

**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 January 2002.

## **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<sup>(1)</sup>, 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<sup>(2)</sup>. Another report on the updated progress since July 2001 and on the latest investment strategy of the ARF was sent to Members for the meeting on 4 February 2002.<sup>(3)</sup> Members agreed at the meeting that the matter should be discussed at the meeting on 11 March. We have therefore updated the report to reflect the position as at end February 2002 for Members' discussion.

## **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. We reported in the update of January 2002 that of the two projects in progress, it was too early to

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

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

(3) Ref : LC Paper No. CB(1)939/01-02

assess the performance of one while another one was indicating problems. Among the completed projects, 17 were considered problematic one way or the other. The situation remains the same as at end February 2002.

6. Of the total 18 problematic cases as mentioned in paragraph 5, 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 reported in the update of January 2002 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 had therefore reached agreement with buyers to sell the ARF's shares in three companies at nominal values, and agreed with the other shareholders to wind up the fourth company which ceased operation since 1999. This means a loss of a total of some \$19 million or 20% of the total approved amount.

### ***Loan Cases***

8. Regarding the 14 loan cases, we reported in the update of January 2002 that our loan in one case had been written off as the company in question had difficulties in sourcing investments and was unable to repay the loan, while a smaller sum was settled for our loan in another case so as to reduce the debt burden of the company in question to facilitate its sale to prospective buyers. Since then, we have further written off the outstanding loan in another case, as it is apparent that the company in question has ceased operation and its guarantor does not have valuable assets for the purpose of repaying the loan. As a result, we have written off a total of some \$5.84 million (excluding interest) or 6% of the total approved amount.

9. We also reported in the update of January 2002 that enforcement actions (such as applying for the bankruptcy of the guarantors) were being taken and settlement offers considered for four cases for which we had taken legal actions and obtained favourable court rulings. We are continuing with the appropriate course of legal and enforcement actions.

10. As regards the remaining seven cases, we are taking legal actions or considering settlement offers as appropriate.

## **II. Projects funded through fund managers**

11. Since our update in January 2002, the ARC has approved one new investment and one follow-on investment in an existing project in the telecommunications sector, involving a total funding of \$15.6 million. As of end February 2002, the ARF has supported a total of 19 projects with a funding of

\$321 million. Details of the 16<sup>(4)</sup> active investments are at **Annex A**. The sectoral distribution of these funded projects is shown at **Annex B**.

12. The venture capital industry has stayed cautious with very few new investments. The general adverse economic situation and shrinking investments from venture capitalists continue to pose challenges to technology businesses. Under such circumstances, the two investee companies which were reported to be in severe financial difficulties in the update of January 2002 are still confronted with financing problems, and a few other companies have remained in financial distress of varying degrees.

13. The latest valuation as at 31 December 2001 of all the investments managed by our fund managers totalled 61% of the investment at cost<sup>(5)</sup>. The main reason for the below cost valuation is that our fund managers have remained 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**

14. We gave an update in the paper of January 2002 on the investment climate and the investment strategy. This remains to be the case and we are reiterating below for Members' easy reference.

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.

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.

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(4) We reported in the paper of December 2000 (Ref: LC Paper No. CB(1)276/00-01(02)) that two investments had been written off, and in the update of January 2002 (Ref: LC Paper No. CB(1)939/01-02) that another investee company had been wound up. This means a loss of a total of \$51.6 million or 16% of the approved funding. Meanwhile, a new investment has been made as mentioned in paragraph 11. Hence, a total of 16 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.

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  
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**Annex A****Applied Research Fund - List of Active Investments Managed by Fund Managers  
(Position as at end February 2002)****Information Technology**

<b>Investee Company</b>	<b>Fund Manager</b>	<b>Technology Area</b>	<b>Funding Approved (HK\$m)</b>
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 Ltd	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 Inc (formerly Uni-tech Systems Engineering Ltd)	AsiaTech Ventures Ltd	System integration, application hosting services	15.55

<b>Investee Company</b>	<b>Fund Manager</b>	<b>Technology Area</b>	<b>Funding Approved (HK\$m)</b>
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
<b>Total</b>			<b>154.60</b>

**Telecommunications**

<b>Investee Company</b>	<b>Fund Manager</b>	<b>Technology Area</b>	<b>Funding Approved (HK\$m)</b>
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 Inc	Softech Investment Management Co. Ltd	Broadband Video Streaming	15.60
CommVerge Solutions Ltd	Walden Technology Management (HK) Ltd	Total solution services	7.80
<b>Total</b>			<b>99.67</b>

**Electronics**

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

**Sectoral Distribution of Projects Funded after the Engagement of Fund Managers**  
**(Position as at end February 2002)**

