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Malaysia: Assessment of the Start-Up Financing Ecosystem

MARCH 2022

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Please contact Smita Kuriakose at skuriakose@worldbank.org for any queries or clarifications regarding this study.

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Acronyms and Abbreviations

AIF	Applied Innovation Fund
ATIO	Angel Tax Incentive Office
CCAF	Cambridge Centre for Alternative Finance
CIP	Cradle Investment Program
CMSA	Capital Market and Services Act
CVC	Corporate Venture Capital
DPN	Dana Penjana Nasional
ECF	Equity Crowdfunding
EMPEA	Emerging Markets Private Equity Association
EY	Ernst and Young
FoF	Fund of Funds
GAP	Global Accelerator Program
GDP	Gross Domestic Product
GEDI	Global Entrepreneurship and Development Institute
GEI	Global Entrepreneurship Index
GERD	Gross Expenditure on Research and Development
GoM	Government of Malaysia
IC	Investment Committee
ICT	Information and Communications Technology
IHC	Investment Holding Company
IoT	Internet of Things
IPO	Initial Public Offering
LP	Limited Partners
MaGIC	Malaysian Global Innovation and Creativity Centre
MAVCAP	Malaysia Venture Capital Management Berhad
MRANTI	Malaysian Research Accelerator for Technology and Innovation
MTDC	Malaysian Technology Development Corporation
MDV	Malaysia Debt Ventures
MoF	Ministry of Finance
MoSTI	Ministry of Science, Technology and Innovation
MVP	Minimum Viable Product
MyCIF	Malaysia Co-Investment Fund
MyDIGITAL	Malaysia Digital Economy Blueprint
NAV	Net Asset Value
OECD	Organisation for Economic Co-operation and Development
P2P	Peer-to-Peer financing
PK	Penjana Kapital
PRI	Public Research Institution
R&D	Research and Development
SAP	Selangor Accelerator Program
SCM	Securities Commission Malaysia
SIF	Strategic Investment Fund
TAM	Total Addressable Market
TRL	Technological Readiness Level
VCC	Variable Capital Company
VCMC	Venture Capital Management Corporation
WIPO	World Intellectual Property Organization

Summary

At the request of the Government of Malaysia, this study aims to identify the financing gaps in Malaysia's start-up financing ecosystem and to propose specific policy levers to address the identified constraints on both the availability of and access to early-stage financing.

In the context of the COVID-19 pandemic and its impact on Malaysia's economy, the need to foster the emergence of an innovation-led economy has taken on increasing urgency. Entrepreneurship contributes to economic development through many channels, including through facilitating innovation, job creation, technology transfer, knowledge spillovers, increased productivity and more.[1] Policymakers are thus keen to identify the appropriate mix of regulations, policy instruments, and institutional arrangements to boost entrepreneurship and thereby to facilitate the achievement of more sustainable, inclusive development. Over recent years, the total factor productivity of Malaysian businesses has lagged behind that recorded by their regional counterparts, with productivity growth declining over time.[2] This trend has been exacerbated by the impact of the pandemic on these businesses. Over recent years, the government has launched a number of plans and blueprints to facilitate the emergence of a more innovation-led economy. It has implemented a number of key initiatives to build up an ecosystem to support a more conducive environment for innovation and to stimulate the establishment of future-ready firms able to compete on a global scale. The over-arching theme of all these plans is that digital-driven growth is needed to drive high-value added and innovation-led entrepreneurial activities.

Public-sector involvement in the early-stage financing phase of the ecosystem is integral to crowding-in private investments, as seen by the impact of the establishment of government-sponsored VC funds in several small OECD countries, including Estonia and Finland. In turn, improved access to finance at the initial stages of a start-up and the crowding-in of private capital will play a pivotal role in strengthening the entrepreneurship ecosystem. The government has devised a number of developmental roadmaps that emphasize the greater use of alternative forms of financing, such as venture capital (VC) and digital platform-based models, including peer-to-peer financing (P2P) and equity crowdfunding (ECF). These strategies are an integral part of the government's strategies for maintaining growth as Malaysia achieves high-income nation status. For example, the MyDIGITAL Blueprint expresses the aspiration of having at least five home-grown or foreign unicorn start-ups in key digital industry clusters headquartered onshore in Malaysia by 2030.

At the request of the government, this study aims to identify the financing gaps in Malaysia's start-up financing ecosystem and to propose specific policy levers to address the identified constraints on both the availability of and access to early-stage financing. Following up on the Digital Economy Study (World Bank, 2018), this study undertakes a regional[3] comparative analysis where data is available to determine where Malaysia may be falling behind its ASEAN peers. This analysis is intended to assess Malaysia's performance with respect to the Southeast Asian region as a benchmark, rather than to analyze the financing conditions in these comparator countries in detail. The focus of the study is on early-stage financing (i.e., from the ideation stage of firms' lifecycle, to product development and commercialization to revenue generation). An analysis of the growth and exit stages is conducted in order to establish two main characteristics on the demand side: i) the motivating force of investor returns; and ii) liquidity conditions. Following the identification of constraints on

1 See Mason and Brown, 2014; Spigel, 2017; Audretsch et. al., 2018.
2 Malaysia Productivity Corporation, 2017.
3 The Southeast Asian sample used comprise of the following countries – Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam.

start-up financing and the financing gaps that result, the study proposes policy recommendations to address these constraints and gaps.

Personal sources of finances and retained earnings are the most important source of financing for start-ups in Malaysia. The fact that potential operators face the risk of 'losing it all' can further stifle innovation and growth. Although some bank financing goes to young firms, bank loan acceptance rates indicate a preference for more established businesses with proven track records and less R&D outlays. More established medium-sized firms are able to better utilize financial institutions for funding, given their longer business track record and their ability to present collateral for loans. However, for firms in frontier industries that require large initial R&D outlays, bank loans are not generally viable as a source of financing.

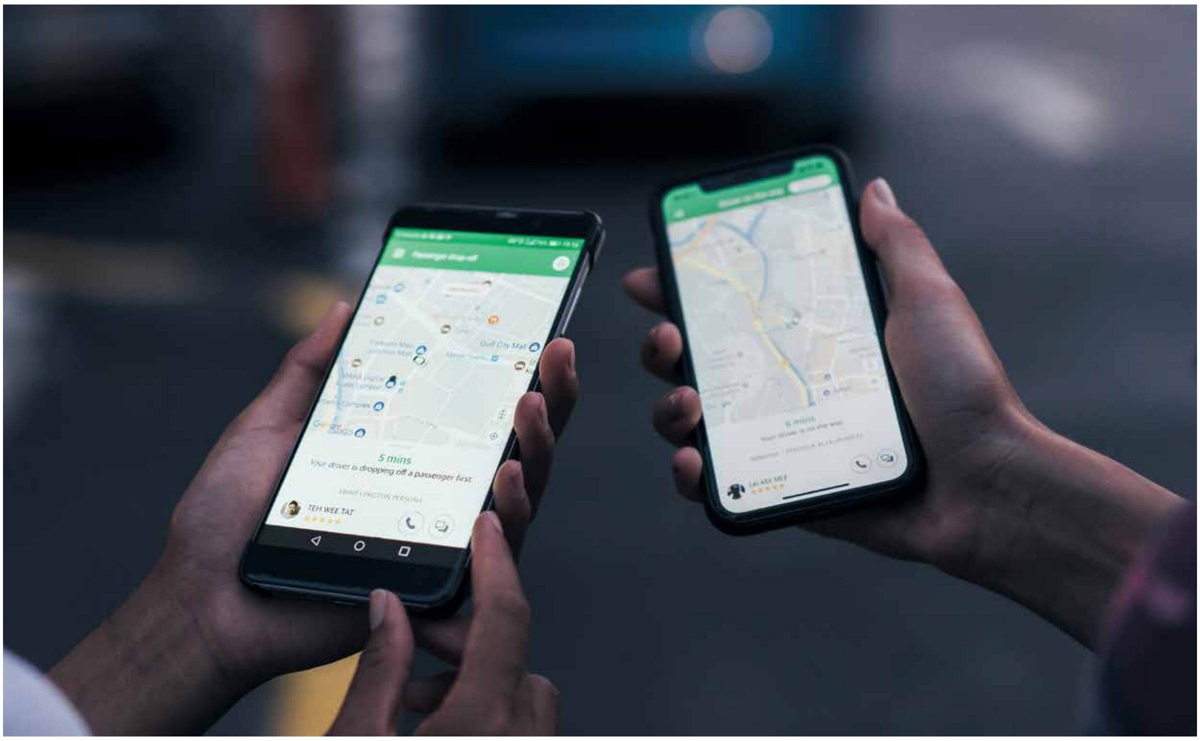
The establishment of alternative sources of financing, such as peer-to-peer (P2P) funding and equity crowd funding (ECF), has increased young businesses' access to finance in Malaysia. ECF is an innovative form of alternative fundraising that enables small businesses to raise capital from the public using online platforms registered by the Securities Commission Malaysia (SCM).[4] By the end of 2020, ten ECF platforms had been registered and were fully operational. P2P platforms[5] are an additional source of debt financing for young companies. To access finance through P2P platforms, firms need to have an established track record and a product with a customer base. While given these preconditions, P2P platforms may not be a viable source of financing for very early-stage businesses. They have however, become an important source of alternate financing for established, but still young, firms.

ECF activities are well-established in Malaysia, with the framework having been strengthened since its inception in 2015 to enhance its accessibility and market liquidity. Malaysia was the first ASEAN country to establish a framework for ECF activities, in 2015. Since then, the government has strengthened the framework to enhance both accessibility and market liquidity. Regulations governing the size of fundraising through ECF platforms have been amended since 2015 to accommodate larger campaigns and to meet the needs of larger enterprises.

While in 2019 the majority of ECF funding was concentrated on businesses at the pre-seed and seed funding stages, this changed in 2020. Prior to the latest liberalization of regulations, pre-seed and seed funding accounted for the majority of funding activities, with a combined share of 68 percent in 2019. In 2020, this proportion fell to 50 percent, with a notable increase in the share of Series A funding and the debut of post-Series A financing. Thus, ECF platforms have evolved from being primarily a means to democratize finance to also serving as a financing tool to address funding gaps between the seed to Series funding stages. Although from a regulatory perspective, nothing has changed to constrain younger firms from tapping this funding source, the liberalization measures may have unintentionally resulted in greater competition for funding sources for younger firms. From stakeholder consultations, it seems that raising funding through ECF platforms is becoming a viable alternative to early-stage VC funding, given the wider access to investors and greater flexibility in financing terms. Additionally, listing on ECF platforms require less legal documentation and less burdensome processes than traditional Initial Public Offerings (IPOs), which also enhances their attractiveness.

Public-sector involvement in the early-stage financing phase of the ecosystem is integral to crowding-in private investments. The analysis of early-stage financing sources shows that there is a large element of risk-aversion, with investors showing a preference for more established enterprises, which has created an ideation financing gap for younger start-ups without a developed product.

4 A detailed discussion about ECF is presented in the next section
5 By the end of 2020, there were 11 P2P financing operators that were fully operational.



Over the past few years, there has been a noticeable shift in the focus of grant funding towards businesses at the more established product development phases. One of the most significant developments was the recalibration of the well-established Cradle Fund grant schemes into the new generation of Cradle Investment Programs (CIP) Ignite (i), Ignite (ii) and Accelerate. All these schemes have more restrictive eligibility criteria, with a focus on more innovative firms (i.e., more advanced in technological readiness levels, or TRLs, and focused on product validation or commercialization activities). This could potentially preclude start-ups at the initial stages of their lifecycle.

A hybrid public-private sector financing structure, in the form of a Fund of Funds (FoF), has been gaining traction, receiving a big boost with the introduction and implementation of Dana Penjana Nasional (DPN) in 2020. This funding program was initially expected to inject fresh funding of up to RM 1.2 billion (~USD 290 million) into the VC sector over a 5-7 year period, with funding involving a 1:1 matching arrangement, with the government making a RM 600 million (~USD 145 million) commitment, with fund mobilization following approval by the Penjana Kapital Investment Committee and financing from private sector VC funds. The DPN initiative also requires domestic VCs to enter into partnerships with foreign VCs, potentially broadening the range of foreign-sourced investment opportunities. DPN is a welcome and important addition to the start-up financing ecosystem in Malaysia. While market operators agree that DPN plays a valuable role in the country's financing ecosystem, greater clarity regarding the continuity of the program and additional government commitments to funding it are required, together with greater clarity regarding application procedures. These measures would strengthen its effectiveness and increase its value as a sustainable source of funding for start-ups in Malaysia.

In Malaysia, VC activity is relatively underdeveloped compared to other countries in the region. As firms progress from the product commercialization phase, VC financing typically becomes the dominant source of equity-based financing for start-ups. To assess whether this level of VC funding activities is commensurate with the level of economic development of a particular country, a comparison is made to determine the share of VC funding deals relative to the respective shares of GDP. From this analysis, it is found that in proportion to its GDP share, Malaysia's VC activity is relatively low, indicating that it is performing below its potential in this respect. In addition, Malaysia's average deal size for seed funding is comparatively low as compared to its regional peers, indicative of a lack of high-quality investment opportunities, as seen by the lower valuations.

Exit strategies and opportunities for investors are a key consideration in investor decision-making processes. Exit strategies and opportunities can also be seen as a gauge of investment liquidity conditions and the ability to return investment proceeds to the VC fund and its investors. Exit strategies and opportunities are a key consideration when investing, although they do not rank high in terms of being a deterrent for LPs investing in or potentially investing in Southeast Asia.

In Malaysia and throughout the region, acquisitions are the most common form of exits, rather than IPOs, which are generally perceived as the benchmark for venture-backed start-up exits, potentially creating the most value for investors. The most common form of acquisition is through share-purchase deals, possibly due to the regulatory ease of this mechanism compared to that for a complete asset takeover deal, which may require more documentation and incur greater costs, especially for the purchaser.

In Malaysia, the establishment in 2017 of the Leading Entrepreneur Accelerator Platform (LEAP) has been fraught with challenges. Although the use of this platform as an exit strategy has gained some traction, a number of challenges that impact its efficacy as an accessible bourse for small, growing enterprises must be overcome to ensure optimal operationalization. The amendments to the Capital Markets and Services Act (2007) in 2021 to widen the definition of sophisticated investors eligible to participate in this secondary market will help deepen LEAP's market liquidity.

This study identifies two main gaps in firms' financing lifecycle. Analysis and stakeholder consultations have revealed two main funding gaps in the firm lifecycle. The first of these occurs during the ideation stage, involving businesses facing a need to develop a Minimum Viable Product (MVP) and those in the early-stage Series funding in the Series A and B rounds. Traditionally, the government has been a key player during the ideation stage, largely due to the high level of risk aversion prevalent in the private funding space. However, in recent years, the government grant funding has been moving out of this phase to concentrate on the commercialization stage of the firm's lifecycle (e.g., the Cradle Fund). An accompanying study that reviews all SME support programs[6] cites the need for greater rebalancing of support towards start-up financing and proposes the need to recalibrate existing programs towards the current needs of the SMEs.

Finally, while it is important for investors to have clearly defined exit mechanisms, these mechanisms are still at low levels of maturity in Malaysia. Thus, policymakers should prioritize measures to establish comprehensive exit infrastructures that facilitate a range of types of exit opportunities. This could help to reduce investor risk aversion in making initial investments and facilitate greater liquidity in the market to establish a potentially larger funding pool.

The policy recommendations for this study are sector-agnostic and have been grouped into two main themes, as follows:

1. **Encouraging a healthier deal flow**
2. **Addressing funding gaps**

6 Kuriakose, Smita and Tiew, Haris. 2022. *Malaysian SME Program Efficiency Review*, World Bank, Washington, DC.

1. Encouraging a healthier deal flow

- **Policymakers should consider measures to crowd in private funding towards privately-run incubators and accelerators.** Incubators and accelerators remain integral to the foundation of the start-up ecosystem, given their role in seeding strong start-up deal flow. They play a vital role in the entrepreneurship ecosystem in identifying a healthy deal flow pipeline at the pre-MVP and ideation stages and in providing mentorship to prospective businesses. This is particularly important given the high level of risk aversion associated with investment at the stages. In this context, a redirection of existing government funds towards private-sector-managed incubators and accelerators could crowd-in greater private funding.[7] The proposed funding could take the form of matching grants, with a matching ratio of 1:2, in order to ensure the private-sector accelerator and incubators also have a stake in the operation and hence improve the incentive mechanism to deliver results. Ideally, a competitive process should be established for incubators and accelerators, with the entities in question applying for matching grants on the basis of their historical track records and evaluation metrics relevant to the objectives of the grant. A top priority is to ensure transparency and clarity in areas such as application processes, grant recipient selection, and eligibility and decision-making criteria in the implementation of this grant program.

2. Addressing funding gaps

- **Improvements to the implementation of the Dana Penjana Fund of Funds (FoF) could further strengthen its effectiveness as a funding vehicle within Malaysia's financing ecosystem.** The establishment of the Dana Penjana FoF is a positive measure, with the institution potentially playing a valuable role in crowding in private VC funding. However, based on the findings of this study and global experience with the implementation of FoFs, a number of improvements could be made. During the initial stages of its implementation, there appears to have been a lack of clarity regarding the required processes and eligibility to apply to act as a VC fund under this program, with uncertainty regarding the timelines for the tender process. Market players have also voiced concerns regarding incumbent funds not being selected to participate in DPN, despite the fact that a solid track record in domestic investments would enhance the efficiency in deploying investments. Although there is considerable merit in allocating funds to new VC players to stimulate their activities, the greater role of more established funds might have been important, particularly during an economic downturn. Moreover, the track record of the VC players might also be important in ensuring the sustainability of the fund flow when subsequent funding is sought. Finally, it is important that the members of the Investment Committee come from a diverse range of backgrounds in terms of their experience and expertise. With the Malaysian government's focus on technology-led investments, there is a need to ensure that the members of the Committee are well-versed in the latest technological developments so they can identify innovative investment opportunities, with the necessary technical expertise to apply the appropriate parameters to evaluate these types of start-ups, whose business structures may not necessarily conform to traditional business assessment criteria. There is currently no disclosure in the public domain related to the specific structure of the relevant board and investment panel members, having the potential to impact the perceived transparency of the fund. Greater clarity regarding the continuity of the program and the government's commitment to funding it, together with improvements to ensure greater transparency, would strengthen the fund's ability to act as a valuable and sustainable source of funding for Malaysian start-ups.

7 An accompanying study that reviews all SME support programs (World Bank 2022), cites the need for greater rebalancing of support towards start-up financing and proposes the need to recalibrate existing programs towards the current needs of the SMEs.

- **Malaysian corporations hold a significant value of untapped liquidity, which could be mobilized to support the emergence of a vibrant start-up financing ecosystem.** So far, policymakers have played little attention to the prospective role of Corporate Venture Capital companies (CVCs), despite the fact that these entities hold a considerable amount of locked-up liquidity, with significant potential to allocate these financial resources to investments in start-ups. CVC investment momentum may have been constrained by legacy corporate management structures and intergenerational succession involving family-owned businesses, with relatively high levels of risk aversion and departures from traditional business operations, largely due to a lack of knowledge or technical know-how, especially in the case of newer industries that utilize new technologies and processes. Given the huge potential of this source of funding to plug funding gaps in the ecosystem, tax incentives to crowd-in CVC funds and to encourage them to invest directly into private VCs and accelerators could act as a catalyst to stimulate more widespread CVC funding activities. By investing in the VC fund, as opposed to the start-up itself, the technical know-how required for start-up investing could be built up over time, without crowding-out VC funds through direct competition in deal flow.

- **Improving the clarity of the legal and regulatory framework for the VC industry is essential to enhance investor confidence and to crowd-in more private VC funds.** With a large proportion of VC-backed deals in Malaysia facilitated by public-sector entities such as government agencies, quasi-government investment companies, and by sovereign wealth funds, there is an inherent need to crowd-in greater private-sector funding in this area. According to the Venture Capital and Private Equity Country Attractiveness Index,[8] issues related to tax incentives and administrative burdens remain Malaysia's most significant weaknesses in these terms. The expedient implementation of the VC industry tax incentives tabled in Budget 2019, including those for Venture Capital Management Companies (VCMCs), Venture Capital Companies (VCCs) and for investors in these funds, would help to stimulate the pace of VC investment activities. Not only would these incentives act as an enticement, their implementation would also provide clarity regarding the tax treatment for these transactions, thus boosting investor sentiment.

- **In addition to the initiatives described above, there remains untapped potential in the country's mid-shore jurisdiction of the Labuan International Business and Financial Centre (Labuan IBFC).** Certain Labuan structures, such as the Protected Cell Company (PCC), possess attractive traits for funds, including sub-fund management flexibility. However, the lack of clarity in the enforcement of substance requirements and income earned (i.e., what could be deemed liable to the onshore corporate tax rate and what activities could be afforded a waiver) creates a high level of uncertainty for some investors, potentially constraining their greater use of these types of structures. It could be useful to have more information campaigns amongst investors to provide greater information and increased awareness of these requirements. The establishment of a national framework to provide regulatory clarity regarding the oversight of VCC operations in both Peninsular Malaysia and Labuan IBFC could be beneficial in this case. With this initiative, a definitive ruling by the Inland Revenue Board by means of a public ruling attachment to the national income tax law (Income Tax Act 1967) could assist tax agents, fund managers and investors to better understand conditions under which tax implications may be material with respect to activities in the two jurisdictions.

8 IESE Business School.

Introduction

A conducive and vibrant ecosystem to support entrepreneurship can act as an important catalyst for economic development and shared prosperity. With Malaysia set to achieve high-income nation status over the next few years, there is an imperative need to foster the emergence of an innovation-led economy. Entrepreneurship contributes to economic development by stimulating job creation, technology transfer, knowledge spillovers, increased productivity and more.[9] Around the world, start-ups are a significant driver of job creation and innovation, with most new jobs coming from businesses that are less than five years old.[10] Moreover, seven of the top ten largest companies in the world are in the technology sector, which is the highest concentration of any industry among the top global companies. Policy makers around the world are thus keen to identify regulations, policy instruments, and institutional arrangements that boost entrepreneurship activities and economic development, particularly in the technology sector.

In Malaysia, a number of plans and blueprints have been launched over the past few years to stimulate the growth of an innovation-led economy. In recent years, a number of key initiatives have been launched to develop an ecosystem that supports entrepreneurship and the adoption of the new technologies that will enable Malaysian businesses to compete on a global scale into the future. The most prominent plans include Bank Negara Malaysia's Financial Sector Blueprint 2011-2020 and the National Entrepreneurship Policy (2019), with the overarching targets of these plans being to facilitate the emergence of an entrepreneurial nation by 2030. In addition, the 10-10 MySTIE framework[11] is intended to drive the development of a knowledge-intensive economy, while the Malaysia Digital Economy Blueprint (2021), or MyDIGITAL, aims to transform Malaysia into a digitally-driven, high-income nation, and a regional leader in the digital economy over the next decade.

