	Comfortable with the business plan Comfortable with the people
Interview 4	Comfortable with the entrepreneur
Interview 6	Comfortable with the entrepreneur
Interview 7	Fiduciary relationship between trustee and beneficiary
Interview 8	Chemistry to working together How you feel towards the other party
Interview 13	Comfort. Connection.

Table 8.4: Focused Coding 3 for Question 1 (Trust).

Personality	
Interview 1	Trustworthy
Interview 3	Trustworthy
Interview 5	Trustworthy
Interview 6	Good values fair and does not cheat
Interview 10	Sincerity Honesty between two or more parties
Interview 11	High integrity
Interview 18	Straight forward Dedication

Table 8.5: Focused Coding 4 for Question 1 (Trust).

Transparency and corporate governance	
Interview 5	Transparency
Interview 9	Transparency
Interview 11	Protecting shareholder's interest Good reputation
Interview 17	Well-negotiated, mutually agreed rights and responsibilities for all parties to embark on a partnership that practise integrity and transparency
Interview 18	Transparency

Trustworthy is the criterion looked for in an entrepreneur and skills to materialize the business plan. A high level of trustworthiness between the venture capitalist and the entrepreneur may reduce the risk of moral hazard. The answers are given by the respondents on the definition of trust in the context within the venture capital setting and are categorised into (refer to focused coding in table 8.1) expectations, comfort and relationship, personality, transparency and corporate governance. In other words trust is defined based on; expectation of the venture capital towards the entrepreneur, comfort and relationship between both of them, personality of the entrepreneur, transparency and corporate governance of business operations. Trust is hard to measure; however, it is important in Mushārakah and for the venture capital companies in overcoming moral hazard and information asymmetry issues.

Under the expectation category the venture capitalist define trust in terms of making the business successful and materializing what is in the business plan. Venture capital companies would expect the entrepreneurs to "walk the talk". This is stated by the interviewee from interviews 1 and 3 (refer table 8.2, focused coding 1). The respondent from interview 2 also mentioned, "...How you would define trust believes in the business plan and the people to run to make the business plan viable...."

Experience and skills the respondent from interview 6 mentioned, "....Trust is also doing your homework and finding the guys abilities and match it with his ability and what he is asking for." The venture capital companies in this case would find out about the entrepreneurs experience, reputation and ensuring that the entrepreneur have the skills to make the business a success.

The relationship between the entrepreneur and the venture capital company in this case is defined as to ensure that both parties are co-operating well and that they are on good terms. This is mentioned by the respondent from interview 8. "...It is how you feel towards the other party. Is there chemistry to working together? From my experience, it took several meetings and interactions to develop the trust. Yet, you still have to be cautious when it comes to money." If the entrepreneur and the venture capital company have a strong relationship it shows that they trust each other.

The personality category is definitions that relate to the character that venture capitalists seek for in an entrepreneur and signifies that they are trustworthy. Some of the traits mentioned by the respondents (refer table 8.4, focused coding 3) are the following:

- Trustworthy
- Good values, fair and does not cheat
- Sincerity
- Honesty
- High integrity
- Straight forward
- Dedicated

These characteristics are also some of the criterions listed by the venture capitalist before choosing an investment. Some respondents mentioned that trust is also defined as good corporate governance. This is seen from their responses to this question, which is indicated below (refer table 8.5, focused coding 4):

- Transparency
- Good corporate governance
- Protecting shareholder's interest
- Good reputation
- Well-negotiated, mutually agreed rights and responsibilities for all parties to embark on a partnership that practise integrity and transparency

The focus is on the agreement in this case and must be understood by the parties involved in terms of their rights and responsibilities. This is mentioned by respondent from interview 17 (refer table 8.5, focused coding 4). This shows that good corporate governance defines trust and also enhances trust between the entrepreneur and the venture capital company. The respondent from interview 2 mentioned, "In terms of trust govern by the legality legal documentation and we try to avoid whatever room that people try to manipulate. Because from day one we already spell out, what you can do what you can't do then no room for them to manipulate." Every single detail on the transaction is documented. Therefore, trust needs to be enforced and empowered and this leads to question 2 (Trust) on strengthening trust. The responses are categorized and given in tables 8.6 up to 8.11.

Table 8.6: Results for Question 2 (Trust)

Question 2	**How can you strengthen trust between the venture capital company and the entrepreneur?**
Focused Coding	
1	Transparency
2	Good relationship
3	Co-operation
4	Interaction
5	Mutual understanding
Theme	**Transparency, good relationship, co-operation, interaction and mutual understanding are crucial to strengthen trust between the venture capital and the entrepreneur.**

Table 8.7: Focused Coding 1 for Question 2 (Trust).

Transparency	
Interview 1	Transparency in the operations
Interview 2	Transparent with each other
Interview 7	Communication and transparency
Interview 10	Implant crucial and important items in the subscriptions agreement
Interview 11	If trust is lacking, venture capital would result to the measures in the term sheet to protect its rights
Interview 12	To have an agreement
Interview 17	Establish transparent communications

Table 8.8: Focused Coding 2 for Question 2 (Trust).

Good relationship	
Interview 2	Relationship Comfortable with the entrepreneur
Interview 6	Deliver what you say you're going to deliver
Interview 9	Honest Willing to admit mistakes

Interview 11	Comfortable with the entrepreneur and management
Interview 15	Trust has to be earned
Interview 16	Promoting and executing the concept that the interest and progress of the company are important aspects of the relationship between venture capital companies and entrepreneur

Table 8.9: Focused Coding 3 for Question 2 (Trust).

Co-operation	
Interview 17	Conflict of interest managed properly Problems encountered are discussed

Table 8.10: Focused Coding 4 for Question 2 (Trust).

Interaction	
Interview 3	Interaction through events like dinners and sports event
Interview 8	Conduct regular meetings
Interview 12	Periodic meetings and discussion

Table 8.11: Focused Coding 5 for Question 2 (Trust).

Mutual understanding	
Interview 7	Understanding with the investee company that their success will be our success and their loss will be our loss
Interview 11	Understanding that the entrepreneur is on the same side with the venture capitalist

Based on the results obtained (refer table 8.6) to strengthen trust, the venture capital company focuses on transparency, good relationship with the entrepreneur, co-operation, interaction and mutual understanding. In terms of transparency one interviewee raised a good point. The respondent from interview 12 stated that one needs to have an agreement to strengthen trust and enhance transparency in the operations and communication between the entrepreneur and the venture capital company. The respondent from interview 10 mentioned, on implanting crucial and important items in the subscriptions agreement.

Having a good relationship between the entrepreneur and the venture capitalist strengthen trust and this is how the Malaysian venture capital companies from this survey define trust as well. The respondent from interview 9 stated that the entrepreneur should be honest and willing to admit his/her mistake to strengthen trust. Respondent from interview 6 stated that, other than being comfortable with the entrepreneur, they are expected to deliver what is presented in the business plan. In addition, trust of the venture capital company has to be earned as stated by the respondent from interview 15.

In relation to strengthening trust, co-operation and interaction will add value not only to the investment but also on the relationship between the venture capitalist and the entrepreneur as mentioned above. Value adding can strengthen trust as it shows that both parties are willing to co-operate and this is in line with the spirit of Mushārakah whereby it is based on the concept of *tawa'un* (co-operation). Conflict of interest managed properly and problems encountered are discussed (refer table 8.9, focused coding 3, interview 17). From the survey, venture capital companies interact with the entrepreneurs in many ways through sport events, dinners, meetings and discussion (refer table 8.10, focused coding 4).

Under the category of mutual understanding it shows that to strengthen trust the entrepreneur and the venture capital companies is to establish an understanding the investee company's success will also be the venture capital companies' success and vice versa (refer table 8.11, focused coding 5, interview 7). The investee company should also know that the entrepreneur is on the same side with the venture capitalist (refer table 8.11, focused coding 5, interview 11). This mutual understanding between the venture capital company and the entrepreneur shows that both have responsibility towards each other.

Trust is an important element in the partnership that is established in the venture capital and in a Mushārakah contract. Furthermore, this is vital in the due diligence process where the venture capital company assess the level of trustworthiness and personality of the potential entrepreneur. A high level of trustworthiness between the venture capitalist and the entrepreneur may reduce the risk of moral hazard and adverse selection. Trust is defined based on: expectation of the venture capital towards the entrepreneur, comfort and relationship between both of them, personality of the entrepreneur, transparency and corporate governance of business operations. To strengthen the trust between the venture capital company and the entrepreneur, both needs to enhance transparency, good relationship, co-operation, interaction and mutual understanding, and they are crucial to strengthen trust between the venture capital and the entrepreneur. In relations to research question number one, the factors needed to apply the Mushārakah financing in the venture capital companies in Malaysia are transparency, good relationship, co-operation, interaction and mutual understanding. Furthermore, to gain trust the entrepreneur must also have the personality and skills to work together with the venture capital companies and meet their expectations.

