

Legislative Council Panel on Commerce and Industry
The Applied Research Fund

INTRODUCTION

This information paper provides an update on the financial position of the Applied Research Fund (ARF) since July 2001 and briefs Members on the latest investment strategy of the ARF.

BACKGROUND

2. The ARF is a government owned venture capital fund of \$750 million set up in 1993 to provide funding support to technology ventures and research and development projects that have commercial potential. The longer term aim is to increase the technology capability and to enhance the competitiveness of local industry, thereby promoting high value added economic development in Hong Kong. The ARF is controlled and administered by the Applied Research Council (ARC), a company wholly owned by the Government and formed specifically for this role.

3. As we started to engage private sector venture capital firms to be the ARF's fund managers in November 1998, the investments of the ARC fall into two categories: those which were processed by the then Industry Department (ID) and funded before the appointment of private sector fund managers, and those which were identified by fund managers and funded after the appointment of fund managers.

4. We briefed Members on the application and management of the ARF at the Panel meeting on 11 December 2000⁽¹⁾, and undertook to provide quarterly written reports on the progress of the ARF. The first and second quarterly reports were sent to Members in April and July 2001 respectively⁽²⁾. As the ARC intended to review the investment strategy of the ARF in September 2001, having regard to the latest economic climate in general and for technology businesses in particular, we considered it more useful to brief Members on the latest investment strategy and update Members on the financial position of the ARF since July 2001 in one go.

LATEST DEVELOPMENT

I. Projects processed by the then ID

5. The ARC has approved 27 projects in this category with a total amount of \$97 million, 25 of which have been completed and two are in progress. Of the two

(1) Ref : LC Paper No. CB(1)276/00-01(02)

(2) Ref : LC Paper Numbers : CB(1)989/00-01 and CB(1)1834/00-01 respectively.

projects in progress, it is too early to assess the performance of one while another one is indicating problems. Among the completed projects, we reported in the update of July 2001 that 15 of them were considered problematic one way or the other. However, since then, we have recovered the loan fully in one of such problematic cases. On the other hand, with the continued downturn of the economy, another three cases are found to be experiencing difficulties in the repayment of their ARF loans.

6. Taking the position of the cases as explained in paragraph 5 into account, as of mid-January 2002, there are a total of 18 problematic cases. We have provided support in the form of equity injection for four cases and in the form of loans for the other 14 cases.

Equity Cases

7. For the four equity cases, we indicated in the previous updates that their chances to grow or improve were not very encouraging, as they did not demonstrate promising business prospects or their products featured low marketability. We have therefore reached agreement with buyers to sell the ARF's shares in three companies at nominal values. For the fourth company which ceased operation since 1999, we agreed with the other shareholders to wind up the company in August 2001. This means a total loss of about \$19 million of the value of the ARF investment, or 20% of the total approved amount.

Loan Cases

8. Of the 14 loan cases, we have written off our loan in one case⁽³⁾ as the company in question had difficulties in sourcing investments and was unable to repay the loan, restructured our loan in another case and taken legal actions for four cases.

9. For the loan restructuring case, we have done so in order to reduce the debt burden of the company in question to facilitate its sale to prospective buyers. After negotiations with many potential buyers, we have decided that the only practicable option in the circumstances was to settle for a smaller sum for our loan so that the company may be sold and our loans repaid. As a result, we will write off about \$4.8 million (excluding interest) or 5% of the total approved amount.

10. As regards the four cases that we have taken legal actions, we have obtained favourable court rulings and are in the process of taking enforcement actions (such as applying for the bankruptcy of the guarantors) and considering settlement offers.

11. As regards the remaining eight cases, we will take legal actions or consider settlement offers as appropriate.

(3) This written-off case was reported in the update in April 2001 and the amount written off was \$850,000 (excluding interest) or 0.9% of the total approved amount.

II. Projects funded through fund managers

12. Since our last update in July 2001, the ARC has approved three follow-on investments in two existing projects in the information technology and telecommunications sectors respectively, which amounted to \$10.57 million. As of mid-January 2002, the ARF has supported a total of 18 projects involving a funding of \$306 million. Details of the 15⁽⁴⁾ active investments are at **Annex A**. The sectoral distribution of these funded projects is shown in **Annex B**.

13. The investee company which was reported to be in financial distress in the last update was eventually wound up and our investment was written off. This means a loss of \$15.51 million, or 5% of the approved funding. Meanwhile, another two investee companies have also been in severe financial difficulties and a few other companies are experiencing financial problems of varying degrees.

