For discussion
on 21 June 2016

Legislative Council
Panel on Commerce and Industry

Innovation and Technology Venture Fund

PURPOSE

This paper seeks Members' support for the establishment of a HK$2 billion Innovation and Technology Venture Fund ("ITVF") as well as the relevant proposed institutional arrangements and management framework.

BACKGROUND

Gaps in the Funding for Technology Start-ups

2. In 2013, the gross expenditure on research and development ("GERD") in Hong Kong was HK$15.6 billion, which translated to 0.73% as a ratio to Gross Domestic Product ("GDP"). The total expenditure on research and development ("R&D") in the private sector was HK$7 billion or 45% of GERD, with the public sector taking up the remaining 55%. This contrasts significantly with the observed international norm of about 40:60 whereby the private sector makes the majority contribution to R&D expenditure. Inadequate private sector investment in technology is a major challenge for innovation and technology ("I&T") development in Hong Kong.

3. I&T start-ups normally need to go through many stages of growth and development in their initial years, and they require increasing level of investment as they grow. The various stages of investment are typically known as pre-seed, seed, pre-Series A, Series A, B, C, etc[1]. There are no hard and fast rules about the investment size in each round. The amount would vary by industry and country, and also change with

[1] Pre-seed to seed funding broadly ranges from HK$100,000 to HK$800,000, and is mainly for developing initial business proposals. Pre-Series A funding ranges from HK$800,000 up to about HK$8 million. Series A funding is in the range of HK$8 million to HK$40 million, while Series B funding is HK$40 million to HK$80 million. The amount of investment in the subsequent funding rounds would generally increase further.

market conditions. Most investors in start-ups see an eventual Initial Public Offering or acquisition by other companies or subsequent funding rounds as the exit avenue.

4. In Hong Kong, there is no lack of funding at the pre-seed to seed stages. For example, under the Technology Start-up Support Scheme for Universities of the Innovation and Technology Fund ("ITF"), each start-up can be funded for not more than three years with a maximum annual funding of HK$1.2 million. The funding can serve as seed money and be used for setting up and operating I&T start-ups, carrying out R&D as well as promotion and marketing. The Cyberport Creative Micro Fund provides funding of HK$100,000 each for companies to develop innovative information and communications technology-related prototypes. Various university funding schemes also provide seed-stage funding to staff/students to commercialise research results through setting up I&T start-ups.

5. For pre-Series A funding, the Hong Kong Science and Technology Parks Corporation ("HKSTPC") has set up a HK$50 million Corporate Venture Fund to focus on early stage investment for high-potential technology start-ups which are tenants or incubatees in the Science Park. Briefly, HKSTPC would co-invest up to HK$8 million in each company on a matching basis with private funds. Cyberport also plans to allocate HK$200 million to set up a Cyberport Macro Fund to invest in its information and communications technology start-ups to assist them attract more investment funding. This fund is expected to be rolled out in the second half of 2016. The Enterprise Support Scheme ("ESS") under the ITF is also providing funding to I&T enterprises directly. With the ESS, the Government is matching public funding with private investment in R&D by I&T enterprises on a project basis up to a ceiling of HK$10 million.

6. On the private sector side, there are a number of private or family endowments that fund early stage ventures. They are collectively referred to as 'angels'. While the number of angels is growing, most of them only provide seed to pre-Series A funding and many do not provide full-range support in terms of networking, business operation and marketing to the start-ups. As regards venture funds, while Hong Kong does have venture capitalists, most of them cover the entire Mainland or Asian market for investment opportunities. Banks and financial institutions in Hong Kong generally prefer collateral lending rather than financing I&T start-ups.

7. Having reviewed the funding landscape in Hong Kong, we are of the view that funding sources available to I&T start-ups, particularly those in Series A to B rounds are inadequate.

Blossoming Start-up Scene in Hong Kong

8. Hong Kong is ranked the top five fastest growing start-up ecosystems and one of the world's top 25 start-up hubs, according to the Global Start-up Ecosystem Ranking 2015 study by a San Francisco based research firm Compass. This study reconciles with the findings of Invest Hong Kong ("InvestHK")'s survey on Hong Kong's start-up ecosystem completed in August 2015. In 2015, Hong Kong saw a significant increase in the number of start-ups (+46%), staff (+56%) and workstations (+60%) from a year ago. As at August 2015, there were some 1 600 start-ups, involving more than 3 700 staff and 4 500 workstations, operating in 24 co-working spaces and six incubators/accelerators surveyed[2]. Over half of these start-ups are in the I&T sector. According to the Compass study, while Hong Kong is still lagging behind in access to venture capital ("VC"), the growth in exits is improving and there are signs that traditionally conservative investors are showing more interest in Hong Kong start-ups. It is opportune for the Government to introduce corresponding measures to catalyse equity investments by venture capitalists in our I&T start-ups.