8.3 Monitoring Investments in Venture Capital

The process of monitoring investments and the invested company is carried out to ensure that the business runs accordingly and also to ensure the efficiency of the risk management process in the venture capital companies. If a venture capital wishes to structure a Mushārakah fund these monitoring methods are off importance. This is linked to answering research question number one which is:

> **What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?**

The results from the interview question 3 (Trust) are provided in table 8.12 below:

Table 8.12: Results for Question 3 (Trust)

Question 3:	**How do you monitor the companies?**
Interview 1	Depending on the amount invested to appoint a representative in the BOD sometimes the company wants us in the BOD as an advisor
Interview 2	Meetings Site visit Working committee
Interview 3	Appoint senior officer for the annual general meeting and general meeting. Account officer to constantly make telephone calls and go for an excursion together
Interview 4	Master report and budget Involved at the board level
Interview 5	Management report Board meeting
Interview 6	Depends on the level of trust High level of trust - one call a month and monthly accounts If he can't deliver - • Management meetings every two weeks • Review sales plan • Go through account properly • Help them change their staff
Interview 7	Regular meetings for update Discussion to address management and operational issues
Interview 8	Board representation Monthly reporting
Interview 9	Financial and business operations Partly involved in decision making process
Interview 10	Close monitoring Board representation
Interview 11	Board seat and being active on the board Monthly management meetings Monitoring of their monthly accounts
Interview 12	Submit management account Yearly audited account
Interview 13	Internal control License platform Reporting system Regular meetings Visits
Interview 14	Financial reports Personal visit

Interview 15	Board representation Periodical reports
Interview 16	Board representation Executive committee meeting Business progress reporting
Interview 17	Financial and progress reports Latest monthly management account Representative appointed to the board of directors Site visit and meetings Filing and maintaining records of the investments Look for signs of problems arising
Interview 18	Monthly reporting Meet them monthly Do regular research on the industry, the company to see how they are doing

Constant monitoring would only increase trust of the venture capitalist. Based on the results obtained from the survey (refer table 8.12), some ways of monitoring methods are:

- Board representation
- Meetings
- Site visit
- Working committee
- Appoint senior officer for the Annual general meeting and General meeting
- Account officer to constantly make telephone calls and go for an excursion together
- Financial and business progress reporting (monthly accounts and yearly audited accounts)
- Partly involved in decision making process
- Internal control

- Regular research on the industry and the company to see their progress

In answering research question number one, if the venture capital companies want to structure a Mushārakah fund these monitoring methods are of importance. In the case of a Mushārakah fund, monitoring methods have to ensure that the businesses are operating according to Shari'ah guidelines and also based on the ISO standards (Islamic) when producing or manufacturing *halal* products. In the case of a Mushārakah fund, it must be monitored to make sure that the invested companies follow the Shari'ah guidelines in terms of accounting reports. In this case, the personnel in the company and the venture capital companies cannot depend on the Shari'ah advisors only to advise them, but the personnel themselves must be well versed with the Shari'ah guidelines and the *muamalat* principles that persist in a transaction that emerge in an Islamic financial institution and these are the responsibility of the Shari'ah scholars in the Syariah Advisory Council in the Securities Commission Malaysia. In the legal system, Malaysia has the Islamic Banking Act 1983 which is an Act to provide for the licensing and regulation of Islamic banking businesses. The Act inter *alia* has provisions on the financial requirements and duties of an Islamic Bank, ownership, control and management of Islamic banks, restrictions on its business, powers of supervision and control over Islamic bank and other general provisions such as penalties.[189] There is also an ordinant under the Malaysian Civil Law to address legal cases that involves Islamic financial institutions.

[189] Financial Law – Banking Law. (n.d.). Retrieve October 17, 2005, from http://www.lawyerment.com.my/financial/banking.shtml

8.4 Conclusion

To summarize, the analysis in chapters five to eight have provided the findings and factors in terms of the Mushārakah's applicability in the venture capital setting in Malaysia. Table 8.13 gives the list of the entire findings obtained in this research.

Table 8.13 List of Findings

Research Question 1: What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?
1) Investment stage 2) Shari 'ah compliant instruments, business, operations and activities 3) Valuation, profitability and potential return 4) Demand by clients 5) Potential instruments such as ordinary shares, convertible preference shares and redeemable preference shares. 6) Potential exit strategies such as Diminishing Mushārakah, buyback and IPO 7) Structure of liability and contracts 8) Risk mitigation 9) Defining and methods of empowering trust 10) Monitoring methods 11) Investment criteria
Research Question 2: Which stage of the business cycle is the Mushārakah best applied?
1) The Mushārakah is appropriate to be applied in the early stage or in the venture capital stage as the case in Malaysia.
Research Question 3: What is the appropriate exit mechanism for Mushārakah funds?
1) Diminishing Mushārakah to be applied as an exit mechanism for companies at the start-up stage because in the later stages invested companies have higher value and venture capital companies prefer to exit using other exit mechanism that would provide them higher return. 2) IPO is the viable exit mechanism for the Mushārakah fund due to the return and Shari'ah compliance. 3) Trade sales, put option and call option, MBO, MBI, buyback, M&A and listings of foreign exchange can be of ptential exit strategy but has to be Shari'ah compliant.
Research Question 4: What do venture capitalists look for before investing in a new company?
1) Management 2) Financial 3) Products and services 4) Business model 5) Market potential 6) Growth 7) Industry 8) Exit 9) Competition 10) Funding requirement 11) Legal 12) High barriers of entry 13) Executable plan 14) Risk factors 15) Details of the deal

The venture capital industry itself encourages transparency and investment efficiency, whereby it gives a good platform for the Mushārakah to operate. Now we follow up with some of the findings and factors from the analysis as written below.

Firstly, the Mushārakah is appropriate to be applied in the early stage or in the venture capital stage as the case in Malaysia. The Mushārakah financing mode can be applied at the early stage, and that it only depends on the instruments that is appropriate for each investment stage on whether it is Shari'ah compliant or not and that it gives fair business environment for the parties involved. If it is applied in the early stage, it can spread the risk between the parties involved in the investment through risk sharing and profit-loss sharing.

In relations to the stages, it brings to another finding which is on the instrument used for the venture capital companies and what is appropriate for a Mushārakah fund. Ordinary shares, convertible preference shares and redeemable preference shares are appropriate for a Mushārakah fund in terms of Shari'ah compliancy and on obtaining competitive return. In the conventional venture capital industry some of the instruments used may not be Shari'ah compliant. In this case, the financial instrument used is in correlations with the exit strategy and the stage of the business, and ordinary shares are more appropriate in the later stage as compared to the early stage which is highly risky. In the early stages, normally preference shares such as the convertible and the redeemable are used as it gives the investors a cushion for risk. The redeemable preference shares are appropriate to apply if the Diminishing Mushārakah is used as an exit strategy. This leads to the third finding which is on applying Diminishing Mushārakah as an exit strategy.

Most venture capital companies from this survey stated that buying out shares are more appropriate in the early stages. Therefore, the Diminishing Mushārakah is more appropriate to be applied in the early stages. It is appropriate and viable for the Diminishing Mushārakah to be applied as an exit mechanism for companies at the start-up stage because in the later stages invested companies have higher value and venture capital companies prefer to exit using other exit mechanism that would provide them higher return. This gives an idea on analysing other exit strategies for the Mushārakah fund at the later stage. Therefore, the fourth finding states that the IPO is a viable exit mechanism for the Mushārakah fund due to the return and Shari'ah compliance. The Mushārakah fund is suitable to be applied at the early stages, where the invested companies can exit through share buyback and IPO and can also be applied in the maturity stages (private equity in the case of Malaysia) where it is less cumbersome. However, leverage buyout is applied and borrowed funds are used in the later stages and this may hinder the applicability of the Mushārakah.

Fifth, the flexibility of the Mushārakah can also be applied in other business structures such as the corporation, limited partnership and through the angel investor. Apart from that, the structure of the liability shouldered by the investors can be structured in accordance to Islamic law whereby, in determining liability in Islamic Law it is not the business structure, but the actual *sharikah* contracts between the parties. If the parties want limited liability, they can choose *sharikah al'inan* or Mudhārabah and if they want unlimited liability, they can choose *sharikah al mufawadah*. This also gives us an insight that Mushārakah can be applied as another fund in the venture capital or as a financial institution. Both ways are acceptable as they are Shari'ah compliant. Chapter nine continues with the findings and factors obtained and several recommendations are discussed on future potential research that can be extended from this subject.

CHAPTER NINE: CONCLUSION AND RECOMMENDATIONS

9.1 Introduction

From the analysis we can see the potential of Mushārakah as a financing tool for entrepreneurs. This instrument is one of the PLS instruments and has been debatable in its application in the bank. In this study, we analyse the potential of Mushārakah in the venture capital setting in Malaysia. If we look at the application of the Mushārakah in general not many financial institutions apply them. Banks are not in favour of them due to the asymmetric information, moral hazard and adverse selection problems that may arise. However, these three problems are minimized if the Mushārakah is applied in the venture capital due to their stringent due diligent process which involves many agreements and monitoring of the invested company. Below is the list of the research questions which formed the cornerstone of this study:

1) **What are the factors needed to apply Mushārakah financing in the venture capital in Malaysia?**

2) **Which stage of the venture capital is the Mushārakah best applied?**

3) **What is/are the appropriate exit mechanism for the Mushārakah?**

4) **What do venture capitalist look for before investing in a new company?**

Based on the analysis, the factors are obtained from the theme derived from the results of the survey. This chapter summarize all findings and factors obtained from the analysis and are explained in the next section.

