



for some time switched to trade based on competitive advantage, there will always be commodities and commodity based products that will continue to produce comparative advantage effects in the exports of a country like Malaysia. In this regard, there is clear indication that Malaysia is looking outwards by looking inwards. In other words, it is looking at global opportunities abroad by examining various domestic comparative-advantage it has in terms of primary resources endowment at home.

The third factor that would enable budget 2002 to get the economy going is the pegged ringgit. Without this in place, there can be no boosting of the local economy through its middle-class society, because there will be insufficient insulation whereby low domestic interest rates will only be met by capital flight which would neutralize whatever benefits that domestic monetary policy have been designed to bring. Also, critics of the efficacy of fiscal policy have been saying that public consumption/investments will usually crowd out private investments because both sectors are essentially competing for the same funding resource. Borrowing rates go up which cut into profit margins. It becomes a disincentive for private sector investments. In the case of Malaysia, on the other hand, the ability to directly control the interest rate regime independently of the pegged ringgit allows for liquidity to be achieved by both sectors simultaneously and in so doing enables both sectors, public and private, to perform their assigned roles accordingly within the local economy.

Of course all this is possible only through the injection of additional funds by the government. This has implications on the country's debt position in the long run and as such, it is definitely not a strategy that can be continued for long. It is like using batteries to turn the engine when starting. Hopefully the momentum will kick in soon, because the local economy has to get back to running on its own.

The missing piece that remains is the capital goods industry, which is not well developed in Malaysia. At the time when the peg came into force, there was still a lot of production capacity available due to imports of machineries that occurred when the ringgit was stronger. However, these machineries would have to be eventually replaced as time progressed on. At the weaker rate of exchange, this means soaring cost of production. Many exporting companies have been able to weather the problem especially if they are labour intensive since, under the peg, workers are paid less in dollar terms and the savings help subsidise the higher cost of imported machines. This is unsustainable, not only because there will be eventual wage pressures but also because industries have to capitalise to become modern and grow competitively. Devoid of a well-developed domestic capital goods sector, Malaysia will not be able to maintain a surplus in trade. Reserves would dwindle, forcing a devaluation leading to weakened confidence on the economy. Thus budget 2002 has also emphasised building up its capital goods sector in order that a resilient domestic economy can become complete by plugging this leakage due to the need for buying machines from abroad.

Therein lies the danger behind budget 2002. Lots of liquidity will bring the expansion in consumption that will drive growth but this is unsustainable if production capacity is not maintained in tandem. A careful balancing act is needed such that one eases the other along rather than elbow or be elbowed out altogether.

Implications to Penang

On the surface, the budget for 2002 appears to be in Penang's favour. The budget gives emphasis to promoting exports to the extent of providing incentives for companies to promote *own brand names* or OBNs abroad. A variety of attractive incentives have also been packaged to entice both local and foreign direct investments. The generous extension on the period of reinvestment allowance has been in the waiting during pre-budget dialogues and its announcement is thus heartily welcomed. At the same time, there is the aim for local small and medium scale industries to form part of the global supply chain for which the government announced incentives for front-end multinationals to help bring this about. Then, of course, there are sweeteners for the tourism sector and for private higher education as well in which Penang will also be a direct beneficiary. What may not appear to be in Penang's favour would be the effort to further develop the primary resource industries and the boosting of non-electronic based industries but these activities are to be in addition to rather than in place of those industrial activities that are found to be more dominant in the case of Penang. Penang has, since the creation of the Multimedia Super Corridor adjacent to the Klang valley, aspired to build a northern supercorridor. Should Penang gets its wish, there will be further boost to Penang's economy via the many ICT industry related incentives that were announced in the budget.

But deeper down in the analysis we have to ask the question how and when will we know if the government's budget strategy is taking effect? The budget represents only the lead in by way of economic signaling by the government. The private sector has to respond accordingly by making the appropriate investments. Unfortunately, there are few indicators dedicated to Penang's economy that are continuously tracked. However, as part of the efforts taken by the Penang government to monitor and manage the economic recovery process within the state,



SERI is now able to keep abreast of loan disbursements in Penang. Loan growth has a direct effect on the expansion of money supply and consequently on economic growth provided that inflationary tendencies are under control. At present, the data points remain sparse as the data go back only to when the crisis first began in mid-1997 and therefore the analysis would not be rigorous. The experience is that quarter to quarter changes in loan growth, as shown in Figure 1, has flipped back and forth even though Bank Negara has set clear loan growth targets as part of the recovery efforts. Hopefully, with the incentives found in budget 2002, loan growth can be kept more steadily along the prescribed track.

Should we try to establish the link between loan growth in Penang with Penang's economic growth based on its gross regional product, the results would appear to be something like that in Figure 2. The r-square fit is about 46.5 percent. Again, this is done with only a few data points which also means that lagged effects between the time of loan disbursements and its resulting effects on the economy also becomes much more difficult to capture in the analysis.

