

# POLICY BRIEF SERIES 2022

SUPERIOR UNIVERSITY

Office of Research, Innovation & Commercialization Superior University – September 2022



## Lessons from Failure: Future of VC backed Start-ups in Pakistan

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### EXECUTIVE SUMMARY

The policy landscape of Pakistan has distinctive features of strengths and shortcomings, and divulge subjects of inquiry regarding improvement of investment climate and economic development in the country. Funding by VCs is normally associated with prior registration under the Companies Act 2017 and thus subject to SECP regulations. Phenomenon of start-ups funded by VCs stays clear of over regulations as the innovation and risk-taking elements of entrepreneurship are both recognized and nurtured by bilateral arrangements i.e. between start-up and VC(s) while fulfilling the conducive regulatory requirements. Policies allowing for asymmetries in form of functional markets in informal domain and lack of sectoral information indirectly condone the patronage of innovation by VC under a bilateral arrangement.

### KEY RECOMMENDATIONS

- Federal Board of Investment takes up the task of consolidating sectoral studies by the provincial Boards of Investment and Trade which serve as primary bodies of collating primary and secondary data from different sources. Thus, consolidated studies on state of different sectors will serve as guiding yardstick for VCs.

- Bureau of Statistics compiles data from different governmental entities on regular basis. The data collection exercise may be expanded to the inclusion of sector experts through building collaborative networks with wide range of stakeholders. The data thus collected is updated on periodic basis with inputs of stakeholders from industry and the academia.

- Market dynamics are better understood by intensive research that is action oriented and appreciates the competition, product placement, consumer behaviour, pricing, and time to scale. Needed research is done by universities, start-ups and planning agencies of public sector.

## Policy Context

Businesses, investments, trade and allied subjects have been deemed integral for economic and ultimately social development of the country. The policy landscape of Pakistan is well structured when it comes to formation of business, regulation of markets, issuance of guidelines, facilitation in undertaking business processes, and provision of services. However, implementation of the policies and gaps therein constitute subjects of inquiry regarding improvement of investment climate and economic development in the country. Notwithstanding the contours of policy implementation is the functionality of informal economic structures that shape and steer large segment of businesses in the country. This policy brief limits itself to the establishment, growth, and financing issues of start-ups with reference to Venture Capital (VC) funding.

Securities Exchange Commission of Pakistan Act 1997 provided for the creation of Securities Exchange Commission of Pakistan (SECP) with multiple responsibilities for facilitating, regulating and guiding the functioning of stock markets, non-financial banking institutions, and other companies. The Act also requires SECP to “maintain facilities and improve the performance of companies and of securities markets, in the interest of commercial certainty, reducing business costs, and efficiency and development of the economy.” Regulation of acquisition of shares and suggesting of changes in law with respect to all the matters under its ambit of responsibilities also form key responsibilities of SECP that affect the VC backed start-ups. It is pertinent to note that as a common practice, all VCs require local start-ups to get themselves incorporated as company recognized by SECP. The measure itself pushes the boundaries of informal working of start-ups or of comparatively less regulations by other laws recognizing firms to the formal extensive regulatory framework of SECP invoked by incorporation under The Companies Act 2017.



Board of Investment (BOI) at the federal level and provincial Boards of Investment and Trade are geared towards promotion of investment and trade along with creation and provision of investment friendly business environment. Ease of doing business and sectoral information form critical areas of communication for investors by these public entities. In an ideal situation, the respective boards ought to have detailed information about different sectors covering state of sector, growth potential, investment opportunities, and regulatory requirements. However, far from ideal situation leads the investors and local companies to reliance on bilaterally agreeable market information for defining a collaborative business venture.

The State Bank of Pakistan (SBP), established under the State Bank of Pakistan Act 1956, regulates all foreign investments and transactions through multiple policy instruments including Protection of Economic Reforms Act 1992; Payment Systems and Electronic Fund Transfer Act 2007; Financial Institutions (Secured Transactions) Act 2016; Anti-money Laundering, Combating the Financing of Terrorism & Countering Proliferation Financing Regulations; and Exchange Companies Manual etc. Taxation by Federal Board of Revenue and provincial revenue authorities form another corner of the policy environment that affects the working of VC backed start-ups in the country. Documentation required of companies by these taxation authorities pre-supposes the presence of capacities and capabilities that ensure compliance with all the taxation requirements.

