WRITTEN BY SAMANTHA CHEW

Ficus Insights

The Islamic Digital Economy and Shariah-Compliant Venture Capital in Malaysia

In This Issue

Reach us:

info@ficus.vc

www.ficus.vc

Ficus Capital

Investment · Guidance · Growth

Malaysia in the Global Islamic Economy Landscape

In 2021, Malaysia led the Global Islamic Economy Indicator (GIEI) by Salaam Gateway - a joint effort between the Dubai Islamic Economy Development Centre and Thomson Reuters to provide the global reference for Islamic economy - for the 8th consecutive year, followed by Saudi Arabia, United Arab Emirates and Indonesia. Malaysia's consistent lead in the Islamic economy landscape elucidates the country's strong capacity to capture opportunities in the multi-trillion-dollar global Islamic economy.

Malaysia's substantial lead is supported by its position as a global halal hub and leader in Islamic finance. The country has long been a pioneer in the halal industry, with the establishment of the world's first Halal certification body, the Department of Islamic Development Malaysia (JAKIM), which is widely known for its stringent standards and highly sought-after halal certification. Annually, the country records a reported export value of RM31 billion for halal products. According to the State of the Global Islamic Economy Report (GIER) 2020/21, Malaysia is also the world's largest Sukuk issuer and recorded US$570.5 billion worth of Islamic finance assets in 2019.

cont'd

According to the GIER 2020/21, the global Islamic economy recorded $2.02 trillion in consumer spending and $2.88 trillion of Islamic finance assets in 2019. Muslims are expected to spend US$2.4 trillion by 2024, driven by the 1.8 billion global Muslim population complemented by the growth of ethical consumption, national Islamic economy strategies and digital connectivity. To maintain and capitalise on Malaysia's capacity to strengthen Islamic economy, it is natural to leverage the country's robust and comprehensive ecosystems in the Islamic economy and progressively advance into Shariah-compliant technological innovations.

The Islamic Digital Economy

Ficus Group Capital (FGC) has identified the Islamic Digital Economy (IDE) as a key driver in further cementing Malaysia's position as the global champion in Islamic Economy. In particular, the Islamic fintech market is a segment which presents a compelling opportunity for Malaysia to disrupt the IDE landscape. Islamic fintech is a burgeoning market, albeit young and fragmented. In 2020, Islamic fintech in the Organisation of Islamic Cooperation (OIC) countries recorded US$49 billion in transaction volume and is expected to grow at a 21% compound annual growth rate (CAGR) through 2025. In the same year, Malaysia led the Global Islamic Fintech Index, a recognition of the nation's thriving ecosystem attributed to its regulatory support, abundant talent pool in Islamic finance and strong Islamic finance market.

Since IDE traverses various regulations, authorities and agencies, it is highly recommended that a multi-ministry committee is established to coordinate and support its development in Malaysia. This committee should be composed of relevant agencies, namely Bank Negara Malaysia (BNM), the Securities Commission (SC), Ministry of Science, Technology and Innovation (MOSTI), Malaysia Digital Economy Corporation (MDEC), Malaysian Communications and Multimedia Commission (MCMC), JAKIM, National Film Development Corporation Malaysia (FINAS) and SME Corporation Malaysia. Moreover, with IDE being in its nascent stages, it is imperative that the relevant key ecosystem drivers are identified and sufficient components are developed to effectively capture opportunities and drive the growth of IDE. Two key areas which require critical government intervention in catalysing the development of IDE are as follows:

- **Regulatory certainty with regards to IDE products and services.**

Due to the nature of its offerings, it is highly likely that IDE products and services would fall under multi-authority territories such as JAKIM, MCMC, BNM and SC. Thus, to enact or develop an overarching act or policy on IDE at the national level would stimulate and facilitate product innovation within the IDE industry.

- **Shariah-compliant funding for IDE start-ups.**

With a young IDE landscape, a global start-up economy valued at over $3.8 trillion and Malaysia's comparatively robust start-up ecosystem amongst Muslim countries, start-ups stand to disrupt the IDE sector with their reputation as agile innovators.

