

The Mesdaq VC factor

Is VC participation in listed companies a good thing?

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IT is hard to imagine the Mesdaq Market thriving without the involvement of venture capital (VC). The former was established to provide an avenue for high-growth companies, usually those in technology-intensive industries, to raise capital.

Most of these companies need help to expand their businesses and to get ready to float their shares on the Mesdaq Market, and this is when the VC companies often come into the picture by providing funds and guidance.

According to the Malaysian Venture Capital Association and Private Equity Association (MVCA), about 30% of the companies listed on the Mesdaq Market last year were VC-backed. That says a lot because 2005 was a record year for Mesdaq IPOs (initial public offerings), with 46 new listings.

Bursa Malaysia, in its 2005 annual report, says this reflected the heightened capital raising activities in the high-growth and technology sector.

Yet, some stock market players feel that VC participation in listed companies is not always a good thing. This apprehension is mainly rooted in cases of certain Mesdaq counters languishing below IPO prices after the VCs have sold their shares in these companies soon after their stock market debuts.

The most recent example is ISS Consulting Solutions Bhd, a software solutions provider that was listed on Aug 2. One of the substantial shareholders, Malaysia Venture Capital Management Bhd (Mavcap), sold almost 16 million ISS Consulting shares within the first three days, slashing its stake from 16.6% to 9.3%.

ISS Consulting ended its maiden trading day at 32 sen, well below its offer price of 41 sen. The stock closed at 21.5 sen last Thursday.

Of course, the price movements of the stocks are not necessarily caused directly by the VCs' transactions. Nor should the share disposals be automatically viewed as indications of the listed companies' prospects. Nevertheless, like it or not, investors tend to interpret a VC's buy or sell decision as a signal.

In fact, some investors are downright wary about putting money in VC-backed Mesdaq companies.

A senior dealer with a stockbroking company says Malaysian fund managers who have been burnt after investing in such companies, need a lot of convincing when approached to take part in share placement exercises for Mesdaq-bound companies.

He adds: "The first thing they ask is, 'Is there a VC involved?' Then, they want to know if the VC will sell after the IPO."

The perception is that because the VCs invest in these companies at an early stage, the entry cost is low and the VCs can therefore realise

gains even if they sell the shares below the IPO prices.

This worry is compounded by the fact that a Mesdaq company typically has a relatively small share capital base, and the VCs usually take up substantial stakes in such companies. As such, when a VC drastically reduces its position in a Mesdaq company, the surge in share liquidity can depress the share price.

Different VC, different vision

Others, however, say such aversion towards VC-backed companies is misplaced. For one thing, observers argue that the overriding aspects when considering an investment in a company are its business and management, and certainly not the presence of a VC.

"The issue is not the VC behind the company," says Green Packet Bhd managing director Puan Chan Cheong. "It's very much about the strength and potential of the company and its industry."

In fact, some people believe that a VC-backed company is more likely to be better managed than one that has not had VC involvement. The theory is that once a VC comes on board, it will help improve the quality of the investee company's management.

Explains Chia Kah Peng, CEO of VF Capital Sdn Bhd, a Sarawak-based VC company: "In a young, entrepreneurial setting, the managers are usually good in creative aspects, but not so in corporate and financial matters."

"We believe we can instil discipline in finance and corporate governance, and provide advice on strategic direction and corporate developments. We won't run the operations. Instead, we provide guidance at a higher level."

In addition, Tricubes Bhd chief executive Kharun Zainal Mokhtar believes that VC-backed companies are more likely to be sound investments because the VC companies would have done due diligence on the investee companies before investing.

Still, perception alone is not enough. There ought to be a deeper understanding of the roles and objectives of VCs, and how these vary from one VC to another.

The fundamental point is that a VC needs to sell its equity in the investee company to reap sizeable returns from its investment, and more often than not, the right time to do so is after the IPO. An exit is inevitable. It is merely a matter of when this will happen.

In most cases, the keen trading interest in the several days following the listing of a stock enables the VC to dispose of a lot of shares.

Says ISS Consulting executive director and chief financial officer Christina Orth, "You know right from the start that the VC has come in to make money. We have to prove to the market that the company is working well, with or without the VC."