Policy Commitment

9. The Innovation and Technology Bureau announced on 20 November 2015 that one of its work priorities was to "encourage more private organisations, VC funds and angel investors to invest in innovation and technology". The Chief Executive subsequently announced in the 2016 Policy Address that the Government would set aside HK$2 billion to set up an ITVF to encourage investment from VC funds in local I&T start-ups.

PROPOSAL

10. We propose to launch the ITVF to stimulate private investment in local I&T start-ups with institutional arrangements and management framework set out in paragraphs 11 to 14 below.

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[2] The InvestHK survey included both public and privately operated incubators/accelerators and co-working spaces. However, these figures do not reflect the full picture as there were incubators/accelerators outside the survey or not responding to the survey.

Considerations

11. The main purpose of the ITVF is not to generate monetary return for the Government but to stimulate private investments in local I&T start-ups and to increase deal flow. The following factors are our primary considerations –

(a) Risk control by casting a wider net – risk exposure of the Government can be controlled by partnering with more high quality VC funds instead of engaging only one or two fund houses. To ensure that the partner VC funds will exercise prudence, they should be required to contribute a larger share of the investment. Our aim is to achieve an overall matching investment ratio of Government fund to VC funds of approximately 1:2;

(b) Pre-determined investment horizon and maximum commitment – to attract private sector investment and to create a critical mass of deal flow of investment in technology start-ups, it is necessary to have a pre-determined investment horizon and maximum funding commitment for matching with each VC fund by the Government;

(c) Stronger incentives for VC funds – upside incentives in the form of carried interest and the option to purchase the Government's shares at a pre-agreed price should be provided to encourage participation of professional VC firms as co-investors;

(d) Flexibility to adjust the scheme and partner with fund managers – we consider it desirable to allow flexibility in partnering with VCs, rather than being locked with individual VCs for a long duration. In addition, it would also be necessary to provide for the flexibility for the Government to refuse investing in businesses that are in conflict with Government policies (e.g. businesses that may be illegal in Hong Kong) without affecting the operations and original investment strategy of the partner VC funds; and

(e) Minimal bureaucracy – the Government should leverage on the business acumen of the VC funds when making investment decisions. Proposed investment deals must be processed expeditiously, with minimal internal process and procedures.

Institutional Arrangements

12. The Government would incorporate a limited company under the Companies Ordinance to facilitate control and administration of the ITVF. This company will serve as a special purpose vehicle, i.e. a vehicle to carry out disbursement of co-investment fund, holding of equity stakes in the investee companies, receipt of dividends from the investee companies, and receipt of any sale proceeds following the sale of such equity stakes. An Advisory Panel comprising veterans in the business and investment sectors, professionals and academics will be appointed to provide independent advice on the selection of partner VC funds and operations of the ITVF at the strategic policy level. However, this Advisory Panel will not make any investment decision on individual deals.

13. The Government will invite applications for cooperation from VC funds, which would be evaluated based on the background and experience of the investment team, investment track record in I&T enterprises, business network and value-added services that can be provided, etc. The fund managers of the selected partner VC funds would be responsible for identifying and conducting commercial and legal due diligence on the potential investee companies. The fund managers, in addition to looking after the investment from a business perspective, should also play a role in assisting the investees to grow and expand their business. The Government will have the right of first refusal of co-investment in respect of any proposed investment by the VC fund. The Government will be a passive investor, making direct investment in the start-ups concurrently with the VC fund upon invitation of the latter. We envisage that we will decline an investment offer under the circumstances mentioned in paragraph 14(e). The proposed institutional arrangements are illustrated at **Annex**.