14. The latest valuation as at 30 September 2001 of all the investments managed by our fund managers totalled 67% of the investment at cost⁽⁵⁾, which features a significant downward adjustment from the valuation of 196% as at end March 2001 as reported in the update of July 2001. The main reason for the reduction is that our fund managers have become more prudent in the valuation in view of the financial difficulties confronting some investee companies and the general unfavourable investment climate for technology businesses.

III. Difficult Investment Climate and Investment Strategy

15. It can be noted that the venture capital industry has become increasingly cautious with very few new investments following the burst of the dotcom bubble in 2000. The sentiment is risk adverse and conservative, and the situation is aggravated by the 11 September 2001 event in the United States and its aftermath. Meanwhile, technology businesses are facing increasing challenges posed by the general adverse economic situation and shrinking investments from venture capitalists. The overall unfavorable climate has largely accounted for the less than satisfactory performance of the ARC's investee companies.

(4) As reported in our paper of this series in December 2000 (Ref: LC Paper No. CB(1)276/00-01(02)), two of our investments have been written off. Another investee company that was reported in the update of July 2001 to be in financial distress has eventually been wound up and this is covered in paragraph 13. Hence, only 15 investments are active.

(5) The valuations of investee companies are provided by fund managers on the basis of the evaluation of individual investee company in its latest round of financing or as evaluated by the fund managers. If there is no additional round of financing after ARF's investment, our equity will be valued at our investment cost.

16. Against such circumstances, the ARC has conducted a review of the operation and performance of the ARF, with a view to formulating an investment strategy for making a more effective use of the ARF to fulfill its public mission in the light of prevailing market conditions. During the review process, the ARC has acknowledged that the ARF has provided the much needed funding support for technology businesses in these difficult times, particularly the start-up companies. Indeed the fund managers have advised that the current climate presents opportunities for investment in quality companies at lower valuation and with less competition. Noting that promising investments will continue to be achievable, the ARC is prepared to adopt a more open and flexible attitude towards prospective investment proposals, in an attempt to broaden the spectrum of the investment portfolio for the benefit of local technology ventures. Specifically the ARC will explore further with the fund managers new investment opportunities which could provide momentum and spin-off effect for local technological development. Publicity of the ARF will also be strengthened to enhance awareness of the Fund.

ADVICE SOUGHT

17. Members are invited to note this paper.

**Commerce and Industry Bureau
January 2002**

Applied Research Fund - List of Active Investments Managed by Fund Managers
(Position as at mid-January 2002)

Information Technology

Investee Company	Fund Manager	Technology Area	Funding Approved (HK\$m)
QuotePower Information Ltd.	AsiaTech Ventures Ltd	Provision of online financial information and real-time electronic trading	8.00
InfoTalk Corporation Ltd.	Walden Technology Management (HK) Ltd	Automatic speech recognition	24.07
ecVision Limited	Walden Technology Management (HK) Ltd	Business-to-business e-commerce software and services	27.24
LECCO Technology Ltd.	Walden Technology Management (HK) Ltd	Software tools	24.59
Wisers Information Ltd.	Walden Technology Management (HK) Ltd	Electronic aggregation and distribution of Chinese language-based content	20.26
Inlooktech.com Ltd.	AsiaTech Ventures Ltd	Enterprise Resource Planning solutions	7.79
iASPEC Technologies Limited (formerly Uni-tech Systems Engineering Ltd.)	AsiaTech Ventures Ltd	System integration, application hosting services	15.55

Investee Company	Fund Manager	Technology Area	Funding Approved (HK\$m)
WebPro Ltd.	Walden Technology Management (HK) Ltd	Internet and e-commerce technologies for the Asian electronics components industry (internet & e-commerce)	15.60
I-Security Solutions Ltd.	Walden Technology Management (HK) Ltd	To develop and market encryption and authentication tools to facilitate e-commerce functions	10.82
Spike Cyberworks Ltd.	Softech Investment Management Company Limited	To provide web-related services and solutions	0.68
Total			154.6

Telecommunications

Investee Company	Fund Manager	Technology Area	Funding Approved (HK\$m)
Wafer Systems Holdings Ltd.	HSBC Private Equity Technology Ltd	Data networking	46.50
Unitech Networks Ltd.	Walden Technology Management (HK) Ltd	Internet/Intranet system integrator	11.63
Continuous Technologies International Ltd.	AsiaTech Ventures Ltd	Computer telephony applications	18.14
Entone Technologies	Softech Investment Management Co. Ltd	Broadband Video Streaming	7.8
Total			84.07

Electronics

Investee Company	Fund Manager	Technology Area	Funding Approved (HK\$m)
NSM Technology Ltd.	AsiaTech Ventures Ltd	Original design manufacturer of telecom equipment	15.58
Total			15.58

Sectoral Distribution of Projects Funded after the Engagement of Fund Managers
(Position as at mid-January 2002)