Start-ups obtain most of their funding from angel investors and venture capital (VC) funds. However, it is apparent that there is a lack of both Shariah-compliant angel investors and VCs for IDE start-ups. Despite global Islamic finance assets being estimated at US$2.88 trillion, it is important to note that it is comprised of relatively traditional assets, with the Islamic banking sector contributing the bulk of it with US$1.99 trillion in global assets. Due to the young and high-risk nature of start-ups, it is incredibly challenging to secure funding from financial institutions.

cont'd

- **Shariah-compliant funding for IDE start-ups.**

A Shariah-compliant VC ensures that all activities of the fund, conduct of fund managers and business activities of investee companies are strictly governed by Shariah principles. Thus, Shariah-compliant VCs would be most aligned to the needs of IDE start-ups, whereby such VCs are able to take on high-risk and provide guidance in growing the start-up in a Shariah-compliant manner. However, it is crucial that sufficient funding is available to realise Malaysia's potential in IDE, thus the challenges in obtaining funding should be addressed.

Challenges in Shariah-Compliant VC Fundraising

- **Government-Linked Investment Companies (GLICs)**

Currently, there is no GLIC in Malaysia with the unique mandate of developing the local VC ecosystem. GLICs typically invest in companies deemed more mature as their mandates typically focus on maximising returns and maintaining fund performance. VC investments are high-risk and do not traditionally fit the risk appetite of GLICs, thus if any of the GLICs were to invest in VC funds, it is highly likely that the funds would be channelled to 2nd or 3rd round funds which are mostly foreign VC management companies with greater track records compared to local, newer VC management companies. Moreover, GLICs would be more inclined to invest in mature and stable Shariah-compliant listed companies instead of new and risky Shariah-compliant VCs. As the world's first Shariah-compliant VC, a management company like FGC faces challenges in successfully pitching for investment from GLICs.

- **The Corporate Sector**

In Budget 2018, the government proposed a RM20 million a year per company or investor tax deduction over a 5-year period to promote private investment in VC funds. This incentive was approved and meant to be gazetted in late 2019, however there has been no update or official circular by the Inland Revenue Board detailing this tax incentive, causing corporates to be wary due to the uncertainty and validity, hence deterring corporate investment in VC funds.

- **The Islamic Banking Sector**

Bank Negara Malaysia's capital adequacy framework for Islamic banks outlines the hefty capital charge to be imposed on Islamic banks for risky investments such as Shariah-compliant VC. This has consequently become the main deterrent for Islamic banks to allocate their treasury and investment allocation into Shariah-compliant VC funds.

In 2014, Bank Negara Malaysia launched an investment account guideline to enhance Islamic bank offerings with the purpose of providing opportunities for Islamic bank clients to invest and share the profit from Shariah-compliant investment activities. The total size of the investment account as at September 2021 is RM114.98 million.

Unfortunately, although the investment account is designed to enable Islamic banks to invest in a wide range of risk preferences, very little has been allocated towards risky assets and none has been allocated towards VC investments. In relation to IDE development, should Islamic banks allocate a mere 1% of the total size of their investment account towards IDE start-ups, it would surely ignite the robust growth of the industry in Malaysia.

cont'd

Malaysia's Venture Capital Industry

Malaysia's VC industry has been around for over 20 years, however it is still considered as being in its early stages and has yet to make significant progress as a holistic ecosystem. In fact, the local VC industry is constantly playing catch-up with regional peers such as Singapore and Indonesia dominating the regional landscape. In 2001, the Malaysian government established several VC firms, including Malaysia Venture Capital Management (MAVCAP) and Kumpulan Modal Perdana (KMP). To put the local VC landscape into perspective, the case of MAVCAP will be highlighted as a government initiative in spurring the growth of the local VC industry.

MAVCAP is Malaysia's largest sovereign VC firm with the unique mandate of developing the local VC industry by producing more local VC companies and talents. In fulfilling its mandate, MAVCAP operates a "strategic funds model" initiated with the purpose of increasing the number of VC funds in Malaysia through collaborations with foreign parties and corporate partners. MAVCAP has indeed been successful in spurring growth in the local VC ecosystem, with a current total fund size of RM2.2 billion with 14 funds and a total investment amount of RM1.6 billion. It has also been instrumental in facilitating the entrance of global VC firms such as 500 Startups and Gobi Partners.

