THE CONVERGENCE BETWEEN ISLAMIC VENTURE CAPITAL AND SOCIAL VENTURE CAPITAL

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Introduction

- Islamic finance industry = USD $1.8 trillion
- Predicted to grow to USD $3.4 trillion by 2018
- Criticism of the use of debt based contracts rather then equity based contracts such as *musharakah* and *mudarabah* – Mufti Muhammad Taqi Usmani
- There's also a criticism of IF not delivering the social outcomes it intends to achieve
- While, Impact investment industry has USD $3 trillion of assets
- A form of impact investment is social venture capital – uses funds to invest in a for-profit business that achieves a social outcome

Thesis

- That the successful framework of social venture capital from the United States can be used as a model to incorporate the ethical outcomes of Islamic venture capital models
- **There is no need to re-invent the wheel to practice Islamic Finance within a North American experience**

Sections

- Part 1 – will explain the history and structure of social venture capital model of financing and how social venture capital incorporates ethical principles into outcomes
- Part 2 – will examine the Islamic venture capital model by explaining the principles and prohibitions of Islamic investments.
- Part 3 – attempt to demonstrate the convergence of the similarities and differences between Islamic venture capital and social venture capital

What is Venture Capitalism

- Venture capitalism has become synonymous with Silicon Valley and successfully funding Google, Facebook, Tesla and Apple
- Venture capitalism is an equity or equity linked investment in young, privately held companies
- Venture capitalists have invested approximately $3 billion
- The purpose of venture capitalist is to maximize the return of their investment by gaining the largest profit from the operations of the business they are invested in.

- In comparison to debt based investments, venture backed firms have a higher:
  - Variance of earnings per share
  - Lower levels of debt
  - Higher R&D spending levels, and,
  - Achieve higher growth rates than non venture backed firms.

History of Venture Capitalism

- The American government was the largest ‘angel’ investor in research and development of military technology, and, was the catalyst in starting the tech boom of what we now know as ‘Silicon Valley’
- First major investment was in the radio technology company Federal Telegraph Corporation based in Palo Alto in the early 1900’s with strong support from the administration of Stanford University (the beginning of the research triangle concept)

History of Venture Capitalism

- Stuart Leslie describes that Silicon Valley owes it present configuration to patterns of federal spending, corporate strategies, industry-university relationship, and technological innovation shaped by the assumptions and priorities of Cold War defense policy.

- Stuart Leslie, “The Biggest ‘Angel’ of Them All: The Military and Making of Silicon Valley” *Understanding the Anatomy of an Entreprenuerial Region* (2000) Stanford University Press, 49.
- The role of government funding in shaping venture capitalism is a variable that must be understood when comparing the development venture capitalism in other countries.

Structure of Venture Capital Funding

- Modern form of venture capital funding was shaped by the needs of young companies invested in high-tech industries that were seeking funding, however they were too risky to qualify for traditional bank loans.

- Funding is released in stages as a means of mitigating the problems that arise from agency cost and asymmetrical information.
- The entrepreneur has the benefit of receiving funding from the fund knowing that the fund's incentive is to develop the business successfully in order to receive further stages of funding

Staging Investments

- There is no set requirement for how to stage investments or how many rounds of investments their should be, however there is an industry standard
- 1st stage – known as early stage financing, in this stage the capital is used to carry out market research and product development
- 2nd stage – known as seed capital funding, the new funds are used to build a prototype and to further the venture towards an official launch
- 3rd stage – known as expansion financing – the venture is scaled up to help recruit more employees to establish engineering, sales, and marketing functions.
- If the company is successful at this pint the venture capitalist will help the venture go public through an Initial Public Offering (IPO).
- However, it has become more common for larger tech companies to acquires smaller firms through mergers and acquisitions
- Paul Gombers has found evidence that indicates that the success of venture capitalism is due to the staging of capital infusion that allows venture capitalist to gather information and monitor the progress of firms and maintain the option to periodically abandon projects
- Paul Gompers, “Optimal Investment, Monitoring and the Staging of Venture Capital” *The* Journal of Finance Vol. 50, No. 5 (1995), 1498.