9.2 Summary of Findings from the Analysis

Firstly, in relations to research question number one and two, the factors that are needed to apply Mushārakah financing in the venture capital company in Malaysia is that the Mushārakah is appropriate to be applied in the early stage or in the venture capital stage as the case in Malaysia. However, this depends on the instruments that is appropriate for each investment stage on whether it is Shari'ah compliant or not and that it gives fair business environment for the parties involved. In relations to the stages it brings to the third factor which is on the instrument used for the venture capital companies and what is appropriate for a Mushārakah fund. Ordinary shares, convertible preference shares and redeemable preference shares are appropriate for a Mushārakah fund in terms of Shari'ah compliancy and on obtaining competitive return.

In the conventional venture capital industry some of the instruments used may not be Shari'ah compliant. The instruments used are also important in determining the profit distribution between the investor, venture capital company and investee company. The financial instrument used is in correlations with the exit strategy and the stage of the business, and ordinary shares are more appropriate in the later stage as compared to the early stage which is highly risky. In the early stages, normally preference shares such as the convertible and the redeemable are used as it gives the investors a cushion for risk. The redeemable preference shares are appropriate to apply if the Diminishing Mushārakah is used as an exit strategy. In relations to research question number three, this leads to the fourth factor which is on applying Diminishing Mushārakah as an exit strategy and applying the IPO as an appropriate exit mechanism for the Mushārakah.

Most venture capital companies from this survey stated that buying out shares as an exit strategy is more appropriate in the early stages. Therefore, the Diminishing Mushārakah is more appropriate to be applied in the early stages and can be applied as an exit strategy. It is appropriate and viable for the Diminishing Mushārakah to be applied as an exit mechanism for companies at the start-up stage because in the later stages invested companies have higher value and venture capital companies prefer to exit using other exit mechanism that would provide them higher return. This gives an idea on analysing other exit strategies for the Mushārakah fund at the later stage. Therefore, the fifth factor focuses that the IPO is a viable exit mechanism for the Mushārakah fund due to the return and Shari'ah compliance and supports to answer research question number three. The Mushārakah fund is suitable to be applied at the early stages, where the invested companies can exit through share buyback and IPO and can also be applied in the maturity stages (private equity in the case of Malaysia). However, leverage buyout is applied and borrowed funds are used in the later stages and this may hinder the applicability of the Mushārakah.

The sixth factor is on the structure of the liability shouldered by the investors. According to the Islamic law, in determining liability in Islamic Law it is not based on the business structure, but on the actual *sharikah* contracts between the parties. If the parties want limited liability, they can choose *sharikah al'inan* or Mudhārabah and if they want unlimited liability, they can choose *sharikah al mufawadah*. The venture capital industry itself provides good platform for applying Mushārakah financing because the contracts and agreements enhances transparency, corporate governance, achieving target returns and risk management to nurture small business to practise this at the early stages of the business and continued at the later stage.

This leads us to seventh factor which is on risk management. The biggest risk in the venture capital companies is concerning the management, market and return. To apply the Mushārakah financing in the venture capital setting these risks need to be managed. When management is concern referring to the results from table 6.20 shows how risk can be mitigated through appointing a board representative that can ensure a degree of control over the business and protect the investment. Secondly, monitoring the financials in the invested company is the second highest method of control over the investment. The third highest is on getting to know the entrepreneur and lastly, co-signing of cheques between the venture capital companies and the invested company, regular meetings, legal instruments, diversify and identify risks are other ways of maintaining control in the business and investment. Applying Mushārakah in the venture capital companies in Malaysia, the risk mitigation process is vital and that the venture capital company holds the biggest responsibility for risk management of the invested company and investment. The daily operations of the business is the entrepreneurs' responsibility and also for risk assessment of the invested company.

The eighth factor is on trust between the venture capital companies and the entrepreneur. Venture capital companies in Malaysia define trust as expectations, comfort and relationship, personality, transparency and corporate governance. Trust can be strengthened through transparency in operations and communication, good relationship, co-operation, interaction and mutual understanding. Furthermore, to gain trust the entrepreneur and must also have the personality and skills to work together with the venture capital companies and meet their expectations.

Monitoring is also essential in structuring a Mushārakah fund. It can enhance trust and mitigate risk. Based on the results obtained (refer table 8.12) some ways of monitoring methods are:

- Meetings
- Site visit
- Working committee
- Appoint senior officer for the Annual general meeting and General meeting
- Account officer to constantly make telephone calls and go for an excursion

together

- Financial and business progress reporting (monthly accounts and yearly audited accounts)
- Partly involved in decision making process
- Internal control
- Regular research on the industry and the company to see their progress.

If the venture capital companies want to structure a Mushārakah fund these monitoring methods are of importance. For a Mushārakah fund, these monitoring methods have to be followed also to ensure that the businesses are operating according to Shari'ah guidelines and based on the ISO standards (Islamic) when producing or manufacturing *halal* products. Given if trust is enhanced through applying Musharakah financing in the venture capital companies, this is definitely an advantage to the venture capital companies. This was pointed out by Rodney Wilson, where he argues that there is a higher level of trust between Islamic banks and their clients than in the case of conventional banks and hence the moral hazard is less.[190] If this is applied with the Musharakah fund, it will definitely be a plus point to its establishment in the venture capital. He also made a great point that higher levels of trust reduce risk and uncertainty, which in turn results in lower monitoring costs for Islamic banks.[191]

Research question number four focused on finding the criteria that venture

[190] Rodney, Wilson. A, (2002). The Interface between Islamic and Conventional Banking. Iqbal. Munawar & Llewellyn, David T. (comp. & ed.) *Islamic Banking and Finance*. (pp.203). UK: Edward Elgar Publishing.
[191] Ibid. 204pp.

capitalist look for before investing into a new company. From the survey, we obtained that management is the most important criteria from the respondents. Financial comes in second, followed by product and services and then the business plan. For a Mushārakah fund to be profitable in the venture capital these criteria should be looked into especially on the management side, whereby it is the people that work the business. Another imperative point in relations to the Mushārakah is on asymmetric information, moral hazard and adverse selection. To minimize asymmetric information and moral hazard is important for financial arrangement and pricing of the shares for the parties involved in a Mushārakah. Managing asymmetric information, moral hazard and adverse selection issues is also essential for risk management since a huge bulk of risk is on the uncertainty of the outcome of the business. This uncertainty is very much tied with personality, skills, moral and efficiency of the entrepreneur. The venture capitalist must get as much information not just about the investment but also on the entrepreneur that they had entrusted to manage the business. Past experience of the entrepreneurs are investigated by the venture capitalist to ensure that they do not have any bad records that may be detrimental to the investment.

In the venture capital industry, there are ways to minimize asymmetric information and moral hazard. Firstly, the numerous agreements available helps to manage asymmetric information thus enhances transparency from the early stages of the business and this gives a good platform for a Mushārakah fund, since that is a must for Shari'ah compliant instruments. Other than that it spells out the rights and responsibilities for both the venture capitalist and the entrepreneur. Secondly, the market as a whole should be transparent to disclose relevant information to the public. Without effective information dissemination, the market will not be efficient and the financial system will perform poorly and will be less attractive to the investors. The government in Islamic countries (which includes Malaysia) can play a vital role in reducing the asymmetric information and moral hazard problem by setting up institutions and enacting laws that increase the availability of information[192] The interesting thing in this study is that we see asymmetric information may not be a major problem for a Mushārakah fund in the venture capital setting as compared to the banks. It may not be that marketable in the banks, simply because banks do not monitor investments/businesses like the venture capitalist does, but there are other avenues that the Mushārakah can be applied such as the venture capital.

Having the criteria set out by the venture capitalist is also to avoid adverse selection problem. It is crucial that the entrepreneur lives up to what they had promised to the venture capitalist and abide with what that had been outlined in the agreements in terms of responsibility and meeting the targeted return. The agreement plays a role again in this matter, and if looked closely, the agreements of PLS Shari'ah compliant instruments such as the Mushārakah can provide incentives for good behaviour among the parties involved, simply because the stringent agreements give them no room to be dishonest to each other. If any of the parties involved go against the agreement, a court order will be thrown against them. The efficient monitoring process carried out in the venture capital assists in ensuring that the entrepreneur delivers as promised and to also strengthen the trust, relationship and value adding between the two. Therefore, if the Mushārakah is applied in the venture capital setting it only enriches the Mushārakah fund not only as a fair pricing instrument but also one

[192] Ahmed, Habib, (2002). Incentive-compatible Profit-sharing Contracts: A Theoretical Treatment. Iqbal, Munawar & Llewellyn, David T. (comp. & ed.) *Islamic Banking and Finance.* (pp.52). UK: Edward Elgar Publishing.

that provides incentives for good behaviour.

9.3 Implications of Research Findings in Relation to the Literature

This section revisits the literature presented in chapter two and three and relates it to the key findings of this research. The focus of attention is towards the venture capital companies and the venture capital industry in Malaysia. Chapter two focuses on the type of financing instruments used by the venture capital companies, the venture capital process and documents involved in the due diligence process. An overview of the Malaysian venture capital industry is highlighted in this chapter. Sources of the venture capital and the preferred industrial sectors together with the SME are covered in this chapter. In addition, this chapter gives some ideas on how the Malaysian venture capitalist selects their business ventures and gives us an insight on why certain criteria are more important than the rest.

Chapter three covers Mushārakah financing and the different types of *shirkah*. Equity financing and debt financing are also compared to further enhance the advantages and benefit of using equity financing as oppose to debt financing to start up a business. A comparison between venture capital, Mushārakah, Mudhārakah and private equity financing commences in this chapter to find areas that may be important for Mushārakah financing in the venture capital. In addition, the application of Mushārakah in contemporary financing is also highlighted. The Islamic venture capital in the light of Islamic finance is discussed in this chapter to highlight the advantages of structuring Mushārakah in a venture capital company.