However, such a "strategic funds model" has yet to establish a formidable local VC management company to lead Malaysia's VC landscape, resulting in the program being skewed towards outsourcing the fund to foreign VCs that set up offices in Malaysia and hire local talents to run the operations. As a result, the presence of foreign, more experienced VC firms in Malaysia has managed to enhance the local ecosystem by attracting more funds to the start-up industry and producing more local VC professionals. However, these achievements are very short-term solutions for local industry development.

It is due time that Malaysia's VC ecosystem is championed by homegrown VC firms as the culmination of over 20 years of industry development. The presence of well-established foreign VCs in Malaysia's ecosystem in the beginning stages is indeed beneficial in stimulating industry growth and exposing local VC talents to best practices, however the local ecosystem will not progress further should it continue to be dominated by foreign VC firms. It is imperative that homegrown firms with greater understanding of the local landscape and national agenda compared to foreign firms take the lead in advancing the ecosystem to propel the local VC space into a compelling sector for investment and eventually, a key sector to drive the nation's economic growth. Furthermore, a drawback of channelling funds into foreign VCs is their tendency to invest in foreign-owned companies, sometimes with base offices in Malaysia, rather than investing in home-grown start-ups. This eventually dampens the development of the local start-up industry due to the rise of foreign start-ups that are predisposed to more favourable investment opportunities and conditions.

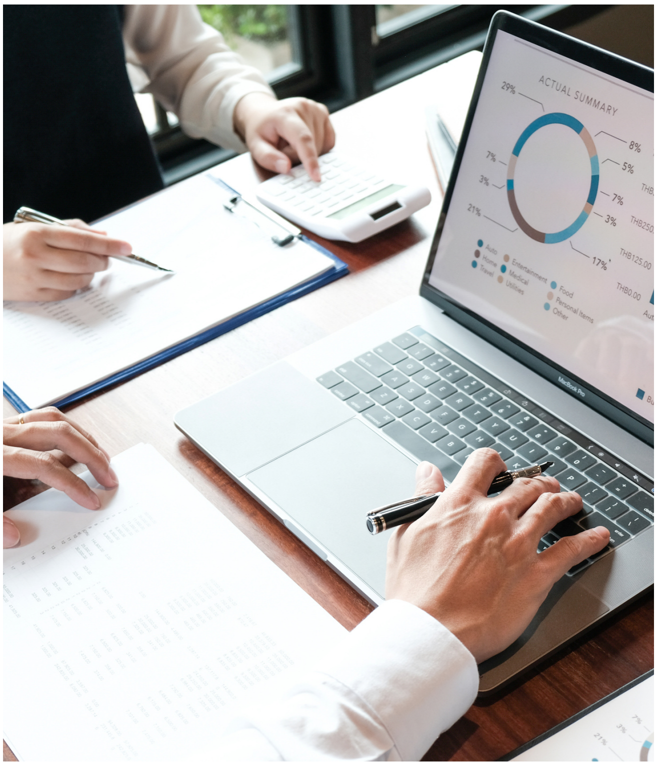
Alongside the introduction of global VCs to the Malaysian VC space, the industry has witnessed a growing number of government initiatives in promoting the start-up and VC ecosystems, mainly from industry development agencies such as MDEC, Cradle Fund, SME Corp, Malaysian Technology Development Corporation (MTDC), Malaysian Industry-Government Group for High Technology (MIGHT) and Malaysian Global Innovation and Creativity Centre (MaGIC). MDEC has since become a major driver in promoting and uplifting the start-up and VC ecosystems through its notable initiatives such as the Malaysian Digital Hubs program, Founders' Grindstone initiative and engagements with state-run firm Penjana Kapital which has a RM600 million VC matching grant.

cont'd

The efforts of industry development agencies have been successful in developing a conducive ecosystem for start-ups and Malaysia has received recognition in the Global Startup Ecosystem Report 2020 as the 11th most attractive destination for start-ups among 250 emerging ecosystems, largely due to the country's relatively low costs and strong government support. More recently, a target of the newly launched Malaysian Digital Economy Blueprint (2021-2030) is to attract 5,000 start-ups by 2030 and 2 unicorns, either home-grown or foreign. With increasing support and growth in the start-up ecosystem, the VC industry has been lagging in comparison.