In November 2021, the Ministry of Science, Technology and Innovation (MoSTI) launched the Start-up Ecosystem Roadmap (SUPER) 2021-2030 initiative, which aims to transform Malaysia into a top 20 global start-up ecosystem by 2030. The implementation of SUPER will take place in three phases, concentrating on five thematic areas, with each of these areas intended to address identified gaps in Malaysia's current start-up ecosystem. These five thematic areas are: i) funding; ii) talent; iii) innovation; iv) policies and regulations; and v) market environment. Under the funding theme, the initiative will focus on stimulating greater private sector-led efforts to support government-led programs. Specifically, the three interventions outlined in the Roadmap include reprioritizing public funding towards the front-end of the start-up's financing stage; making the investment environment more attractive for potential investors; and establishing a platform to showcase the deal flows of high-growth start-ups. While still in its initial stages, the establishment of the MyStartup digital platform spearheaded by Cradle is expected to facilitate the final intervention under the funding umbrella. MyStartup is intended to bring together start-up businesses, funding program providers, and private investors through the establishment of a single platform to facilitate greater transparency in the start-up ecosystem and to foster greater knowledge-sharing and networking capabilities.

Public-sector involvement in the early-stage financing phase of the ecosystem is vital to ensuring the crowding-in of private investments, as evidenced by the experience of government-sponsored venture capital (VC) funds in several small OECD countries, including Estonia and Finland. Access to finance at the initial stages of a start-up's life-cycle and the crowding-in of private capital plays a pivotal role in the entrepreneurship ecosystem. The Malaysian government has also established a number of developmental roadmaps that lean towards the greater use of alternative forms of financing, including VC and digital platform-based models, such as peer-to-peer financing (P2P) and equity crowdfunding (ECF), in order to foster the development of the entrepreneurship ecosystem. The MyDIGITAL Blueprint explicitly sets a goal of facilitating the emergence of at least five home-grown or foreign unicorn start-ups in key digital industry clusters located in Malaysia by 2030.

9 See Mason and Brown, 2014; Spigel, 2017; Audretsch et. al., 2018
10 The Global Startup Ecosystem Report 2020, Startup Genome
11 10-10 Malaysian Science, Technology, Innovation and Economic (MySTIE) Framework spearheaded by the Academy of Sciences Malaysia

While initially experiencing a decline due to the impact of the pandemic, funding activities gained some traction towards the end of 2020. The pandemic created deep uncertainty regarding business prospects generally in the early months of 2020, resulting in a decrease in funding activities in the first quarter. However, by the fourth quarter, there was a strong revival, albeit concentrated in certain high-profile sectors, particularly the healthcare and technology sectors, both of which have been resilient to the global pandemic-related shocks. This increase in funding activities was driven at least in part by the liberalization of a number of regulatory requirements, the temporary waiver of administrative fees for fundraising,[12] and by increased allocations to funding schemes such as the MyCIF co-investment program for ECF and P2P financing. MyCIF has been responsive to the economic conditions in the context of the pandemic, incentivizing and encouraging business owners and founders to explore the possibility of raising funds for their businesses through ECF or P2P campaigns. For instance, in response to the pandemic, in 2020, MyCIF revised its co-investment ratio from 1:4 to 1:2 to sustain liquidity and to promote investor confidence in the ECF market.[13] Under Budget 2022, the government provided further allocations to MyCIF, to a total value of RM 80 billion, in recognition of its effectiveness in supporting Malaysia's start-up scene.

This study aims to identify both the financing gaps in Malaysia's start-up financing ecosystem and the specific policy levers that could relieve constraints on both the availability and the access to early-stage financing. While the government's pandemic-related responses are appropriate and timely in the current context, there is a need to consider the financing ecosystem in a holistic way. This requires a medium-term outlook to achieve a more inclusive financing ecosystem for start-up firms. Building upon the research conducted in the World Bank's study entitled Malaysia's Digital Economy – a driver of development (2018), which identified the current state of Malaysia's start-up financing ecosystem as a key impediment to the healthy growth of new enterprises, this study contains an overview of the current market landscape, institutional players, and the regulatory environment faced at each stage of financing.

Where data is available, the study utilizes a regional[14] comparative analysis to evaluate Malaysia's performance relative to its ASEAN peers. This analysis is intended primarily to determine how well Malaysia is doing in terms of access to finance, using the Southeast Asian region as a benchmark, rather than to analyze the financing conditions in these comparator countries in detail. The focus of the study is on early-stage financing (i.e., from the ideation, to product development and commercialization to revenue generation phases of the firm lifecycle). The study also conducts an analysis of the growth and exit stages that may follow the early-stage financing phases for businesses that reach maturity in order to establish two main characteristics on the demand side: i) the motivating factors of investor returns; and ii) liquidity conditions. Thus, private equity activities have not been analyzed in depth, as the motivation of these investors is different from the developmental growth drivers for other types of financing.

Following the identification of constraints on access to start-up financing and the financing gaps that result, the study proposes policy recommendations to address these gaps. In addition to concrete policy measures, the study also attempts to identify the optimal policy mix between demand- and supply-side interventions and interventions to unlock any existing legal and regulatory bottlenecks in the start-up financing ecosystem. Some international best practices are reviewed in order to assess their relevance to Malaysia's context as a means to facilitating the development of the financing ecosystem and early-stage businesses' ability to leverage it.

12 In 2020, the SCM waived lodgement fees for unlisted capital market products such as debt financing and the SCM and Bursa Malaysia offered a 50% rebate on annual listing fees. For ACE and LEAP markets, it was a full rebate in 2020.
13 The ratio reverted to its original 1:4 ratio in 2021.
14 The Southeast Asian sample used comprise of the following countries – Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam.

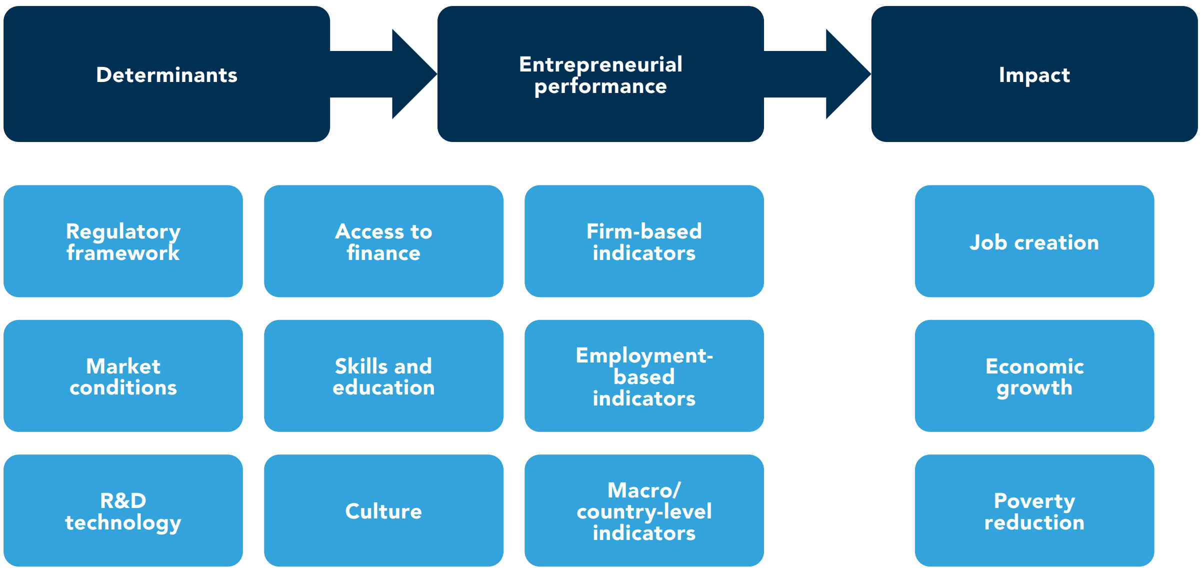
CHAPTER 1

Malaysia's Entrepreneurial Landscape

The role of finance in fostering entrepreneurship

Several key factors are required to ensure the emergence of a conducive entrepreneurship ecosystem, with financing being one key node in its structure. Based on the entrepreneurship model proposed by the OECD-Eurostat Entrepreneurship Indicator Program (2009), with minor modifications, the main determinants of entrepreneurial performance and the impacts of the resultant entrepreneurial activities are identified (see Figure 1). The model outlines the individual determinants of entrepreneurial performance, with a recognition that these may be interconnected. Thus, it is presumed that favorable outcomes can be derived from the efficient targeting of policy initiatives in these areas.

Figure 1: Model outlining the determinants of entrepreneurial performance in a country



Source: Fostering Entrepreneurship in Georgia, The World Bank (2013).

An examination of the main determinants in this model enables the identification of the key aspects important in each category.[15]

- **Regulatory Framework:** A country's regulatory framework determines the ease with which a business can enter a market, conduct its operations, and exit when required. Thus, regulations pertaining to permit and license requirements, corruption and bankruptcy, would all fall into the broad regulatory framework that covers a business's entire lifecycle. Measures to ensure ease of entry and exit, with minimal frictions or additional costs, would support entrepreneurial activities.

- **Market conditions:** While these are determined to some extent by the regulatory framework, the underlying landscape is also highly dependent upon the sector in which the business operates. That said, the core of this determinant lies in the extent to which a specific market is competitive, and subsequently

15 World Bank. 2013

the manner in which businesses behave towards both new entrants and their industry competitors, given their market power and technological capabilities. A market that is more entrant-friendly and that is characterized by strong competition and equal access to opportunities would be an ideal landscape for start-ups to operate and to innovate.

- **Research and Development (R&D) technologies:** For businesses to be innovative, they need to place sufficient emphasis on R&D as part of their strategy and planning processes. These activities are not solely confined to creating new technologies or original, patentable innovations. Making improvements to the operational aspects of a business or implementing enhancements to products can also be considered as a form of innovation. The ability and willingness to engage in more innovative activities can enhance the success of entrepreneurial endeavors.

- **Skillsets and education levels:** These are fundamental determinants of human capital and of the ability of the country's labor force to engage in entrepreneurial activities through the absorption and application of knowledge. Higher levels of human capital are strongly related to the ability of businesses to be innovative and to conduct their business operations in a more competitive manner. A more knowledge-based workforce enhances the ability of an economy to move up the economic value-chain, enabling businesses to engage in more technologically sophisticated activities and to generate innovative new ideas, providing the basis for a more vibrant start-up culture.

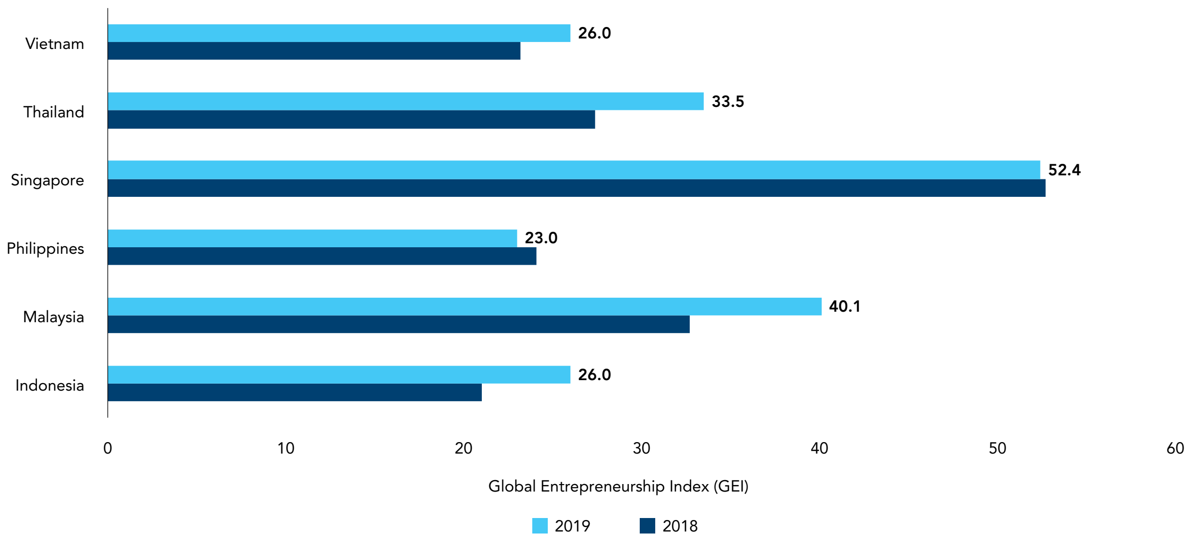
- **Culture:** In addition to the quantifiable factors necessary for vibrant entrepreneurial activities, culture forms an intrinsic aspect of this model. In this context, culture refers to social norms and individual characteristics such as risk-taking behavior that make entrepreneurship a valorized trait in a society. As an illustration, a society in which a culture of gender equality is the norm is likely to encourage greater female participation in entrepreneurship, and vice versa. Similarly, if risk-taking behavior is encouraged in the workplace, then entrepreneurship is more likely to become the norm in a given country.

- **Access to finance:** This aspect, which is the main focus of this study, is integral to the viability of entrepreneurial activities, with constraints on access to finance being a particular challenge for start-up businesses. These businesses are often regarded as unacceptably high risk due to their lack of an established history in business operations. In addition, they often lack the necessary collateral required to obtain bank loans. Thus, personal sources of funding, such as loans from family and friends, government transfers and subsidized loans, tend to be the most commonly utilized source of funding for entrepreneurs, although these are usually limited in volume and small in value. Thus, an increase in the availability of accessible, well-regulated funding sources, with sufficient actors in the market to ensure liquidity and efficient pricing, is critically important to encouraging start-ups.

Malaysia's innovative capability and deal flow for start-ups

Taking the entrepreneurial ecosystem as a whole, Malaysia fares relatively well compared to its regional peers. The Global Entrepreneurship Index (GEI) produced by the Global Entrepreneurship and Development Institute (GEDI) in 2019 aims to provide a holistic assessment of countries' entrepreneurial foundations and to facilitate normalized comparisons. According to this index, Malaysia performs very well compared to regional peers, with a score of 40.1, lower only than Singapore (52.4) and considerably higher than Thailand, at 33.5 (see Figure 2). Malaysia also displayed the most significant improvement in its score from the previous year on a regional scale, with the second-highest increase to its score from 2018 globally, following Hungary. Stakeholder consultations also show that Malaysia is regarded favorably by private investors in the region.

Figure 2: Comparison of entrepreneurship-conducive environments around the ASEAN region



Source: Global Entrepreneurship and Development Institute

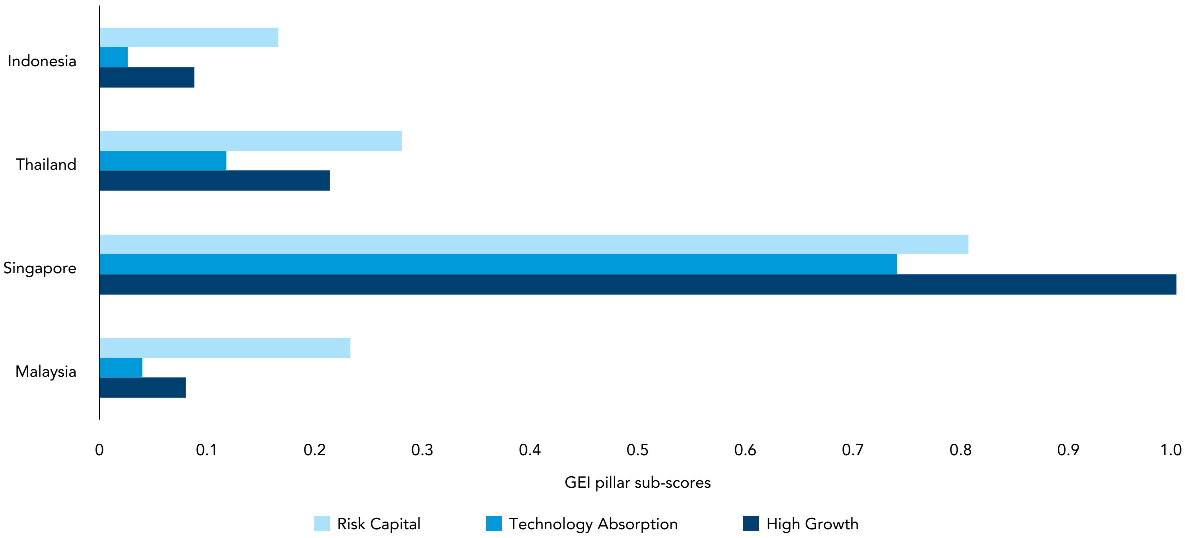
Malaysia's entrepreneurial ecosystem could be constrained by the lack of innovation-led firms, limiting deal flow and hence investor interest. According to the GEDI assessment, Malaysia's entrepreneurship ecosystem could be enhanced through greater policy efforts to increase access to risk capital and to promote technology absorption. Despite the overall positive assessment, a closer examination of Malaysia's performance in terms of the 14 pillars of the index make it possible to identify Malaysia's particular weak points (see Figure 3). The clear identification of these weak points can enable policymakers to provide direct interventions in the areas where they will have the greatest positive impact on the overall entrepreneurial ecosystem. In particular, the assessment shows that Malaysia has weak points in the following areas:

a) **Risk Capital:** This relates to the availability of risk finance, as measured by informal investment and the depth of the capital market.

b) **Technology Absorption:** This is an institutional variable that measures the diffusion of new technology and firms' ability to absorb it.

c) **High Growth:** This is a composite measure of high-growth potential and VC financing interest, which proxies for the attractiveness of the deal flow.

Figure 3: Malaysia's weaknesses in the GEI from the perspective of individual pillars



Source: Global Entrepreneurship and Development Institute

By benchmarking Malaysia's sub-component scores against its ASEAN counterparts, a number of weaknesses are revealed, despite its good performance in the overall GEI. In particular, there are stark deficiencies in the ability of firms to absorb new technologies and to apply them in their business processes and operations. This results in suboptimal growth potential and thus a lower level of attractiveness to investors. This is a significant weakness, as it directly affects the amount of financing that may be available to businesses as the perceived lack of available deal flow makes financing start-ups less enticing. There is evidence to suggest that this aspect has led to Malaysia's poor performance in terms of the high-growth sub-component of the index, which is a composite measure of start-up growth potential and VC financing interest. Guided by these findings, factors pertaining to start-up growth potential, deal flow and the limited availability of risk financing are analyzed in more detail in this Study.

The next section describes the assessment of the regional early-stage financing landscape from the perspective of the different funding stages in a business' lifecycle.

CHAPTER 2

The Financing Ecosystem: Financing Performance, Main Players and Regulations

The following analysis focuses on the early-stage financing phase of start-up businesses. Given the significant incremental growth potential that the development of entrepreneurship can have for employment and innovation-led growth, it is important to examine early-stage businesses' level of access to financing, with these early stages generally the riskiest from a financing perspective. A business generally goes through three broad phases of development in its lifecycle. These are: i) seed and start-up; ii) growth; and iii) maturity. In terms of access to finance, businesses may have different motivations at each of these levels. Also, those funding these enterprises may have different expectations and apply a different set of assessment criteria when providing financing to businesses at each of these different phases. As a result of these firm-investor objectives, the financing sources available to businesses at each phase of development will also vary, dependent upon these conditions.

Table 1: Firm and investor assessment criteria at the 3 main stages of a firm's lifecycle

Business Stage	Firm objectives	Investor's assessment criteria
Seed and Start-up	To establish a company and to start engaging in business. The start-up period will also require the business to validate a minimum viable product (MVP). At this stage, the business may or may not start to generate revenues. This is considered the riskiest stage of a business, with the highest fold rate during the lifecycle. Businesses' main challenge is to get past the "Death Valley Curve" during the stage when they are building the business but not yet generating revenues.	The most important consideration at this point is the viability of the business, or at least the pull of the initial business idea.
Growth	At this stage, the business has to achieve a 'product-market fit' upon which the impact is successfully validated. The business also has some level of stability in its operations (which may or may not have reached the break-even point). At this stage, it generates some recurrent cashflows, demand for goods and services is growing, and market presence is expanding. During this growth phase, the business will require more capital to expand and cater to growing demands.	Investors will be closely examining financial management in the growth phase to determine whether the business has the appropriate management and technical skills to drive it through this growth phase.
Mature	The business has reached a 'steady state' in terms of market share. It is no longer growing at a rapid rate and it no longer requires significant investments to grow the business (fixed assets and working capital). At this stage, the focus is on achieving day-to-day resilience and sustainability	At this late stage, investors will tend to consist of more established players such as private equity funds or sovereign wealth funds. Funding will be required for purposes such as listing the entity or acquiring larger stakes in the business. Moreover, investors may be interested in the business for reasons other than growth and profit, such as for what the company stands for and its branding.

Source: Can Venture Capital and Private Equity Work for You? IBRD - World Bank Group, 2020

Early stage of start-up financing

The early-stage financing phase of the lifecycle has two funding segments with different sets of funding sources and opportunities. Using a framework from WIPO (2020) and with information based on desk review and stakeholder consultations, Table 2 provides an overview of the financing sources available for start-ups in Malaysia. From this table, sources of early-stage financing for start-ups appear to be abundant. However, it is important to note that even within the early-stage phase, these start-ups can be divided into two different cohorts: i) those at the ideation stage, without a finalized minimum viable product (MVP); and ii) those with a defined product that are on the verge of commercialization. These two categories of start-ups have different sources of funding available to them.

Table 2: A framework of the financing source structure for start-ups in Malaysia

	Type	Seed/early-stage	Expansion/ later-stage growth	Mature
Personal or internal funding sources	Personal savings			
	Friends and family			
	Retained profits			
Non-debt, non-equity funding	Government grants			
Debt	Bank loans			
	Public sector loans			
	Peer-to-peer (P2P) financing			
	Venture debt			
Equity	Incubators and Accelerators[16]			
	Equity Crowdfunding (ECF)			
	Angel investors			
	VC Companies			
	Corporate VC Companies			
	Government VC Companies			
	Hybrid public-private structures (Co-investment and Fund of Funds)			
	Private Equity			

Source: Adapted from WIPO World Innovation Index 2020 report, Chapter 4, Peter Cornelius – AlpInvest Partners and through insights from stakeholder consultations.

