VENTURE CAPITAL BANK

CHAPTER 14

THE ROLE OF VENTURE CAPITAL IN ISLAMIC FINANCE

INTRODUCTION

Venture Capital (VC) is equity capital provided by professional investors who invest alongside management at the earliest stages of establishment often when entrepreneurial risk is at its highest and sources of funding are limited for entrepreneurs. Equity capital is an ownership interest or share in a business, as opposed to a debt or loan against the business. VC firms typically provide this type of funding for companies in innovative industries or with innovative business models which are perceived to have exponential growth potential and expected to become significant contributors to the economy. Over the years, this form of funding has provided support for innovative entrepreneurs and helped establish companies that started as ideas and grew to become world leaders in their respective industries. Tables 1 and 2 provide examples of VC funded companies that have grown to become pioneers in their industries and contributed significantly to the economy.

VC is an important source of equity capital for start-up and mezzanine stage companies. Professionally-managed VC firms are typically private partnerships or closely held corporations funded by wealthy individuals, foundations, corporations, private and public pension funds, endowment funds, foreign and local

Table 1: Employment at VC Backed Companies Known for Innovative Business Models

Company	Employees at time of IPO	Current Employees	Increase in Employment
The Home Depot	650	331,000	330,350
Starbucks Corporation	2,521	160,000	157,479
Staples	1,693	89,019	87,326
Whole Foods Market, Inc.	2,350	69,500	67,150
eBay	138	31,500	31,362

Source: National Venture Capital Association Yearbook 2014

Table 2: Employment at VC Backed Companies Known for Innovative Technology Products

Company	Employees at time of IPO	Current Employees	Increase in Employment
Microsoft	1,153	94,000	92,847
Intel Corporation	460	100,100	99,640
Medtronic, Inc.	1,287	45,000	43,713
Apple Inc.	1,015	76,100	75,085
Google	3,021	53,861	50,840
JetBlue	4,011	12,070	8,059

Source: National Venture Capital Association Yearbook 2014

investors and entrepreneurs. The VC firm invests capital in exchange for an equity stake in the ownership of the target enterprise.

A unique feature of VC as an asset class is that risk and return is shared between the venture investor and the entrepreneur. The value and return to the VC firm is unclear at the early stages of establishment and only becomes clear if the company is acquired or offered to the public on a stock exchange. VC firms provide start-ups not only with capital but also with technical, operational and managerial expertise in exchange of a controlling stake of the company. VC firms take an active role in the day-to-day management of the company, sitting on the board of directors and communicating regularly and frequently with management. They also provide valuable resources through their network for additional funding at later stages of a company's life cycle.

The funds raised through VC are typically used to develop new products or technologies, to expand working capital, to make acquisitions, or to strengthen a company's balance sheet. Venture capitalists mitigate the risk of venture investing by developing a portfolio of young companies in a single venture fund. Many times they will co-invest with other professional VC firms. In addition, venture partnerships usually manage multiple funds simultaneously.