Benefits of Venture Capital Funding

- Venture capital funding have an equity stake in the company they are invested in and are liable for losses in the investment – a profit and loss sharing mechanism.
- This provides an incentive to perform due diligence on the firm in order to ensure losses are not incurred and high profits can be achieved
- In contrast debt contracts can lead to conflicts of interest between the borrower and lender. Since the entrepreneur has to pay fixed payments regardless of the performance of the project, the investment made by the lender has less incentive to ensure for successful performance of the business.

Benefits of Venture Capital Funding

- Of all U.S. public companies founded between 1979 and 2013 approximately 1 330, 43% of those were venture backed.
- These companies comprise 57% of the market capitalization and 38% of the employees of all ‘new’ public companies.
- Also, their Research and Development expenditure constitutes over 82% of the total R&D of all new public companies.
- Will Gornal and Ilya A. Strebulaev, “The Economic Impact of Venture Capital Evidence from Public Companies” *Stanford Graduate school of Business Research Paper No. 15-55* (November 1, 2015).

- However, the emphasis of many venture capitalist funded enterprise is for maximizing profit without focusing on a positive social outcome- This gap is being filled by Social Venture Capital

Socially Responsible Investments

- Socially Responsible investment – uses conventional methods of investing by retail and institutional investors and incorporate a social or moral criteria that must be adhered to while ensuring a return on the investments.
- Began to become popular in the 60’s and 70’s when socially responsible investors began to boycott investments in companies that were involved in the war in Vietnam or trade with apartheid-era South Africa.
- The strategy of not investing in a particular company that fits with a particular criteria known as ‘negative screening’.

Socially Responsible Investments

- The movement for investors to implement positive screening techniques, to actively search for companies that the investors considers to have a social or environmental impact – this is known as 'impact investing'.
- Most socially responsible investments typically involve pension funds, mutual funds and some retail investors – they invest their funds into securities.
- Whereas, social venture capital takes the form of a venture capital fund and invests in small private companies to help them scale up and receive a profit.

Social Venture Capital

- Social venture capital movement began in the 1980's led by investors who were seeking their investments to be linked with social and moral outcomes
- There is not a determined guideline or criteria of what the social or moral outcome must be.
- Rather, the common trend is that social venture capital takes into account a social and moral outcome which is not considered within the traditional venture capital investments that are solely based upon maximizing investor return and profit.
- However, the structure of social venture capitalism takes the same structure from the traditional venture capitalist

Similarities between Social Venture Capital and Venture Capital

- Social venture capitalist do extensive due diligence as they are liable to losses made in their investment, similar to venture capitalist, while also having to ensure the investments meet their requirement of socially responsible investments.
- They also closely monitor their investment and provide ongoing mentoring and support.
- The social venture capitalist carefully evaluates the possibility to grow the venture to address the widespread social problems

Islamic Venture Capital

- Islamic venture capital is based upon specific legal prohibitions and requirements of Islamic law – known as *Shari'ah. (literal definition – a path)*
- *Shari'ah* represents not only the canonical texts and legal rules of Islam, but it also comprises a comprehensive cosmology pertaining to all of life's actions.
- in other words, an Islamic cosmology is itself part of an enveloping moral system that transcends the categories of theology, and metaphysics.