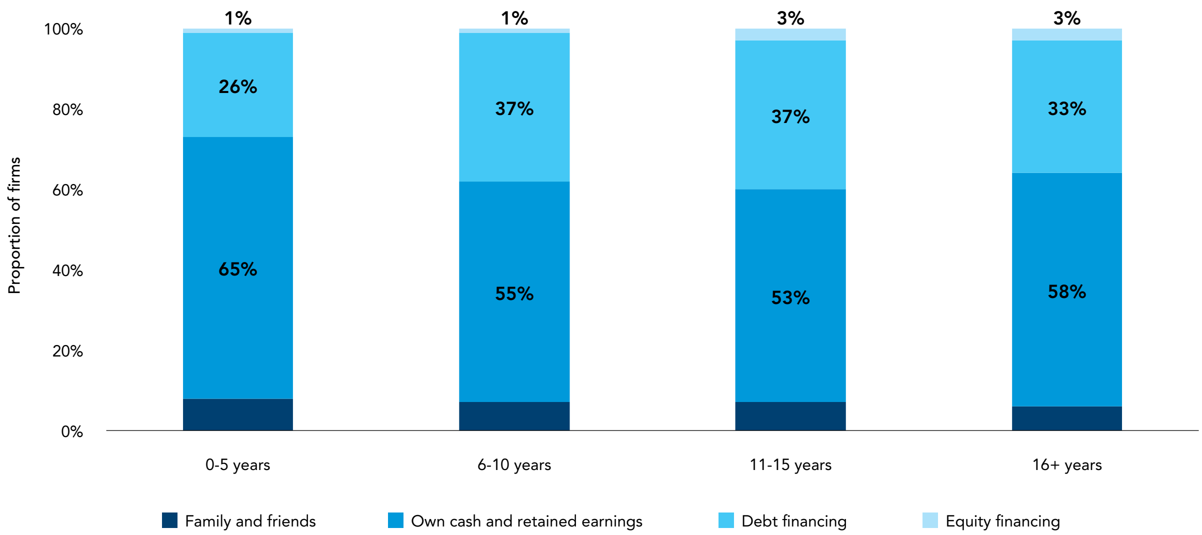
The availability of support at a start-up's ideation phase directly affects the establishment of an economy's entrepreneurial base. The ideation phase is an integral part of a business' lifecycle. At this stage, experimentation plays a vital role, enabling business ideas to be developed to become viable products. At this

16 Some accelerators may also invest in the expansion stage of a start-up, especially those that have been successful in previous funding rounds in their accelerator programmes.

stage, product prototypes may be made and subjected to initial market acceptance tests. Ideally, entrepreneurs are provided with mentorship and guidance to navigate business fundamentals and to prepare for impending challenges. At the ideation stage, one of the biggest challenges facing the entrepreneur is to develop a clear vision of how his or her product will solve a particular problem or add value to a process. With such a vision, it is then necessary to improve and refine the product through an iterative process, which requires sufficient funding. Given the low odds of a particular new product winning acceptance on its intended market, investors are likely to regard this as a high-risk proposition. At this stage, government programs can play a vital role in supporting start-ups and crowding-in private capital. Apart from publicly-sourced funds, global evidence shows that the entrepreneur's own savings, loans from friends and family, and support from angel investors are the most common sources of financing during this ideation stage.[17] During this phase, a lack of support in the ecosystem will have a direct negative impact on the establishment of the entrepreneurial base of an economy. The analysis below will assess the state of early-stage funding sources available to firms in Malaysia, as identified in Table 2.

Retained earnings and other personal sources of funds are the most important source of financing for start-ups in Malaysia. According to Bank Negara Malaysia's *Financial Stability and Payment Systems Report* (2018),[18] 65 percent of young firms in Malaysia (from 0-5 years in operation) use the founder's own financial resources to fund the establishment of their businesses. This bootstrapping by start-ups puts these businesses in a highly vulnerable position. The added risk aversion associated with the fear of losing these personal accumulated savings in the event of the business's failure can further stifle innovation and growth. At present, debt financing accounts for 26 percent of start-up firm financing, with external equity financing contributing to only 1 percent. It is worth noting that even as firms mature, the proportion attributed to equity funding does not increase substantially, accounting for only 3 percent of total financing even in the case of businesses in operation for 16 years or more (see Figure 4).[19]

Figure 4: Sources of financing by age of firm in Malaysia



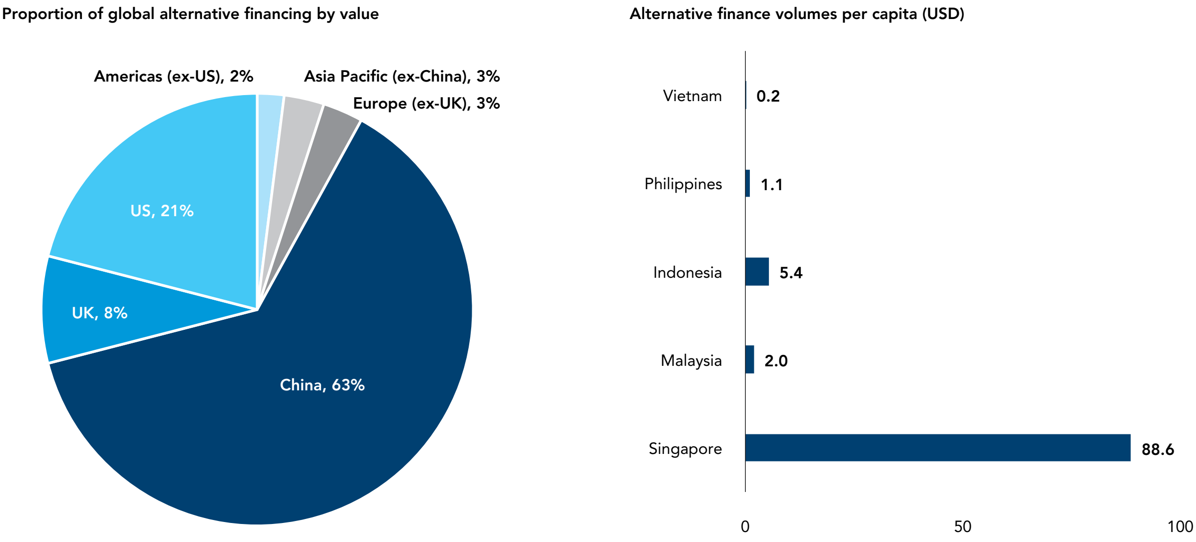
Source: Bank Negara Malaysia, 2018

17 The Venture Investment-Readiness and Awareness Levels (VIRAL) pathway created by Villlage Capital helps to illustrate this generic fundraising structure for start-ups. https://www.mainetechnology.org/wp-content/uploads/2018/08/VIRAL-Assessment-for-Entrepreneurs.pdf
18 https://www.bnm.gov.my/documents/20124/56694/cp02_001_box.pdf
19 To note that these survey results may not be fully reflective of alternative financing activities such as P2P and ECF as these modes of funding were still in their initial stages when the survey was conducted.

Traditionally, bank financing is better suited for more established businesses with proven track records than for start-ups. This is mainly due to the structure of bank debt contracts, which emphasize repayment risk mitigation. The proportion of loans extended to young start-ups (0 to 3 years) was estimated to stand at 20 percent in 2016, broadly in line with the proportion of overall loan applications received from this segment, although rejection rates are higher (21 percent) than the average overall banking system rates (9 percent). The rejection rates for start-ups are only marginally higher than the overall rejection rates for SMEs in general, with the latter standing at 20 percent.[20] That said, there has been an observed increase in the banking system's willingness to fund younger SMEs, largely due to ongoing improvements in risk and viability assessments by the banking sector. More established firms are able to better utilize financial institutions to access funding, given their longer business track records and their ability to present collateral for loans. However, for firms in frontier industries that require large initial R&D outlays, bank loans are generally not a viable source of financing, due to the risks associated with extending a loan to businesses with uncertain abilities to repay.

The establishment of alternative sources of debt financing, such as peer-to-peer (P2P) funding and equity crowd funding (ECF), has increased young businesses' access to finance in Malaysia. ECF is an innovative form of alternative fundraising that enables small businesses to raise capital from the public using online platforms registered by the Securities Commission Malaysia (SCM).[21] By the end of 2020, ten ECF platforms had been registered and were fully operational. P2P platforms[22] are an additional source of debt financing for young companies. To access finance through P2P platforms, firms need to have an established track record and a product with a customer base. While given these preconditions, P2P platforms may not be a viable source of financing for very early stage businesses, they have become an important source of alternate financing for established, but still young, firms.

Figure 5: Global shares of alternative financing activities by region and relative size of markets



Source: The Global Alternative Finance Market Benchmarking Report (2020), CCAF.
Note: No data for Thailand as it does not rank in the Top 20 countries for its level of development, Upper Middle Income.

20 Estimated from CCRIS data in 2016 and referenced from BNM's Staff Insights 2017/15.
21 A detailed discussion about ECF is presented in the next section.
22 By the end of 2020, there were 11 P2P financing operators that were fully operational.

Throughout the region, alternative financing platforms have gained prominence over the past five years, playing an important role in the democratization of start-up financing. The Asia Pacific region (excluding China) accounted for only a marginal share of global alternative financing activities in 2018, at 3 percent, with China the clear leader in this area (see Figure 5, left panel). In the chosen sample of Southeast Asian countries, Singapore's alternative financing activities are dense with volumes per capita, putting it far ahead of its regional peers and making it a clear leader in this area (see Figure 5, right panel). Research by the Cambridge Centre for Alternative Finance (CCAF) suggests that this is the result of Singapore's strong innovation-led economy, together with its liberalized financial sector. There is also evidence that performance in terms of alternative financing per capita is also closely linked to a country's level of development, as proxied by GDP per capita.

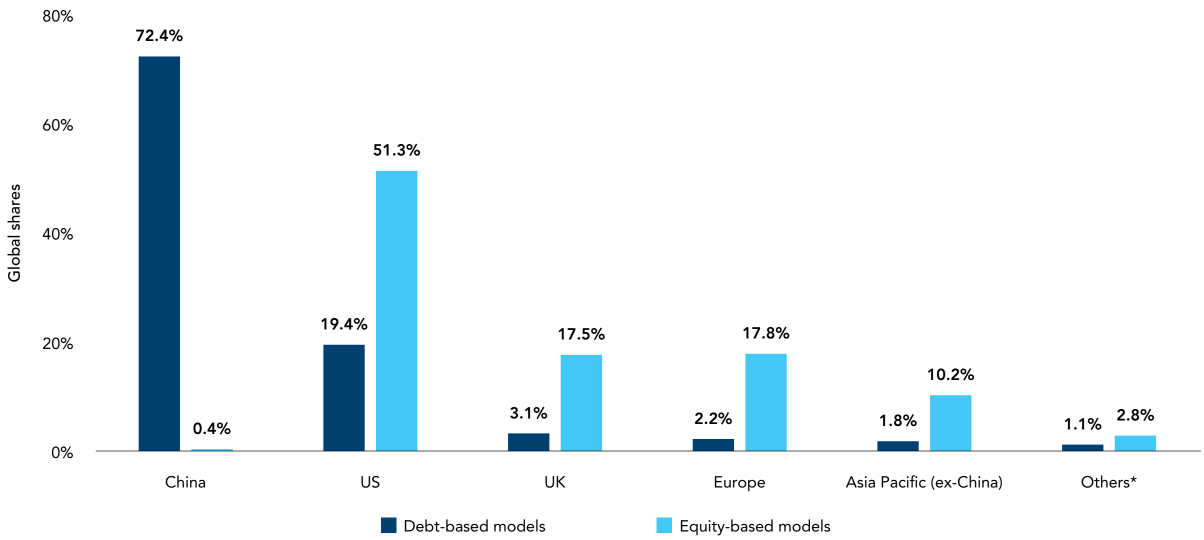
CCAF's global benchmarking report considers broad categories of alternative financing, as follows:

1. Equity-based models (e.g., ECF)
2. Debt-based models (e.g., P2P lending)
3. Non-investment-based models (e.g., reward-based crowdfunding)

The following paragraphs present a brief description of the P2P market as an alternate source of financing to traditional banking institutions. For this study, the focus will be on the first category (ECF), which will be discussed in detail in the next section.

Globally, China is the market leader in alternative financing activities, with the vast majority of these activities involving debt-based models, with the US a global leader in equity-based models. China has very little involvement with equity-based models, with its alternative financing dominated by the debt-model financing modes (see Figure 6). In total, China accounts for 72.4 percent of global debt-based model alternative financing. The Asia Pacific region (excluding China) accounts for only a marginal share of the global total, at just 1.8 percent. However, it accounts for a relatively much greater proportion of equity-based financing, at

Figure 6: Global shares by region in types of alternative financing models

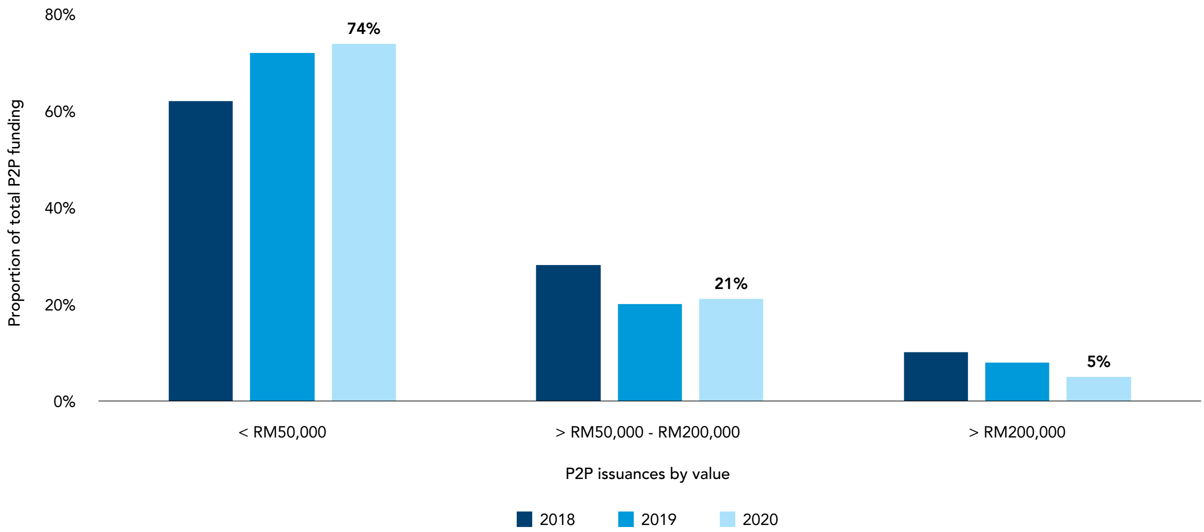


Source: The Global Alternative Finance Market Benchmarking Report (2020), CCAF.
Note: Others refer to regions of Latin America, Middle East, Canada and Africa.

10.2 percent. By contrast, China's corresponding share is a marginal 0.4 percent. Overall, the United States stands as the global leader in equity-based models in alternative financing.

In Malaysia, both the increased supply of government matching funds and the pandemic-induced increase in the demand for bridge financing led to an increase in the size of the P2P market in 2020. The total value of loans generated through Malaysia's P2P market increased by 20 percent in 2020, going up to RM 503.3 million (~USD 119 million) from RM 418.6 million (~USD 99 million) in the previous year. Throughout the year, a total of 7,760 campaigns were launched, with 1,325 successful issuers. The increased level of interest in P2P as a fundraising vehicle was partly due to the government's implementation of a matching fund program, known as the Malaysia Co-Investment Fund (MyCIF),[23] which covered both ECF and P2P markets. Interest was also driven by the impact of the pandemic, which resulted in an increased need for bridge financing, as evidenced by the smaller ticket sizes in borrowings (see Figure 7). In addition, online financing platforms also won increased acceptance due to social distancing requirements and mobility restrictions, which may have constrained in-person visits to financial institutions. Budget 2022 contains provisions for a 100 percent stamp duty exemption for new campaigns registered with the SCM between 1 January 2022 to 31 December 2026, which will benefit users of P2P platforms and further drive their growth.

Figure 7: Proportion of P2P financing by loan amounts



Source: SCM Annual Reports 2019 and 2020.
Note: <RM 50,000 (~<USD12,500), >RM 50,000-RM 200,000 (~>USD12,500-USD 50,000), and >RM 200,000 (>~USD50,000).

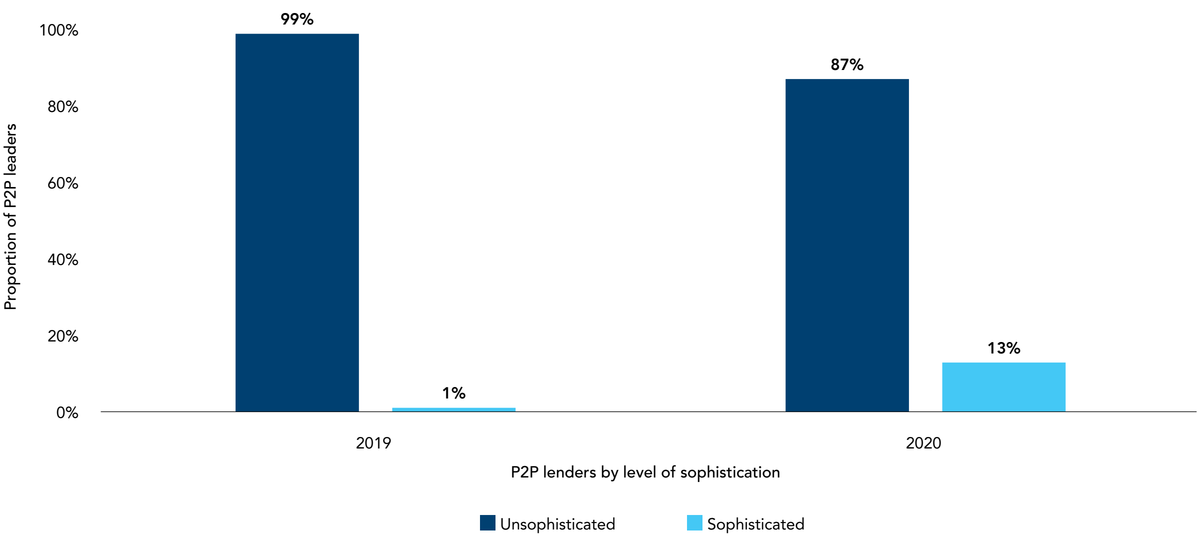
The cost of financing through P2P platforms is higher than for conventional loans and government-assisted debt programs. The simple interest rates on P2P financing notes are significantly higher than for both commercial bank loans[24] and soft loans provided through government-backed schemes. Thus, they may not be as attractive from the perspective of cost of financing as the public-sector offerings. Even so, the escalation in P2P funding activities over the past year indicates that despite this disadvantage, the access to funding that these

23 Malaysia's Co-Investment Fund or MyCIF is a co-investment fund in ECF and P2P funding. Having an initial allocation of RM 50 million in 2019, this allocation was raised to RM 100 million in 2020. In recognition of adverse business conditions faced by firms on account of COVID-19, the co-investment ratio was temporarily made more favorable during the March-December 2020 duration, from 1:4 to 1:2.

24 As at end-2020, average interest rates per annum for P2P issuer notes stood at 12.7%, as opposed to average bank lending rates which stood at 3.51%.

platforms provide remains attractive to enterprises, especially when they enable small loans without collateral requirements. The higher cost of funding (due to the fact that investment notes are generally unsecured) also acts to incentivize the participation of lenders, as returns are at a premium. P2P platforms have the advantage that there is a clearer timeline for earning returns, compared to the uncertainties in the ECF market regarding exit timelines, generally through a trade sale or an IPO. This has resulted in greater participation in the P2P market than the ECF market, particularly on the part of relatively unsophisticated investors with a lower risk appetite (see Figure 8). Finally, the establishment of a secondary market is less of a concern for retail investors, given their general preference for shorter-tenured P2P notes, with a sizeable proportion being for revolving credit. The proportion of loans with maturity periods of three months or less increased to 77 percent in 2020, up from 63 percent in the previous year (SCM Annual Report, 2020).

Figure 8: Characteristic of P2P lenders in Malaysia



Source: SCM Annual Report 2020

25 To note, P2P interest income is taxable whilst ECF capital gains are not. On the flipside, P2P investor losses are also not tax deductible. Although P2P investments may be perceived to be less risky, these investments can potentially incur more financial outlay than ECF investments, in the form of tax liabilities and the inability to write- off investment losses through the tax system.

Early-stage financing is characterized by a high degree of risk aversion, resulting in an 'ideation' financing gap for younger start-ups without a developed product, with investors showing a preference for backing more established enterprises. With this risk aversion, it is observed that the involvement of government agencies in early-stage financing mostly takes the form of grants, matching grants, soft loans, and loan guarantee schemes. Figure 9 below provides a graphical representation of the three main ministries involved in early-stage start-up financing in Malaysia and the agencies charged with the management of financing instruments under various programs. Of the forms of financing instruments provided by government agencies, soft loans are the most common.[26] Given that these involve a form of debt instrument, there is a preference for providing financing allocations to more established businesses, with requirements for firms to meet minimum annual revenue thresholds and to have been in operation for a minimum period. That said, these instruments have the advantage of more favorable interest rates compared to those available on the broader market.

Figure 9: Early Stage Instruments in Malaysia by Agency and Ministry

Ministry	Agency	Instruments
Ministry of Science, Technology and Innovation	Malaysian Global Innovation and Creativity Centre (MaGIC)	Grants, Accelerator programmes
	Malaysian Technology Development Corporation	Subsidised loans, P2P, ECF
Ministry of Communications and Multimedia	Malaysia Digital Economy Corporation Sdn Bhd (MDeC)	Grants
Ministry of Finance	Cradle Fund Sdn Bhd	Grants, Accelerator programmes
	Dana Penjana Nasional	Fund of Funds programme
	Malaysia Venture Capital Management Bhd	Venture capital
	Malaysia Debt Ventures Bhd	Venture debt

Source: Authors' Elaborations.
Note: In November 2021, MaGIC and the Malaysian Technology Development Corporation were combined to form the Malaysian Research Accelerator for Technology and Innovation (MRANTI).

The Malaysian Research Accelerator for Technology and Innovation (MRANTI) was established by consolidating a number of pre-existing agencies to strengthen the foundation for initiatives to support young businesses from the ideation stage to the commercialization stage. The recent consolidation of MaGIC and Technology Park Malaysia (TPM) in November 2021 into a single government agency known as MRANTI, under MoSTI, aims to facilitate better coordination in the provision of support to businesses during the ideation and commercialization stages by establishing an end-to-end ecosystem that involves the

26 https://smeinfo.com.my/development-programmes

public and private sectors, academia and start-up businesses. The provision of high-impact programs run by MaGIC and the facilities and infrastructure provided by TPM will facilitate the achievement of the wider goal of accelerating commercialization activities and fostering greater innovation. As also suggested in the World Bank's report on *Assessing the Effectiveness of Public Research Institutions* (2020),[27] an innovation-driven growth model is imperative for Malaysia to navigate the current economic downturn and to achieve high-income nation status by enhancing value-added activities and productivity. In line with MRANTI's focus on the participation of academia in the ecosystem, the report also emphasizes the role of public research institutions (PRIs), particularly in the creation and diffusion of new knowledge. In order for this to be successful, a strong institutional setting is required to enable the movement of knowledge between knowledge creators (academia and PRIs) and users (firms and societies). Besides enabling this movement, knowledge transfer is also integral.