These two chapters and the list of empirical study plus the findings have shown that the venture capital operations and the features of Mushārakah financing complement each other. Furthermore, the venture capital provides a good platform to structure Mushārakah funds. In addition, the features of the Mushārakah provide efficient risk allocation and capital utilization. In addition, the studies of Mushārakah from an equity financing perspective should focus on how to structure profit and loss sharing instruments in the venture capital scene.

As highlighted in chapter three and in the list of empirical study, the features in the Mushārakah that are management and profit and loss sharing, provide efficient risk allocation and capital utilization as a medium of financing on the equity side. This makes it ideal to be structured in the venture capital setting where equity financing is used to finance companies at the venture capital stage (early stage and the expansion stage). In the list of literature presented it is not mentioned at which stage the Mushārakah is best applied. This is important because the investment stage plays a part in determining the instruments used, valuation and exit strategy for the invested company. At this stage where it is highly risky, the financial instruments applied are important for profit distribution and determining exit strategy.

In terms of financial instruments, according to the findings obtained some of the potential Shari'ah compliant fund that can be used are redeemable preference shares, convertible preference shares and ordinary shares. Preferred shares provide a risk cushion for the venture capital companies due to the high risk involved at the early stage. In addition, the portfolio diversification applied in the venture capital companies helps to spread the investment risk. In Rashid's paper, an extensive analysis is carried out on analysing the Shari'ah compliancy on the instruments in the current market. This is a breakthrough for most of the literature on Islamic venture capital.

Exit strategies play a crucial role in determining return (capital gains) for the shareholders, venture capital companies and the entrepreneur. In this research, the potential exit strategies for a Mushārakah fund are IPO, buyback and Diminishing

Mushārakah. IPO are the preferred exit strategy based on the survey due to its high return. Applying the Diminishing Mushārakah however, requires that company have large amount of cash. The venture capital companies would not want to be bought out at a lower value, therefore, IPO would be more preferable than Diminishing Mushārakah and buyback. However, if the shareholders and the venture capital companies can get their target return by exiting through Diminishing Mushārakah and buyback, this will be fine. There are several other exit strategies such as trade sale, mergers and acquisition that are also potential exit strategies for a Mushārakah fund. Investors wants to make the best out of their investments and due to the nature of equity financing where it is performance based, it ensure that capital it utilized at its fullest, the best exit strategy is chosen for that investment.

In terms of contracts, Islamic law states that determining liability is not based on the business structure, but on the actual *sharikah* contracts between the parties involved. If the parties want limited liability, they can choose *sharikah al'inan* or Mudhārabah and if they want unlimited liability, they can choose *sharikah al mufawadah*. This shows that there is potential to further expand contracts based on Islamic Law to be used for a Mushārakah fund in the venture capital setting. In addition, the rights and responsibilities (which consists in the contract) for the venture capital companies and the entrepreneur were also obtained from this research. Comparing this point with the literature given in chapter three, contracts and agreements are highlighted briefly in Al-Rifai and Khan's article. The article stated the role of covenants in terms of transfer of control, venture capitalist's rights of first refusal and providing information to the investors.[193] This is covered in the analysis and it shows that the venture capital can provide a good platform for structuring Mushārakah fund or any Shari ʿah compliant funds because contracts are transparent and nurture companies corporate governance at the early stage.

The risk management process in the venture capital companies provides efficient risk allocation for the shareholders, venture capital companies and the entrepreneur. The results from table 6.20 shows that risk can be mitigated through appointing a board representative that can ensure a degree of control over the business and protect the investment. Secondly, monitoring the financials in the invested company is the second highest method of control over the investment. The third highest is on getting to know the entrepreneur. The rest of the methods are co-signing of cheques between the venture capital companies and the invested company, regular meetings, legal instruments, diversify and identify risks are other ways of maintaining control in the business and investment. These methods show how rigid the risk management process is in the venture capital companies and as stated by Ahmed, the organizational structure of venture capital firms is an appropriate model for minimizing risks involved in equity financing.[194] This research shows that the venture capital process complements the Mushārakah fund by providing a good platform for risk management in the investments undertaken.

The venture capital companies that were surveyed in this research defined trust

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[193] Al-Rifai, Tariq, & Khan, Aamir (2000). *The Role of Venture Capital in Contemporary Islamic Finance*. Retrieved December 21, 2004, from Failaka International Inc. Website: http://www.failaka.com/Library/Articles/VC%20in%20Islamic%20Finance.pdf

[194] Ahmed, Habib (2005). *Operational Structure for Islamic Equity Finance: Lessons from Venture Capital.* Retrieved July 11, 2006, from Research Paper No.69, Islamic Research and Training Institute, Islamic Development Bank. Website: www.irtipms.org/OpenSave.asp?pub=212.pdf

as expectations, comfort and relationship, personality, transparency and corporate governance. Based on the responses, trust can be strengthened through transparency in operations and communication, good relationship, co-operation, interaction and mutual understanding. In addition, to gain trust the entrepreneur must also have the personality and skills to work together with the venture capital companies and meet their expectations. Trust can be related again with the moral hazard issues that are faced in Islamic banks as mentioned in the literature of this thesis. This is not the case if a Mushārakah fund is structured in the venture capital companies. As seen above, the methods of strengthening trust is a value added process of the venture capital companies to the entrepreneur. This area in this thesis puts trust into a business perspective and can also relate to the partnership based on trust that is encouraged through Mushārakah financing. The issue about trust is mostly highlighted and related with moral hazard and information asymmetry as mentioned in most of Al-Harran's papers. However, the scope of his paper is from microfinance perspective where lending and borrowing is the main transaction.

Investment criteria for a Mushārakah fund is analysed based on the findings obtained through the interview in this research. Based on the survey carried out management is the most important criteria from the respondents. Financial aspect comes in second, followed by product and services and then the business plan (for the rest of the criteria please refer to table 5.5). In chapter three it is mentioned that moral hazard, adverse selection and asymmetric information are issues in Islamic banks that uses profit and loss sharing instruments. The stringent investment criteria applied by the venture capital companies in this survey may reduce the problem of adverse selection and choose a trustworthy entrepreneur and profitable investments.

9.4 Contribution of this Research

This research is carried out with the motivation to further develop Islamic equity financing which is mainly based on profit and loss sharing instruments such as Mushārakah and Mudhārabah. This research will add to the literature in the area of Mushārakah, venture capital (in Malaysia) and equity financing, which can also be a good source of reference for venture capital companies with the intention to structure Mushārakah funds or other Shari'ah compliant funding in the venture capital company. Although the venture capital industry in Malaysia is relatively small, by having such funds engineered in the venture capital companies can spool funds from other Muslim countries.

In addition, this study can contribute in terms of education on using Islamic financing instruments such as Mushārakah and on understanding the venture capital process. Through education and gaining knowledge on using Islamic financing instruments, this research can motivate entrepreneurs to work together with experts in building businesses and further developed the application of Mushārakah in the Islamic banking and finance industry. Thus, this research contributes to academic research and professional finance sector.

9.5 Limitations of the Research

Similar to any topic under research, which is by nature is controlled, this research has certain limitations as well. For instance, the information about the venture capital industry and the venture capital companies in Malaysia is limited. In other words, there are not many resources and materials regarding the venture capital companies operating in Malaysia. Information about the venture capital industry can only be obtained from the Central Bank of Malaysia and information about the venture capital companies can be obtained from the Companies Commission of

Malaysia and the venture capital companies' websites. However, this was not enough for analysing and answering the research aim, questions and objectives of this research. Furthermore, not all the venture capital companies have websites and the report on the venture capital industry from the Central Bank of Malaysia just provide the statistics and performance of the industry. However, this should not hinder from further improving this research, as other ways of gathering more information on the Malaysian venture capital industry and companies could have been located for this research.

For instance, other information may be attainable from sources such as the Mushārakah agreements and documents that are used in Islamic banks. The content may be different compared with the agreements in the venture capital companies but it can give an insight on how a Mushārakah contract is structured. In addition, information about the venture capital companies such as the size of funds, stages of funds and area of investment can be obtained from the Technopreneur Development Division Portal but not all of the venture capital companies registered with the Securities Commission of Malaysia can be obtained from this portal. The Technopreneur Development Division Portal was established by the Multimedia Super Corridor of Malaysia to further develop Malaysia's SME in the area of information, communications and technology, but this is focused on venture capital companies in the area of information technology only. The financial reports on the venture capital companies can be obtained from the Companies Commission of Malaysia.

Another way to further improve the limitation of information in this research could have been by expanding the list of interviewers. For example, lawyers that are well verse in Shari'ah contracts can be interviewed to analyse how a Mushārakah deal can be structured in the venture capital setting and what would be its advantages and disadvantages in terms of efficiency and transparency. Although, this may cover legal matters mainly, it may be able to support the existing information there is about the venture capital companies in Malaysia.

Lastly, secondary data from the venture capitals firms could have been used to provide further quantitative meanings to the analysis presented.