Framework for the Management of Investments

14. We propose that the Government should sign with the partner VC funds a master agreement ("MA"), which set out the details of cooperation as well as the rights and obligations of each party. We plan to draw up the MA based on the following broad terms –

(a) Eligibility of VC funds – an I&T VC fund with investment coverage including Hong Kong[3] and a minimum uncommitted

[3] For example, a Greater China Fund or Asian Fund.

capital balance of HK$120 million[4]. Eligible VC funds may apply to join the scheme within two years;

(b) Eligibility of investee companies – Hong Kong I&T start-ups with adequate presence in Hong Kong. The detailed criteria will be determined in due course;

(c) Active investment period and maximum aggregate amount of matching investments – VC funds shall invite the Government to make co-investments in eligible deals within five years after being selected. For each VC fund, the maximum aggregate amount of matching investments from the Government shall be capped at HK$400 million to avoid over-concentration of risks;

(d) Maximum investment quantum by the Government in each investment deal – not more than 40% of the total amount of investment sought by the investee company in such deal or HK$30 million, whichever is lower. To limit the maximum loss the Government can incur on one single start-up company, the Government's aggregate amount of investment in each start-up would be capped at HK$50 million;

(e) Conditions for declining a proposed investment from the VC fund would include – (i) the proposed investee company is unable to meet the criteria of a Hong Kong I&T start-up with adequate presence in Hong Kong; (ii) the business of the proposed investee company is in conflict with existing or planned government policies or legislation; (iii) there is cause to believe that the proposed investee company may be involved in activities that may bring the Government into disrepute; or (iv) violation of other terms as agreed with the partner VC funds;

(f) Upside incentives[5] to VC partners – competitive carried interest plus the option to purchase the Government's shares within five years at a cost of the principal amount plus a suitable premium. The detailed terms of these incentives would be determined in due course; and

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[4] Both new and existing VC funds can apply for the scheme.

[5] These are performance-based incentives contingent on successful and profitable exits. Similar profit-sharing arrangement is common in agreements for other VC funds in other places.

(g) Terms of investment and exit – the Government will co-invest in individual start-up on the same investment and exit terms as the VC fund.

15. It should be noted that further fine-tuning would be required to accommodate operational needs and to cater for the evolving practices of the VC industry. The details will be worked out based on the above framework. We will consult the relevant Legislative Council ("LegCo") Panel should there be key changes to the above management framework (such as adjustment of investment ceiling per deal and/or per start-up).

Expected Benefits

16. The proposed ITVF should help fill the funding gap encountered by local I&T start-ups in the growth stage. At the proposed investment ratio of 1:2, it is expected that the fund could attract about HK$4 billion private investment from VC funds in I&T start-ups in the long run. More technology companies would likely be set up in Hong Kong, thereby creating more high value-added jobs for our youngsters. More start-ups will also help attract VC funds from abroad and build a vibrant and self-sustaining VC market. From a broader perspective, the proposal could also help foster a business environment that encourages application of I&T, thereby benefiting the development of Hong Kong as a knowledge-based economy.

Control and Review Mechanism

17. We will also put in place proper control and review mechanism to monitor the performance of the ITVF. We will devise detailed procedures and criteria to select VC funds through an open and fair selection mechanism. The partner VC funds will be required to sign with the Government an MA which sets out the rights and obligations of each party (see paragraph 14 above). The MA will include appropriate terms and conditions to safeguard Government's interest. The partner VCs should provide timely updates on portfolio companies and submit annual financial statements to the Government, which will administer the ITVF in accordance with the MA and prepare annual consolidated financial statements. Regular management reports on the investment performance of the fund would be submitted to the Advisory Panel on ITVF. We will also appoint an external auditor to carry out the annual audits of the financial statements of the fund. We will review the operation of the ITVF and report its performance to the relevant LegCo Panel as appropriate.

FINANCIAL IMPLICATIONS

18. A non-recurrent allocation of HK$2 billion will be required for setting up the ITVF. The ITVF is not a vehicle for generating financial returns but an integral part of the infrastructure for I&T development. Any returns, including dividends and realised profits from exits of the investments concerned, would be deposited into the dedicated account of the SPV for the purpose of further investment under the scheme.

19. Recurrent expenditure of HK$9.1 million per year will be required to meet the staff cost of the Secretariat, as well as legal and other administrative and promotion expenses. We have included the relevant provision in the 2016-17 Estimates of Innovation and Technology Commission to meet the requirement.

ADVICE SOUGHT

20. Subject to Members' support to our proposal in paragraphs 11 to 14 above, we will seek funding approval from the Finance Committee for establishing the fund and finalise the implementation details accordingly with a view to launching the fund in the first half of 2017.

Innovation and Technology Bureau
Innovation and Technology Commission
June 2016

Annex

Proposed Institutional Arrangements