There has also been a noticeable shift in grant funding towards more established businesses in the product development phases. One of the most significant developments over the past couple of years was the recalibration of the well-established Cradle Fund grant schemes into the new generation of Cradle Investment Programs (CIP) Ignite (i), Ignite (ii) and Accelerate (see Table 3). All these schemes have more restrictive eligibility criteria, with a focus on more innovative firms (i.e., more advanced in technological readiness levels i.e. TRLs, and focused on product validation or commercialization activities). This could potentially preclude start-ups at the initial stages of their lifecycle, including those at the formulation of concept and experimental proof of concept stages, as defined in the TRL framework.[28] Insights gathered from stakeholder consultations show that this movement up the business lifecycle in terms of financing strategy was in direct response to a perceived gap in the later stages in the financing lifecycle. However, the concentration in post-MVP funding, without still having support available for firms at the pre-MVP stage, is viewed as an over-correction in the Government's strategy. It is noted that the recently launched SUPER aims to address this gap through its funding interventions.

Table 3: Comparison between new Cradle Fund CIP Programs

<table>
<tr><th></th><th>Target Firms</th><th>Purpose of Financing</th><th>Max Amount</th><th>Financing Period</th><th>Key Eligibility Conditions</th></tr>
<tr><td>CIP Ignite (i)</td><td>Deep-tech companies of TRL 5-7</td><td>Product validation</td><td>RM500,000</td><td>12-18 months</td><td rowspan="3">• A private limited company with at least 51 percent Malaysian ownership.
• Revenue not more than RM5 million and minimum RM10,000 paid up capital.
• Must not be a subsidiary of any company or have another company hold 25 percent or more of its shareholdings.
• Must have IP rights to the product.</td></tr>
<tr><td>CIP Ignite (ii)</td><td>Non-Deep-tech companies of TRL 8-9</td><td>Product commercialization</td><td>RM500,000</td><td>16-24 months</td></tr>
<tr><td>CIP Accelerate</td><td>Deep-tech companies of TRL 8-9</td><td>Product commercialization</td><td>RM2,000,000</td><td>12-18 months</td></tr>
</table>

Source: Cradle Fund Sdn Bhd

27 https://openknowledge.worldbank.org/handle/10986/34612
28 https://www.twi-global.com/technical-knowledge/faqs/technology-readiness-levels

The Cradle Fund's current targeting strategy involves another transformation to its approach to start-up funding, with the fund having experienced a number of changes over the past decade.

- **2003-07:** Under the Cradle Investment Program (CIP), small-ticket cash grants of up to RM 50,000 (~USD 12,500) were disbursed to investee start-ups for the purpose of developing technology-based ideas into commercially viable ventures. MyTeksi (now Grab) was one of the early recipients of this grant.
- **2007-17:** Cradle CIP developed into CIP Catalyst and u-CIP Catalyst, with an increase in maximum grant allocation to RM 150,000 (~USD 37,500).
- **2009-17:** CIP500 was launched, with a further increase to the maximum grant allocation to RM 500,000 (~USD 125,000), with the objective of facilitating commercialization activities.
- **2014:** Cradle Fund launched a co-investment program, partnering with corporates and venture funds to invest in investee companies collectively in exchange for equity.
- **2015:** Cradle Fund launched its own VC arm, Cradle Seed Ventures, which successfully invested in a number of Series A start-ups, including The Lorry, StoreHub and Money Match.
- **2016:** A number of ECF platforms were also brought in as co-investment partners.
- **2017:** The CIP Catalyst and CIP500 programs were replaced by a new scheme, CIP300, which was intended to support early-stage start-ups to achieve quick commercialization.
- **2017-19:** A new funding scheme was launched, DEQ 800, with funding for start-ups to a value of up to RM 800,000 (~USD 200,000) provided in exchange for equity.
- **2020-present:** CIP Ignite and CIP Accelerate have been launched, with all previous funding schemes ceasing to operate.

From the timeline above, it is clear that there has been an upward movement in funding amounts, with increasingly greater ambitions in terms of firm maturity and the activities targeted. Another such program which has been involved in seeding successful start-ups was the MSC Technopreneur Pre-seed fund, launched at around the same time as CIP, which also targeted start-ups at the pre-MVP stage. However, at present, there is a lack of programs that target businesses at the pre-MVP phase.

In addition to the Cradle Fund, under MoSTI's mandate, there are a number of other grant schemes available for entrepreneurs spread out across different TRLs.[29] One such grant, the Applied Innovation Fund (AIF), targets businesses at the pre-MVP stage, concentrating on providing funds for the development of a prototype that may lead to the filing of a patent, ahead of commercialization. It should be noted that many activities that are important for the development of an MVP are included in the scope of funding – from data analysis, raw materials for MVP development, to the costs incurred to obtain IP certification for the prototype, amongst others. However, applicants may stand a better chance of obtaining this financing if they are engaged in a partnership with research bodies, such as public-private institutions of higher learning or government research institutes, with the eligibility criteria encouraging participation in such partnerships. While this is certainly an important initiative to promote greater industry-research collaboration and to enable research to be commercialized, it may preclude applicants that have a limited network and that have not yet established a position in the R&D ecosystem. A number of other entities are also active in this space, including Tekun Nasional and the Malaysian Technology Development Corporation (MTDC), both of which offer soft loan financing rather than grants.

29 https://edana.mosti.gov.my/

A hybrid public-private sector financing structure, in the form of a FoF, has been gaining traction, receiving a big boost with the introduction and implementation of Dana Penjana Nasional (DPN) in 2020. This funding program was initially expected to inject fresh funding of up to RM 1.2 billion (~USD 290 million) into the VC sector over a 5-7 year period, with funding involving a 1:1 matching arrangement, with the government making a RM 600 million (~USD 145mn) commitment, with fund mobilization following approval by the Penjana Kapital Investment Committee and financing from private sector VC funds. Encouragingly, recent disclosure updates from the fund show that the total value of private sector capital raised has reached RM 676 million (~USD 164mn), exceeding the original goal of RM 600 million (~USD 145mn).

DPN has a number of favorable characteristics, including both those that are inherent to FoF structures and those unique to DPN itself. Firstly, a special purpose entity, Penjana Kapital Sdn Bhd (PK), has been established to manage the Ministry of Finance (MoF) funds allocated to this program, with a well-established governance framework, with a board of directors, investment committee and management team. In addition, funds are allocated to businesses across the financing lifecycle, including those at the Seed, Series A and B stages, to ensure that much-needed funds are directed to early-stage businesses, with the matching funding arrangement mitigating risk aversion. Without provisions of this sort, VC entities may naturally gravitate towards more established businesses in their lower-risk investment phases. The DPN initiative also requires domestic VC players to enter into partnerships with foreign VCs, potentially broadening the range of foreign-sourced investment opportunities. This enables knowledge transfer from foreign investors to domestic VC operators, potentially increasing the technical competencies of domestic VC operators in the area of VC fund management. With this local-foreign partnership structure, a general partnership (GP) is established to manage the fund, with an investment team that consists of representatives from both parties.

BOX 1

State-funded start-up development programs in Malaysia

Two state governments in Malaysia, those of Selangor and Penang, have established their own start-up support schemes, with the intention being to develop the entrepreneurial ecosystem in these states. This box presents a discussion of these programs, including the funding stages in sectors they target and whether they attempt to bridge the pre-MVP funding gap (and thereby meet a need not fulfilled by federal public-sector schemes).

The Schemes are summarized below:

Penang i4.0 Seed Fund: In 2018, the Penang State Government established the i4.0 Seed Fund, which is implemented through InvestPenang. The fund was set up to enhance Penang's technology ecosystem, with an emphasis on serving businesses involved in innovative technologies such as the Internet of Things (IoT), Advanced Manufacturing, MedTech and EduTech amongst others. As its name suggests, the fund targets start-ups that require seed finance in order to commercialize their prototype. An MVP with some proof of market acceptance is a minimum requirement for a firm to be eligible for this funding, with the submission of audited accounts required as part of the application process. Moreover, firms that receive support through this fund are required to establish some form of business presence or satellite office in Penang for a minimum of five years. As a safeguard for the Penang State government, a start-up receiving more than RM 50,000 (~USD 12,500) in funding will be required to place 4 percent of their company's equity as a warranty.

Selangor Accelerator Program (SAP): The SAP, which was established in 2019, is solely an accelerator program and does not incorporate any funding initiatives. Rather, it provides cash rewards on a competitive basis for the five best start-ups at the annual *Smart City & Digital Economy Convention*, with these rewards totalling RM 30,000 (~USD 7500). The SAP is essentially a 4-month program that provides training and mentorship for the successful cohorts enrolled in the scheme. It targets start-ups that have not secured Series A funding at the time of application but that have an MVP, with evidence of market traction. The program targets firms with a technology-led focus in verticals, including those involved in artificial intelligence, blockchain, big data and IoT, amongst others.

These newly-initiated, state-led start-up support schemes target businesses at the post-MVP stage in the funding cycle that are concentrated in technology-based sectors. It should be noted that the scheme may or may not provide actual funding during the program. Penang's i4.0's seed fund remains the most developed of these schemes, with a well-functioning structure and with the stated goal of supporting Penang's development as a premier technology hub. State-funded start-up schemes could play an important role in complementing national programs and could also support the achievement of state-specific economic development objectives. However, the current offerings still cater largely to businesses that have a developed product that has been validated by markets. Hence, the gap at the product development phase remains largely unaddressed.

DPN is a welcome and important addition to Malaysia's start-up financing ecosystem. It has a number of mutually-beneficial characteristics, including the provision of co-investment support for additional liquidity, risk-sharing arrangements between public and private sectors, and the private sector-led allocation of funding and overall investment management, all of which fare better under a fee-based structure rather than with the salaried fund manager structure that characterizes many public-sector VC funds. However, it is not yet clear how fund managers will be remunerated and whether there is a requirement to allocate at least 1-2 percent of the committed capital into the fund, as is usually required by investors such as sovereign wealth funds. This commitment serves to improve the incentive mechanism to deliver results.

DPN is seen as an extension of the incumbent Malaysia Venture Capital Management Berhad (MAVCAP), albeit sector-agnostic and with a clearer investment-matching ratio and a required foreign tie-up. MAVCAP, which was the first FoF in Malaysia, has played an instrumental role in the establishment and development of many start-ups over the past 20 years, including Carsome, Fashion Valet, Fave and GoGet. MAVCAP's strategy focuses on companies in the information and communications technology (ICT) sector across Southeast Asia, from seed to late stages. It operates in partnership with leading funds in Malaysia, including Gobi Partners, 500 Start-ups and Vynn Capital. Although it has been a very successful initiative in the financing ecosystem, it has been constrained by the limited availability of funding, with its funds allocated through MoF.

While market players agree that DPN plays a valuable role in the country's financing ecosystem, greater clarity regarding the continuity of the program and additional government commitments to funding it are required, together with greater clarity regarding application procedures. These measures would strengthen its effectiveness and increase its value as a sustainable source of funding for start-ups in Malaysia.

While start-up incubators and accelerators have become an integral part of Malaysia's ecosystem, they are not yet key sources of funding. Traditionally, incubators provide essential mentorship and guidance through short-term programs to entrepreneurs who have not yet established a legal corporate entity. These programs generally precede the stage at which start-ups are ready to enroll in accelerator programs. In this study, a distinction is drawn between incubators and accelerators in terms of the entities to which they provide support. In these terms, an accelerator is a body that provides mentorship and entrepreneurship training and support to start-up entities, rather than to individual entrepreneurs, as in the case with incubators. While incubators are more likely to concentrate on businesses at the very early stages of entrepreneurial interest and ideation, accelerators focus on those at more advanced stages, while still providing support in the early phase of the firm's life-cycle, where funding may or may not be provided.

Malaysia has a number of successful private-sector accelerators that play a vital role by providing mentoring and funding to businesses in the early stage of their life cycle. Successful accelerator schemes in Malaysia that focus on businesses in the pre-MVP stage include the NEXEA Start-up Accelerator Program and 1337 Accelerator, both of which take equity stakes in the investee entity. Another program that concentrates on businesses in the commercialization stage of their life cycle is ScaleUp Malaysia, which incorporates a ramp-up in funding after a successful initial period of the start-up's operation, with the accelerator also taking an equity stake in these start-ups. One much-praised public-sector linked accelerator program, the Global Accelerator Program (GAP), which operates under the Malaysian Global Innovation and Creativity Centre (MaGIC), an agency under MoSTI, does not provide funding, but rather aims to enable a business to establish a solid foundation to source financing following the provision of training and mentorship, including through enhanced access to the accelerator's network of investors. This program plays a vital role in Malaysia's entrepreneurial ecosystem. It should be noted that there are also a number of government grant-funded university incubator schemes in

BOX 2

Lessons learned from government-sponsored VC funds around the world

Finland, New Zealand, and Estonia are all small economies with low volumes of investment opportunities and limited indigenous sources of VC. All three economies conduct active policies to foster the development of VC activities. An evaluation of their experiences shows that government policy can help overcome scale and distance constraints on the establishment of VCs to support innovative, potentially high-growth ventures.

To ensure the success of these initiatives, the simultaneous implementation of a number of policies is required, with these policies relating to: (i) government regulatory/tax policy; and (ii) dedicated finance policy institutions with the ability to deliver government funding, including government sponsored investment funds. Experiences from strategic investment funds (SIFs) that develop equity markets in MENA economies demonstrates the need to address market constraints by establishing an appropriate legal and regulatory framework. In particular, regulations are required to ensure: (i) suitable supervision and oversight frameworks for early-stage equity finance; (ii) appropriate fund structuring (e.g. GP and LP structure), fund management (e.g., governance requirements, liquidity), taxation (e.g., on capital gains), and a range of investment instruments (e.g., equity, quasi-equity, debt); (iii) the development of access to finance through crowdfunding, pooled SME long-term finance funds, and peer-to-peer financing platforms; (iv) the specification of the types of institutions (pension funds, insurance companies, and banks) that may invest in seed and early stage VC activities in order to ensure that they have optimal impact on the amount of capital available for VCs.

Other factors include:

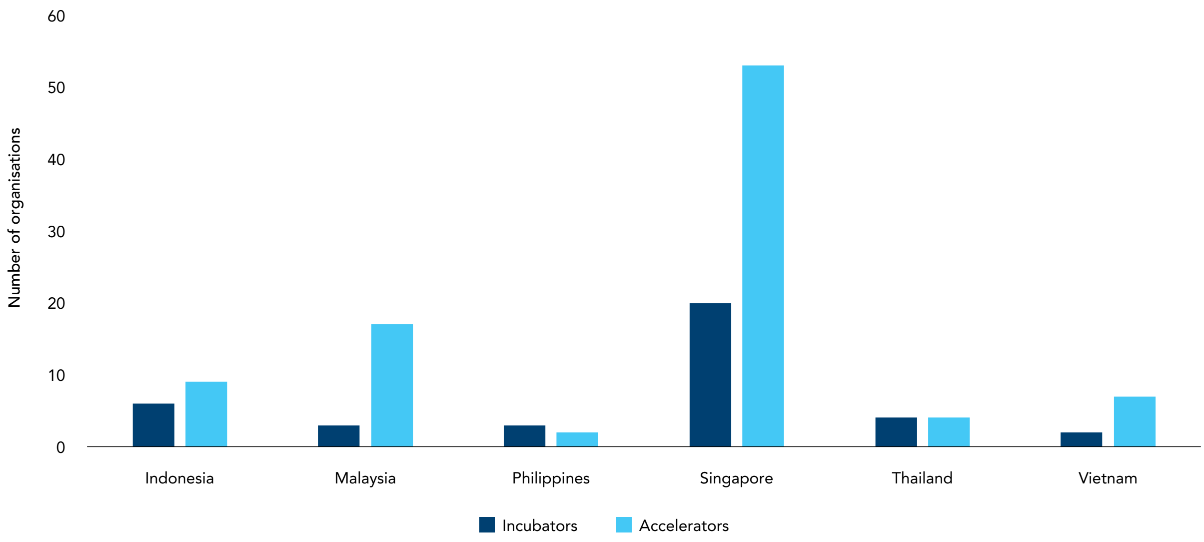
- ***Building linkages to entrepreneurial development through ongoing demand-side stimulation policies*** and to angel investors (development of enhanced business angel networks and co-financing arrangements to leverage greater investment in seed and early stage business financing).
- ***Expanding investment market through cross-border investing***, which can increase the scale of venture capital, import expert investors to upskill the industry, open up global market connections and opportunities for portfolio firms, and improve exit opportunities.
- ***Growing the scale and market reach of regional and national Specialized Investment Funds*** to enable them to invest across borders to ensure that they have sufficient size and capacity to develop a sustainable investment cycle and to encourage overseas business angel and VC investments. This can be achieved through supporting international business angel networks and VC collaborations; providing incentives to foreign VCs; facilitating the establishment of international linkages between innovation institutions (e.g., universities, R&D centers); and assisting start-ups to enter overseas incubator/accelerators, including encouraging reciprocal foreign corporate accelerator investments into the home market.

Source: Owen & Mason (2019) and World Bank Project documents for investment funds in Lebanon, Morocco, Jordan, Tunisia and Egypt.

Malaysia, which also play an important role in nurturing the research and entrepreneurial skills required to build up the ecosystem. One of the main challenges for Public Research Organizations and research centers is their limited access to a stable and consistent flow of funding, especially with the government's current strategy of encouraging these institutions to seek alternative sources of private funding for their operations. As shown in the World Bank's study on *Assessing the Effectiveness of Public Research Institutions* (2020), one means by which these bodies could attract more sources of private funding would be to produce more demand-driven research products that meet industry needs.

The establishment of a greater number of incubator schemes may help to facilitate businesses' graduation into accelerator schemes and subsequently their access to formal funding. Singapore is the clear regional leader in terms of its number of incubators and accelerators, with this leading to its high ranking in terms of the number of pre-seed deals facilitated (see Figure 10). Its success in this area can be attributed to its early start with measures to build up its start-up ecosystem and to facilitate the participation of incubators and accelerators within this ecosystem. Moreover, amongst the various incubators and accelerators in Singapore, a number of them are linked to universities or research institutes or to established corporations that have sufficient financial resources and market exposure to provide a credible springboard for start-ups. Although Malaysia's regional share has been growing over the past few years, support at the front-end of the early-stage funding phase, with a higher proportion of incubators to accelerators, could elevate this type of funding. It should be noted that the ratio of incubators to accelerators in Singapore stands at 0.4, with Malaysia's corresponding value standing at 0.2.

Figure 10: Malaysia fairs better than most regional peers in terms of start-up accelerators but the presence of incubators may be lacking



Source: Crunchbase

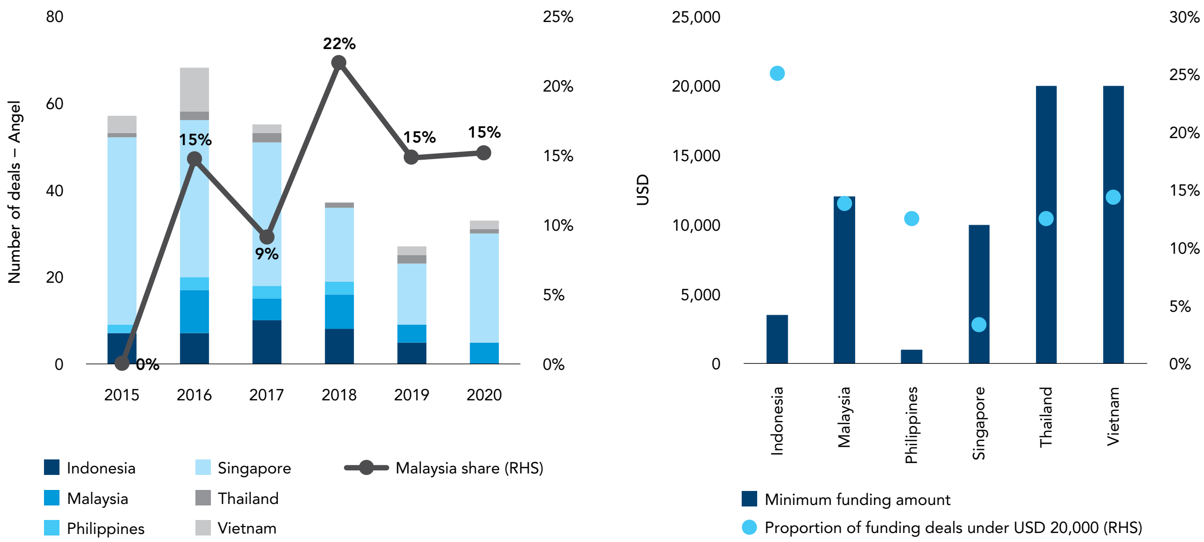
With these foundational organizations supporting the base of the start-up ecosystem, the amount of funding that they receive is integral to determining the number of businesses they can facilitate and the size of potential deal flow for subsequent investors in the ecosystem. From stakeholder consultations, it appears that accelerators are not currently a key source of deal flow for subsequent, formal funding avenues, such as VC funds, which tend to rely on their own professional networks and financial institution contacts,

including ECF, to identify deal flow prospects. That said, some private sector VC operators and accelerators form strategic partnerships on their own accord, although these collaborations are very limited in number. Thus, measures to facilitate the establishment of these strategic partnerships would greatly strengthen both the quality and quantity of deal flow in Malaysia.

Angel investors have traditionally been an important source of both pre-seed and seed funding. This study faced particular challenges in obtaining data related to angel investors. Besides the lack of uniformity in data availability across the region due to angel associations' different maturity and reach, data remains limited due to a lack of regulatory requirements for angel investors to be accredited to any industry body. Moreover, independent, individual angel investors, usually high net-worth individuals or from high net-worth families, may place a high value on their privacy and be reluctant to be accredited with an angel network. Thus, most of the available data refers only to more conspicuous angel investor entities such as angel clubs and the like. Singapore's dominance in angel-funded investments could be, in part, a manifestation of this data characteristic, by virtue of the higher prevalence of angel networks in the country relative to the rest of the region. With these limitations, an increasingly important proportion of angel investor activities through ECF investments is largely unaccounted for in this dataset. This may have resulted in an upward bias in the identified average ticket sizes of angel investments by virtue of the number of deals presented.