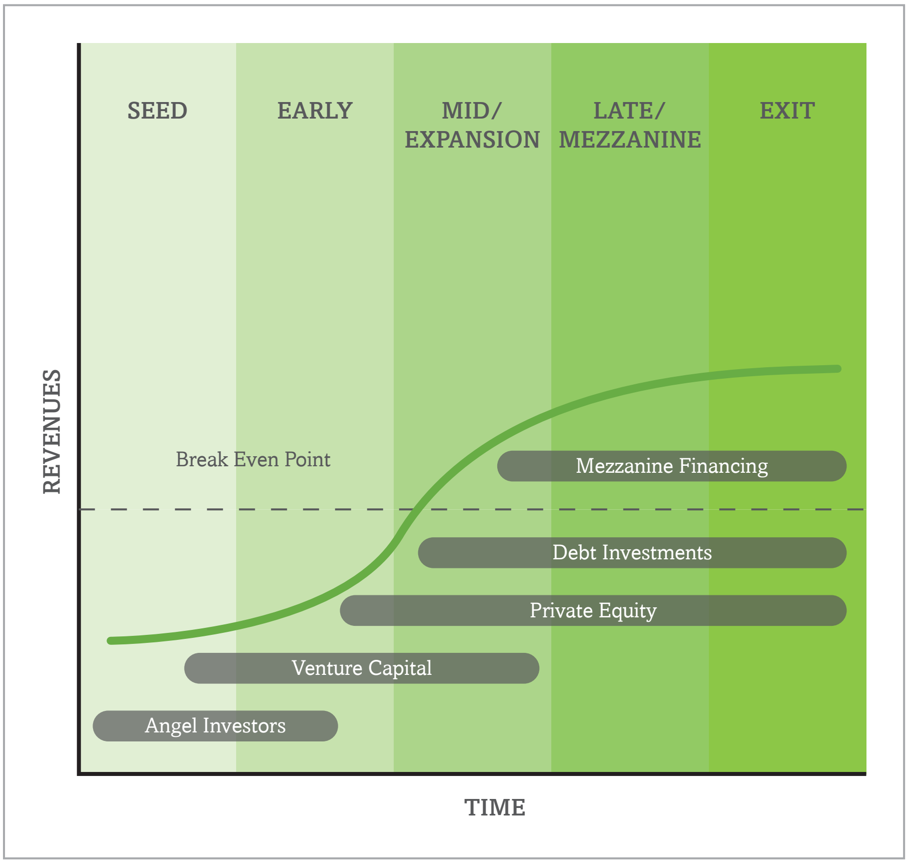
BOX 10: THE STAGES OF VC INVESTING

The oldest and most common form of a VC investor is known as angel investors, who are often individuals closely related to the business or entrepreneur, and are willing to share in the risks and profits of the startup business. Angel investors enable the business to move from the self-funded stage to the stage where VC is required.

The first stage of VC funding is the seed stage, in which capital is provided to start the business. At this stage, the funds are often used for research, design, and development and testing of a product or a service. Seed stage investors usually participate at later stages of funding along with other providers of capital to fund the next stages of the life of a company.

The second stage of VC funding is known as early stage funding, at which funds are provided to companies who are operational but have not yet reached a manufacturing and sales level.

Funding that includes the seed and early stage funding is known as formative stage funding. Another stage of VC funding is known as mid or late stage funding, in which venture capitalists provide funding to companies with manufacturing capabilities and have products or services commercially available. At this stage the company would typically be experiencing growth in revenue and undergoes different types of expansions of its operations.



The exit stage is when the venture capitalists hope to make their profits, as they sell their shares to another investor or list them on a stock exchange, known as IPO. The aim is to sell their shares at a much higher price than they initially paid for them, which should cover the costs of other VC investments that may have not been as successful.

VC investment is closely linked to innovative industries, such as information technology, healthcare, education and consumer products. VC investments experienced an abnormal spike in amounts invested in 2000 mainly driven by investor funds attracted by the dot-com bubble increasing the number of funds and commitments during that period. The period of inflated investment in VC was followed by a challenging period for exits leading to a difficult period for this asset class. Since then the industry has experienced fundamental shifts and has right sized itself returning to pre-2000 levels. The VC industry in the US provides the most successful example of this form of equity financing for entrepreneurs. According to the National Venture Capital Association (NVCA), VC has provided funding and supported the establishment of over 11% of private sector firms in the United States representing approximately 20% of the GDP.

Whether in the United States or Europe, the VC industry was founded on the recognition of the vital role that SMEs can play in creating well-paid and highly skilled employment opportunities, increasing investment levels, adding value, boosting research and development and producing export income.

VC IN THE CONTEXT OF ISLAMIC FINANCE

Since its early days, Islamic finance has continued to grow and has expanded to include areas other than commercial banking such as capital market and hedging products.

The expanding spectrum of Islamic products on offer and increasing number of transactions provides a competitive environment for practitioners and increases confidence in the industry. Profit sharing is a concept deeply rooted in Islamic finance. Among its many potential benefits is the capacity to fund entrepreneur-ism in communities, which promotes innovation, job creation and growth. Lately more attention has been given to private equity and VC in the context of IBF.