9.6 Further Research

The research conducted in this area helps to provide a picture of Mushārakah financing and the venture capital industry in Malaysia and on how to further develop it. Both method of financing are utilized in small percentage in Malaysia. One area for further research would be on applying Mushārakah financing at the private equity stage where leverage is present. Instead of using loans or subordinated debts, one can apply Islamic debt for exits such as mergers and acquisition, management buyout, leverage buyout and management buy-in.

Another area for further research is in relations to the investee company's growth and performance. In the case of Malaysia, most of the venture capital funds are provided by the government as compared to privately owned venture capital companies. It will be interesting to study which avenue (government or private) gives more investment growth and the research can be expanded towards selection criteria of the government backed venture capital and the private venture capital companies to establish differences and similarities in performance.

In relations to selection criteria, this is another area in the venture capital industry than can be further explored to study the business culture among Malaysian entrepreneurs. This can assist in reducing adverse selection problems. The efficiency of the MESDAQ market for IPO's is also another area for research.

9.7 Recommendations

Other than structuring Mushārakah funds in a venture capital, the Malaysian government can establish a venture capital company that is based strictly on Mushārakah. It is an Islamic venture capital only that it operates with Mushārakah transactions. Other financial institutions, such as pension funds and takaful insurance companies, can provide the incentives. In addition, it will be licensed under the Islamic Baking Act in Malaysia. This type of venture capital can pool funds from other Muslim countries and with equity participation it shares expertise and profit with the parties involved.

Another recommendation coin for this study would be on establishing network among angel investors. A group of investors or business angels who are experienced and have a lot of money will provide capital and knowledge in business to assist the entrepreneurs with their business management. As discussed previously, business angels are not evident in Malaysia. With the Mushārakah fund, a pool of angel investors can be established and it will be easier for the entrepreneurs to network with them. These angel investors can assist in establishing business at the seed and start-up stage.

Other than that, these pools of investors may be interested with Shari'ah compliant investments and financing structure and this can further develop the small and medium enterprise in Malaysia. These angel investors can be investors from another country and that would be even better as it will help bridge the financial gap between Muslim countries. Other than encouraging international trade between Muslim countries, it is also good to establish business relations through partnership from small business financing. In addition, upon becoming the *halal* food hub on a global scale, this move can be a good platform for small businesses in areas related to the industry (*halal* food) to look for financing and start-up a company on a local an international scale.

Malaysia has the opportunity to establish an international *halal* food centre and emerge as not only the world's top *halal* food producer but also a centre for marketing, certification and reference.[195] The potential market for *halal* food is estimated in the range of RM1.3 trillion to RM1.5 trillion per year based on the world Muslim population of about 1.8 billion.[196] Other than that, the small and medium industries (SMIs) constitute approximately 84% of the manufacturing establishments in Malaysia.

Areas for further research and the recommendations stated above are for further research by the author and are aimed at the venture capital companies in Malaysia as well. Other than focusing on the practical issues, this research is also important in the academic area where it adds to the literature review on the same area and in the industry as a whole. In addition, the findings from this study are also a stepping stone for that matter and it can also alleviate entrepreneurship through equity financing (Mushārakah) in Malaysia and Muslim countries. It is also another step in financial innovation and further improves the Islamic banking and finance industry in Malaysia.

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[195] (2004, September 10). Strong potential to be halal food hub. *Business Times*. Retrieved April 7, 2006, from http://www.btimes.com.my
[196] Ibid

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APPENDIXES

Appendix 1: Interview Questions

<u>Category: Overview of Venture Capital Industry</u>

Q1: Are the venture capital in Malaysia based on partnership of any kind?

Q2: What are the criteria that you look for before investing into a company?

Q3: What are the factors deemed important if a venture capital wants to structure funds to be Shari'ah compliant, for an example like the CIMB Muamalat Fund.

Q4: What are the limitations of using such funds?

<u>Category: Risk and Return</u>

Q1: How are capital gains distributed between the shareholders of the venture capitalist (Investor) and the invested (Investee) company?

Q2: Is it distributed based on the invested value? Please elaborate.

Q3: Between the Net to asset value (NTA), P/E ratio and the cash flow analysis, which is your preferred method of valuation? Please explain.

Q4: What happens when investments perform poorly or the business ceases trading?

Q5: What is the biggest risk in the venture capital business?

Q6: How do you ensure that you maintain a degree of control over the business to protect your investment?

Q7: Is risk management the prime responsibility of the venture capitalist or the entrepreneur?

Category: Corporate Governance, Liability and Exit Strategy

Q1: What are the rights and responsibilities of the company and the venture capitalist in this partnership?
Q2: Is the venture capitalist liable for any action undertaken by the entrepreneur?
Q3: Is it possible to use just use ordinary shares? Please explain.
Q4: Would it be a good strategy to exit if the investee slowly buys out it shares bit by bit until the investee wholly owns the business?
Q5: What is your preferred exit strategy? Please explain.
Q6: What other exit avenue do you use?

Category: Trust and Transparency

Q1: How would you define trust?
Q2: How can you strengthen trust between the venture capital company and the entrepreneur?
Q3: How do you monitor the companies?

Appendix 2: Coded Answers of the Survey

Category : Overview of Venture Capital Industry	
Q1: Are the venture capital in Malaysia based on partnership of any kind?	
Interview 1	Partnership exists between Management Company, Fund Company and invested company.
Interview 2	Partnership dimension is standard in Malaysia.
Interview 3	Partnership exists through shareholding.
Interview 4	Partnership exists through shareholding.
Interview 5	Venture capital do not follow the Limited partnership or General Partnership structure
Interview 6	Company with limited liability
Interview 7	Partnership contributions to the development of the venture capital. All investments undertake some form of partnership or else there won't be a venture.
Interview 8	Partnership through shareholding.
Interview 9	Partnership between investors of the fund and the venture capital company.
Interview 10	Risk and rewards based on shareholding
Interview 11	Venture Capital set up as a company. Venture capitalist collaborate with their investors and the investee companies.
Interview 12	Subscribe to preference shares.
Interview 13	Venture capitalist set up as "Sdn. Bhd. (Sendirian Berhad) or "Bhd. (Berhad).
Interview 14	Partnership synonymous with venture capital as there are a lot of collaboration.
Interview 15	Partnership through shareholding
Interview 16	Shareholding relationship determined by interested parties.
Interview 17	Limited partnership.
Interview 18	Limited liability company.

Category : Overview of Venture Capital Industry	
Q2: What are the criteria that you look for before investing into a company?	
Interview 1	Management; Industry; Product; Business Plan
Interview 2	People; Business Plan; Product; Market; Financials
Interview 3	Management; Historical Balance Sheet; Product and service
Interview 4	Potential; Management ;Track record
Interview 5	Return on Investment
Interview 6	Early stage (management, market & opportunities, executable plan) : Later stage (financials): Depends on the financials

Interview 7	Product potential; 5-10 yrs financials; Funding requirement; management most important
Interview 8	People; Financials; Industry; Product; Customers; How to get the return
Interview 9	Management team ; Value proposition; Competitive advantage of product and service; Risk factors
Interview 10	Value proposition ; Industry
Interview 11	Management ; Product and service ; Competition and technology employed; Market size and potential; Amount raised with the financial projection; Business model and exit plan
Interview 12	Viability of the business and profitable or not
Interview 13	Growth; Management
Interview 14	People whether they have the right skills; Product and service; Market in extension to the product; Geographical spread; Financial evaluation for dollar of investment.
Interview 15	Potential to be profitable ; Exiting on a profitable note
Interview 16	Management team ; High barrier of entry ;High growth potential in the global market; Financial control and business process
Interview 17	Management ; Product and service technology; Business model ; Market; Financial and legal ; Details of the deal
Interview 18	Based on funds and the venture stage ; Early stage the business plan ; Person ; Forecast; Growth

Category : Overview of Venture Capital Industry	
Q3: What are the factors deemed important if a venture capital wants to structure funds to be Syariah compliant, such as the CIMB Muamalat Fund ?	
Interview 6	Demand
Interview 7	Source of fund; Location of investment; Syariah compliant business; Exclusion of interest; Type of investment.
Interview 8	Business must be halal; No interest element; Spirit and objective of the investment must be clear; Risk mitigation.
Interview 9	Not well verse.
Interview 10	Willingness of the party to adhere to the structure.
Interview 11	Not well verse
Interview 12	Look at the returns and nature of business
Interview 13	No interest; Good return; Pay good dividend; Long-term; Growing and consistent.
Interview 14	What type of business investing in.

Interview 15	Satisfaction of the Syariah law.
Interview 16	Not well verse.
Interview 17	Syariah advisor appointed; Syariah compliance operations and activities; No riba; Profit sharing; Investment portfolio accordance with Syariah; Financial and legal.
Interview 18	Instruments used; Return must be in capital gain and not interest; Interest attached to the preference shares at the early stage and depends on the stage; Profit sharing element.