With its recent efforts to encourage the participation of angel investors, Malaysia performs well in the region. In the area of angel investor financing, Malaysia fares well, second only to Singapore in terms of the number of deals in 2020 and accounting for 15 percent of total deals in the regional sample (see Figure 11, left panel). In Malaysia, angel investor interest has been stimulated by the government's recent efforts to encourage more investments in this space, with the recent extension of an angel investor tax exemption to 2023. From an analysis of minimum funding amounts by angels, it is found that Indonesia and the Philippines have funded relatively smaller deals compared to the rest of the region. In particular, Indonesia has funded a larger proportion of angel deals with smaller ticket sizes than its regional peers. In these terms, Malaysia ranks in the middle in terms of both these measures, which might also indicate that more established, younger start-ups have better opportunities to be financed in this way (see Figure 11, right panel).

Figure 11: Angel-funded deals in the Southeast Asian region



Source: Pitchbook and Crunchbase

While the Angel Tax Incentive, administered by the Angel Tax Incentive Office (ATIO) under the Cradle Fund, is a good initiative, it has not gained significant traction. Although this scheme is in principle a good initiative to address the lack of tax-based incentives in start-up financing, its introduction has not had as much take-up as was originally envisioned, as found from stakeholder consultations with a number of industry pioneers at the forefront of angel investment. This appears to be partly due to the privacy issues mentioned above. This would partially explain the low uptake of the tax exemption, as angel investors who claimed this exemption would need to disclose their investment activities. Other reasons cited included the requirement for the investments to be held for a minimum period of two years before the tax incentive can be claimed. Given that the scheme is still fairly new, there might be a delay before claims are made. In addition, the administrative requirements may constrain the rapid take-up of this incentive, with eligible investee companies needing to be approved by the MoF.[30] Thus, not all investments are eligible for the tax exemption. As the tax break targets technology firms, more traditional brick-and-mortar businesses may not be eligible, thus also accounting for limited uptake. In order to qualify for this tax exemption, angel investors must register with the Malaysia Business Angel Network (MBAN). While the initiative did indeed drive increased registrations, there has not yet been a corresponding increase in the pace of take-up of the tax incentive.

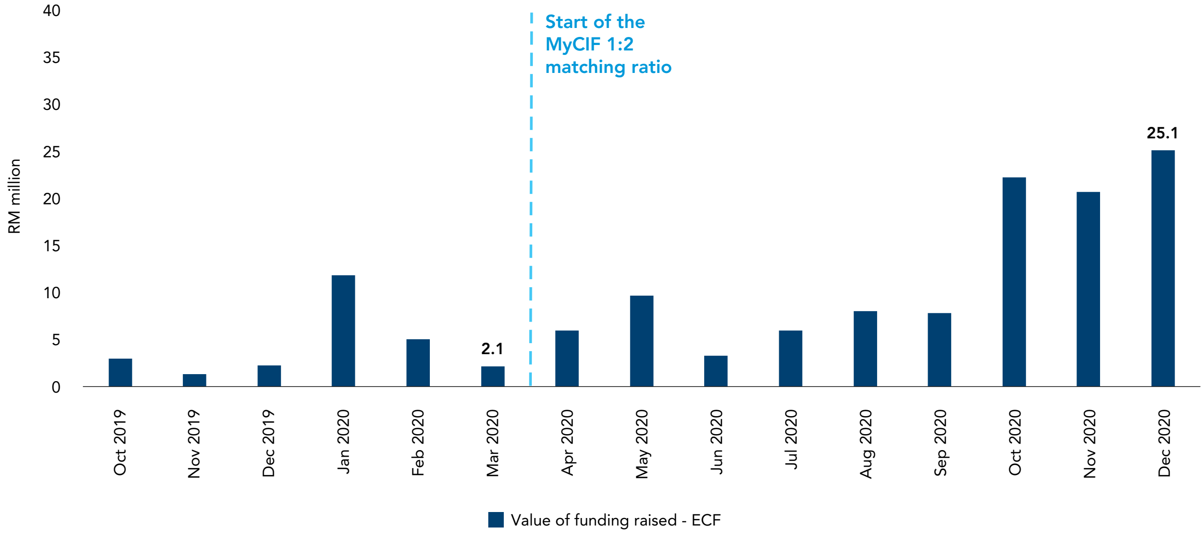
While primarily intended as a source of early-stage funding, alternative financing through digital platforms is also being used by businesses beyond the pre-seed and seed stages. Alternative financing has been an important source of early-stage funding for start-ups due to its greater accessibility and lower barriers to participation. However, some firms that are beyond the pre-seed and seed stages have also tapped into these platforms for funding, and there has been an extension into series funding. The incorporation of alternative finance into the early stage of start-up financing reflects these sources being comparatively more accessible for younger firms. This development has been part of a coordinated effort to make financing more accessible for entrepreneurs.

The following section focuses on alternative financing in Malaysia, with a more detailed analysis of the ECF market as a source of start-up funding, as opposed to P2P, which was previously examined as an alternative to bank financing.

In Malaysia, ECF activities are well-established, with the framework having been strengthened since its inception in 2015 to enhance its accessibility and market liquidity. Malaysia was the first ASEAN country to establish a framework for ECF activities, in 2015. Since then, the government has strengthened the framework to enhance both accessibility and market liquidity. Regulations governing the size of fundraising through ECF platforms have been amended to accommodate larger campaigns and to meet the needs of larger enterprises. There was a dramatic increase in the value of capital raised for ECF activities over the last year, going up from RM 22.9 million (~USD 5.6 million) in 2019 to RM 127.7 million (~USD 31 million) in 2020. The value recorded in 2020 represents a total of 80 campaigns launched, with 78 successful issuers. In 2020, ECF-lifetime fundraising limits were increased from RM 5 million (~USD 1.2 million) to RM 10 million (~USD 2.4 million) per issuer. The upper threshold of paid-up capital for firms to access these platforms was also increased from RM 5 million (~USD 1.2 million) to RM 10 million (~USD 2.4 million). The other key driver of this dramatic increase was the government co-investment funding scheme implemented under MyCIF,[31] for which allocations were also increased during this period. In addition, as a pandemic response measure, a more attractive matching ratio of 1:2 was implemented throughout the March-December 2020 period to address pandemic-related funding challenges (see Figure 12). As of 2021, the lifetime fundraising limit has been raised to RM 20 million (~USD 5 million) per issuer, with the upper threshold on paid up capital no longer applied.

30 http://lampiran1.hasil.gov.my/pdf/pdfam/PR_12_2020.pdf
31 https://www.sc.com.my/resources/media/media-release/mycif-co-invested-rm165-million-benefitting-over-1000-msmes

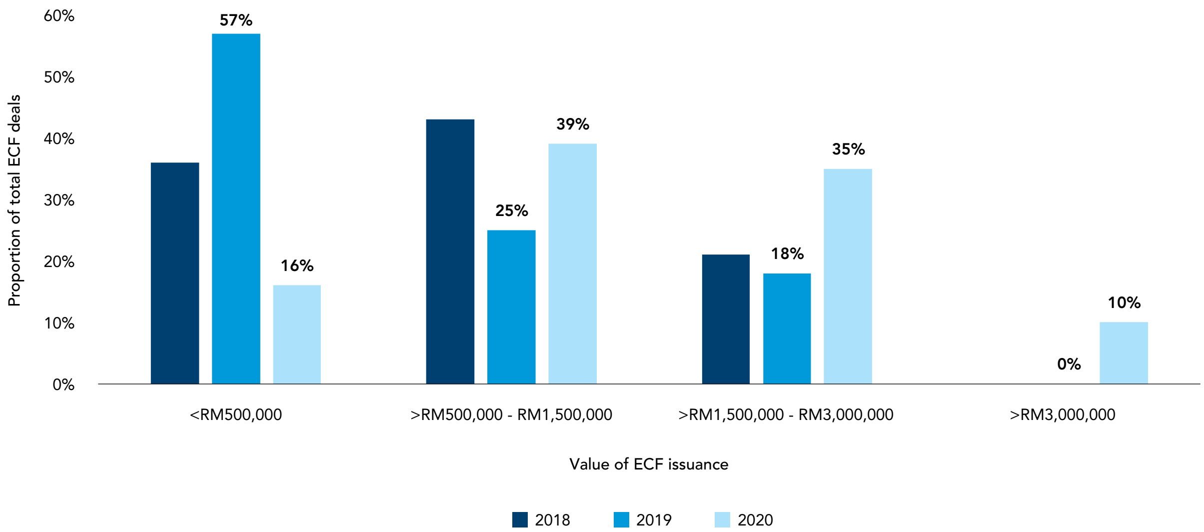
Figure 12: Total funding raised through ECF platforms boosted by MyCIF program



Source: SCM

While the liberalization of regulations related to ECF fundraising contributed to the huge growth in these activities in 2020, it may have inadvertently increased the competition in obtaining funding for smaller, less established businesses. The widening of the potential investee base resulting from the increase of the upper threshold for paid-up capital for firms could have resulted in additional investor interest. This could be due to the wider pick of larger, more established firms in which to invest, alleviating some risk aversion in this market. As such, in 2020, there was a notable shift towards larger ticket-size issuances (see Figure 13).

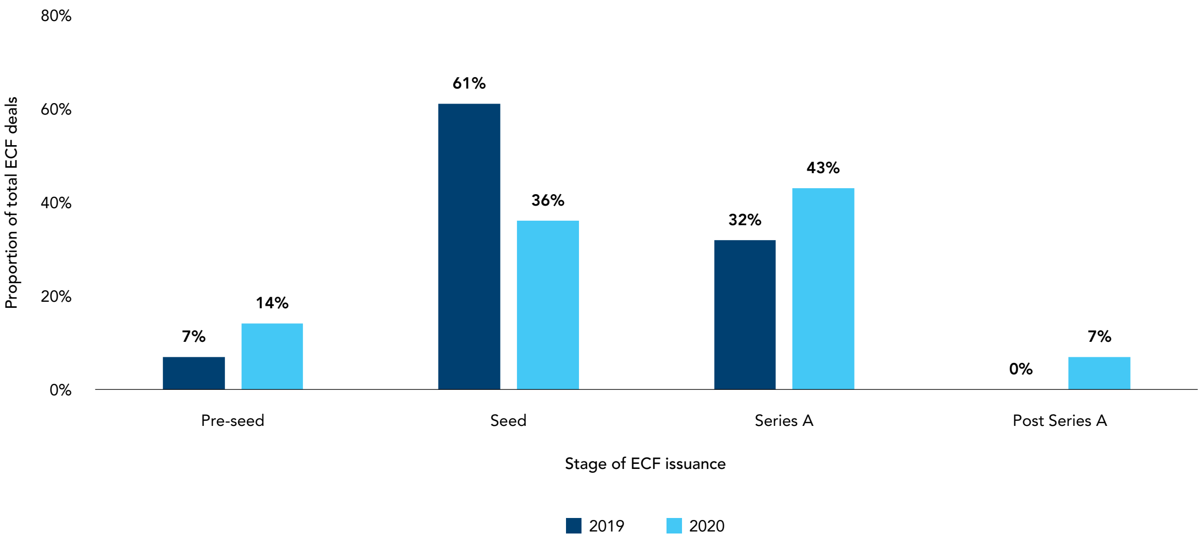
Figure 13: Greater ECF funding activities in larger issuance values



Source: SCM Annual Reports 2019 and 2020

While in 2019 the majority of ECF funding was concentrated on businesses at the pre-seed and seed funding stages, this changed in 2020. Prior to the latest liberalization in regulations, pre-seed and seed funding accounted for the majority of funding activities, with a combined share of 68 percent in 2019. In 2020, this proportion fell to 50 percent, with a notable increase in the share of Series funding and the debut of post-Series A financing (see Figure 14). Thus, ECF platforms have evolved from being primarily a means to democratize finance to also serving as a financing tool to address funding gaps between the seed to Series funding stages. Although from a regulatory perspective, nothing has changed to constrain younger firms from tapping this funding source, the liberalization measures may have unintentionally resulted in greater competition for funding sources for younger firms. From stakeholder consultations, it seems that raising funding through ECF platforms is becoming a viable alternative to early-stage VC funding, given the wider access to investors and greater flexibility in financing terms. Moreover, listing on ECF platforms require less legal documentation and less burdensome processes than traditional IPOs, which also enhances their attractiveness.[32]

Figure 14: ECF funding liberalization has also changed the characteristic of funding purpose



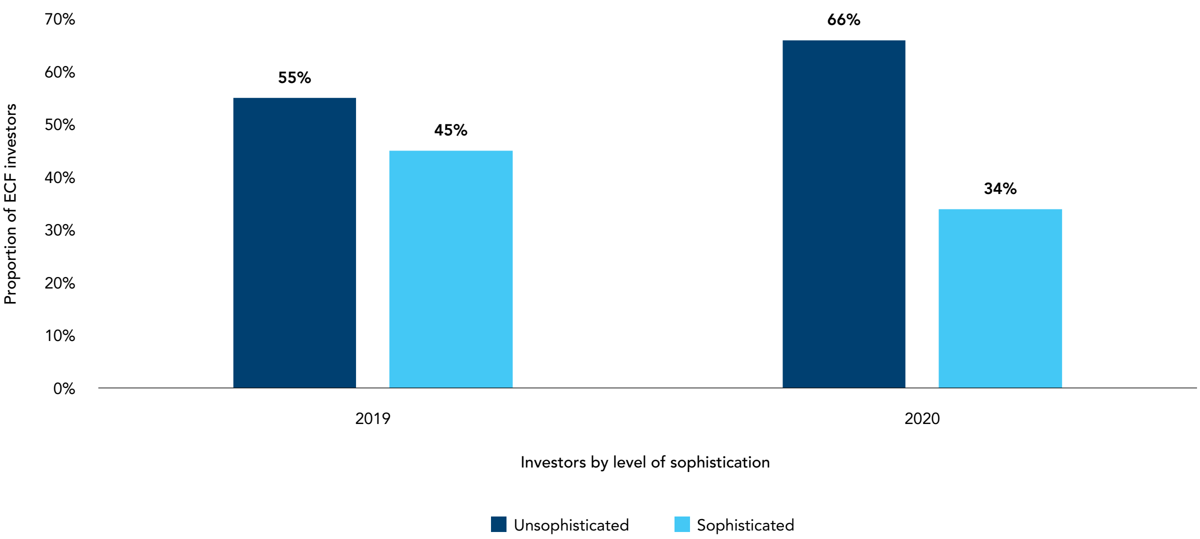
Source: SCM Annual Report 2020

Sophisticated angel investor participation in the ECF market has been strong. For angels, the attraction of this market stems from its ability to enable smaller-ticket size investments and from the availability of due diligence assessments. These traits are particularly attractive to novice angels. However, in terms of investor demographics, unsophisticated retail investors dominate these markets, with the proportion of ECF investments that these investors account for increasing from 55 percent in 2019 to 66 percent in 2020 (see Figure 15). Retail investors tend to be more risk-averse and hence the wider access to larger investee companies could have resulted in greater interest from this investor type. The shift towards more advanced funding rounds of Series A and beyond is also a reflection of greater investor risk aversion and hence the gravitation towards more established entities, with a higher possibility of exit opportunities. Given retail investors' significant degree of participation in this market, it is important to note that under the regulatory framework for ECF platforms (the *Guidelines on Recognized Markets*), clear guidance is provided to establish the manner in which ECF operators

32 That said, despite the relative flexibilities afforded to the ECF market, all campaigns on ECF platforms must still comply with SCM Guidelines on Recognized Markets.

should operate in order to protect the interests of the investors on their platform. Rules on the need to conduct due diligence on potential platform issuers, the requirement to inform investors of adverse material changes to the issuer's funding proposal, and the obligation to operate a trust account to hold investment funds to safeguard against improper use of investor monies, are covered by these guidelines.[33]

Figure 15: Lack of sophisticated investor base may hinder long-term development of ECF



Source: SCM Annual Report 2020
Note: Unsophisticated investors – retail investors, Sophisticated investors – Angel investors, High Net Worth Individuals, and Institutional investors

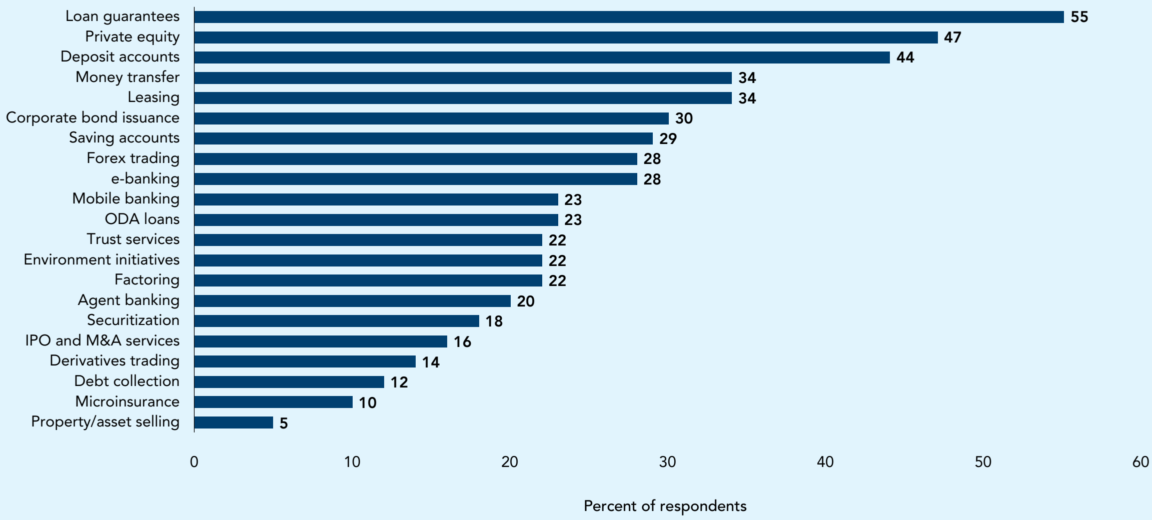
33 The main regulatory framework for capital markets in Malaysia is the 'Capital Market and Services Act 2007' (CMSA) of which the SCM is the main regulator. As such, the SCM has oversight over the registration and operation of venture capital companies (as well as venture capital management companies), alternative financing platforms such as P2P and ECF, as well as private equity players. Financial institutions such as banking entities are regulated and supervised by Bank Negara Malaysia. Effective from 1st July 2021, the SCM amended Schedules 6 and 7 of the CMSA which widened the definition of sophisticated investors to include investors with investments in capital market products such as unit trusts, private retirement savings funds, worth over RM 1 million (either individually or jointly with spouse).

BOX 3

The role of development financial institutions in accelerating early-stage finance activities

Development financial institutions (DFIs) are financial institutions established by governments and their agencies to drive the growth of key strategic sectors or to fulfill key national development mandates. DFIs can play a highly significant role in addressing market failures and financing gaps in the country and in providing counter-cyclical financing support during economic downturns and tightening credit cycles. Globally, DFIs have been established to address the financing gaps experienced by SMEs and young enterprises without a long financial history or that are otherwise deemed to be high risk by the private sector due to their participation in new, emerging industries resulting in limited industry track records and a lack of clarity regarding repayment capabilities.

The figure below represents some of the products and services that are most commonly offered by DFIs globally.



Source: World Bank, "2017 Survey of National Development Banks"
Note: Forex – Foreign Exchange, ODA – Overseas Development Assistance, IPO – Initial Public Offering, M&A – Mergers and Acquisitions.

Although DFIs should generally be structured, operated and funded in line with a particular country's economic and institutional standing to best cater to its development needs, well-functioning and efficient DFIs should have the following attributes:

1. **A well-defined mandate or mission statement.**
2. **Focus on serving segments of the economy for which the private sector is unable to cater independently in order to minimize the crowding out of private investment activities.**
3. **A management structure independent from the government to ensure good governance and transparency.**
4. **The ability to independently access different sources of financing for ongoing operational expenditure to reduce financial reliance on public sector sources.**

In particular, in countries where fiscal consolidation is particularly important for the achievement of fiscal sustainability objectives and/or where there is room for private sector financing activities to be enhanced, blended financing structures could be an ideal middle ground. Patient capital, such as concessionary finance (e.g., grants) or equity financing, may be a more suitable form of funding for start-ups at the ideation stage and working towards a MVP than debt financing, given that these firms would largely be operating at a loss for most of this period. Government agencies or DFIs can play a larger role in these structures by providing concessionary financing components, guarantees or technical assistance to motivate the greater mobilization of private sector capital to provide the equity component of these blended structures. The public-sector or quasi-public sector component in these structures would act as a risk mitigation mechanism, alleviating some risk aversion on the equity investor side and boosting appetite at the pre-seed stage.

Some examples of DFIs that have the optimal traits described above include the British Business Bank and the Business Development Bank of Canada. Additionally, other aspects of their operations that make them successful include clear mandates to distinguish their role from that of similar financial institutions in the ecosystem. They provide mentoring services and technical assistance programs that coincide with lending activities to SMEs; they have a network of local delivery partners suitable for assessing the business loan applications and granting it; and they provide loan guarantee products to the network of financial intermediaries within the funding ecosystem, rather than providing loans directly to SMEs. These risk-sharing mechanisms have resulted in the greater participation of private-sector banking institutions in this segment.

Source: National Development Financial Institutions: Trends, Crisis Response Activities, and Lessons Learned, World Bank (2021); British Business Bank (https://www.british-business-bank.co.uk/) and Business Development Bank of Canada (https://www.bdc.ca/en) and Convergence (https://www.convergence.finance/about)

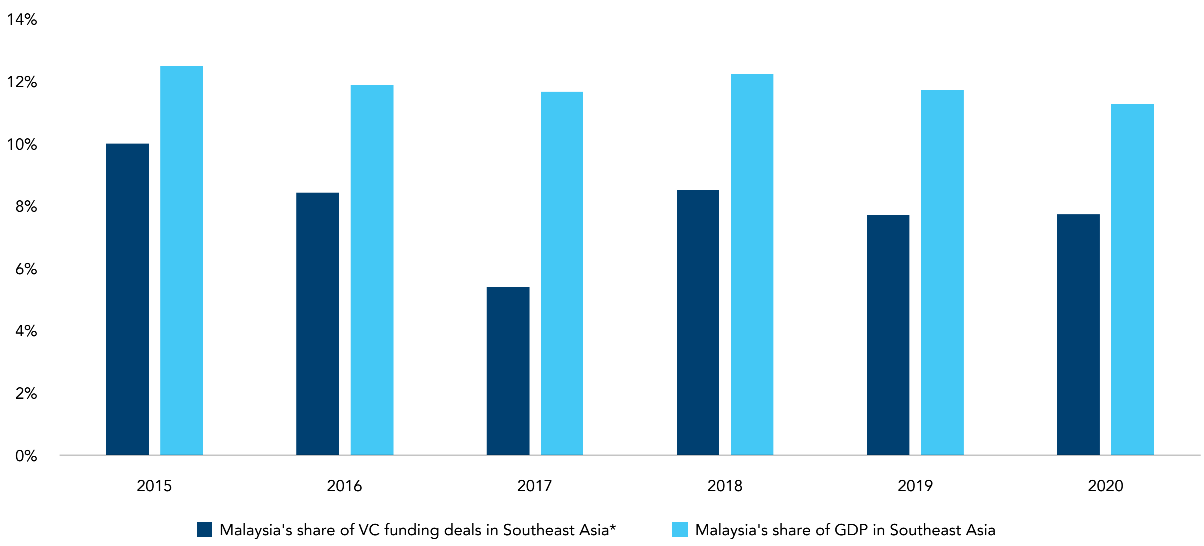
Later-stages of start-up financing

The following section provides an overview of the later stages of the start-up financing ecosystem. From the analysis of early-stage financing sources and activities, it can be seen that there is a bias towards the funding of businesses involved in more mature start-up activities, such as product testing and commercialization, leaving a gap at the earliest phase of start-up firm formation. This indicates as a start that the deal flow coming through to the later stages of the funding cycle may be suboptimal, given this initial gap. The analysis of later-stage financing enables a better understanding of the potential attractions to financing Malaysian start-up firms from the investor perspective, complemented by the subsequent exit potential of these firms.