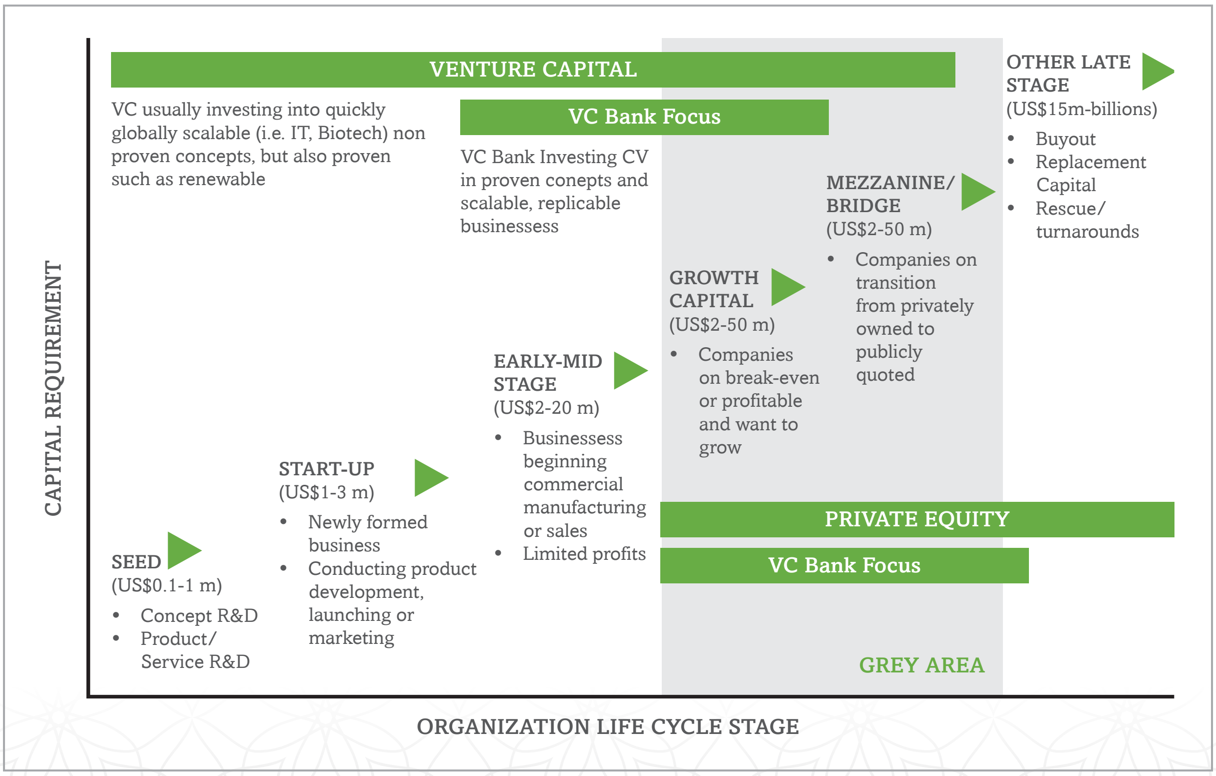
Shari'a-compliant VC transactions fall under the partnership models. Partnership models support the PLS concept that is the essence of VC financing. Two of the most commonly used structures for setting up Islamic VC transactions are the musharaka and mudaraba. These structures provide a tool that enables Shari'a conscious entrepreneurs to procure financing for their privately-owned companies from VC firms that in turn share in the returns potential of innovative industries. The venture capitalist provides the funds needed to start the business, given that the nature of the business is Shari'a-compliant, and the entrepreneur provides the idea and daily management of the company.

The inherent characteristics of VC funding – PLS and providing an equitable source of funding for entrepreneurs – encourage the entrepreneurial spirit in the economy and are very much in line with the spirit of IBF. For any early stage company, the burden of loan repayments or instalments from a conventional loan may be too much to bear, as the cash flows from a business are needed to fund expansion and growth. So VC funding, which does not have any fixed instalments or repayment schedules, is a very welcome form of funding for a new enterprise that needs to conserve its cash. Coupled with the established Islamic banking instruments that enable bankers to engage in VC transactions, venture capitalists have made VC funding an increasingly interesting asset class for Islamic bankers and investors. It also provides a tool through which practitioners could grow IBF outside of its traditional markets. The ethical and equitable elements in VC as a concept as well as its potential profitability have made it increasingly appealing to practitioners of IBF.

VC IN THE MENA REGION

VC and private equity investment are a fairly new phenomenon in the MENA region, especially in the context of IBF. Small businesses have traditionally relied on informal means of funding such as personal savings,

Figure 1: VC Bank's Approach to Business



bank loans, and family reserves for survival and growth. Despite the fact that for decades the GCC had been a source of capital for international and, more recently, regional private equity firms that raise capital and invest principally in the United States and Europe, regional investors have largely shied away from supporting local businesses and industries. Micro businesses and SMEs represent vast majority of business establishments in most economies, and are usually responsible for job creation, accounting for one to two thirds of the turnover in the private sector. The MENA region is no exception. However, SMEs in the MENA region are mostly driven by family groups as opposed to individual entrepreneurs.