The growth of a start-up is often complemented by the support of VCs as strategic and value-adding partners. The success of Carsome in obtaining the highly coveted unicorn status should inspire and compel Malaysia to further strengthen the local VC industry. With another unicorn, Aerodyne, in the making, it is imperative that the ecosystem is ready to grow more unicorns, particularly by having sufficient funding and ancillary services to facilitate a holistic ecosystem for both start-ups and VCs.

As per mentioned, the main drivers of investment in Malaysia, the GLICs, are naturally focused on their unique mandates and none of their raison d'etre is to develop local VC firms. As a result, these GLICs are more inclined to invest in experienced foreign VC funds rather than younger, capable local VCs. Moreover, even with MAVCAP and Penjana Kapital, their funding available for VCs remains small when compared with funding available to GLICs.



Furthermore, noting the nascency of Malaysia's VC industry, the initiative to develop a bigger pool of local VC professionals through knowledge transfers from foreign VCs present in Malaysia is highly commendable. However, this knowledge transfer initiative alone is not sufficient to drive the local industry to be on par with its regional peers. The track record of a VC professional in a VC firm, which in Malaysia's case is often a VC firm in partnership with a foreign VC, is considered as the track record of the company itself rather than the individual's track record.

Therefore, should these individual VC professionals venture into establishing their own home-grown VC firm after gaining sufficient experience, it would be challenging to attract investors and sufficient funds due to the absence of a track record. Knowledge transfers should be complemented with a local VC brand-building initiative in order for Malaysia to produce formidable VC firms.

cont'd

MALAYSIA AS HOME TO GLOBAL SHARIAH-COMPLIANT VC

While Malaysia continues playing catch-up in the VC space, it is indisputable that Malaysia leads the global pack when it comes to Islamic finance. As such, Malaysia should always play strategically to its status as the global leader in Islamic finance and investment, particularly in the Shariah-compliant VC niche where a player is yet to be crowned champion. Malaysia has previously received recognition by the Islamic Development Bank (IDB) in the Shariah VC realm, when IDB signed a MOU with the Malaysian government to establish the world's first Islamic VC fund in 2017. However, this initiative has been stalled until today.

Should there ever be akin to Sequoia Capital in the Shariah-compliant space, that company should be a Malaysian company. Hence, since Malaysia embarked on its own IDE initiative in 2017 and gained traction from global players entering the Islamic market, Malaysia should thread its "crown jewel" with more caution. It is gratifying that Malaysian talents in the Islamic economy are recognised as the best in the industry, however it is often the case that our local expertise is exported to foreign, more established companies instead of being employed locally to further develop our local ecosystem.

Drawing upon past experiences, it would likely be the case that Malaysian companies are approached to be appointed as Shariah advisors or consultants to newly established Shariah-compliant VC firms. Therefore, in the effort of nurturing a formidable home-grown Shariah-compliant VC, Malaysia should play its cards to the long-term benefit of the nation instead of a short-lived joy of exporting its extensive Shariah expertise and facilitating the establishment of foreign Shariah VC firms. By limiting our role to being mere Shariah advisors or consultants, such Malaysian companies would only gain the commercial benefit and goodwill from brand affiliation with foreign companies. In the event that the Malaysian companies decide to establish Shariah compliant VC firms, it is unlikely that they are able to share the foreign VC firm's investment track record from their affiliation. Moreover, the foreign VC firms are able to appoint a different Shariah advisor upon completion of their engagement. In the VC space, a firm's investment track record is of paramount importance, thus Malaysia would stand to lose in developing a global Shariah-compliant VC champion should its role be limited to providing Shariah advisory.

FGC as the world's first Shariah-compliant Venture Capital is well positioned to play a part in catalysing the transformation in the IDE ecosystem. With the recent investment from MAVCAP, one of the most established VC firms in Malaysia, along with its home base in the global hub for Islamic economy, FGC is highly promising in contributing towards the development of a global Shariah-compliant VC brand that effectively spurs the growth of start-ups in the IDE sector. Malaysia's start-up ecosystem has proven to be conducive in growing unicorns and FGC believes that the time has come for Malaysia to begin building the first unicorn in Islamic fintech along with a strong position in the Shariah-compliant VC space.

end