In Malaysia, VC activity is relatively underdeveloped compared to other countries in the region. As firms progress from the product commercialization phase, VC financing typically becomes the dominant source of equity-based financing for start-ups. To assess whether this level of VC funding activities is commensurate with the level of economic development of a particular country, a comparison is made to determine the share of VC funding deals relative to the respective shares of GDP (see Figure 16). From this analysis, it is found that in proportion to its GDP share, Malaysia's VC activity is relatively low, indicating that it is performing below its potential in this respect.

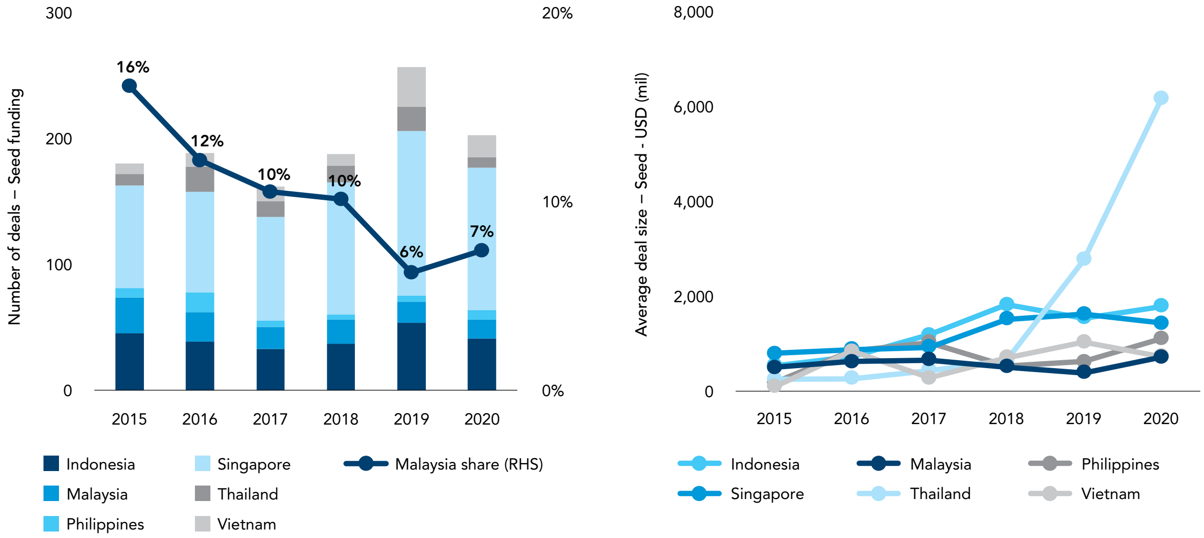
There has been a decline in Malaysia's regional dominance, with a tendency towards smaller average deal sizes in seed funding over recent years. Malaysia's share of VC-funded seed funding deals in the region has declined over the past five years, standing at a marginal 7 percent of total deals in 2020 (see Figure 17, left panel). Even in 2019, when seed funding experienced a regional boom, with notable increases in Vietnam and Thailand, Malaysia's share declined, indicating that deal flow remained stagnant. In addition, Malaysia's average deal sizes for seed funding are comparatively low relative to its regional peers, indicative of a lack of high-quality investment opportunities, as indicated by the lower valuations (see Figure 17, right panel).

Figure 16: Malaysia's VC deal proportion falls short of its level of development



Source: IMF WEO database and Pitchbook
Note: Dark blue bars = Malaysia VC deals by number of deals/Total VC number of deals in the region (*Southeast Asia sample consists of 6-country regional sample as the denominator). Light blue bars = Malaysia's nominal GDP/Total regional nominal GDP (also using the 6-country regional sample).

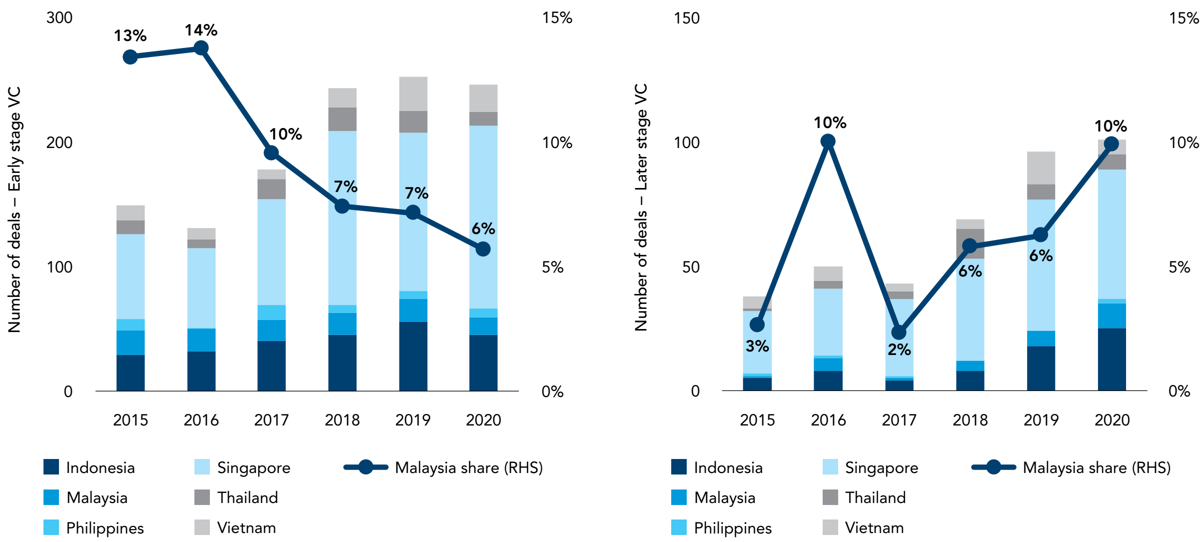
Figure 17: Seed funding in the Southeast Asian region



Source: Pitchbook and Crunchbase
Note: The trend representing Thailand in 2020 could be skewed by a lack of data availability, with the data available representing large valuations thus creating an outlier effect.

The spike in later-stage VC funding, preceded by lackluster early-stage VC activities, is another sign that there is a preference in Malaysia for more established, lower risk investments (see Figure 18). In Malaysia, there is a trend towards investor concentration in the later stages, even in Series funding rounds. Over the past five years, Malaysia's share of the number of deals in the early-stage VC rounds of Series A and B have fallen significantly, standing at a marginal 6 percent of regional share, a sharp decline from the figure of 14 percent recorded in 2016.

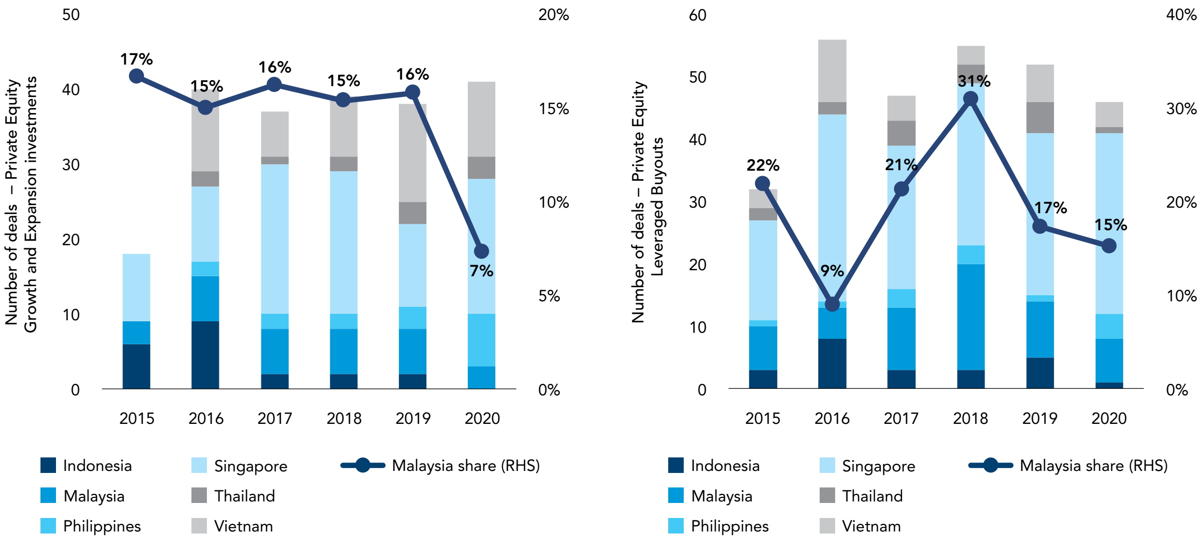
Figure 18: Two distinct trends emerge for Malaysia in the Series funding segment



Source: Pitchbook
Note: Early-stage VC defined as Series A and B rounds and Later-stage VC refers to Series C and D rounds.

Despite some Private Equity (PE) activities in the growth and expansion phase of firms in Malaysia (see Figure 19, left panel), regional investments gravitated towards the Philippines and Vietnam in 2020, displacing the stable trend in PE growth stage investments that Malaysia was able to attract in earlier years. PE activities in Malaysia are still tilted towards leveraged buyout (LBO) exits rather than growth stage investments in terms of the relative number of deals and the regional LBO deal shares (see Figure 19, right panel).

Figure 19: Private Equity activities in Malaysia more concentrated in exits



Source: Pitchbook

As the main regulator of the capital market in Malaysia, the SCM has been supportive of VC formation, establishing a solid framework and providing the necessary supervision to strengthen the industry. Regulations related to the establishment of VC funds are generally less stringent than those for asset-management houses with mutual funds. Moreover, VC companies (VCCs) and VC management companies (VCMCs) are tax transparent (pass-through entities), with incomes earned not subject to capital gains tax. However, the implementation of a range of tax incentives to encourage additional VC investment activities in Malaysia has been slow. According to the IESE Business School's Venture Capital and Private Equity Country Attractiveness Index, tax incentives and administrative burdens constrain Malaysia's performance in terms of this index and relative to peer countries.[34] The delay in the implementation of these incentives could have constrained the pace of VC investment activities over the past year, as evidenced by the stagnant number of VCCs and VCMCs in the market in Malaysia. As a result of lags in policy implementation, the domestic VC network has not developed a critical mass, with start-ups still needing to tap foreign funding sources, where VC networks are denser.

Some of the tax incentives that are in the pipeline but have yet to be gazetted include the following:

a) **Venture Capital Management Company (VCMC):** Income tax exemptions, including management fees, performance fees and income from the share of profit from investments.

b) **Venture Capital Company (VCC):** Income tax exemptions from all sources of income excluding interest on savings etc. These are to be provided for five years from the time SCM grants approval for the

34 https://blog.iese.edu/vcpeindex/malaysia/

investment. The VCC needs to invest at least 50 percent into early-stage, seed and start-up stages.

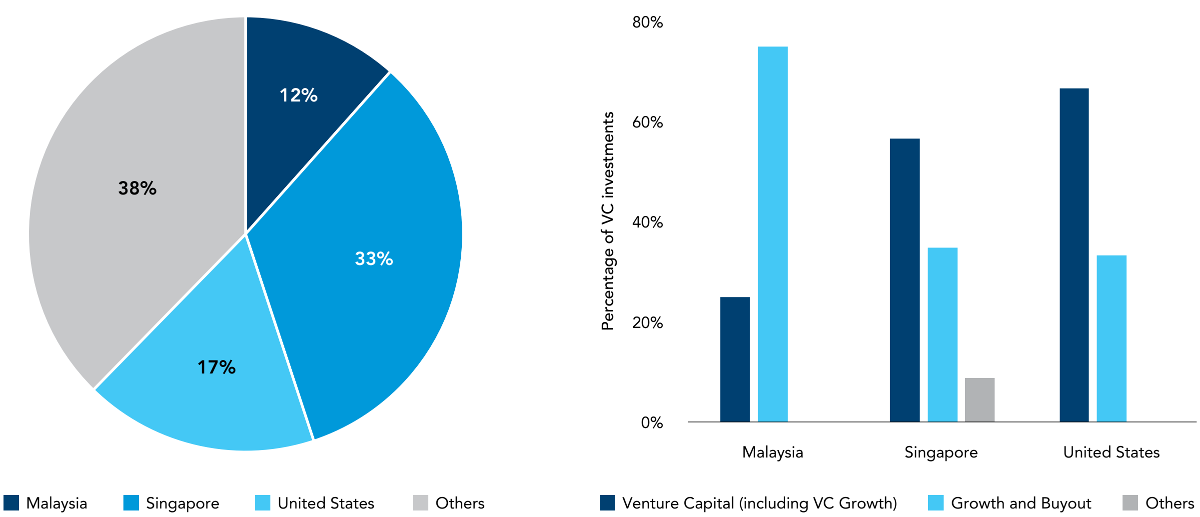
c) **Investors in VCC funds created by Venture Capital Management Companies:** Income tax exemptions for individuals and companies invested in VCC funds, capped at RM 20 million (~USD 5 million) per year.

d) **Investors in Venture Capital Companies:** Income tax exemptions for individuals and companies invested in VC funds equivalent to investment amount.

In addition to the lack of tax incentives applied to stimulate the growth of the VC sector, there are other areas in the prevailing regulatory framework where more flexibility could be granted in order to enhance onshore VC activities. Firstly, it is difficult to manage more than one fund without incurring additional costs and having to complete an additional set of administrative processes. Thus, investment managers who intend to set up to a new fund mandate or specific fund in a new vertical are required to establish a new legal entity to do this. Additionally, some funds are also incorporated in the Cayman's for tax efficiency purposes. With the lack of a framework to re-shore funds in order to mobilize them for onshore investment purposes, this could greatly restrict the flexibility in investment portfolio re-allocations when the need or opportunity arises. Although there is no difference in the legal treatment of onshore or offshore funds, the ability to re-shore would create additional flexibility for funds, particularly those that are more geographically diverse in their investments.

The VC funding market in Malaysia is dominated by foreign investors, with a tendency to favor businesses in the growth and buy-out stages of the firm life-cycle. The VC market in any given country is dependent on the attractiveness of the deal flow to an international market and on potential investor returns. The majority of investor sources (88 percent) for VC funding in Malaysia comes from external sources. The left panel of Figure 20 shows that the top three source countries for VC investments in Malaysia are Singapore (33 percent); the United States (17 percent); and Malaysia (12 percent). It should be noted that foreign investors are not constrained by regulations from investing in local start-ups, except in a few specific sectors, including education and healthcare. Domestically, investor sources tend to veer towards the later-stage VC rounds of growth and buyout funds (see Figure 20, right panel), which indicates a predominance towards advanced-stage investments that are relatively low risk due to the investee's established track record.

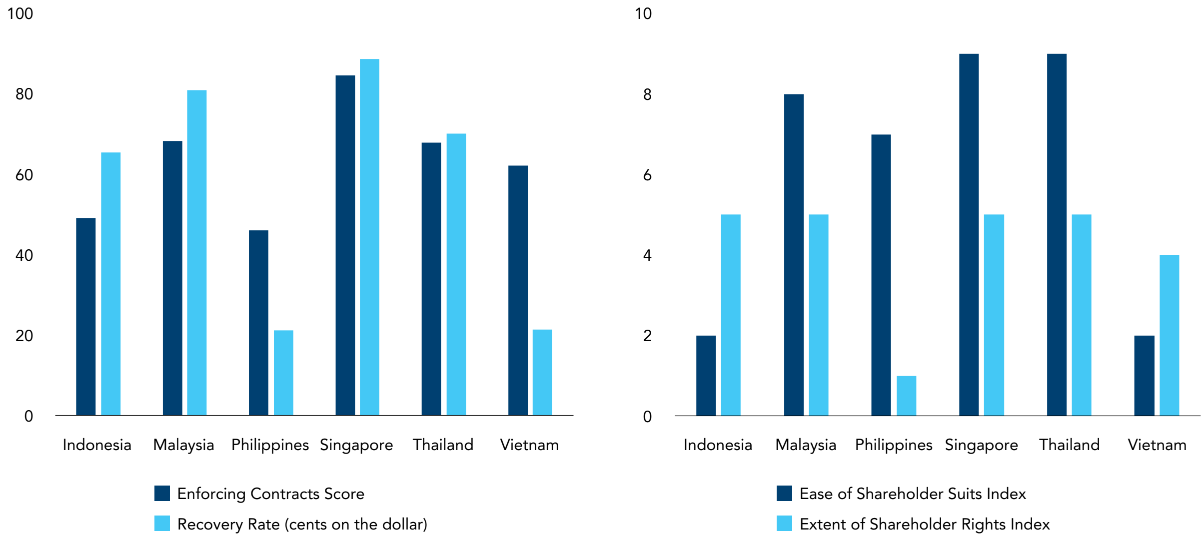
Figure 20: Source of Malaysia's VC investments by asset manager headquarters



Source: Emerging Markets Private Equity Association (EMPEA)

From stakeholder consultations, it was found that international VC investors still consider Malaysia to be an attractive destination. From a regional perspective, Malaysia stands out as an established market, with good governance and rule of law (see Figure 21). Based on the interviews with stakeholders, it was found that Malaysia's strong technology-absorption potential and the relatively low costs of doing business are also perceived as key attractions for investors. Although it is considered an attractive destination, the relative lack of investible deals in Malaysia compared to its regional peers, including Indonesia and Vietnam, has dampened activity momentum in recent years. This may be attributed to the earlier stage of the financing lifecycle, with the establishment of new start-ups possibly slowing due to the lack of financing avenues at the pre-MVP stage, thus impacting the subsequent deal flow.

Figure 21: Malaysia's regional standing in terms of investor and shareholder protection



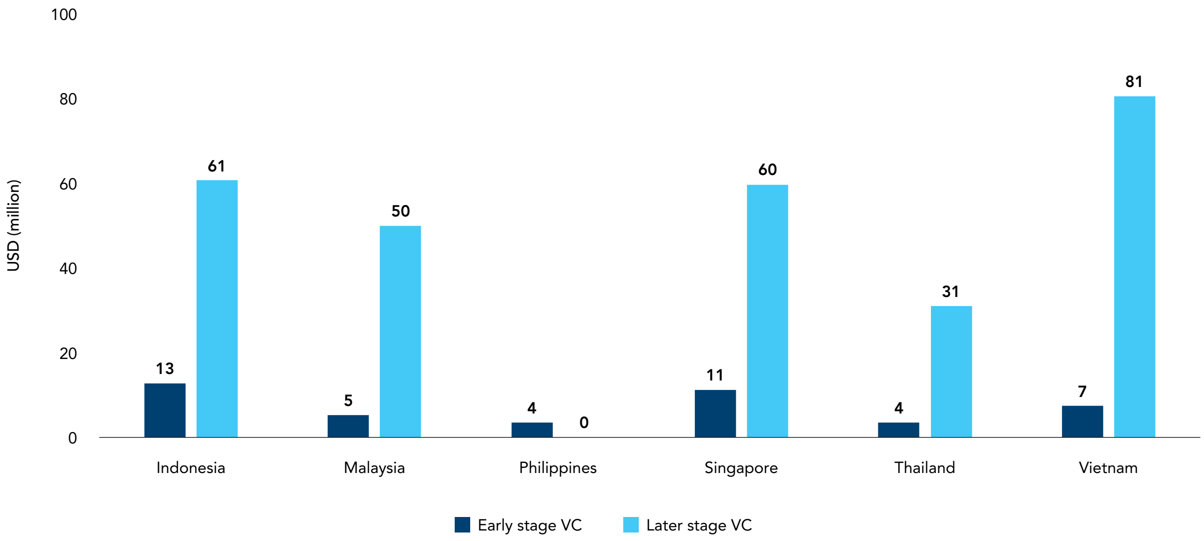
Source: World Bank, Doing Business 2020

Another important factor is based on Malaysia's geographical characteristics. Malaysia's market size means that its total addressable market (TAM) is small. Combined with the lack of deals, this could be constraining potential funding that would enable Malaysian start-ups to expand. One widely cited example of a home-grown start-up that has successfully created regional scalability and that has sparked significant international investor interest in its growth stage is Carsome.[35] As of July 2021, Carsome became Malaysia's first start-up technology unicorn.

The lack of potential business scalability with Malaysian start-ups could explain the lower average VC deal size in Malaysia compared to that in regional peer countries. Although in Malaysia most VC deals are externally funded and tend to skew towards later-stage funding, average deal sizes are comparatively lower in value compared to that of its regional peers (see Figure 22). This may suggest that these investments are not of the same caliber as some in the high-growth VC markets, such as Vietnam and Indonesia, being a function of technology levels, innovation and exit attractiveness. From the stakeholder consultations conducted, it was found that a large proportion of start-ups lack the vision to become a regional player, potentially limiting their business scalability.