It is estimated that SMEs account for about 99% of the total number of companies and about 67% of total jobs in the MENA region, thus making a significant contribution to the regional GDP. The GCC countries are reported to have over 5,000 family businesses with assets exceeding US$500 billion, accounting for 75% of the private sector. These figures highlight the importance of family-owned enterprises to the overall well-being of the GCC economy.

Governments are increasingly supporting various VC and private equity schemes in acknowledgement of the role these can play in diversifying economies, nurturing and growing innovative industries, reducing unemployment, and encouraging exports. In a recent regional survey by Gulf Venture Capital Association and KPMG of the impact of VC and PE on the development of PE-backed firms, all firms surveyed reported improved turnover, overall profitability, and employment following a VC or PE injection.

The development of VC and private equity investment in the region is the next logical step, as HNWIs and wealthy family groups act as a substitute for institutional investors or bank finance, which dominate the VC industry in the United States and Europe, respectively.

VENTURE CAPITAL BANK'S CONTRIBUTION TO THE INDUSTRY

Bahrain-based Venture Capital Bank (VC Bank) is among the pioneers of Shari'a-compliant VC investments in the region. Established a decade ago, VC Bank operates under three lines of business:

- VC and business development
- PE
- Real estate

As Figure 1 shows, VC Bank's key line of business, VC and business development, targets SMEs in innovative high growth sectors primarily within the GCC region and opportunistically in the wider MENA region. For investments for business development, the bank seeks start-up or early to mid-stage enterprises with proven transplantable concepts. While for VC type investments it seeks early to mid-stage companies with scalable growth firms and established management. Within its primary geographical region of focus, the GCC and MENA, the definition of SMEs varies widely but is often seen as having less than 250 employees and turnover of up to US$40 million.

Other business lines of VC Bank include PE and real estate investments with different mandates and investment criteria. For PE the Bank targets majority stakes in undervalued or underfunded growth SMEs in defensive sectors, in companies that are cash flow positive. Companies looking for PE investments typically have at least a three-year track record, which still makes them relatively early stage investments. For real estate investments, the bank seeks medium sized projects yielding stable returns in core markets in the MENA region as well as internationally.

Below are case studies of a number of VC Bank's investment portfolio.

i. German Orthopaedic Hospital

Since opening in 2010, German Orthopaedic Hospital has quickly earned a reputation for world class orthopaedic treatment and surgery centre in Bahrain and the wider GCC market, especially the Eastern

Province of Saudi Arabia and Kuwait. The hospital was established with the aim of providing patients with an alternative to going abroad to seek the highest standards of German medical treatment. The hospital covers 2,000 square metres and houses 18-bed in-patient facilities, 2 operating theatres plus a 5-bed recovery room. The services provided include surgical and conservative orthopaedics, sports medicine, radiology, pain therapy, rehabilitation and physiotherapy. The hospital has entered into an agreement with the General Organization for Youth and Sports (GOYS) for the treatment of players of Bahrain's national sports teams. This was an investment made at the seed stage by VC Bank in a new venture for the GCC, which can be easily replicated across the region.

ii. Liquidity Program

The Liquidity Program was launched in March 2009 to create an alternative to the existing liquidity products available for Islamic banks based on murabaha and mudaraba. The Program comprises of short-term liquidity instruments for a total value of US$55 million in the form of Shari'a-compliant certificates that are issued against the building of VC Bank and income generated from it. The underlying property is a prime asset comprising an iconic building situated in the heart of Bahrain's busiest business district, the Diplomatic Area. The property, which continues to operate at near 100% occupancy levels as of today, comprises a well-conceived blend of office, retail, and over 900 car parking spaces that caters to a build-up of unmet demand in the central areas of Manama, Kingdom of Bahrain. This innovative product offers short term investments that can be made for 1, 3, 6 or 12 month periods and provides investors with a rate of return of 4% to 6% for the revenues generated by the building of VC Bank.