Selected Mesdaq companies with VC backing

| Company | Date listed | VC | VC's stake upon listing | VC's stake now |
|--------------------------|-------------|---|-------------------------|--|
| Willowglen MSC | 29.4.02 | OSKVI | 8.1 | 13.3 (Note 1) |
| KarenSoft Technology | 24.1.03 | MSC Venture Corp | 6.8 | Ceased to be substantial shareholder on 7.7.03 |
| Infotech Alliance | 28.7.03 | OSKVI | 8.4 | Ceased to be substantial shareholder on 30.7.03 |
| Nova MSC | 19.8.03 | OSKVI | 6.4 | Ceased to be substantial shareholder on 22.8.03 |
| eBworx | 17.11.03 | OSKVI | 8.3 | 22.6 |
| REDtone International | 9.1.04 | MSC Venture Corp | 9.8 | Ceased to be substantial shareholder on 5.2.04 |
| OpenSys (M) | 29.1.04 | Commerce-Ventures | 13.6 | 9.7 |
| GPRO Technologies | 2.6.04 | Mavcap | 15.8 | 13.4 |
| Viztel Solutions | 23.7.04 | Mayban Ventures | 19.4 | 17.6 (Note 2) |
| JobStreet Corp | 29.11.04 | WIIG Global Ventures Pte Ltd | 5.3 | Ceased to be substantial shareholder on 30.11.04 |
| Impressive Edge Group | 7.12.04 | OSKVI | 7.4 | Ceased to be substantial shareholder on 7.12.04 |
| The Media Shoppe | 8.12.04 | BI Walden Ventures Ketiga S/B Pacven Walden Ventures VLP | 8.0 7.5 | 5.6 5.3 |
| Tricubes | 15.12.04 | Commerce-Ventures Mayban Ventures | 15.6 10.5 | 15.5 10.5 |
| Carotech | 15.4.05 | Commerce-Ventures | 9.3 | 7.1 |
| Green Packet | 25.5.05 | OSKVI | 3.6 | 19.2 |
| mTouche Technology | 21.7.05 | OSKVI | 4.7 | 20.3 |
| INS Bioscience | 26.7.05 | OSKVI | 13.1 | 13.1 |
| MNC Wireless | 25.10.05 | OSKVI | 7.4 | 20.1 |
| Wimems Corp | 20.1.06 | Commerce-Ventures | 16.2 | 8.6 |
| Microlink Solutions | 23.6.06 | BI Walden Ventures Ketiga S/B | 14.4 | 10.8 |
| ISS Consulting Solutions | 2.8.06 | Mavcap | 16.6 | 9.3 |

Notes
1. OSKVI had ceased to be substantial shareholder on 20.8.03 but became substantial shareholder again on 17.6.05
2. Mayban Ventures' stake diluted by issue of new shares
Source: Bursa Malaysia announcements

"Furthermore, it's not that Mavcap has pulled out completely. The fact that it still retains a substantial stake shows its confidence in ISS."

Mavcap chief executive officer Norazharuddin Abu Talib has not replied the questions that BizWeek has emailed to him.

Eddie Yap, executive director and chief operating officer of OSK Ventures International Bhd (OSKVI), a VC company listed on the Mesdaq Market, points out that the VC companies themselves have investors who expect returns from the money they have put into the VC companies.

Some VC companies invest their own money and their revenue comprises the returns from these investments. Others earn fees from managing VC funds set up with money put in by investors.

A phrase you will hear frequently from VC players is, "It's a numbers game." That means the principal aim of a VC company is to secure overall returns – not all the investments will fare well, but hopefully, the bright spots will far outshine the disappointments – that will satisfy its investors.

"It's our job to return money back to our investors," says Azam Azman, the chairman of MVCA, the industry body.

Making a graceful exit

OSKVI's Yap explains, "We have a portfolio of about 20 companies, and we can't hold everything. We have to make a choice. If we can make good returns from selling an investment, we will sell. If we feel an investee company has not reached its full potential, we will keep it and continue to add value."

For other VC companies, the timing of the share disposals does not just depend on the size of the returns. Those that manage funds with finite lives do not have the luxury of waiting patiently for years for the share prices to appreciate further. They have to realise the value of their investments before closing the funds.

The counter-argument here is that in the past, some VCs have shown little market-savvy when selling their shares in the investee companies.

Chia Kah Peng, CEO of VF Capital

Sdn Bhd, a Sarawak-based VC company, says there are ways to structure share disposals so that they are less painful to others. He adds: "Yes, there will come a time for us to exit, but we're not going to dump the shares just like that. We'll not sell down."

REDtone International Bhd group managing director Wei Chuan Beng warns: "An IPO is a natural way for the VC to exit. The thing is, if there is no proper plan for the exit, this can lead to drastic movements in the share price. There has to be a orderly exit." REDtone's substantial shareholders once included MSC Venture Corp.