Category : Overview of Venture Capital Industry	
Q4: What are the limitations of using such funds?	
Interview 6	Cumbersome; Later stage more flexibility
Interview 7	Reinvestments of capital gains may be limited to Syariah approved investment products that may not yield the highest return
Interview 8	No limitations; Lack of comprehension in the spirit of Mushārakah
Interview 9	Are they (investors) open to invest in such funds
Interview 10	No limitation; Parties agreeing to use the concept
Interview 11	No answer;
Interview 12	Ability to recover
Interview 13	Limitations when the fund is small; Specific expiry date; Expectations
Interview 14	Not well verse
Interview 15	Same as conventional
Interview 16	Not well verse
Interview 17	Interest income from conventional fixed deposits or other interest bearing financial instruments
Interview 18	Limited to the instruments used; Lack of knowledge; Most of the funds in the market are not syariah compliant; Still new in Malaysia

Category : Category: Risk and Return	
Q1: How are profit distributed in your company?	
Interview 1	Redemption; Uses redeemable preference shares and ordinary shares
Interview 2	Specified profit ratio
Interview 3	Specified profit ratio
Interview 4	Distributed between shareholders
Interview 5	Distributed between shareholders
Interview 6	Relationship between the fund company and the investment ; 20-30% profit share ; Double dip
Interview 7	Not distributable unless reinvest capital gains; Upon exit shareholders cash out, proceeds are divided proportionately according to shareholding
Interview 8	No standard formula; Don't be greedy
Interview 9	Profit sharing with the investor not invested company
Interview 10	Distribute income and profit; Capital gains belong to the shareholders
Interview 11	Interim dividends; Distribution upon liquidation of the fund company when it reaches the end of its charter life
Interview 12	Pay the principle out to the business and dividend; 25% of share; Interest accrued throughout the tenure of the loan order
Interview 13	Source fund by itself; IPO
Interview 14	Goes back to the government; Return minus hurdle rate and the rest is distributed to the partners and the employees
Interview 15	No fix formula; Structures and terms on a negotiated basis
Interview 16	Shareholders of a invested company: dividends or sale of shares; Shareholders of venture capital: through redemption of preference shares, dividends and liquidation of funds
Interview 17	Venture capitalist and invested company via dividend payout; To the shareholders via capital gain for the sale of shares in the company
Interview 18	Distributed between the shareholder and the VCMC

Category : Category: Risk and Return	
Q2: Is it distributed based on the invested value?	
Interview 1	Profit distribution is based on invested value
Interview 2	It depends on the pre-money and the post money valuation It depends on negotiation with the invested company
Interview 3	Venture capital don't fall together with the entrepreneur Internal rate of return is not Islamic
Interview 4	
Interview 5	Based on the shareholding
Interview 6	Subscription agreement outline the relationship between, the parties involved and the investment
Interview 7	No, based on proceeds of divestment
Interview 8	Not applicable
Interview 9	Based on profit of the venture upon exit
Interview 10	Distributed based on shareholding
Interview 11	Discretion of the fund manager
Interview 12	Yes, looking at principal loan
Interview 13	No fixed one How you cut the deal Preference shares
Interview 14	Distributed between shareholder and the VCMC
Interview 15	Depends on the structured agreed Invested value translated to investment instrument
Interview 16	Shareholding proportion
Interview 17	Yes, distributed based on the invested value plus the return on investment of the company
Interview 18	Distributed between shareholder and the VCMC

Category : Category: Risk and Return	
Q3: Between the Net to Asset Value (NTA), P/E ratio, Cash Flow Analysis, which is your preferred method of valuation? Please explain.	
Interview 6	Mandate; Early stage not applicable P/E matters in the private investment in public companies (PIPES)
Interview 7	Multiple earnings method, company should be completing product development in 2 to 3 years time
Interview 8	P/E (company valuation) Depends on negotiation No standard formula
Interview 9	No preference Combination of valuation
Interview 10	Cash flow considers actual value of the company
Interview 11	No preferred method One or more can be used and compared
Interview 12	NTA (basis principle) Cash flow for complicated cases
Interview 13	Cash flow (reality check and calculate value back in cash)
Interview 14	P/E Ratio Early stage, benchmark with listed companies
Interview 15	Difference in valuation methods used for different industries
Interview 16	No preference
Interview 17	No specific methods it depends on the industry and current market conditions, quality and reliability of the data given and the stage of development of the company Normally P/E and NTA DCF for more than 10 years
Interview 18	Cash flow

Category : Risk and Return	
Q4: What happens when investments perform poorly or the business ceases trading?	
Interview 1	Portfolio diversification Write-off Partial write-off
Interview 2	Sell-off and write-off Management takeover Modify business plan
Interview 3	Right to call back the put option Bankruptcy proceeding and write off
Interview 4	Write-off Restructure Recover value Takeover Pump in additional capital
Interview 5	Write-off
Interview 6	Sacking Help management Make hard decisions Take early action
Interview 7	Restructure the way the business is managed Liquidation, mergers and acquisitions, exercise option Change of management Write-offs
Interview 8	Depends on the agreement between the parties. If there is position for legal recourse, then legal action will be initiated
Interview 9	How to minimize loss Possible sale of intellectual property Business for interested parties
Interview 10	Restructure Write-off
Interview 11	Write-off Venture capitalist endeavour its best to assist the investee to go through difficult phase

	Changing the management
Interview 12	Write loss
Interview 13	Cut loss Active in management Management rights Management change Salvage
Interview 14	Value adding and try to address the problem (I14) Remove the CEO Initiate voluntarily Sell shares back to the promoters or to a third party Pump it into another business Shut down
Interview 15	Analyse poor performance Salvage value Criminal case option is to seek legal redress
Interview 16	Salvage the company Write-off the last resort
Interview 17	Liquidation Fix the problem Sell the business
Interview 18	Help them get back on their feet Rectify Salvage and recover investment Write off

Category : Risk and Return	
Q5: What is the biggest risk in the venture capital business?	
Interview 6	Poor management
Interview 7	Not achieving the expected return/capital gains Product/Service deployment did not receive the expected market response resulting in lower revenue Combination of factors that make an investment fail: product, management, execution, business climate etc.

Interview 8	Biggest risk is the competitor How you manage your company
Interview 9	Entrepreneurs losing focus and distracted by other products and services Changes in technology, government policies and market trend
Interview 10	Trusting the entrepreneur
Interview 11	Nearly 6 out of 10 investments under perform and need 1 or 2 home run deals to repay back the fund with capital gains
Interview 12	Business viability Not really viable why pursue
Interview 13	People
Interview 14	People
Interview 15	Industry itself very risky, failure rate at least 80% Integrity of the promoter Jumping on the bandwagon when investing
Interview 16	Experience Competency and credibility of promoters Key team members
Interview 17	Competency of the management team which manage the venture capital fund Investing into a company with poor management Depends also on the sector
Interview 18	People Failed investments Governance

Category : Risk and Return	
Q6: How do you ensure that you maintain a degree of control over the business to protect your investment?	
Interview 1	Diversify risk based on company and quantum of investment Spread risk to control risk
Interview 2	Monitoring the management and entrepreneur Evaluate technology Hire expert to advise if the technology is new Ensure promoter materialize business plan Meetings (monthly, weekly)
Interview 3	Board seat

	Monitoring Quarterly reports and management reports
Interview 4	Identify risk areas and address them
Interview 5	Monitoring Nurturing Incubation centers
Interview 6	Spend more time at the early stage Pick good managers Must know the people well Do not take out the legal agreement
Interview 7	Directorship Authorized signatory for banking transactions Maintain a close watch on their accounts Investee to operate in the same country Transparency and control
Interview 8	Control measures such as:- (I8) - Board representation - Co-signing of cheques - Review of monthly financial performance
Interview 9	Board representatives Financial control
Interview 10	Board representations Close post-investments monitoring
Interview 11	Having a board seat and being active on the board Having monthly meetings with the management and monitoring the monthly financial and other reporting of the investee Written approvals needed by the venture capital for major changes in the investee such as change in business direction, hiring of key employees
Interview 12	Monitor the performance
Interview 13	Control on the people Board control Internal control Meeting Visit Get to know the entrepreneur

	Financial update
Interview 14	Legal instruments Put options, call options within the shareholders agreement to protect us The best method in control is the soft skills to build good relationship with the investee
Interview 15	Board representation Periodical reports
Interview 16	Board representation Close relationship with key managers Constant financial monitoring Pre-agreed operational matters that required venture capital's consent
Interview 17	Voting rights on certain items Information rights Entitlement to elect one representative to the company's board
Interview 18	Sit in the board of directors Monthly reporting Instruments used i.e put option

Category : Risk and Return	
Q7: Is risk management the prime responsibility of the venture capitalist or the entrepreneur?	
Interview 1	Venture capitalist holds the biggest responsibility Negotiation and agreement affects risk
Interview 2	Both venture capitalist and entrepreneur holds the risk together Daily operations is the entrepreneurs responsibility
Interview 3	Management of risk is on the venture capitalist Less burden on the entrepreneur
Interview 4	Shared risk Venture capital ensure that the investment performs
Interview 5	Shared risk Daily operations is the entrepreneurs responsibility Long-term basis or a strategic basis is the Board of Directors responsibility
Interview 6	Entrepreneur

Interview 7	Both have critical role to play in managing the operational risks of the company The venture capitalist will want to ensure that the executions of plans are in line
Interview 8	Joint responsibility
Interview 9	Venture capitalist
Interview 10	Both parties
Interview 11	Joint responsibility, but entrepreneur must be aware of the venture capitalist as the minority stakeholder
Interview 12	Both, the venture capitalist manage what they invest in, the entrepreneur handle the day to day business
Interview 13	Fund manager receive risk and manage risk Financial risk Mismatch expectation
Interview 14	Entrepreneur is responsible for the operations and strategic role of the company VC is responsible for his investment in the company
Interview 15	General accepted risk tolerance would be set together by both parties Day to day running at the hands of the entrepreneur
Interview 16	Risk management of the company - Board of Directors (Promoters and VC are represented) Risk management of the investment - VC Normally the risk management of the business is undertaken by the key managers
Interview 17	Both Entrepreneur responsible for the risks assessment of the investee company Venture capital look into risk factors to minimize its own investment risks
Interview 18	Check and balance is on the entrepreneurs' side and investor VC is responsible to do the internal control assessment on the invested company, whether they have good accounting policy and procedures

