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The Role of Venture Capital in Contemporary Islamic Finance

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ABSTRACT

At the forefront of the emerging "new economy" are the venture capital companies that supply much-needed equity to bring entrepreneurial ideas into reality. Such equity investments at the early stages are a pure form of *mushāraka* financing, not only because of the partnership relationship but also because investors can stipulate how they want their funds used. Given these exciting developments, one must wonder why Islamic financial institutions, for the most part, have shied away from venture capital. This paper is an analysis of this and an overview of the many Islamic venture capital opportunities. It will discuss why Islamic institutions have eschewed venture capital, give examples of Islamic venture capital investments, analyze industry segments and technologies with exceptional growth opportunities, structure an ideal *sharīʿa*-compliant venture capital deal, demonstrate opportunities to capitalize on entrepreneurship, and briefly describe some of the players and their roles and responsibilities.

I. INTRODUCTION[i]

Rapid developments in new technologies over the last decade have created enormous amounts of wealth in developed countries. NASDAQ, which is recognized as the world stock market for technology companies has seen its market capitalization grow from $386 billion in 1989 to $5,205 billion in 1999.[ii] New technology companies, more commonly referred to as "new economy" companies, are leading the way for future economic growth. At the forefront of this economic shift are venture capital companies. These companies provide much-needed financing to bring the entrepreneurial idea from concept to reality.

This paper aims to describe the venture capital lifecycle from fundraising to structuring and exiting, and ultimately review its application under a *sharīʿa*-compliant framework.

II. INDUSTRY SIZE AND KEY STATISTICS

To put the venture capital (VC) industry into perspective, in 1993 there were an estimated $3.9 billion worth of VC deals closed in the U.S. In 1999, there were $46.6 billion worth of deals according to the National Venture Capital Association (NVCA). It was also reported that there were $22.7 billion in VC deals recorded in the first quarter this year alone, which is a 266% increase over the same period last year and a new record.

It is probably not surprising that over 80% of VC funding went to computer-related and communication companies. Computer-related includes Internet companies as well as B2B and B2C companies. Over 85% of these deals occurred in the early or expansion stage of the companies' life cycles.[iii]

In a more in-depth study of the industry, professors Josh Lerner of Harvard University and Samuel Kortum of Boston University examined the impact of venture capital on innovation and economic development in their paper "Assessing the contribution of venture capital to innovation."[iv] They examined the influence of venture capital on patented inventions in the United States across twenty industries over three decades. Their findings suggest that venture capital accounted for 8% of industrial innovations in the decade ending in 1992. Given the rapid increase in venture funding since then, with the assumption that the potency of venture capital funding remained constant, the results implied that venture funding accounted for about 14% of U.S. innovative activity by 1998.

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III. VENTURE CAPITAL LIFECYCLE

A. Fundraising

Fundraising can be defined as the role played by professional investors who provide equity or equity-linked capital (to be discussed below) to privately held companies. A key element in this equation is the involvement of the private equity investor in monitoring and assessing the company on an ongoing basis.

1. Funding Sources

Funding for venture capital activities tend to come from other corporations, insurance companies, high-net-worth individuals (i.e., angels) and a large portion tends to come from pension funds and university endowments as they are flush with extra cash and are willing to diversify small portions of their portfolios into higher risk investments.

2. Venture Fund Structures

There have been a growing number of venture capital funds in the United States that seek out private equity deals and venture funding. These funds have not only grown in size but also in depth and market coverage. Over two-thirds of all venture capital funding in Asia was sourced from U.S.-based capital in 1994.

These private equity and venture capital funds are usually structured as limited partnerships (LP). The same holds true in developing countries except where it make more legal sense to structure as a corporation, as is the case in Asia.

The general partners in an LP are in charge of raising funds, choosing investments, monitoring transactions and exiting investments when appropriate. In return they are paid a management fee plus a share of profits. Partners play an active role in managing their portfolio of investments. In many cases, the general partner will provide "incubation" assistance to help new companies get on their feet.

B. Investing

As is commonly known, venture capital investors tend to focus on companies in the high technology area. In this section the paper will discuss the identification of potential investments, deal structure, valuation, and exit strategies with the high tech industry in mind.

1. Identifying Potential Investments and Due Diligence

Venture capitalists receive hundreds more investment proposals on their desks than they can select for investment. As a result, screening for the best investments are a major focus of the venture capitalist.