For example, a road show can be held to articulate the VC's exit strategy. Also, the market tends to react more positively if the VC places out its shares to strong institutional investors instead of selling them in the open market.

Most importantly, there has to be good relations between the VC and the other major shareholders so that the relevant parties can work out a smoother exit by agreeing on the timing, price and volume of the VC's disposal.

Huge growth potential

THERE is no Malaysian equivalent of California's Sand Hill Road, famous for the large number of VC companies based there. And even if we place all the local venture capitalists in one location in Kuala Lumpur, we will still be a long way from attaining Sand Hill Road's buzz and profile.

Our VC industry, says Azam Azman, chairman of the Malaysian Venture Capital and Private Equity Association (MVCA), is still nascent and has yet to gain much awareness among businessmen, particularly those behind small and medium enterprises (SMEs), and investors – the very people whose participation can help boost the industry.

(According to Azam, VC is a subset of private equity (PE). In Malaysia, VC generally relates to investments, also known as seed capital, in businesses at the early stage.)

The good news is there is huge growth potential. It is apparent that the Government recognises that as well as the fact that VC has an important role in moving the economy up the value chain.

Budget 2007 has proposed to increase funding in seed capital by giving income tax exemption for 10 years to VC companies that invest at least half of their funds in the form of seed capital.

In another budget proposal, Khazanah Nasional Bhd will establish a RM200mil agriculture fund to provide venture capital for new technology-intensive agriculture projects. The fund will be backed by the Government, Khazanah Nasional and the private sector.

At the Venture Capital Investors Forum last month, Securities Commission chairman Datuk Zarinah Anwar, who is also chairman of the Malaysian Venture Capital Development Council, said: "The Government has long been a supporter and financier for VC as an alternative and integral funding mechanism for critical growth areas, directly through subsidies or indirectly through participation in private sector projects."

"This has been reaffirmed by the Ninth Malaysia Plan allocation of RM1.6bil, a

whopping increase over the RM690mil allocated in the last plan for VC to bridge the crucial financing gap at early stages of enterprise development."

At the same time, she pointed out that the time was right for the private sector to play a bigger role to augment the government's efforts in providing the fund flow.

She added that private institutional involvement in VC in Malaysia definitely has room to grow. As at the end of last year, Malaysian banks, insurance companies and pension funds accounted for only 17% of the total VC funds. In contrast, institutional investors contribute as much as 40% of VC finance in the United States.

Indeed, one of MVCA's priorities is to convince local investors that VC and PE should be regarded as an asset class of its own, much like shares, bonds and commodities.

The association also wants to drive home the point that VC and PE players contribute significantly to the development of the capital market. One idea is to give out awards to VC-backed listed companies to highlight that the quality of such companies.

But perhaps stock market gains speak louder than awards, and if this is true, some of the best examples currently are JobStreet Corp Bhd, mTouche Technology Bhd, Green Packet Bhd and OSK Ventures International Bhd (OSKVI).

These companies are among the Mesdaq Market's best price performers. OSKVI, which has associate stakes in mTouche and Green Packet, is possibly the hottest VC company right now.

Says OSKVI executive director and chief operating officer Eddie Yap: "A lot of people don't understand the spirit of VC. Traditionally, people go to banks for funding. They view VC companies as financiers that can take a lot more risk and there is the false believe that that it's okay for the investee companies to fail."

"There's also the fallacy that VC companies are called in only when they can speed up a company's listing. But I think the awareness about VCs has improved."

Key statistics of VC industry

| | As at end-'04 | As at end-'05 |
|--|---------------|---------------|
| VC funds (RM mil) | 2,266.0 | 2,589.0 |
| ● Total investment (RM mil) | 1,058.0 | 1,441.5 |
| ● Local sources (RM mil) | 887.7 | 1,179.3 |
| Foreign sources (RM mil) | 170.3 | 262.2 |
| No of VC companies | 38 | 48 |
| No of VC capital fund management companies | 34 | 39 |
| No of investee companies | 332 | 380 |
| | During '04 | During '05 |
| Total investment (RM mil) | 298.3 | 431.5 |
| ● Local sources (RM mil) | 248.4 | 338.2 |
| ● Foreign sources (RM mil) | 40.9 | 93.3 |
| No of investee companies | 139 | 101 |

Source: Securities Commission

(Left clockwise): Khairun Zainal of Tricubes, Puan Chan Cheong of Green Packet, Chia Kah Peng of VF Capital, Eddie Yap of OSK Ventures, Azam Azman of Opus Capital, Wei Chuan Beng of REDtone and Christina Orth of ISS Consulting