Category : Corporate Governance, Liability and Ownership	
Q1: What are the rights and responsibilities of the company and the venture capitalist in this partnership?	
Interview 1	Live up to the expectations of the entrepreneur Transparency of agreement Some companies manage on their own and some come back for opinion Agreement can be terminated if expectation not met
Interview 2	Shareholders agreement lists the do's and don'ts Exit clause Right to exercise put option Transparency
Interview 3	Shared responsibility
Interview 4	Based on the shareholders agreement
Interview 5	Investee companies responsibilities is on the operations side Venture capitalist's responsibility is to disburse money on time.
Interview 6	Depends at what stage and the mandate Early stage the vc should provide money, market opening and assistance
Interview 7	Mutual understanding of the deliverables and compliance of the agreements entered into. Day to day operations are the responsibilities of the management. Venture capitalist look into periodic compliance like monthly reporting, yearly accounts
Interview 8	Daily operations would be the responsibility of the invested company. Being shareholder, often try to value add their presence by opening doors for business opportunities and sharing expertise.
Interview 9	Focus on business plan and flexible to market & economic changes
Interview 10	To maximize shareholder wealth
Interview 11	Investee has the right to manage their companies without interference from the vc. Responsibility to meet the target. VC has rights as shareholders. VC's responsibility is to ensure that investee move in the direction mutually agreed upon and assist them
Interview 12	Right to recover interest. Running the business as agreed upon

	Profit define in the loan agreement
Interview 13	Expectation Perception
Interview 14	The invested company should deliver on what they had committed for. Monitoring environment change. Market risk, business risk and to ensure safe passage and success of the company. VC help with the networking but not their responsibility.
Interview 15	Venture capitalist provides the funds and is entitled to profits. Invested company responsible for making the company profitable
Interview 16	Shareholders agreement
Interview 17	Voting rights Right of first offer and first refusal Rights and responsibilities in decision making process Rights and responsibilities of the board Responsibilities to other shareholders Responsibilities for risk assessment Rights and responsibilities on information and communication
Interview 18	Investors and VC provide network, provide insight into another deal In the agreement

Category : Corporate Governance, Liability and Ownership	
Q2: Is the venture capital liable for any action undertaken by the entrepreneur?	
Interview 1	Cohort Foreign buying must do due diligence to some extend
Interview 2	Venture capital are not liable Fraud Negligence Consented basis Corporate governance Transparent
Interview 3	Liable Insurance policies
Interview 4	Shareholder not liable but exposed to the problem

Interview 5	Not applicable in Malaysia. It's on company basis. Venture capitalist protect themselves through RCPS (redeemable convertible preference shares)
Interview 6	No, we're the one who get defraud.
Interview 7	No.
Interview 8	Depending on the circumstances, the venture capitalist may be viable
Interview 9	Usually No.
Interview 10	Yes.
Interview 11	Generally no, if the company is implicated, there is a possibility the company will be implicated by virtue of them being director.
Interview 12	Yes.
Interview 13	Depends on the shareholding agreement Depend on the percentage invested
Interview 14	Fiduciary, manipulation venture capital is not liable
Interview 15	The venture capitalist would face the same liabilities as any company director and shareholder
Interview 16	It depends on the legal framework agreed upon and are specific for each investment
Interview 17	There is a clause on indemnity in the agreements to indemnify the venture capital company.
Interview 18	To a certain extend Yes, when invested companies don't pay the employees provident fund. Liable due to board seat. Liability that a director holds.

Category : Corporate Governance, Liability and Ownership	
Q3: Would you agree to just use ordinary shares?	
Interview 1	Quasi kind of mechanism Convertible securities
Interview 2	Depending on situation Start-up uses preference shares Conversion Redemption If the venture capital is comfortable with the valuation then they use ordinary shares
Interview 3	Must use preference shares as well Depending on the business requirement and size of shareholding
Interview 4	Must use preference shares as well Depends on which is the most efficient structure

Interview 5	Uses RCPS (redeemable convertible preference shares)
Interview 6	Not in venture capital in an LBO it is fine Ordinary shares does not secure venture capitalist's profit
Interview 7	Yes. Uses CCRPS to obtain necessary funding
Interview 8	It is possible The decision largely depend on factors such as how soon the company can be listed, any dividend
Interview 9	Yes and no. Preference share is preferred to minimize risk exposure
Interview 10	No. Hybrid is preferred. It provides a risk management element i.e through preference shares
Interview 11	Yes. But vc prefer to use convertible redeemable preference shares which can be converted into ordinary shares upon listing and the shares can be redeemed by the investee company
Interview 12	Not really, not the best. Prefer preference shares or loan more secured creditor
Interview 13	Yes. It is how you cut the deal
Interview 14	Yes. Ordinary shares are in a bulk of investments in shareholders advance. Easier to manage can be converted anyway. do not need to go through capital reduction and so much legal manoeuvres
Interview 15	The investment can be structured using any instruments so long as it is legal
Interview 16	Yes. The investment instrument is determined based on the risk profile and the exit options of the investment
Interview 17	Yes. Ordinary shares are entitled to all income and capital after the rights of all other classes of capital
Interview 18	Yes. Mature companies go in as shareholders

Category : Corporate Governance, Liability and Ownership	
Q4: Would it be a good strategy to exit if the investee slowly buys out it shares bit by bit until the investee wholly owns the business?	
Interview 1	Good for developmental venture capital. Can be applied in the normal venture capital
Interview 2	As long as it meets target return. Profit limited as compared to an IPO. There is also a 50 percent buy back 50 percent sell in the market No limitation to structure of funds Depends on a case to case basis Venture capital consider buy back
Interview 3	Preferred IPO market, it doesn't cause anybody any money. Third payment scheme, whatever the company owes can be paid in instalments but must have prior agreement to that.
Interview 4	As long as you get return.
Interview 5	Start up level is appropriate but late stage not appropriate.
Interview 6	Happens when business is not successful. If the business is successful vc won't let the entrepreneur to buy out cheaply Buying out with the highest price in the market is fine.
Interview 7	Yes. The price of the shares are usually pre-determined, it won't be a disadvantage to the investor
Interview 8	It is good if it is a win-win situation.
Interview 9	Case by case basis.
Interview 10	Usually the two parties.
Interview 11	Not exactly. Devalue the company
Interview 12	Yes.
Interview 13	Call option. Large amount of cash (listed cash)
Interview 14	Not practical. If there is potential that a company is doing so well, why should I take their money? High risk, therefore, high return
Interview 15	Depends on the objective and value extracted by the venture capitalist.

	This exit would be good it is in line with the vc term
Interview 16	No. Preference shares could be redeemed but don't offer good return to vc
Interview 17	It is a good strategy as long as the investee company has extra cash. Buying back to add value
Interview 18	That's where the put option is. Investee can buy back their own shares provided they give the required return to the investors.

Category : Corporate Governance, Liability and Ownership	
Question 5: What is your preferred exit strategy?	
Interview 6	Anything that gives the highest valuation
Interview 7	Share buyback by promoter Earnings increase and valuation increases and the promoter will have the means to buy back the shares
Interview 8	Listing (IPO) Enable to own shares which are tradable
Interview 9	IPO for maximum return. Buyout or sale is preferred sometimes because of shorter time frame
Interview 10	IPO Provides a proper channel of exiting
Interview 11	One that gives higher returns IPO, trade sale or M&A
Interview 12	Entrepreneur to pay back loan
Interview 13	IPO Strong dividend policy
Interview 14	IPO and trade sale
Interview 15	Depends on the objectives different investments requires different strategies. Short term investment the choice would be put option Long term investment the choice would be an IPO
Interview 16	IPO Tap into the market for future capital raising and have market liquidity Beneficial for both shareholders and the company
Interview 17	IPO Public market pays more for a company than almost any other source Higher return

Interview 18	Depends on the stage. Early stage – IPO Trade sale as well because IPO takes a long time and company value may be affected.

Category : Corporate Governance, Liability and Ownership	
Question 6: What other exit avenue do you use?	
Interview 6	Most exit in Asia are done through trade sale not listing
Interview 7	Sale to third party, IPO on MESDAQ, listing on foreign exchange
Interview 8	Trade sale with third party Redemption by the promoters
Interview 9	IPO Buyout Sale
Interview 10	Trade sales (sell to other private investors or vc's)
Interview 11	Selling back the shares to the founders Selling back to an existing shareholders
Interview 12	Dividend payment
Interview 13	IPO Teaming
Interview 14	Trade sale
Interview 15	Depends on the objectives as different investment requires different strategies Short-term investment the choice would be put option Long-term investment the choice would be an IPO
Interview 16	Trade sale Manager & Acquisition Buy back
Interview 17	Put option and call option Redemption of capital from investee company after criterion predetermined period Sale of investee company shares to promoters or shareholders via management buy-out or management buy-in
Interview 18	MBO – if you use just ordinary shares.