Some of the qualifying criteria they look for include the need for "chemistry" between the venture capitalist and the entrepreneur along with the commitment, reputation, and creativity of management. There are other criteria that are key in the decision-making process such as the size of the market, competition, threat of obsolescence, and the ability to exit. However, venture capitalists point out that the overriding factor in the success of any venture is management.

2. Structuring the Transaction

Investors tend to use a variety of financial instruments to structure a transaction. These include, but are not limited to, different classes of preferred stock, debt, warrants, and in a few cases common stock may be used in conjunction with other instruments. Combinations of two or more instruments or hybrid instruments are also used. These instruments allow the investor to allocate risk, establish ownership rights, control management, and provide them with incentives. As we shall see, keeping management in the company and keeping them motivated is usually the difference between the success and failure of the subject company.

In the following sections the paper discusses six different instruments that are most commonly used in structuring a deal, but we begin with a brief discussion on why common stock is not an effective instrument.

a. Common Stock

Common stock is the most widely held form of equity, especially for publicly held companies. However, it does not carry any special rights outside of those outlined in the company's charter and bylaws. It gives the holder of such stock ownership, but it is at the bottom of the food chain after government claims (i.e., taxes), regulated employee claims (i.e., pensions), debt, and preferred stock. For example, if the company files for bankruptcy, all of the above claims must be satisfied first before holders of common stock see any benefits or claims to company assets. This is the main reason why venture capitalists avoid common stock transactions.

The example below will highlight the case for the venture capitalist and will be used to further describe other instruments.

A newly formed company called Company.com is looking for a venture capitalist to finance its great idea for a new internet portal. Management believes it has developed leading edge technology to capture a sizable portion of web-surfers. Company.com meets with VC Corp., who likes management and the business plan and agrees to provide Company.com with $5 million it requires to get it operational until the next round of funding. Both parties agree to issue common stock for the deal where Company.com holds 50.1% of the firm (to maintain controlling interest) and VC Corp. holds 49.9% of the common stock. Therefore, VC Corp. valued the company at $10 million (rounded figure). Company.com receives a valuation for its tangible assets such as computers, office space, and some intangible assets such as employees, business plan, …etc.

Immediately after the closing, Company.com receives an offer to buy the company for $8 million from BigPortal.com, an internet portal company that is flush with cash and wants to maintain its leadership in the field. Since Company.com can realize an instant gain on its venture and maintains controlling interest, it agrees to sell to BigPortal.com. Company.com immediately receives $4 million for one day's work, while VC Corp. losses $1 million instantly on its $5 million investment.

This situation would have never happened in a real-world transaction since the venture capital firm would have ensured that its investment was protected from such events. However, in this example, VC Corp. could have avoided this tragedy by using several other instruments, such as preferred stock, vesting management's interest in the firm, and using covenants.

The valuation given to Company.com was based on the potential value and not the current tangible value. Venture capitalists bridge the gap between value accretion events while at the same time the entrepreneur's/management's stake should not be perfected until he/she has delivered on the promised value. This is the basis for using instruments other than common stock. Company.com did not earn its equity at the time of the BigPortal.com purchase and that violated the basic principle of reward for performance.

b. Preferred Stock[v]

Preferred stock has preference over common stock in the event of sale or liquidation of the company. Preferred stock has a face value that is paid out before looking at common stock. Typically, the face value of preferred stock in a private equity transaction is the cost basis the venture capitalist pays for the stock. In the example above, if VC Corp. used preferred stock it would have been paid back its original investment through redemption of the preferred shares. Any amount above the preferred redemption would be paid out to common stockholder and divided according to the type of preferred stock used. Redeemable, convertible, and participating convertible preferred stock will be discussed next and we will see the outcome of the sale of *Company.com* to *BigPortal.com* under each scenario.

<u>Redeemable Preferred Stock</u>

Redeemable preferred stock is stock that has no convertibility into equity. Its value, therefore, is its face value plus any dividend rights.[vi] Redeemable preferred then acts more like subordinated debt than equity. The stock carries a negotiated term specifying when the investor, most likely the sooner of a sale or public offering, or five to eight years, must redeem it. It is used in private equity transactions in conjunction with common stock or warrants.