Figure 1: GDP Change & Loan Change

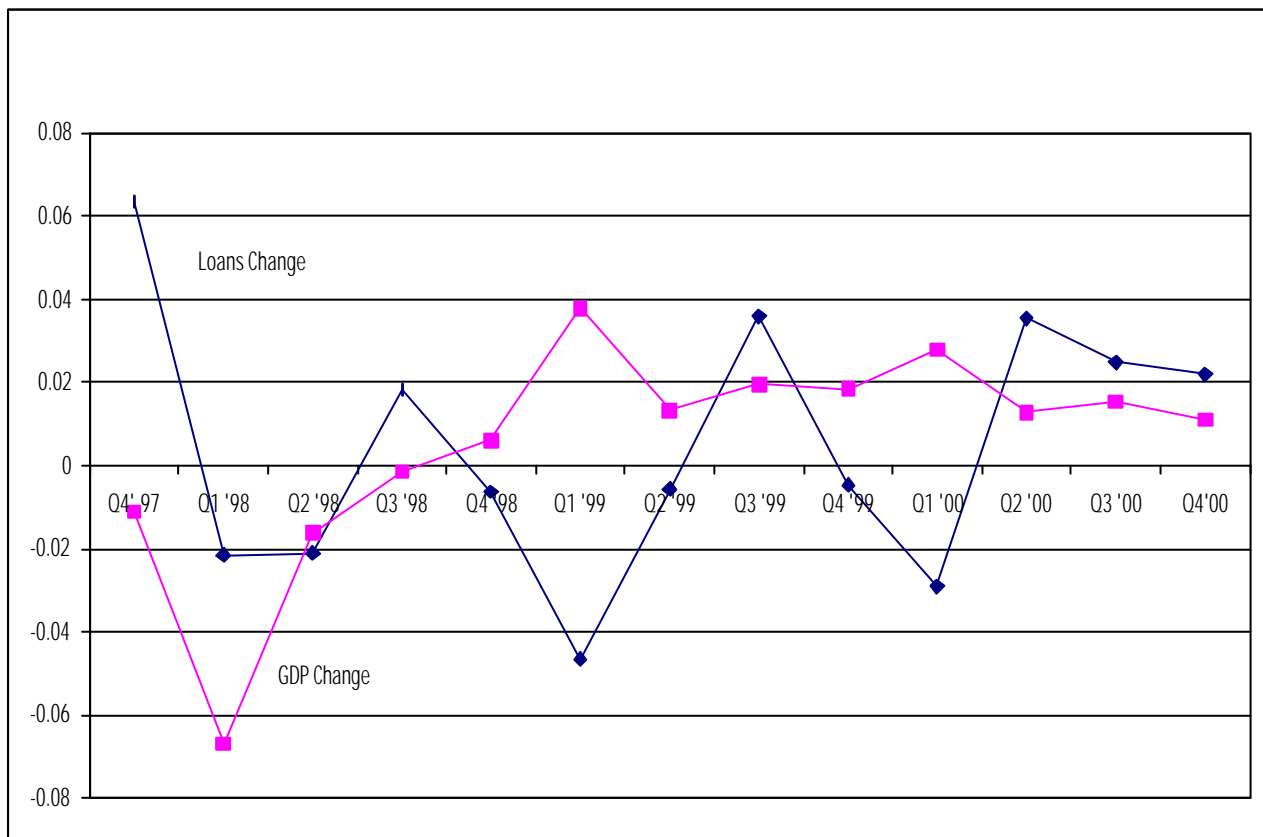
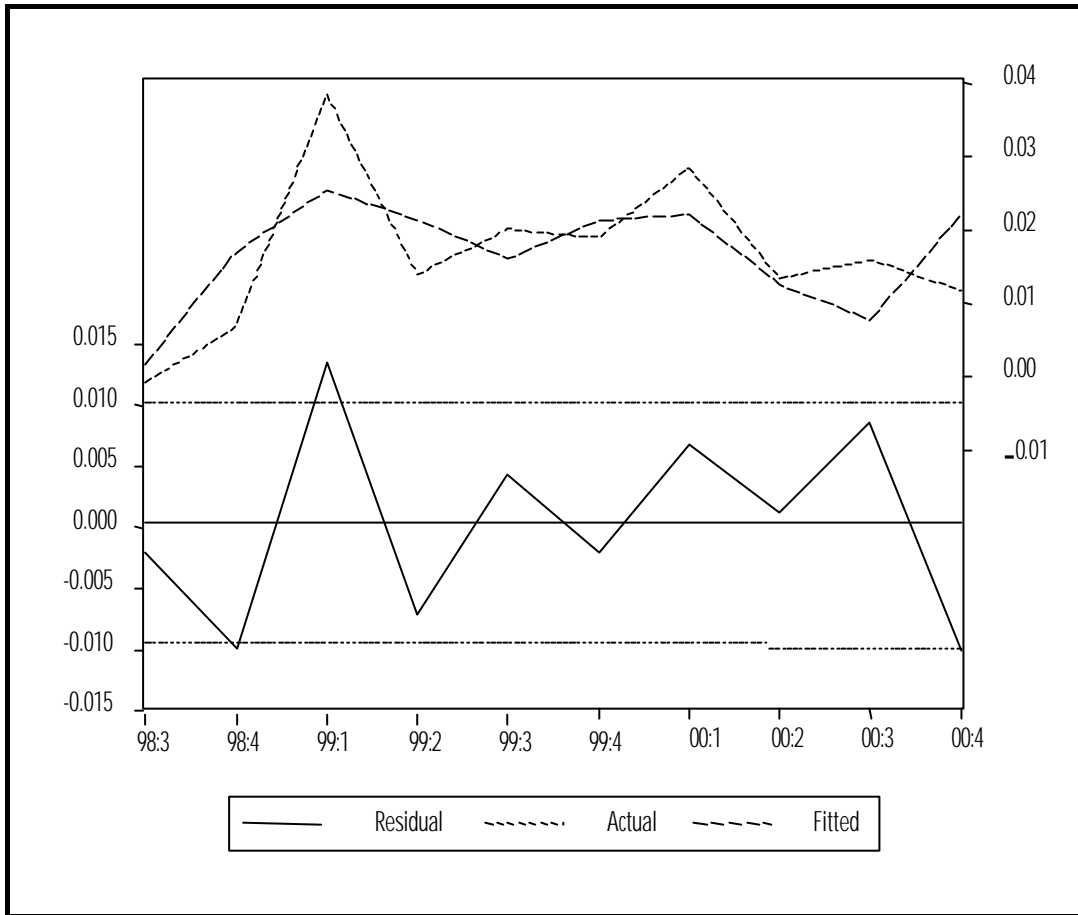