## **Backing up of Strat-ups by VCs: Contextual Reflections**

Start-ups symbolize the innovation drive of youth or in some cases of seasoned professionals that seek growth of business owing to the strength of an idea or a newly developed technology. Acquisition and functionalization of acquired technology or knowledge product in context of marketability provide the necessary impetus to start-ups for business strategy formulation. Anecdotal evidence suggests that first choice of legal recognition by start-ups is The Partnership Act 1932 that provides an accommodating space without burdening them with extensive documentation requirements thus offering minimal exposure to regulatory mechanisms. Funding by VCs is normally associated with prior registration under the Companies Act 2017 and thus subject to SECP regulations. However, in case of non-registration, release of funds is contingent upon registration. Therefore, the financial capacity and capability to meet regulatory requirements is simultaneously acquired in most cases.

Fund raising by start-ups, unless supported by family and other personal sources, is a complicated and cumbersome process. Access to finance has been considered a major impediment in business development and has been recognized as such by SMEDA. Securing VC funding is associated with sound value proposition and organizational prowess that ultimately leads to the acquisition of negotiated funds. Solving the winning pitch-deck mystery with extensive working to support the stated numbers of market and projected profitability is considered another problematic milestone in markets riddled with information asymmetries. Since, sectoral studies by the investment boards, other public entities, academics, and research organizations offer limited insights into dynamics of market functioning and their respective contribution to local GDPs; reliance on data accumulated by start-ups for building their business cases increases manifold. Implications of this reliance are far reaching as only partners in business including the VCs reach a convincing business case through a negotiated deal mainly relying upon an established proof of concept within the mutually agreed upon framework. Logic model or market analyses

governing the proof of concept may have its limitations that are overlooked by the prospective partners.

## **Blitz Scaling: Defeating the Odds**

Pakistan received over US \$ 500 million as VC funding for start-ups in the last 2 years out of which 350 million was in 2021 with half of it received by e-commerce start-ups. B2B, B2C and FinTech start-ups saw their rise in the recent years with increase in internet penetration and awareness of online purchases at the consumer level. Electronic Money Institution and digital banking licenses tend to support the transformation of FinTech start-ups in Pakistan.

US \$ 200 million went to Airlift and Bazar with an individual share of almost \$ 100 million each culminating in the business closure of the former. The poster child of start-up industry of Pakistan with prospects of being the first start-up unicorn met a fate that not only jolted the industry but also raised questions on the state of market regulation and future of VC funding for start-ups in the country. Pre-seed to seed and later series of funding, each is characterized by checks and balances that bear testimony to materialization of a great idea through a well-performing organization thus delivering on the promise of growth to scale and bringing about a market transformation. Therefore, despite these checks and balances, the shortcomings in business model and operations emerge as an intriguing phenomenon. The answer to this phenomenon has been noted in the form of blitz scaling.

Blitz scaling has been recognized as a method that helps beat the market odds by moving leaps ahead in the areas of extending customer / consumer base, revenue generation, and organizational development where the complementarity of each reinforces the growth of a start-up. The rationale, being drawn from lessons of World War II regarding carrying of supplies for offensive launches, does support the logic model of scaling as divulging dividends but steering away from conventional scaling-up methods also shrinks room for reflection and knowledge-based responses to market dynamics. Once business model for scaling a start-up is successfully agreed upon by VC, and that covers the proof of concept

stage, the responsibility for such scaling up rests with the start-up under the oversight of VC. Only possible safeguard is the milestone-based financing mechanism that is likely to allow for some check on performance. There also the milestones of progress may tend to be erroneous as the case of Airlift substantiates.

It is pertinent to note that Pakistan also hosts debates of over regulation in various forms that purportedly make the market dysfunctional. However, the phenomenon of start-ups funded by VCs stays clear of over regulations as the innovation and risk-taking elements of entrepreneurship are both recognized and nurtured by bilateral arrangements i.e. between start-up and VC(s) while adhering to the conducive regulatory requirements. Right from incorporation of company to the offering of equity to foreign / local VCs, regulations of SECP lay down specific requirements and guidelines for companies. The risk taking embarked upon by the start-ups and VC falls well within the policy framework space governing them as it fulfils all legal and policy requirements and thus is to be shouldered by the contracting parties.