35 Carsome is a used car e-commerce platform with a presence in Malaysia, Singapore, Thailand and Indonesia.

Figure 22: Average funding sizes for VC deals in the region in 2019



Source: Crunchbase

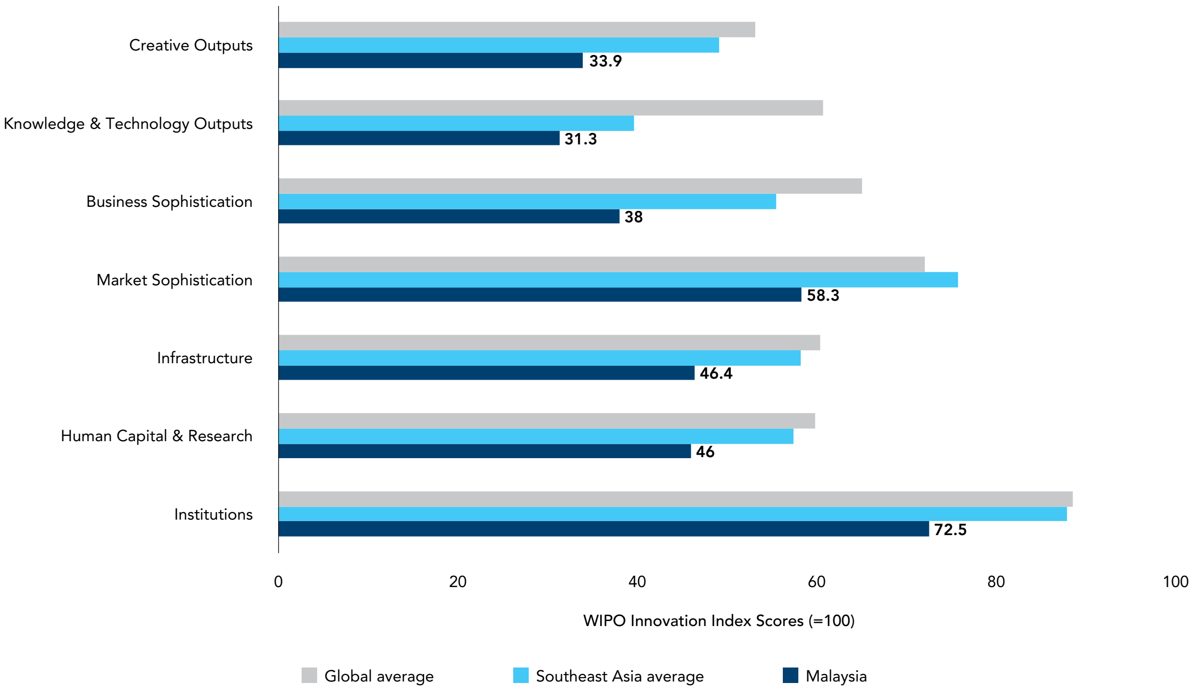
The limited level of knowledge creation in Malaysia could further constrain the deal flow required to facilitate the emergence of a vibrant VC industry. Findings from the World Intellectual Property Organization's (WIPO) Innovation Index (2020) confirms the impression that Malaysia's lack of innovative activity may be making it a less attractive destination for potential funders. With Southeast Asia as a whole lagging behind global benchmarks in terms of output indicators (i.e., creative outputs and knowledge and technology outputs), Malaysia's score is significantly lower than the average for the region (see Figure 23). This is indicative of the lack of pipeline projects that might attract international or even domestic high-growth investors. Malaysia scored particularly poorly in terms of *knowledge creation* (score of 12.1),[36] weighed down by its low rate of patent creation and poor score for *online creativity* (15.9), due to the weak presence of homegrown apps and top-level domains originating from Malaysia. In terms of Malaysia's input components, its lowest-scoring pillar is for *business sophistication* (38.0), with the weakest link being its performance in terms of gross expenditure on research and development (GERD) indicators, both in terms of business enterprises' total investments in R&D in proportion to GDP and in terms of investments in R&D by foreign entities, also in proportion to GDP. These factors indicate that Malaysia still has a significant way to facilitate the emergence of a fully digitally-driven, innovative economy.

As demonstrated in the World Bank report on *Assessing the Effectiveness of Public Research Institutions*, public research institutions (PRIs) and universities can play an integral role in fostering innovation. These institutions could potentially play a key role in accelerating innovation initiatives to close the gap. The government could play an important role here by formulating public policy strategies to better facilitate this knowledge transfer and thus to better leverage the academia-government-industry relationship (the *triple helix*). Although the government has implemented a number of significant measures to strengthen commercialization activities, this area is still a weak-point in the innovation ecosystem, with successful technology transfer and the commercialization of public research organizations and research centers remaining a relatively rare occurrence. In the abovementioned study, only a few PRIs reported the successful commercialization of research outputs

36 All WIPO Innovation Index scores are normalized to a maximum score of 100.

through licensing. Inconsistent funding flows, ineffective implementation of incentives, and cultural gaps between industry and the research entities were some of the most commonly cited constraints on knowledge and technology transfers.

Figure 23: Malaysia's innovation indicators do not stack up against the global and regional benchmarks



Source: WIPO Innovation Index 2020

The three most prominent VC-funded verticals in Malaysia in 2020 were i) technology, media and telecommunications (TMT); ii) e-commerce; and iii) FinTech. Table 4 shows the top 10 VC-backed verticals in 2020 at a global scale, and for the six regional economies discussed in this study. The values in the grid show the share of deals for each specific verticals in proportion to the total deals for the selected location. Benchmarking against global trends, some interesting regional and country-specific characteristics can be seen. At the global level, the top 10 verticals account for 59 percent of total deals, a lower proportion than at the regional level, with the top 10 verticals accounting for 63 percent of total deals in Singapore and 81 percent in the Philippines and Thailand. Malaysia places in the middle of this range, at 71 percent, with its largest deal concentration in the TMT vertical, which accounts for 17 percent of total deals. These figures show that Malaysia has a higher degree of concentration in fewer verticals compared to the global benchmark (although a lower degree compared to the regional benchmark). Southeast Asia has a higher proportion of deals in the e-commerce, FinTech and mobile verticals than the global average, but a lower share of deals in artificial intelligence and SaaS verticals. Finally, a few verticals rank in the global top 10, but not in the regional top 10, these being HealthTech, life sciences and manufacturing. This could serve as a gauge as to which verticals carry the greatest growth potential for the region going forward. In a survey conducted by EMPEA (2020), it was found that 15 percent of investors were interested in opportunities in HealthTech.

Table 4: A representation of the top 10 verticals globally and around the region in 2020 by deal count

Vertical (%)	Global	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
AgTech			3				
Artificial Intelligence & Machine Learning	8		3	4	8		
Big Data	4				4		
Cryptocurrency/ Blockchain					7	4	
Digital Health							5
E-Commerce	4	10	11	13	3	9	14
EdTech		4		4		5	
FinTech	5	11	11	19	15	9	5
FoodTech		4	4		3	5	7
HealthTech	4						
HR Tech				4			5
Industrials		5					
Life Sciences	5						
LOHAS & Wellness					3		5
Manufacturing	3						
Mobile	6	13	8	11	5	16	13
Mobile Commerce		3		4			
Mobility Tech						5	
Real Estate Technology			4	6		5	8
SaaS	8	4	6	6	8	7	6
Supply Chain Tech		3	4				
TMT	12	12	17	11	9	15	12

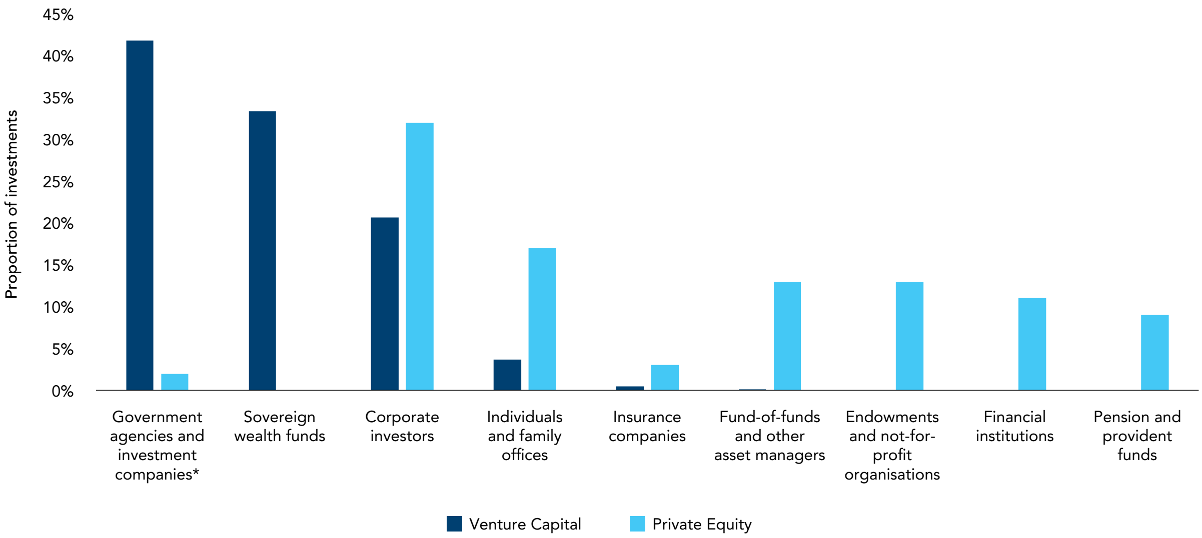
Source: Pitchbook

The composition of the VC investor base in Malaysia also provides insights into the tendency for financing to flow to more established, later-stage firms. In Malaysia, there is a significant public sector component in the VC-backed funding of start-up firms in Malaysia (see Figure 24). In 2020, 41.8 percent of VC funding in Malaysia originated from government agencies and quasi-government investment companies, while 33.4 percent came from sovereign wealth funds. However, the significant role of governments in VC markets is not unique to Malaysia. In Europe, the proportion of total VC funds raised from publicly-sourced funding increased from 14 percent in 2008 to 35 percent in 2014.[37] This is mainly attributed to the fact that governments may be motivated by underlying development objectives to support risk capital financing activities, rather than with an exclusive focus on potential returns on capital. Moreover, a significant proportion of institutional investors are constrained by stricter risk management guidelines than the pure private sector VC operators,

37 Brigl, M. and Liechtenstein, H. (2015) *A Rise in Good Deals, but an Investor Drought*. Boston Consulting Group and IESE Business School

accounting for their marginal participation in VC activities. As such, a large proportion of these investors, by virtue of their type of operations, will invest primarily in more established entities. The seemingly marginal participation of pension funds in VC investment activities is attributed to the practice of outsourcing these activities to private sector VC players with credible and longstanding track records. During the stakeholder consultations, participants expressed the view that despite the very high level of public sector participation in this area, this does not crowd out investments, but rather fills a financing gap that is not currently addressed by private sector players. With the Malaysian government's current fiscal constraints, measures to crowd in private sector involvement could create greater dynamism. Effective public-private collaborations could provide a middle ground in the establishment of a dynamic risk-sharing ecosystem that is able to crowd-in private sector investment.

Figure 24: Investor composition in VC and PE-based funding in Malaysia



Source: SCM Annual Report 2020
Note: *Includes Ministerial investment companies (e.g., Minister of Finance Incorporated), government agencies, statutory bodies and government-linked investment companies established for the purpose of managing investments of public funds (e.g., Permodalan Nasional Berhad, Ekuinas).

An assessment of the investor composition of VC and PE deals enables the identification of funding segments that could be greatly expanded to increase private-sector involvement in VC. One of the starkest trends to emerge from an examination of the investor composition of VC and PE deals in the domestic market is the marginal presence of FoF investment structures within VC funding. The attraction of FoF structures lies in their incentive structure, which facilitates public-private sector collaboration, with the public sector providing the funding source and the private sector providing portfolio allocation services. This structure creates a better incentive framework for investors, who are rewarded on the basis of the performance of the investments to which they allocate funds, as opposed to the salary structure of public-sector VC entities, which may distort the alignment of motivations. A comparison with PE investors shows a more significant concentration of FoF in that space. Thus, a shift of FoF funding focus to VCs could potentially be a key turning point. This again points to the significance of the government's commitment of funds to a value of RM 1.2 billion (~USD 292 million) through the DPN FoF program, which is a welcome boost to the financing ecosystem.

Another potential avenue to unleash investor funds could be through greater corporate venture capital (CVC) participation in VC funding activities. CVCs mostly emerge as investment arms of prominent corporations, established to facilitate the achievement of corporate strategic targets. Analysis of the top CVCs in the region by their number of investments shows some of the dominant characteristics of well-functioning CVCs (see Table 5). These include:

a) CVCs tend to invest in areas or verticals that benefit from their strategic focus, such as technology foundations.

b) CVCs invest in several parts of the financing ecosystem and are not concentrated on businesses at a particular level of maturity, with an overarching focus on technology.

Table 5: Established CVCs in the Southeast Asian region (excluding Malaysia) and areas of focus

Country	CVC arm	Corporate affiliation	Founding year	Geographical focus	Stage of financing concentration	Sector concentration
Singapore	Singtel Innov8	Singtel Group	2010	Singapore, USA, China, Australia, Israel	Venture capital	Technology
	SPH Ventures	Singapore Press Holdings	2014	Not specified	Early-stage venture, Late-stage venture	Consumer Tech and Media
Thailand	SCB 10X	Siam Commercial Bank	2020	Global	Early-stage venture, Late-stage venture	Technology
	InVent	InTouch Holdings PCL	2012	Thailand and abroad (not specified in detail)	Early-stage venture, Late-stage venture	ICT-related investments
	Beacon Venture Capital	KASIKORNBANK	2017	Southeast Asia	Seed, Early-stage venture, Late-stage venture	Technology
	Krungsri Finnovate	Krungsri Group	2017	Not specified	Early-stage venture, Late-stage venture	Technology with emphasis on FinTech
Indonesia	MDI Ventures	Telkom Indonesia	2016	Southeast (focus), global consideration	Seed, Early-stage venture, Late-stage venture	Technology
	Mandiri Capital Indonesia (MCI)	Bank Mandiri	2016	Southeast Asia	Seed, Early-stage venture	FinTech
Philippines	Kickstart Ventures	Globe Telecom	2012	Southeast Asia, United States, Israel	Seed, Early-stage venture, Late-stage venture	Technology

Source: Crunchbase and various company websites. This list was created by filtering the largest number of investments by CVCs in Southeast Asia in the Crunchbase database as at April 2021.

In Malaysia, large companies have an untapped VC potential. Like other CVCs around the region, large corporations, especially listed ones, are interested in increasing their stake in companies that provide strategic benefits to their business and/or that have a strong technology focus. Moreover, their driving motivation is to identify investments that had strong potential for growth and future returns. CVCs in Malaysia are a relatively new construct, with the most established of these entities only in operation for the past few years or so (see Table 6). Examples include Petronas Ventures (a special CVC arm of Petronas Berhad), Sunway Group Bhd's Sun SEA Capital, and AirAsia Digital (previously known as RedBeat Venture). Although there is no official framework specific to the establishment of CVCs, most of them are structured as investment holding companies (IHC), with the regulatory framework for these common investment entities sufficing. Alternatively, corporate entities could request approval to be recognized as a VCMC by the SCM. However, this component of the financing ecosystem has been left to develop organically, with no specific incentives to encourage more involvement from this segment as yet.

Table 6: Established CVCs in Malaysia and areas of focus

CVC arm	Corporate affiliation	Founding year	Geographical focus	Stage of financing concentration	Sector concentration	Notable investments
Sun SEA Capital	Sunway Group Bhd	2018	Southeast Asia, Hong Kong, Taiwan, China, Korea, Japan	Seed to Series B, with a focus on pre-Series A and Series A	Primary focus in FinTech, HealthTech, EdTech, E-Commerce and New Retail	The Lorry (logistics), Intrepid (E-commerce), Wise AI (Regulatory Tech)
Petronas Ventures	Petroliam Nasional Berhad	2019	Asia, United States and Europe	Not specified	Technology, Energy and Chemicals verticals such as - Robotics and automation, Asset Intelligence, Smart Maintenance, Renewables, Smart Grid, Electronic Chemicals, Lubricants	Braintree Technologies (Agrotech), Sols Energy (Alternative Energy), Urbint (Artificial Intelligence for Utilities uses)
AirAsia Digital	AirAsia Group Berhad	2018	Southeast Asia	Not specified, but there is focus on growing young firms. RedBeat Academy was set up in 2020, in conjunction with Google.	Platforms, Logistics and e-commerce, Financial Services	AirAsia.com (platform), BigPay (financial services), teleport (logistics)

Source: Various company websites.

That said, CVCs may have characteristics that constrain their commitment to and their level of involvement in VC investment activities. Firstly, CVC legacy management may hinder new investment strategies, as newer ventures may be deemed excessively high-risk or not in line with their corporate mission and vision. With CVCs accountable to corporate boards and senior management who may not be well-versed in these investment activities, this tends to lead to additional documentation requirements and the need for additional internal clearances in order to make the investments. As a result, the amount of investments may be sub-optimal or shift frequently over time to align with corporate objectives. In practice, CVCs rarely invest in the seed funding stage due to this higher level of risk aversion.

Finally, venture debt financing is mostly available only to well-established firms that have successfully graduated from pre-seed or seed funding.[38] Malaysia's most-established venture debt institution is Malaysia Debt Ventures (MDV), a subsidiary of MoF (Inc.). MDV is focused on investments during the more mature funding phases, including to facilitate the growth and expansion of incumbent businesses. Specifically, it targets companies that have already managed to acquire VC funding and that have a focus on technology segments such as advanced technology, ICT, green technology, and biotechnology. A debt instrument is essentially a more sophisticated funding instrument for firms, with these instruments requiring collateral, financing covenants

38 http://www.mdv.com.my/v3/venture-debt-2/

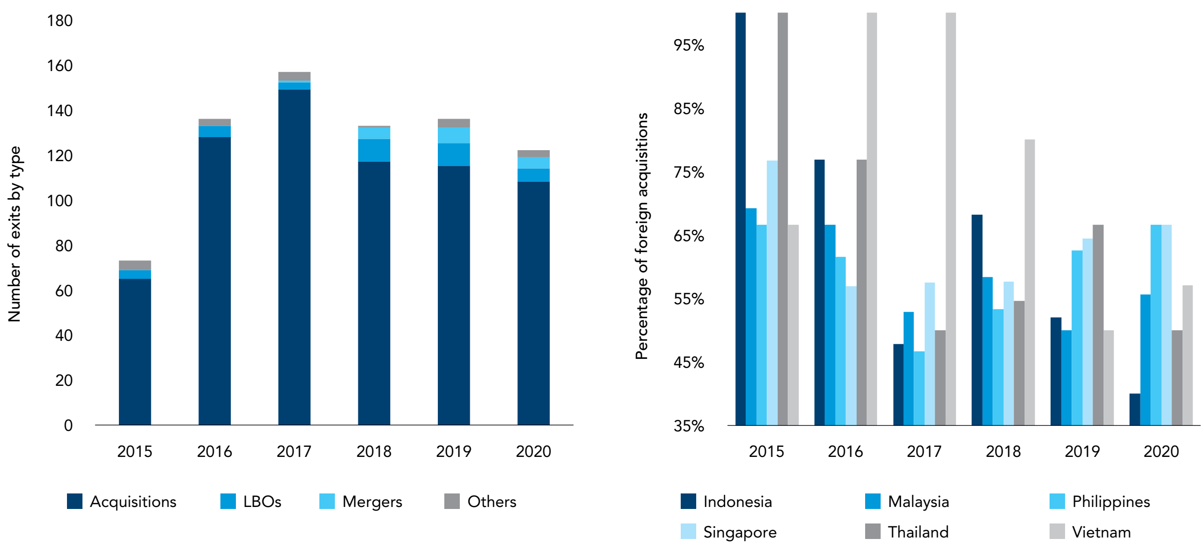
and warrants. Firms that opt for this type of financing may want to diversify their capital structures away from a purely equity-based concentration or they may find venture debt a more viable bridging finance option between equity funding rounds than traditional bank loans due to their tech-based, riskier business models. Thus, venture debt helps to round up the debt-based financing component of the more advanced phase of the financing ecosystem for start-ups, complementing later-stage Series funding.

Exit opportunities in the start-up financing ecosystem

Exit strategies and opportunities are a key consideration in investor decision-making. Exit strategies and opportunities can be seen as a gauge of investment liquidity conditions and the ability to return investment proceeds to the VC fund and its investors. Exit strategies and opportunities for investors are a key consideration in investor decision-making, but does not rank highly as a deterrent for LPs investing in Southeast Asia. According to EMPEA's 2020 survey of investors, only 15 percent of LP respondents indicated that weak exit environments were a key impediment on investing in the region. By contrast, 42 percent of investors in Africa and 24 percent of investors in the Middle East identified this as a key impediment.

In Malaysia and throughout the region, acquisitions are the most common form of exits (see Figure 25, left panel), rather than IPOs, which are generally perceived as the benchmark for venture-backed start-up exits, potentially creating the most value for investors. The most common form of exit is through share-purchase deals, possibly due to the regulatory ease of this mechanism compared to that for a complete asset takeover deal, which may require more documentation and greater costs, especially for the purchaser.

Figure 25: Acquisitions across the region by type

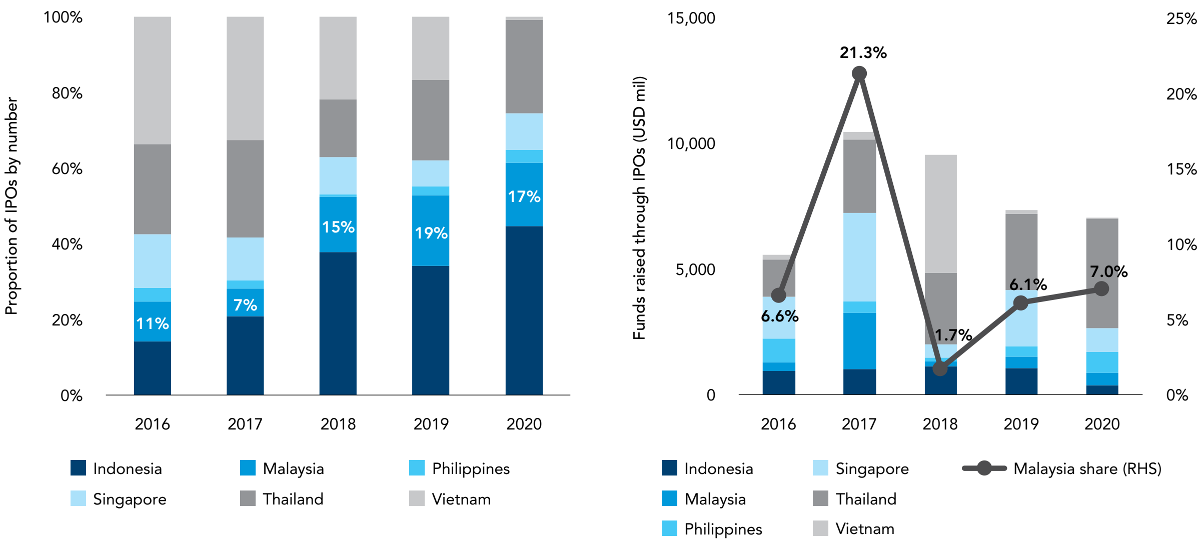


Source: Crunchbase

Although M&A activities declined in 2020 due to uncertainties created by the pandemic, 2021's performance broke new ground. Global M&A volumes reached a historical high in 2021 reaching USD 5 trillion in value[39], mostly driven by a prolonged period of loose liquidity conditions and a bull-run in the equity markets. Moreover, this is complemented by some deals backlogged from the 2020 pipeline, with companies actively seeking acquirees that could strengthen their business performance in the context of lower valuations. As such, these acquirers will face greater competition from private equity firms, as assets that are undervalued due to the pandemic shock will create more buyout opportunities. In an Ernst and Young (EY) Global Capital Confidence Barometer Survey released in March 2021, 89 percent of senior executives indicated that cross-border acquisitions would be part of their business strategy over the next 12 months, with Singapore and Thailand as the top investment destinations in Southeast Asia. Moreover, the companies surveyed also concurred that there would be greater competition for assets from PE firms as the market picks up and valuation multiples become more attractive and firms indicate increasing distress.