Figure 2: Predicting Penang's GRP Based Only On Loan Growth



Conclusion

The preliminary conclusion we can draw is, while we can crudely estimate the effects of loan growth in the state on Penang's economic growth but we remain uncertain over the current dynamics of loan growth. Targeting its path is a typical government strategy, which will certainly continue and hopefully we will see more stability in the not too distant future. **§ Chan Huan Chiang**



Venture Capital: An Alternative Source Of Financing For Small & Medium Local Firms?

Introduction

In the present economic downturn, small- & medium-sized enterprises (SMEs) are finding it difficult to expand their businesses, not only because of the lack of markets but also because of the lack of finances. The firms that are seeking to raise more money may find a less-than-enthusiastic reception from the banks and financial institutions. As such, they have to turn to alternative sources of funding. While funding from 'friends & family' is rather scarce during an economic downturn, the SMEs have another source of funding to turn to, namely in the form of venture capital funding.

Today, venture capitalists (VC) provide companies, particularly start-ups with a deeper degree of support that surpasses the traditional financial investment. VCs are providing their portfolio companies with seed and early stage capital as well as a range of value added services, which include guidance to build an effective and efficient management team; assistance to develop short and long term business plans; executive recruitment; market- and technology-knowhow and network; as well as operational counseling and mentoring. Some of the VCs also provide capital for expansion, financing and buyout purposes.

The VCs normally perceive themselves as the providers of 'risk money' and 'value added services'. This is mainly because in today's competitive marketplace, enterprises are increasingly requiring investors who could add significant value to their operations. The VCs are thus, advantageous to the entrepreneurs because they are able to assist the entrepreneurs to achieve maximum potential by blending their energy and vision with their network of contacts.

What Venture Capitalists Look For?

It is important to note that VCs are not moneylenders and they seek equity ownership of the companies that they invest in. As such, VCs have specific criteria and requirement when they invest in a company and many companies do not fit those criteria and requirement. The VCs do not invest in just any company but companies, which they deem would bring them profits. Today, VCs are more discriminating than before and are more interested in financing new and innovative technology businesses, particularly those that can reduce costs or increase productivity. This is partly due to the fact that the technology sector had been the engine of growth in the past decade. However, due to the recent global economic slowdown, venture capital funding has been declining and many promising and potential companies are either dying from lack of cash or are hibernating.

The type of companies that VCs normally target include those in communication & networking; electronics & computer hardware; semiconductor; software & application; information services; healthcare services; automation; industrial & advanced materials, optoelectronics; medical information systems, devices & equipment; bio-technology; consumer & business products/services; e-infrastructure; e-services; e-commerce; e-content player; and application infrastructure/services as well as life science sectors.