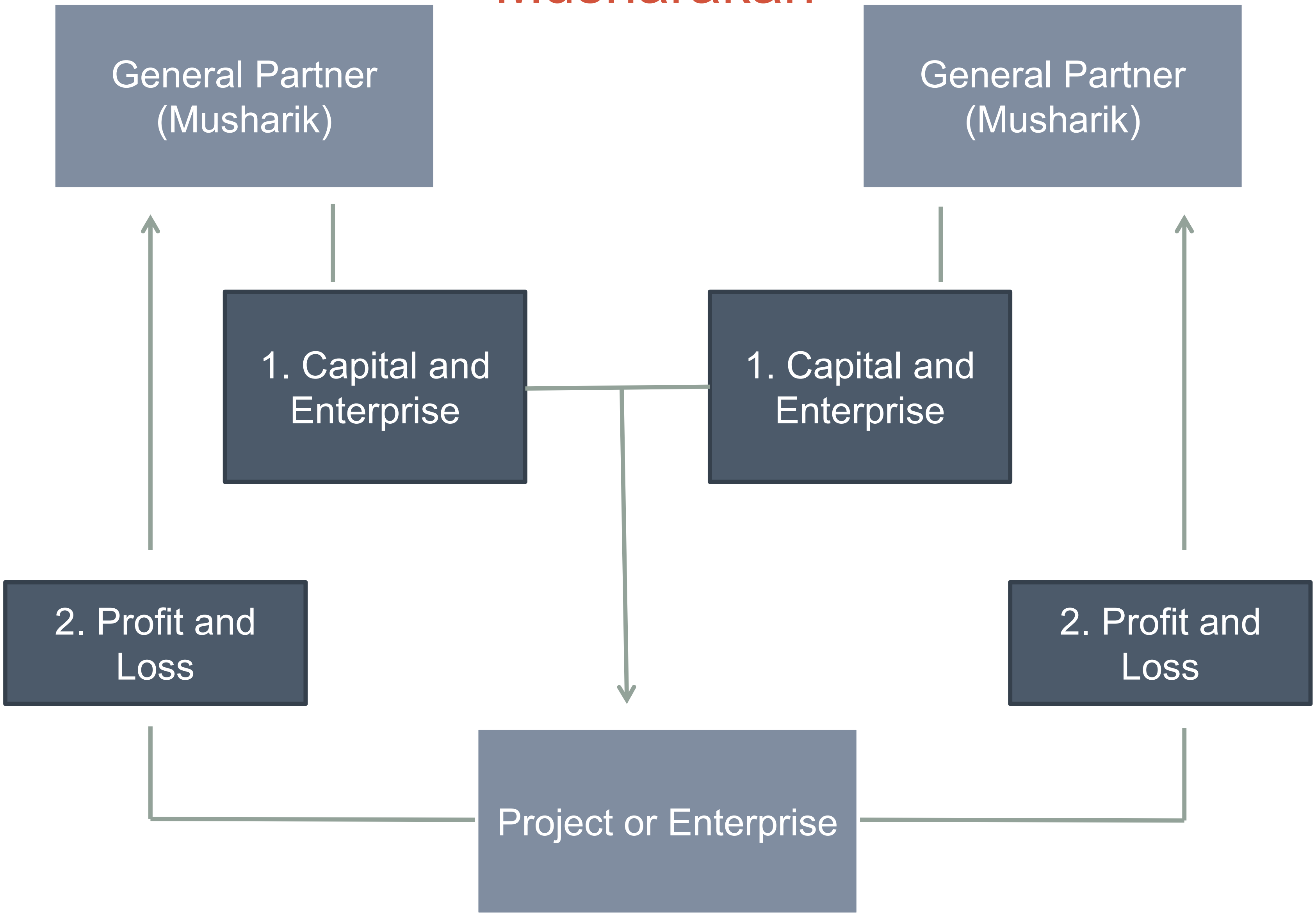
Islamic Venture Capitalism

- The need for Islamic investment to ensure ethical outcomes is based upon a comprehensive notion of ethics
- Investments must comply with Islamic commercial law (fiqh al muamalat) and its investment principles:
  - That prohibit the charging of interest (riba)
  - Prohibitions of uncertainty (gharar)
  - Prohibitions on gambling and speculation (maisir)
  - Prohibitions on certain banned commodities (alcohol and pork) and
  - The requirement of asset backed investment into tangible economic activities