While the number of regional IPO deals declined in 2020, market capitalization actually increased by 16 percent on the back of listings of large-cap companies with attractive valuations. While Malaysia's share of IPOs in the region has been relatively stable over the past few years (see Figure 26, left panel), it lags behind the region in terms of value of funds raised (see Figure 26, right panel). In 2020, Malaysia raised USD 490 million in funding through IPO listings, with this value boosted substantially by the much-anticipated listing of the international home improvement chain, Mr DIY Group (M) Bhd, which raised USD 362 million and which was ranked as the fifth largest IPO in Southeast Asia in 2020. Thailand recorded the best performance in the region in terms of funds raised, accounting for more than 62 percent of total funding. This performance was also driven by a small number of large listings, with the listing of Central Retail Corporation Public Corporation Public Company Limited (USD 1.77 billion) and SCG Packaging Public Company Limited (USD 1.27 billion) being the first and second largest IPOs in the region in 2020 respectively. These companies displayed a high degree of resilience during the pandemic and hence were able to fetch good valuations. Thailand is very proactive in terms of measures to liberalize and deepen capital markets, with regulations relating to the listing of foreign firms expected to be loosened and the expected establishment of a SME bourse in 2022.

Figure 26: IPO activities around the region



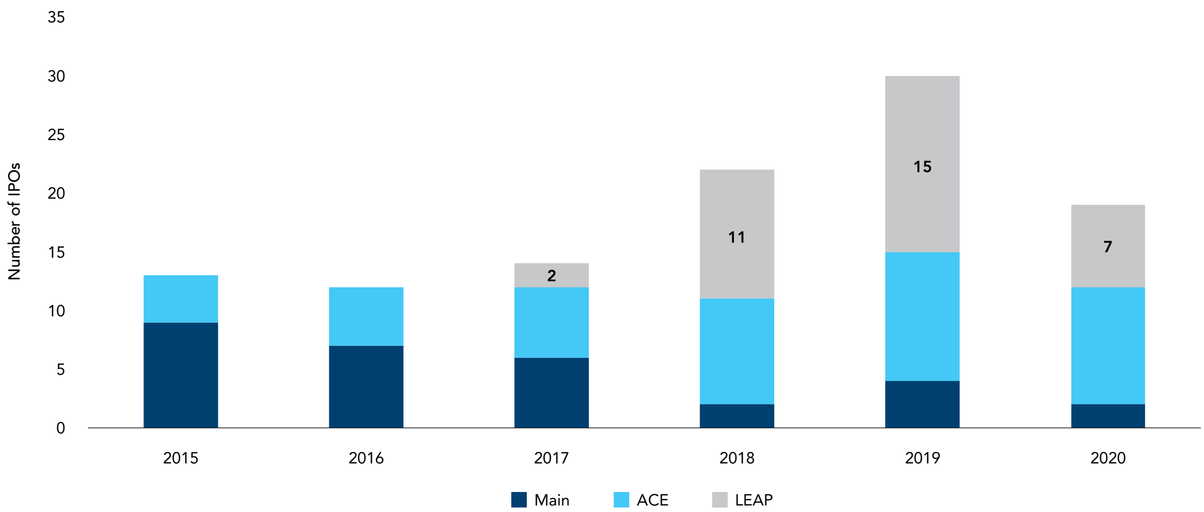
Source: Deloitte Southeast Asia Capital Market, 2020

39 https://www.reuters.com/markets/us/global-ma-volumes-hit-record-high-2021-breach-5-trillion-first-time-2021-12-31/

Malaysia has established three markets for company listing activities, these being the Main Market; the ACE (Access, Certainty, Efficiency) Market;[40] and the LEAP (Leading Entrepreneur Accelerator Platform) Market. The prime differences between the three relates to the type of companies to which they cater to and to the investors permitted to participate in the respective markets. The Main Market caters to large, well-established firms that meet minimum profit track record and/or market capitalization requirements. This market is open to all retail investors. Although quantitative measures related to minimum profit and operating track record requirements do not apply for the ACE and LEAP markets, there are a number of qualitative measures relating to sponsorship arrangements, financial positions and liquidity measures, and safeguards on management continuity. The rules regarding these are different in each of these two markets. ACE market listings are required to adhere to more stringent requirements in these areas than are LEAP market listings. The other main difference between the ACE and the LEAP markets is that the ACE market, like the Main Market, is open to the public, while LEAP is restricted to sophisticated investors, as defined by the SCM.

In Malaysia, the establishment of the Leading Entrepreneur Accelerator Platform (LEAP) in 2017 has been fraught with challenges. Although the use of this platform as an exit strategy has gained some traction (see Figure 27), a number of challenges that impact its efficacy as an accessible bourse for small, growing enterprises must be overcome to ensure its optimal operationalization. Firstly, listing expenses for LEAP could range from 8-42 percent of the total value of funds raised.[41] The fees imposed by consultants and investment banks already pose significant financial constraints on many small companies, so this would be neither an attractive nor viable option for them. Secondly, there is currently no transfer framework to enable companies listed on LEAP to graduate to ACE. As a result, companies already listed on LEAP that intend to list on ACE would need to conduct a separate IPO exercise, issuing new disclosures and prospectus, with all the additional costs associated with this process. In recent updates from Bursa, the regulator has stated that it is exploring either a time-based or performance-based benchmark to assess if a LEAP start-up should be able to graduate to more advanced bourses. The most recent amendments to the CMSA, effective from July 1, 2021, will consolidate both the ACE and LEAP markets under a single regulator, Bursa Malaysia, as opposed to the ACE market being under the oversight and supervision of the SCM, as was the case prior to the amendment.

Figure 27: IPO listings by Bourse in Malaysia



Source: Bursa Malaysia

40 The ACE Market was formerly known as the MESDAQ (Malaysian Exchange of Securities Dealing and Automated Quotation) market. ACE is a sponsor-driven market, as defined by Bursa's eligibility criteria, whilst LEAP is an adviser-driven market for emerging SMEs.
41 https://www.theedgemarkets.com/article/finance-not-such-great-leap-forward

This measure should accelerate the establishment of a transfer framework between the two markets. Thirdly, the LEAP market is also restricted to sophisticated investors (high net-worth individuals or entities), which significantly limits liquidity in the market. As a result, a number of companies have delisted from the bourse. Finally, the 12-month moratorium on founders' exiting from LEAP may also limit the ability of promoters to generate sizeable exit returns.

In Malaysia, some companies have elected to list on exchanges in other countries, such as Australia's ASX and the US's Nasdaq, due to less restrictive listing requirements on these bourses. To be listed on Malaysia's Main Market, companies must pass a profit test (unlike for listing on the ACE market). This requires a company to demonstrate uninterrupted profit after tax of at least RM 20 million (~USD 5 million) and minimum RM 6 million (~USD1.2 million) profit after tax for 3-5 full financial years. The prerequisites to list on the Australian Securities Exchange (ASX)[42] are less restrictive, with companies not required to achieve specific profit milestones, so long as they can pass either a profit or an asset test. Post-listing, the start-up needs to show either of the following:

- **Profit test:** AUD 1 million (~USD 770 K) aggregate profit over the past three years;
- **Asset test:** AUD 4 million (~USD 3 million) in net tangible assets or AUD 15 million (~USD 11.6 million) market capitalization.

For listing on the US Nasdaq,[43] start-ups need to meet at least one of the following financial benchmarks:

- **Earnings:** At least USD 11 million for the two past years and USD 2.2 million per year over the past two years;
- **Capitalization and cashflow:** At least USD27.5 million cashflow in aggregate over the past three years and market capitalization of at least USD 550 million during the previous 12 months;
- **Capitalization with revenue:** At least USD 850 million market capitalization over the past 12 months and over USD 90 million of revenue;
- **Assets with equity:** USD 80 million in assets and USD 55 million in shareholders' equity.

Sophisticated investors' greater participation in the ECF could add to its sustainability by injecting greater liquidity, with a clearer path to successful exits through trading activities. To date, the exit rate for ECF-backed entities is under 10 percent.[44] Some notable exits include the first in 2019, involving SkolaFund (a tertiary education fundraising platform), through an acquisition; and MyCash Online (e-marketplace), through a buyout by VC firm, 500 Start-Ups. Despite the SCM releasing guidelines that permit individual ECF platforms to establish secondary trading platforms, this measure has as yet gained little market traction, mainly due to its recent promulgation, with anecdotal evidence that the establishment of such marketplace structures is being discussed by the regulator and stakeholders. The most appropriate trading configuration for this purpose may not take the form of a traditional stock market bourse, but could also be constructed as an internal bulletin board similar to the Seedrs model in the UK, or it could involve bidding through an auction. Whatever the form these secondary markets take, it will be imperative for a critical mass of issuers and investors to be established on the platforms in order for sufficient liquidity to be achieved for active trading.

42 https://www.asx.com.au/documents/resources/00080_Listing-with-ASX_Brochure_Dec-2016_07_final.pdf
43 https://listingcenter.nasdaq.com/assets/initialguide.pdf
44 https://www.theedgemarkets.com/article/investing-ecf-growth-story

The lack of market momentum for the establishment of secondary trading platforms could act as a greater bottleneck than any regulatory challenges. Both ECF and P2P operators are already approved as recognized markets under the SCM's framework. This effectively allows for the buying and selling of capital market products (i.e., unlisted securities in start-ups raising money through ECF or investment notes by P2P issuers). Thus, the secondary market feature is an extension of the existing approval already provided to the platforms, with a 'recognized market' being covered by less stringent regulations than those imposed on 'approved markets' such as Bursa Malaysia, which faces a more stringent set of regulations. Moreover, considering that the existing SCM's guidelines for the secondary market are drafted in a principles-based manner rather than being conditions-based, it implies that the SCM can afford some flexibility and discretion to ECF platforms. SCM's approach as the regulator in this instance is to impose the obligations on the ECF operator to ensure compliance commensurate with the nature, operations and risks posed by the operator. Instead, some regulatory flexibility could be provided to these operators in the initial stages, with valid justification, in order to keep these operations in-house, based on the relevant platform's current market size and presence.

CHAPTER 3

Policy Recommendations

The importance of this study is further reinforced by the developments brought on by the COVID-19 pandemic. With the impacts of the pandemic, a significant proportion of Malaysia's population have lost their livelihoods, with the government facing additional fiscal constraints due to expenditure on the pandemic response and a decline in revenues. In this context, the government must urgently implement measures to reignite growth. The creation of a conducive environment for the establishment of productive businesses is vital for the achievement of inclusive economic development, both through the role this plays in creating jobs, sustaining livelihoods, and reducing poverty, and in fostering innovation and competition in the economy. Thus, ensuring the emergence of a robust entrepreneurial ecosystem that encourages business creation is of great significance for the achievement of sustainable economic development.

There is no better time than now for the government to implement measures to leverage the dynamism of the private sector to play a larger part in the financing ecosystem, particularly given its constrained financial space. Policymakers could consider opportunities to establish hybrid financing structures, especially those with risk-sharing conditions and market-oriented allocations of funding. In a context in which any allocated budget needs to generate optimal positive impacts, policymakers should consider a thorough assessment and re-examination of non-tax incentives and regulations that impede the entrepreneurship ecosystem as a means to close funding gaps. They may also consider the provision of staggered tax incentives, in order to space-out the necessary government expenditure.

In addition to short-term and mid-term issues relating to constraints on the government's fiscal space, the establishment of an enabling ecosystem to stimulate the development of innovative and scalable businesses is also vital for Malaysia's achievement of long-term sustainable, inclusive growth. Surveyed stakeholders have frequently alluded to a shortage of attractive deal flows in Malaysia, alluding to the narrow scope of business scalability due to concentration on the domestic market and to the relatively low level of technological innovation. Thus, measures to establish an innovation-led entrepreneurial landscape are also vital to creating a conducive financing ecosystem. The World Bank's *Malaysia's Digital Economy* report (2018) identified a number of factors that may result in the perceived lack of attractive deal flow, including human capital constraints and difficulties in identifying mentors and a professional network for new entrepreneurs. A significant proportion of the Malaysian population appears to have embraced the entrepreneurial mindset, considering entrepreneurship as an opportunity rather than a necessity. Thus, the lack of attractive deal flow can be seen as the outcome of the lack of supporting foundations, rather than a lack of interest on the demand side. With minority shareholder rights and investor protection legislation strong in Malaysia,[45] modelled on UK laws, this is not regarded as being a major cause of investor risk aversion in Malaysia. Rather, this risk aversion is more likely to result from a lack of deals that have favorable risk-return metrics compared to other countries in the region.

This study has identified two main gaps in firms' financing lifecycle. Analysis and stakeholder consultations have revealed two main funding gaps in the firm lifecycle. The first of these occurs during the ideation stage, involving businesses facing the need to develop a MVP and those in the early-stage Series funding in the Series A and B rounds. Traditionally, the government has been a key player during the ideation stage, largely due to the high level of risk aversion prevalent in the private funding space. However, in recent years, there has been a noticeable shift in the focus of grant funding towards businesses at the more established product development phases (e.g., Cradle Fund). Moreover, some grants require or recommend start-ups to have linkages with research institutions to be eligible for funding (e.g., MoSTI's Applied Innovation Fund). Thus, during the firm creation phase, entrepreneurs are still heavily reliant on informal sources, such as savings and funding from friends and family.

45 Malaysia has had one of the highest scores in ease of minority investors protection on a global scale, according to the WIPO Global Innovation Index.

Finally, while it is important for investors to have clearly defined exit mechanisms, these mechanisms are still at low levels of maturity in Malaysia. Thus, policymakers should prioritize measures to establish comprehensive exit infrastructures that facilitate a range of types of exit opportunities. This could help to reduce investor risk aversion in making initial investments and facilitate greater liquidity in the market to establish a potentially larger funding pool.

The policy recommendations for this study are sector-agnostic and have been grouped into two main themes, as follows:

1. **Encouraging a healthier deal flow**
2. **Addressing funding gaps**

1. Encouraging a healthier deal flow

- **Policymakers should consider measures to crowd in private funding towards privately-run incubators and accelerators.** Incubators and accelerators remain integral to the foundation of the start-up ecosystem, given their role in seeding strong start-up deal flow. They play a vital role in the entrepreneurship ecosystem in identifying a healthy deal flow pipeline at the pre-MVP and ideation stages and in providing mentorship to prospective businesses. This is particularly important given the high level of risk aversion associated with investments at these stages. In this context, a re-direction of existing government funds towards private-sector-managed incubators and accelerators could crowd-in greater private funding.[46] The proposed funding could take the form of matching grants, with a matching ratio of 1:2, in order to ensure the private sector accelerator and incubators also have a stake in the operation and hence improve the incentive mechanism to deliver results. Ideally, a competitive process should be established for incubators and accelerators, with the entities in question applying for matching grants on the basis of their historical track records and evaluation metrics relevant to the objectives of the grant. A top priority is to ensure transparency and clarity in areas such as application processes, grant recipient selection, and eligibility and decision-making criteria in the implementation of this grant program. The main purpose of this recommendation is to facilitate the crowding-in of private funding for investment in private entities that have the skills and know-how to identify ideas that could be scaled and potentially provide the deal flow for VCs in Malaysia during the ideation stage. Currently, for a number of reasons, VCs do not attribute a large proportion of deal flow to accelerators. Firstly, the limited number of incubators may constrain the number of high quality deals from the start, with a relatively small number of accelerators in the ecosystem, most of which are still relatively new. In this context, well-established VCs have traditionally relied on their own long-standing relationships with start-up networks to source deals. Thus, better-resourced accelerators could help to build up the quality of the deal flow on a larger scale, subsequently enhancing the early-stage financing ecosystem. If the average grant to each of these entities were in the range of RM 500,000-RM 750,000 (~USD 122,000-USD 183,000), the fund could crowd-in private funding to a total value of RM 1.5 million-RM 2.25 million (~USD 365,000-USD 548,000) per entity awarded the grant.

46 An accompanying study that reviews all SME support programs (World Bank 2022), cites the need for greater rebalancing of support towards start-up financing and proposes the need to recalibrate existing programs towards the current needs of the SMEs.

2. Addressing funding gaps

- **Improvements to the implementation of the Dana Penjana FoF could further strengthen its effectiveness as a funding vehicle within Malaysia's financing ecosystem.** The establishment of the Dana Penjana FoF is a positive measure, with the institution potentially playing a valuable role in crowding-in private VC funding. However, based on the findings of this study and global experience with the implementation of FoF (see Box 2), a number of improvements could be made to this scheme. During the initial stages of its implementation, there appears to have been a lack of clarity regarding the required processes and eligibility to apply to act as a VC fund under this program, and a lack of clarity in the timelines for the tender process. Market players have also voiced concerns about incumbent funds not being selected to participate in DPN, despite the fact that a solid track record in domestic investments would enhance the efficiency in deploying investments. Although there is considerable merit in allocating funds to new VC players to stimulate their activities, the greater role of more established funds might have been important, particularly during an economic downturn. Moreover, the track record of the VCs might also be important in ensuring the sustainability of the fund flow when subsequent funding is sought. Finally, it is important that the members of the Investment Committee come from a diverse range of backgrounds in terms of their experience and expertise. With the Malaysian government's focus on technology-led investments, there is a need to ensure that the members of the Committee are well-versed in the latest technological developments so they can identify innovative investment opportunities, with the necessary technical expertise to apply the appropriate parameters to evaluate these types of start-ups, whose business structures may not necessarily conform to traditional business assessment criteria. There is currently no disclosure in the public domain related to the specific structure of the relevant board and investment panel members, with this lack also having the potential to impact the perceived transparency of the fund. Greater clarity regarding the continuity of the program and regarding the government's commitment to funding, together with improvements to ensure greater transparency, would strengthen the fund's ability to act as a valuable and sustainable source of funding for Malaysian start-ups.

- **Malaysian corporations hold a significant value of untapped liquidity, which could be mobilized to support the emergence of a vibrant start-up financing ecosystem.** So far, policymakers have paid little attention to the prospective role of CVCs, despite the fact that these entities hold a considerable amount of locked-up liquidity, with significant potential to allocate these financial resources to investments in start-ups. As discussed previously, CVC investment momentum may have been constrained by legacy corporate management structures and intergenerational succession involving family-owned businesses, with relatively high levels of risk aversion and departures from traditional business operations. This could be largely due to a lack of knowledge or technical know-how, especially in the case of newer industries that utilize new technologies and processes. Given the huge potential of this source of funding to plug funding gaps in the ecosystem, tax incentives to crowd-in CVC funds and to encourage them to invest directly into private VCs and accelerators could act as a catalyst to stimulate more widespread CVC funding activities. By investing in the VC, as opposed to the start-up itself, the technical know-how required for start-up investing could be built up over time, without crowding-out VCs through direct competition in deal flow.

- **As with the incentives previously tabled in Budget 2018 (but not yet gazetted), these CVC tax incentives should be sector-agnostic and offered to Malaysian-registered entities.** These incentives would ideally be structured to cover 100 percent of the investments each year, with a cap of RM 20 million (~USD 5 million), with the need for the investment to be held for a minimum of two years before the tax exemption is claimed in the third year, as a safeguard against the misuse of the exemption. Thus, the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structure of this tax incentive and the safeguards against its exploitation would mirror that of the Angel Tax Incentive. As with the Angel Tax Incentive, having the additional requirement for vetting by MoF to ensure that these investments are made in legitimate start-ups through a quick cross-check in the Companies Commission Malaysia database would eliminate the need to cap CVC investment amounts to a percentage of company equity. By alleviating the need for this limit, greater amounts of the untapped corporate liquidity could be mobilized into the market. Moreover, in order to limit potential conflicts of interest with the CVC's parent company, the CVC fund's memorandum would ideally clearly define the investment parameters of the Investment Committee to avoid instances of investments in directly competing investee companies. This incentive could be offered for a minimum period of five years as a start, with an assessment of its progress and outcomes thereafter.

- **Improving the clarity of the legal and regulatory framework for the VC industry is essential to enhance investor confidence and to crowd-in a higher degree of private VC funds.** As this study has made clear, Malaysia's regional performance in terms of early-stage Series funding (i.e., Series A and B) is suboptimal for its level of development. Although this trend may be partly attributable to the lack of innovative and scalable deals, the limited availability of private VC funding may also be a factor (i.e., the demand for deals may also be lacking). As a large proportion of VC-backed deals in Malaysia remains facilitated by public-sector entities such as government agencies quasi-government investment companies, and by sovereign wealth funds, there is an inherent need to crowd-in greater private sector funding in this area.

- **According to the Venture Capital and Private Equity Country Attractiveness Index,[47] issues related to tax incentives and administrative burdens remain Malaysia's most important weaknesses in these terms.** The expedient implementation of the VC industry tax incentives tabled in Budget 2019, including those for VCMCs, VCCs and for investors in these funds, would help to stimulate the pace of VC investment activities. Not only would these incentives act as an enticement, their implementation would also provide clarity regarding the tax treatment for these transactions, thus boosting investor sentiment.

- **In addition to the initiatives described above, there remains untapped potential in the country's mid-shore jurisdiction of the Labuan International Business and Financial Centre (Labuan IBFC).** Certain Labuan structures, such as the Protected Cell Company (PCC), possess attractive traits for funds, including sub-fund management flexibility. However, the lack of clarity in the enforcement of substance requirements and income earned (i.e., what could be deemed liable to the onshore corporate tax rate and what activities could be afforded a waiver) creates a high level of uncertainty for some investors, potentially constraining their greater use of these types of structures. It could be useful to have more information campaigns amongst investors to provide greater information and increased awareness of these requirements. The establishment of a national framework to provide regulatory clarity regarding the oversight of VCC operations in both Peninsular Malaysia and Labuan IBFC could be beneficial in this case. With this initiative, a definitive ruling by the Inland Revenue Board by means of a public ruling attachment to the national income tax law (Income Tax Act 1967) could assist tax agents, fund managers and investors to better understand conditions under which tax implications may be material with respect to activities in the two jurisdictions.

47 IESE Business School.

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