The VCs normally allow the management team of the companies to run the day-to-day operations. The VCs will consider a business venture as good and advantageous if the company has ownership or control of its products/services. Furthermore, the products/services must be scalable, meaning that they must be able to move outside the original niche focus or add on other value without the corresponding increase in cost. Excellent examples of such ventures are yahoo.com and amazon.com. However, it is still important that the company maintains its niche focus and imposes entry barriers for other competitors.

In addition to products and services, the VCs also look at the marketability of the products/services. The products/services must fall under the high growth sector of the domestic, national as well as regional markets. Furthermore, there must be a demand for the products/services and if necessary, the companies must create a need for the products/services in the market.

The people in the companies that seek venture capital funding must be visionary, versatile as well as possess experience & expertise. These people must have access to market as well as the ability to monetise the product. In short, convert the product into money/profits. However, many VCs are not getting enough revolutionary ideas and they also need to emphasise quality. A problem that the VCs normally encounter is that the companies that are seeking funding do not know exactly how much money/fund they need. Many companies at start-up stage are seeking amounts of capital that are much less than what the VCs are interested in investing. It is also very important



that the companies practice corporate governance and are operating legally.

On the other hand, VCs also do not expect the companies to be perfect. Before the VCs commit to a business deal, they normally carry out a validation of the company that they intend to invest in. The VCs even spend time with the company by providing guidance and feedback on how to qualify for their funding. This includes the preparation of a business plan by the company that seeks funding. The business plan should include an executive summary of the company, including its people, product/service as well as an analysis of the industry or market. The analysis should comprise the characteristics, history, size, growth and trends of the industry/market; market location, both internal and external; barriers to entry and synergies; competitors as well as marketing strategies. Furthermore, the business plan should include financial information of the company as well as the amount of funding required.

An important point to note is that the VCs will always look for ways to exit from the deal. This normally happens when the company has reached the stage where it can have access to other sources of funding, such as public funds. The VCs will liquidate their equity stake through the stock exchange to a third party or a sell back to the other shareholders of the company as agreed at the outset of the deal. It is important that the companies have the flexibility to allow for the VC's exit. The VCs normally exit when they receive high returns from their investment.

What Can The Venture Capital Recipients Contribute?

In addition to complying with the criteria and requirements of the VCs, the recipients of venture capital funding must also be able to choose the right VCs. This is mainly because each VC is different from the other and the different VCs target different products/services to invest in.

To ensure high returns from their venture, the venture capital recipients must provide products/services that are of acceptable standard and high quality. In most cases, the recipient companies are normally suppliers and thus, it is their duty to upgrade themselves to become the 'number-1' or '1-stop' global supplier. Furthermore, the recipient companies should not only stop at being the 'number-1' or the '1-stop' but also to continuously create new businesses, with the aim of becoming an ODM (original design manufacturer) or an OBM (original brand-name manufacturer).

Conclusion

It is irrefutable that there are debates about the pitfalls of seeking venture capital funding. Reasons given for being cautious include the following:

- (i) For every 100 companies that are seeking venture capital funding, only 1 will actually receive the funding.
- (ii) Many companies with excellent opportunities are not venture capital material or in short, they do not meet the specific criteria and requirements of the VCs.
- (iii) Venture capital could be expensive and intrusive and although many VCs allow the management teams to run the day-to-day operations, there is a high possibility that the entrepreneurs can reasonably expect to give up control of their companies.

There were also claims that during the height of the dot.com bubble in 1999 and 2000, the VCs were virtually throwing money at start-ups, many of which had no clear plan for making money but to increase their 'market value'. These companies were merely chasing 'valuation' or the people's perception of the value of the company, rather than 'money/cash/profit'. When the dot.com crashed, some of the VCs were left adrift in the troubled deals and were shrinking their portfolios or even winding up companies, which prospects were dim and concentrating only on those they think will survive in a long downturn. In addition to the dot.com crash, some of the VCs invested large amount of capital in companies that were about to sell their stocks, in hopes of getting quick profits when the stocks started to trade. However, such strategy, many a time, has cost them dearly when the investors turned their backs on such shares.

While many people have mistakenly interpreted the dot.com meltdown as the end of the technology industry, the truth is that technology permeates every aspect of our lives and will continue to grow. The dot.com crash shows that the VCs have to clean up their acts but VCs have also pointed out that their business is cyclical and that they have been through down cycles before, such as the boom fueled by PC makers and suppliers limping to a halt in the late 1980s. It is also undeniable that the experienced VCs with successful track records will always help new entrepreneurs to envision the bigger picture beyond the technology solution by taking active roles in their portfolio companies to ensure success. As such, despite various arguments about VCs, venture capital funding could still be an alternative source of financing for innovative and potential SMEs. **§ Anna Ong**