Nonetheless, the model of market disruption and impact of innovation perceived by the start-ups and VC have a strong organic relationship with the state of sector and room for intervention. The marketability of innovation and effective functioning of market in formal domain are attributes of investment climate which is shared by stakeholders but shaped by the policies. Thus, policies allowing for asymmetries in form of functional markets in informal domain and lack of sectoral information indirectly condone the patronage of innovation by VC under a bilateral arrangement. The likelihood of misinterpreting the market and its needs increases manifold when investing into an idea or a knowledge product consumes the better sense of adopting market assessment mechanisms.

## Lessons from Failure and Recommendations

The national dialogue arranged by SEE Pakistan 2022 brought together entrepreneurs and representatives of VCs over the subject of Lessons from Failure: Future of VC backed Start-ups in Pakistan. The contextual policy analysis and

observations of key informants highlighted the following lessons for the start-ups of Pakistan:

### Understanding the Market

An entrepreneurial venture may present a convincing case of turning around the market through its innovative product and ensuing practices. However, the market dynamics may pose a diametrically opposite picture of consumer behaviour according to varying segments and local influences. Being mentally invested in an idea may not necessarily mean that a real market of scale exists for that particular product.

#### Recommendations

- a. Market dynamics are better understood by intensive research that is action oriented and appreciates the competition, product placement, consumer behaviour, pricing, and time to scale. Such research needs to be undertaken by actors in financing of start-ups.
- b. Stock-take as a systemic option of reflecting on the progress of entrepreneurial venture is exercised in its letter and spirit. This comes in addition to the routine monitoring mechanisms set in place by a start-up so that the whole internal ecosystem of progress against milestones with allocated resources is subjected to review / stock take. Periodicity of stock take may vary according to the nature of business and may be aligned with major milestones.

### Caution with Heuristic Approach

Heuristic approach to business problems is enticing and provides value with respect to constraints of time thereby determining efficacy within specified limits. However, quick fixes are not always the best solutions to real business problems. Incremental approach to problem solving with optimization of results while adhering to time and resource constraints may be considered as an alternate option.

#### Recommendations

- a. Time to market and staying relevant in the market are understandable concerns that can be effectively addressed by developing

a deeper understanding of the business problems. Relatively larger data sets may be required to substantiate the adopted business approach.

## Sectoral Studies

In the absence of state of the sector studies by research and development organizations or by the investment boards of governments, the available macro-level indicators for each sector of investment have to suffice for screening and selection purposes. Sectoral analyses presented by start-ups and readiness of sectors for a macro-scale intervention substitute for in-depth studies of multiple sectors.

### Recommendations

- a.** Federal Board of Investment takes up the task of consolidating sectoral studies by the provincial boards of investment and trade which serve as primary bodies of collating primary and secondary data from different sources. Thus, consolidated studies on state of different sectors will provide in-depth sectoral information and will serve as guiding yardstick for VCs.
- b.** Bureau of Statistics compiles data from different governmental entities on regular basis. The data collection exercise may be expanded to the inclusion of sector experts through building collaborative networks with wide range of stakeholders. The data thus collected needs to be updated on periodic basis with inputs of multiple stakeholders from industry and the academia.
- c.** Data sets from the bureau of statistics and other line departments are shared with universities and research institutes on periodic basis in accordance with the letter and spirit of the Right to Information laws. Moreover, the sharing of data produced by public sector entities will open avenues of research on issues of socio-economic importance besides feeding into the entrepreneurial ecosystem of universities.

## Achieving Proof of Concept

Start-ups strive for achieving proof of concept through appropriate level of functionality and profitability. Pre-seed and seed funding contribute to establishing the start-up and gearing it up to strive for proving that its idea is workable and profitable. Majority of the start-ups are unsuccessful in attaining initial functionality within the defined market let alone establishing beyond doubt that the innovation is worthwhile.

### Recommendations

- a.** Alternate means of financing are to be explored by start-ups comprising local financiers, financing institutions, and use of personalized financial instruments. Before seeking the VC's trust through financial assistance, the entrepreneurs ought to believe in their innovation and fund it through all available personal means.
- b.** Given the high rate of failure of start-ups, perseverance and continuous strive for materializing innovations are the business values to be adhered to by entrepreneurs.

*This Policy Brief Series is the product of Azra Naheed Centre for Research & Development (ANCRD).*

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