Category: Trust and Transparency	
Q1: How would you define trust?	
Interview 1	Trustworthy
Interview 2	Confident in the project Comfortable with the business plan Comfortable with the people
Interview 3	Trustworthy Skills to make business work
Interview 4	Comfortable with the entrepreneur
Interview 5	Transparency Trustworthy
Interview 6	Comfort level with the entrepreneur Good values, fair and does not cheat Trust and also finding the guys ability and match it with what he is asking for.
Interview 7	Fiduciary relationship between trustee and beneficiary
Interview 8	How you feel towards the other party Chemistry to working together
Interview 9	Transparency Good corporate governance
Interview 10	Sincerity Honesty between two or more parties
Interview 11	Believe in the entrepreneur to charter the best course for the company and delivering it Protecting shareholder's interest High integrity Good reputation
Interview 12	The ability to love a common goal in pursuing the business
Interview 13	Comfort Connection
Interview 14	The assurance that whatever that had been agreed upon is kept Governance
Interview 15	Refer dictionary
Interview 16	Confidently depend on other party to carry out its obligation
Interview 17	Well-negotiated, mutually agreed rights and responsibilities for all parties to embark on a partnership that practice integrity and transparency

Interview 18	Transparency Experience Straight forward Dedication

Category: Trust and Transparency	
Q2: How can you strengthen trust between the venture capital company and the entrepreneur?	
Interview 1	Transparency in the operations To assist the company to get listed and helping each other to gain trust
Interview 2	Relationship Comfortable with the entrepreneur Capability of the entrepreneur to run the business Sharing of ideas Sharing of problems Transparent with each other
Interview 3	Interaction through events like dinners and sports event
Interview 4	Look at the results
Interview 5	No rule of thumb
Interview 6	Deliver what you say you're going to deliver
Interview 7	Understanding with the investee company that their success will be our success and their loss will be our loss Communication and transparency Win-win situation
Interview 8	Conduct regular meetings
Interview 9	Honest Willing to admit mistakes
Interview 10	Implant crucial and important items in the subscriptions agreement
Interview 11	Investment relies mainly on the entrepreneur (and management) If trust is lacking, venture capital would result to the measures in the term sheet to protect its rights Comfortable with the entrepreneur (and management) Understanding that the entrepreneur are on the same side with the venture capitalist
Interview 12	To have an agreement

	Periodic meetings and discussion
Interview 13	Relationship Honest
Interview 14	Venture capital to demonstrate that they can value add Entrepreneur is competent
Interview 15	Trust has to be earned
Interview 16	Promoting and executing the concept that the interest and progress of the company are important aspects of the relationship between vcc and entrepreneur
Interview 17	Establish transparent communications Conflict of interest managed properly Problems encountered are discussed
Interview 18	Co-operation and management value adding Helping entrepreneurs out with areas that the lack knowledge Referring back to the venture capital

Category : Trust and Transparency	
Q3: How do you monitor the companies?	
Interview 1	Depending on the amount invested to appoint a representative in the BOD Sometimes the company wants us in the BOD as an advisor
Interview 2	Meetings Site visit Working committee
Interview 3	Appoint senior officer for the Annual general meeting and General meeting Account officer to constantly make telephone calls and go for an excursion together
Interview 4	Master report and budget Involved at the board level
Interview 5	Management report Board meeting
Interview 6	Depends on the level of trust High level of trust - one call a month and monthly accounts If he can't deliver - - Management meetings every two weeks - Review sales plan - Go through account properly

	- Help them change their staff
Interview 7	Regular meetings for update Discussion to address management and operational issues
Interview 8	Board representation Monthly reporting
Interview 9	Financial and business operations Partly involved in decision making process
Interview 10	Close monitoring Board representation
Interview 11	Board seat and being active on the board Monthly management meetings Monitoring of their monthly accounts
Interview 12	Submit management account Yearly audited account
Interview 13	Internal control License platform Reporting system Regular meetings Visits
Interview 14	Financial reports Personal visit
Interview 15	Board representation Periodical reports
Interview 16	Board representation Executive committee meeting Business progress reporting
Interview 17	Financial and progress reports Latest monthly management account Representative appointed to the board of directors Site visit and meetings Filing and maintaining records of the investments Look for signs of problems arising.
Interview 18	Monthly reporting Meet them monthly Do regular research on the industry, the company to see how they are doing.

Appendix 3: LIST OF REGISTERED VENTURE CAPITAL CORPORATIONS AS AT 30 JUNE 2005 and LIST OF REGISTERED VENTURE CAPITAL MANAGEMENT CORPORATIONS AS AT 31 MAY 2005

LIST OF REGISTERED VENTURE CAPITAL CORPORATIONS AS AT 30 JUNE 2005

NO.	COMPANY NAME
1.	Arris Venture Sdn. Bhd.
2.	Banyan Venture One Sdn. Bhd.
3.	BI Walden Ventures Keempat Sdn. Bhd.
4.	BI Walden Ventures Ketiga Sdn. Bhd.
5.	BIMB Musyarakah Satu Sdn. Bhd.
6.	Bumiputera and Technology Venture Capital Sdn. Bhd.
7.	Cache Ventures 1 (M) Sdn. Bhd.
8.	CIMB Mezzanine 1 Sdn. Bhd.
9.	CIMB Private Equity 1 Sdn. Bhd.
10.	Commerce Technology Ventures Sdn. Bhd.
11.	East Malaysia Growth Corporation Sdn. Bhd.
12.	Ekuiti Teroka (Malaysia) Sdn. Bhd.
13.	General & Global Equities Sdn. Bhd.
14.	iSpring Capital Sdn. Bhd.
15.	Jaringan Gagasan Sdn. Bhd.
16.	Malaysian Technology Venture Three Sdn. Bhd.
17.	Malaysian Technology Venture Two (Agriculture) Sdn. Bhd.
18.	Malaysian Technology Venture Two Sdn. Bhd.
19.	Malaysian Ventures (Three) Sdn. Bhd.
20.	Malaysian Ventures (Two) Sdn. Bhd.
21	Mavcap Biotech Sdn. Bhd.
22.	Mavcap ICT Sdn. Bhd.
23.	Mavcap Photonics Sdn. Bhd.
24.	Mavcap Technology Sdn. Bhd.
25.	Mayban Venture Capital Company Sdn. Bhd.
26.	Mezzanine Capital (Malaysia) Sdn. Bhd.
27.	Momentum STI Sdn. Bhd.

28.	MSC Venture One Sdn. Bhd.
29.	Netrove Asia Sdn. Bhd.
30.	OSK Technology Ventures Sdn. Bhd.
31.	OSK Venture Equities Sdn. Bhd.
32.	Pic Capital Ventures (M) Sdn Bhd
33.	Renong Ventures Sdn. Bhd.
34.	Resilient One Sdn. Bhd. (formerly known as Resilient Portfolio Sdn. Bhd.)
35.	S.B. Venture Capital Corporation Sdn. Bhd.
36.	Soligress Portfolio Sdn. Bhd.
37.	Spring Hill Bioventures Sdn. Bhd.
38.	Sumber Modal Satu Sdn. Bhd.
39.	Technology Asia Ventures Sdn. Bhd.
40.	THG Capital Sdn. Bhd.
41.	Trans Econ Venture Sdn. Bhd.
42.	VF Capital Sdn. Bhd.
43.	Waterfront Incubator Sdn. Bhd.

LIST OF REGISTERED VENTURE CAPITAL MANAGEMENT CORPORATIONS AS AT 31 MAY 2005

NO.	COMPANY NAME
1.	Amanah Ventures Sdn. Bhd.
2.	Arris Venture Management Sdn. Bhd.
3.	Banyan Ventures Sdn. Bhd.
4.	BI Walden Management Kedua Sdn. Bhd.
5.	BI Walden Management Ketiga Sdn. Bhd.
6.	BIMB Venture Capital Sdn. Bhd.
7.	BPMB-NIF Modal Teroka Sdn. Bhd.
8.	BTV Management Sdn. Bhd.
9.	Cache Capital (M) Sdn. Bhd.
10.	CAV Private Equity Management Sdn. Bhd.

11.	Commerce-Meridian Capital Sdn. Bhd.
12.	DTA Ventures Management Sdn. Bhd.
13.	Expedient Equity Sdn. Bhd.
14.	FirstFloor Capital Sdn. Bhd.
15.	Ingenious Haus Sdn. Bhd.
16.	Intelligent Capital Sdn. Bhd.
17.	iSpring Venture Management Sdn. Bhd.
18.	Kumpulan Modal Perdana Sdn. Bhd.
19.	Malaysia Venture Capital Management Bhd.
20.	Malaysian Technology Development Corporation Sdn. Bhd.
21.	Malaysian Ventures Management Incorporated Sdn. Bhd.
22.	Matrix Divine Sdn. Bhd.
23.	Mayban Ventures Sdn. Bhd.
24.	MSC Venture Corporation Sdn. Bhd.
25.	MTDC Penang Sdn. Bhd.
26.	MTDC Private Equity Management Sdn. Bhd.
27.	Netval Management Sdn. Bhd.
28.	Netval Ventures Sdn. Bhd.
29.	OSK Private Equity Management Sdn. Bhd.
30.	Pengurusan EMGC Sdn. Bhd.
31.	Photonics Venture Capital Sdn. Bhd.
32.	Spring Hill Management Sdn. Bhd.
33.	Tech And Bio Incubator Sdn Bhd
34.	Zen Capital Partner Sdn Bhd (formerly known as Zenith Paradigm Sdn Bhd)