In the example above, if VC Corp. issued redeemable preferred stock with a face value of $5 million, plus a split of common stock as before (50.1% held by Company.com and 49.9% held by VC Corp.), the outcome of the sale to *BigPortal.com* would have looked much different. If the company were to be sold, VC Corp. would have redeemed it redeemable preferred stock at its face value of $5 million and the remaining $3 million would have been split according to common stock ownership, hence $1.5 million additional to VC Corp. and $1.5 million to *Company.com*. In effect, VC Corp. would have received its original investment back and kept its equity investment in the company. However, this "double-dipping" effect by VC Corp. would have a negative impact on the company's valuation since it would continue to maintain its ownership of the company without any real investment. This led most private equity deals to go with convertible preferred shares instead to maintain the risk/reward balance mentioned earlier.

<u>Convertible Preferred Stock</u>

Convertible preferred stock is stock that can be converted at the shareholder's option into common stock. In this situation, the shareholder must choose between redemption of his/her preferred shares at face value or convert them into common stock. Obviously if the value of the stake is worth more than the face value of the preferred shares, the shareholder will convert to common stock and realize a gain in value. The issuance of convertible preferred stock is the most common used financial instrument by venture capitalist and tends to be used in parallel with other instruments.

In this scenario, if both parties agreed to the issuance of convertible preferred stock, VC Corp. would have opted to redeem its shares at face value ($5 million) since 49.9% of the $8 million sale would have been roughly $4 million. *Company.com* would receive the remainder. However, if *BigPortal.com* had offered $12 million for the purchase of the company, VC Corp. would have clear chosen to convert its shares since the value would have increased to $6 million.

Participating Convertible Preferred Stock

Participating convertible preferred stock is the same as convertible preferred stock with the additional feature that in the event of a sale or liquidation of the company, the shareholder has the right to receive the face value and the equity participation as if the stock were already converted. Thus, the shareholder does not have to decide between redeeming or converting since any increase in value over the face amount would be given to the investor in the form of common stock or cash equivalent. Using the previous example, VC Corp. would have received the same in value. The difference lies in what VC ended up having. Under the convertible preferred scenario, VC Corp. would have had to choose between redemption for face value or converting all to common stock. Under the participating convertible scenario, VC Corp. would have received redemption for face value plus common stock for any value above that.

When a company decides to go public, markets expect the company to have a simple capital structure (i.e., only common stock or debt). This is why underwriters insist that all preferred stock be converted before an initial public offering (IPO). To avoid further negotiations between investors and the company, convertible stock usually contains a mandatory conversion clause that specifies that the company can force a conversion as part of an IPO of a certain negotiated size and price. The size and price tend to be high enough to insure that it is in the investor's interest to convert.

It is important to note that the numbers in the examples above were clearly hypothetical. A venture capital firm would never enter into such a transaction unless there is strong potential to earn high returns on its investment, typically between 55% to over 700% annually.

c. Vesting

The concept of vesting states that an entrepreneur's stock does not become his/her own until being with the company for a certain amount of time or until some value creation event occurs (i.e., reaching sales targets or in the event the company receives an offer to sell). Vesting occurs over a period of time (i.e., three to four years) and the stock becomes vested (entrepreneur has ownership) proportionally over that time period. This can be yearly, quarterly, or even monthly.

Previous research has shown that preferred stock transactions do a better job of "reward for performance" since it relies on the investment's terminal value. Also, vesting is a basic contract where for it to be as effective as preferred stock, potential situations and events must be anticipated and written down. The main appeal to having a vesting clause in a contract is because it plays a very important function of preventing management or employees from leaving the company and taking with them valuable resources. If the company is doing well and a key member of management holds valuable stock that would be lost if he/she left before a certain date/event, then the incentive to leave become a lot less.

Therefore, vesting protects the incentive stock from employees that have not held up their end of the deal and retains it for others who have. This also protects the morale of employees knowing that the ones who leave will not receive the same benefits as those who stay.

d. Covenants

Covenants are agreements between the investor and the company and are, by far, the simplest way for the venture capitalist to protect their investment. They include such elementary stipulations such as providing investors with audited financial reports, having board meetings, and paying taxes on time.

Covenants are also used to ensure that the venture is being operated according to the plan and pre-agreed guidelines. Since the venture capitalist is also concerned about changes in control, an agreement may state that the entrepreneur cannot sell/issue any common stock or enter into a merger without approval of the private equity investors or offering stock to the original investors first. Transfer of control is also important to venture capitalist since they put a lot of time and money in investing in the people.

The main reasons for having covenants are to disconnect control on important decisions from owning a majority equity stake. This leaves management to deal with operational issues and investors to deal with the financial matters.