iii. Goknur

In a deal valued at US$120 million, VC Bank has taken an indirect investment in the equity shares of Goknur Foods Import Export Trading & Distribution Company (Goknur) in Turkey. Already an established company, Goknur is the largest fruit juice concentrate and fruit puree producer and exporter in Turkey, with a 50 percent market share. It exports to over 60 countries worldwide, with a focus on Europe, USA and Russia; and its client base includes leading international brands such as Coca Cola, Pepsi Cola, Sun Top, Hero and Smuckers. The growth capital provided by VC Bank and its investors has allowed Goknur to increase its farmland from 4.2 million to 10 million square meters and establish two new plants and so increase the total production capacity from a daily processing capacity of 2,000 tons of fruit to 7,000 tons of fruit in a relatively short time period of only 2 years.

iv. JAFCCO

Jordan Al Abyad Fertilizers & Chemicals Company (JAFCCO) is a Jordan based fertilizer and chemicals company specialized in the production of high quality potassium sulfate (SOP) and hydrochloric acid. Over the years, JAFCCO has gained the technical expertise and know-how required to run a successful fertilizer manufacturing company. JAFCCO's full production capacity is pre-sold to customers in Egypt, Saudi Arabia, Syria, Spain, Australia, India and UAE. At the current production level, JAFCCO is the only major producer of SOP in the MENA region, supplying only a fraction of the demand from Asia and Africa while the rest is imported from Europe and North America. With VC Bank and its investors JAFCCO's has completed a US$100 million state-of-the-art industrial complex specialized in manufacturing chemical fertilizers and other kinds of industrial chemicals that are currently imported into the MENA region. This expansion project is designed to increase the overall output of SOP for JAFCCO by up to eight times, which will provide other valuable chemicals to the local market, help the local economy generate jobs and foster development.

v. QCon

Qatar Engineering & Construction Company ("QCon") is a leading engineering, procurement and construction contracting company based and operating in Qatar. It specializes in projects and plant maintenance for the oil and gas, petrochemicals, fertilizers, power and other industrial infrastructure sectors. Established in 1975, QCon has built a dominant position, and a high reputation for quality and safety, in the niche segments in which it operates. Since VC Bank made its investment in 2010, QCon has managed to expand its operations overseas into the United Arab Emirates market and has made progress to commence operations in the Kingdom of Saudi Arabia in line with its strategic goals.

f. Royal Maternity

VC Bank is in the process of setting up The Royal Maternity Hospital ("RMH") in the Kingdom of Bahrain. RMH will operate a world-class hospital specialized in the provision of basic and advanced healthcare services for women and children. The initial focus of the Hospital will be to provide comprehensive maternity services, extending to pre-natal and post-natal care, in addition to gynaecology. RMH is designed as an exclusive retreat, where women can seek the highest levels of tailored medical services. The 25 bed Hospital will be located in the outskirts of Riffa, Bahrain where the project promoter has secured a location with an area of 40,000 m^2. The services that would be introduced include maternity, gynaecology and fertility, diagnostics, and reconstructive surgery. RMH is expected to be operational by early 2016.

CONCLUSION

Since its inception the VC industry has supported innovative ideas and has gone a long way in nurturing the entrepreneurial talents in societies. VC has enabled many entrepreneurs to realize their ideas and establish what have now become household name companies such as Microsoft, Google and Facebook. Market analysts believe that the industry will continue to grow and adapt to changes in the market. Moreover, the VC industry has proven to be very flexible and applicable to the different cultural, financial and regulatory mandates of different jurisdictions. Hence its appeal to Islamic bankers and the increasing interest it has attracted from practitioners. In addition to the vast growth potential of the traditional Shari'a-compliant products, the Shari'a-compliant VC industry provides another dimension of potential growth for the Islamic financial services industry. Its adaptability to IBF mandates coupled with its track record in supporting entrepreneurial spirits in more developed markets makes it a prime tool for growing IBF and engaging in Shari'a-compliant transaction outside of traditional IBF territories. Moreover, it provides Shari'a conscious investors with the ability to take part in higher risk higher return investments that are in line with their beliefs. As practitioners in this field and coming out of the recent financial and regional political turmoil, we believe that the future holds great potential for the Shari'a-compliant VC industry and IBF in general.

Over the last decade VC Bank has proudly invested in and helped develop around 40 small-and-medium sized companies from across multiple industry sectors and selected real estate themed projects, with an aim of increasing growth prospects and stimulating economic development across the MENA region and beyond. Through many unique and innovative investments, our intention is to connect our highly supportive and active investor base with these opportunities, which are in full compliance with Shari'a principles.