Equity based contracts – Musharakah and Mudarabah (more information + examples)

- Islamic financial products have developed profit and loss sharing contracts in order to circumvent the problem of interest based lending
- **Musharakah** – a joint enterprise in which all partners share the profit of loss in relation to the size of their investment

Musharakah


General Partner (Musharik)
General Partner (Musharik)
1. Capital and Enterprise
1. Capital and Enterprise
2. Profit and Loss
2. Profit and Loss
Project or Enterprise

Mudarabah

- Is partnership based, where one partner gives money to another for investing in a commercial enterprise
- The investment comes from a partner, while the management and work is exclusively the responsibility of the other
- With this contract if there is any it is suffered by the investors, while the manager’s loss is restricted to a loss of time and that their work has not resulted in a profit.
  - This is similar to the concept of limited liability

Outcomes

- **Limitations** of Mudarabah and Musharakah contracts are due to the inspiration and structure of ventures that take place within a particular society.
- Masadal Alam Chouhdury explains
  - “problems have arisen because of the restrictive and dichotomous ways in which these two instruments are used, causing the non-participatory nature of sharing profits through them, as agents remain in sleeping partnership between being owners of capital who are not entrepreneurs, and workers who provide effort in producing profits.”

  Suggestion by Mufti Muhammad Taqi Usmani

  - that new forms of utilizing these contracts cannot be rejected merely because it has no precedent in the past.
  - Every new form of contractual arrangement is acceptable by *Shariah* as far as it does not violate the legal prohibitions of Islam

Maqasid Al Shariah

- When the Qur’an and hadith literature mentions economic activity there is a focus on co-operation and active participation for purposes of generating productive yields that bring about well being to society. This is often called Maqasid al Shariah
- 10th century Islamic scholar Abu Hamid Al Ghazali defined it as
  - “the very objective of the Shariah is to promote the well-being of the people, which lies in safeguarding their faith, their self, their intellect, their posterity, and their wealth. Whatever ensures the safeguard of these five serves the public interest and is desirable, and whatever hurts them is against public interest and its removal is desirable.”

Incorporating Maqasid al Shariah into Equity based contracts

- This would move towards intentionally achieving moral outcomes to those investing, rather then merely satisfying the legal requirements.
- Choudhury states ‘ the result would be a realisation of both financial profitability in terms of the productivity of capital and its development in terms of increasing empowerment, entitlement and ownership among partners including labour.’
- Moving beyond legal requirements and incorporating Maqasid al Shariah there is a convergence with Social Venture Capital

Convergence - Similarities

- 1. intention to seek ethical outcomes as the purpose of the ventures
  - Market size of Impact investing is USD $60 billion
  - With the potential to reach $2 trillion

  Example of this is the Norwegian Sovereign Wealth Fund and the Ontario Teachers Pensions Fund

  2. Islamic venture capital and social venture capital are both equity based investments

  - there is no need to reform current legislation in Canada to support Islamic venture capital

Limitations

- Can only succeed in countries with well defined property rights, an affective legal system, positive social attitude towards sharing, as well as entrepreneurial activities, and an efficient mechanism for venture capitalist to cash out their investment, such as functioning market for public securities and/or mergers and acquisitions." Al-Suwailem
- Possibility to testing the effective of IVC in developed nations then apply them towards developing nations

Differences

- IVC is based on pre-existing contract structures that have limited the financial engineering of possible investments.
- SVC is focused on raising capital, monitoring and measuring investment to ensure there is an ethical outcome.
- Dr. Asutay argues that here has been a social failure in the modern Islamic finance and banking movement.
  - He argues “that in the new institutional stage, Islamic banks should relate to the ‘substance’ and the ‘consequence’ rather then merely the ‘form’, which would help to moderate and remedy the divergence observed in the present practice.”

Conclusion

- Convergence between SVC and IVC is that both are based on equity investments and both attempt to intentionally invest in ventures to seek a positive social outcome