C. Valuation

The valuation of any investment proposal is based on many factors both internally and externally. Internal factors include some mentioned previously such as management's experience, commitment, and reputation along with their ability to attract and keep top talent. The company must also show that it has potential for its products/services and can compete with others.

External factors include both industry-specific and macroeconomic. Industry specific factors include the competitive environment, industry growth, analysis of key players in the field, the value placed on similar ventures, rates of return (previous and expected), and investor demand. Macroeconomic factors include the overall health of the economy, trends on the stock market, and the government regulatory environment.

D. Exit Strategies

Contrary to popular belief, most ventures do not reach the IPO stage. It is estimated that over half get merged or bought out by competitors and other rivals. Some large companies have special venture arms that seek out companies in their industry with promising prospects. Companies such as Microsoft, Intel, Cisco Systems, Nortel Networks, and Sun Microsystems all have in-house venture capital departments. This is common in the high tech business since the leaders have to constantly be on the leading edge of new developments to secure their survival.

Likewise, over 55% of IPOs are not venture-backed, which in most cases means that the company either had internal sources of funding or was an offspring of a larger company.[vii] A good example of this was the recent AT&T Wireless IPO, which was the largest IPO to date raising $10 billion.[viii]

IV. Bringing It All Together under a *Sharīᶜa*-Compliant Framework

Now that the key elements of a venture capital transaction have been discussed, it is important to look at how this can fit into a *sharīᶜa*-compliant structure. There are a few basic questions that need to be answered to determine this. First, is venture capital an acceptable investment vehicle for Islamic investors? If so, then the next question would be whether or not the structure mentioned above is *sharīᶜa*-compliant. If not, what structure can be used?

A. *Sharīᶜa* Views on Equities

Sharīᶜa scholars are in agreement that venture financing at the early stages of a company's life is a classic form of *mu∞āraba*[ix] financing, not only because of the relationship between the provider of capital and the user, but also because investors can stipulate how they want their funds used. A *mushāraka*[x] structure is another tool that can be used be used to finance a venture.

To illustrate the acceptance of equity under *sharīᶜa* let's take a look at the equity fund industry. Prior to 1995 there were only a handful of Islamic equity funds on the market compared to over 100 today. Islamic bankers realized that if they wanted to become a serious alternative to conventional banking, they had to offer similar investment choices as their conventional rivals.

In the early nineties, Islamic bankers were set in developing equity funds where Muslim investors are able to participate in the growth of world equity markets. *Sharīᶜa* scholars had the complicated task of setting the parameters by which Muslims can invest. Today, equity funds are a standard product offered by Islamic institutions.

To sum up the *sharīᶜa* view on equities, the following is a statement issued by a prominent *sharīᶜa* scholar in the Gulf:

> "… If we consider the circumstances of these companies (traded on world stock exchanges), we realize that they constitute an indispensable need in the economic structure of the country, and no state can dispense without them. Moreover, they meet the urgent needs of individuals for investing their savings."

B. The Fundamental *Sharīᶜa* Principle of *Muᶜāmalāt*

This principle, which is clearly defined in jurisprudence, relates to human dealings and contracts along with issues regarding human relations. It simply states that everything is permitted unless clearly prohibited. As such, private equity and venture capital are perfectly acceptable modes of finance and investment provided they meet certain Islamic guidelines.

The principle of *muᶜāmalāt*, which literally translates into "dealings," should not be confused with the *sharīᶜa* principle of *ᶜibāda*, which literally translates into "worship." The principle of *ᶜibāda* states that everything is prohibited unless permitted and this relates to all issues of worship and not dealings.

Thus, trade and business activity is permitted and is actually encouraged. Since trade and business fall under the principle of *muᶜāmalāt*, entry into business dealings is permitted if they avoid prohibited activities (i.e., paying or receiving interest).

C. Structuring Issues

Although investing in a venture is an acceptable financial transaction, some aspects of the structure mentioned in 3.2.b. are not in line with *sharīᶜa* guidelines. These aspects are mainly related to the structure of preferred stock and shares that act like debt instruments. A *sharīᶜa*-compliant structure aims to balance the risk/reward benefits to all parties involved in a deal. As such, any financial instrument that acts like a debt security where the investor can get a "riskless" reward is prohibited. However, if the burden of risk is tilted unevenly toward the investor, the investor will lose the incentive to participate in an unexpectedly high-risk venture. What can be done to balance the risk in a *sharīᶜa*-compliant venture? Fortunately, as Islamic banking continues to develop, new and innovative financial instruments are being developed to answer these questions. The following aims to offer solutions to two issues, the first regarding the use of preferred stock and the second regarding the use of a discount rate to arrive at a company's valuation.

1. Preferred Stock

In order to minimize the downside risk to Islamic investors, workable Islamic alternative to preferred stock has been suggested, but there is no evidence to see whether or not such an instrument has been used in a venture capital transaction. This "Islamic" preferred stock acts like a pure preference share with predetermined varying profit ratios. There can be no accumulation of profits and no liquidity preference to one investor over another in case of a sale or liquidation. Thus, this is more like common stock with predetermined profit ratios.

2. Valuing Company Using Discount Rate

Since private equity deals are by nature risky transactions for several reasons, true valuation of the deal is crucial to achieve a target rate of return. Conventionally, discounting rates are benchmarked against some risk free security, such as U.S. Treasuries. This is a gray area from an Islamic perspective. However, Islamic investors need not worry about such discount rates since venture capitalist tend to value a company based on (a) returns on a project of a similar risk profile, (b) the average return on a well diversified equity portfolio. This is *sharīᶜa*-compliant.

3. A Workable Solution under Existing Structures

Finally, a simple and ready to use solution is available but may not be an optimal solution for some Islamic investors. The solution is to use a combination of vesting and covenants along with the issuance of common stock. Both vesting and covenants can be easily designed for the Islamic venture capitalist and will avoid costly structuring of untested financial instruments.

Islamic investors can pool their resources into a venture capital fund to seek out lucrative investments, while at the same time, minimize their risk by spreading it across a diversified investment portfolio of companies.

V. Conclusion

Venture capital is a lucrative industry not only for investors but also for the overall advancement and development of economic and innovative commercial activity. Even though some financial instruments used in conventional venture capital structures are not compliant with *sharīᶜa* guidelines, there are alternatives already available and used on the conventional side that can immediately be used by the Islamic venture capitalist. There are also new Islamic instruments being developed to address other investor concerns.

A few Islamic financial institutions have been involved in venture capital deals. Their approach, however, has been that of a provider of funds rather than a lead investor. Such institutions tend to rely on the knowledge and expertise of others and would simply "piggyback" on the transaction. Islamic institutions are slowly realizing the potential of this industry and are more willing to take a leading role in private equity deals.

The potential for purely “Islamic” venture capital is large. There are many Muslim entrepreneurs living in developed countries that are seeking Islamic VC. In Silicon Valley, for example, several high-tech start-ups launched by Muslims have attracted the attention of mainstream VC companies. Since Islamic financing was not available to them, the entrepreneurs opted for conventional financing.

There is clearly an opportunity for an Islamic financial institution to create a niche market that specifically targets Muslim entrepreneurs in high-tech hotbeds like Silicon Valley. This is not to say that there are no opportunities in developing countries. 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.[xi]

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[ii] NASDAQ. http://www.nasdaq.com.

[iii] National Venture Capital Association. http://www.nvca.org.

[iv] Lerner, Josh. "Assessing the Contribution of Venture Capital to Innovation." Available on http://www.people.hbs.edu/jlerner.

[v] Lerner, Josh. "A Note on Private Equity Securities." Cambridge: Harvard Business School, 1999.

[vi] Typically, private equity deals, because investment are made in new and growing companies, never result in dividends because all profits are "plowed back" into the company for continued growth.

[vii] National Venture Capital Association.

[viii] http://www.ipo.com.

[ix] An agreement between two parties, one party provides 100% of the capital for a venture and the other, known as the *mu∞ārib*, manages the venture using his/her skills. Profits are distributed according to a pre-agreed ratio. Monetary losses are borne only by the provider of the capital, while the *mu∞ārib* loses his/her time, effort, and chance for remuneration. Management is provided solely by the *mu∞ārib*. The *mu∞ārib* does not share in any losses because, according to Islam, a *mu∞ārib* can not lose what he/she did not contribute. *Mu∞āraba* is among the most common modes of Islamic financing.

[x] This is a classical partnership agreement. All parties involved contribute toward the financing of a venture. Profits are shared according to a pre-agreed ratio, while losses are shared according to each party's equity. Management of the venture is carried out by all members, some members, or just one member.

[xi] IslamiQ Financial Daily. http://www.islamiqdaily.com.