

# CHAPTER I

## INTRODUCTION

### 1.1 Background

In the early stages of a company's lifecycle, securing capital is crucial for enabling growth, innovation, and market competitiveness. Startups often struggle to access traditional funding sources, like bank loans, due to their high-risk nature and unproven business models. As a result, Venture Capital (VC) investors play a fundamental role in providing financial support that is required to scale operations, develop products, and refine business strategies. This financial investment allows early-stage companies to navigate the uncertainties of their early years and increase their chances of long-term success. Given the essential role of capital in a startup's growth trajectory, venture capital has emerged as a key enabler for companies seeking to transform ideas into viable businesses.

VC is a type of private equity financing focused on investing in early-stage companies with high growth potential. In exchange for funding, investors receive equity or an ownership stake in the business, sharing in both the risks and rewards of the company's success. This form of financing is crucial for startups, offering not only capital but also valuable expertise and networks that can significantly accelerate growth and innovation. Given the high risks and unproven business models of startups, venture capital provides a vital funding mechanism that enables these companies to scale and compete in dynamic markets. In 2023-2024, Indonesia is home to approximately 65 million micro, small, and medium enterprises (MSMEs), which employ over 90% of the national workforce, where these

businesses plays a critical role in the country's economic growth<sup>1</sup>, contributing around 61% of Indonesia's GDP, equivalent to approximately IDR 9.5 trillion.<sup>2</sup> Their vital role in driving Indonesia's economic growth underscores the need for sustainable development and the scaling of MSMEs. Despite their importance, many of these businesses face significant challenges in accessing funding, particularly as they seek to expand and innovate. Hence, venture capital plays a crucial role in funding high-potential MSMEs in Indonesia, offering the necessary capital for growth and helping businesses navigate the financial gaps that hinder their growth. As such, the evolving venture capital landscape in Indonesia plays a key role in supporting MSMEs' development and driving the country's long-term economic growth.

The origin of venture capital in Indonesia can be seen in the establishment of PT. Bahana Pembina Usaha Indonesia (BPUI) in 1973, where it was established with primary goal of offering assistance and working capital MSMEs in Indonesia. To ignite the development of venture capital in Indonesia, BPUI expanded its financial services in to include capital market investment, investment banking and trading securities<sup>3</sup>, along with the utilization of loans from the EXIM Bank, which led to the funding of regional venture capital entities across Indonesia.<sup>4</sup> Since then,

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<sup>1</sup> Otoritas Jasa Keuangan, "Roadmap For the Development and Strengthening of Venture Capital Firms 2024-2028, (2024), page 7

<sup>2</sup> Otoritas Jasa Keuangan, "Roadmap For the Development and Strengthening of Venture Capital Firms 2024-2028, (2024), page 7

<sup>3</sup> IFC, "Sejarah Indonesian Financial Group" <https://ifg.id/history>, accessed on 15 November 2024.

<sup>4</sup> Sulistyowati, "Existence of Venture Capital (Alternative Financing Solutions Micro, Small and Medium Enterprises", *Eksistensi Modal Ventura*, Vo. 05, No. 01, (April 2013), page 987 - 990

the venture capital landscape in Indonesia has grown significantly, which aims to provide support for early-stage companies and MSMEs across Indonesia.

Indonesia's investment ecosystem is notably fragmented, with a diverse range of investor profiles actively participating, which would include global venture capital firms, crossover growth investors with a global focus, sovereign wealth funds, corporate venture capital entities, Southeast Asia-focused venture capital firms, and venture capital firms that specifically targets the Indonesian market.<sup>5</sup> As of November 2023, venture capital firms in Indonesia have disbursed approximately IDR 17.39 trillion to businesses across the region and aims to reach venture capital funding of IDR 20 trillion in 2024.<sup>6</sup> Despite the growth of venture capital in Indonesia, KPMG reported that:

“[g]lobal [venture capital] (VC) investment fell from a five-quarter high of \$95.5 billion in Q2’24 to a nearly seven-year low of \$70.1 billion in Q3’24, amid ongoing geopolitical conflicts, the continued exit drought, anticipated seasonal lulls in investment in several key jurisdictions, and the uncertainty driven by the upcoming US presidential election.”<sup>7</sup>

Futhermore, the Indonesian Government has shifted its focus to strengthen the role of venture capital in Indonesia. This is seen through the enactment of the Regulation of the Financial Services Authority of the Republic of Indonesia Number 25 of 2023 on the Business Organization of Venture Capital Companies

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<sup>5</sup> AC Ventures & Bain Company, “Indonesia Venture Capital Report 2023”, (November 2023), page 23

<sup>6</sup> Jakarta Globe, “Indonesian Venture Capital Association Eyes Rp 20 Trillion Funding in 2024#:~:text=As%20of%20November%202023%2C%20venture,allocated%20for%20Sharia%2Dcompliant%20disbursements. accessed on 9 November 2024

<sup>7</sup> KPMG, “Global VC investment falls to lowest level in nearly seven years as number of US\$1 billion+ deals falters, according to KPMG Private Enterprise’s Venture Pulse report”. “<https://kpmg.com/xx/en/media/press-releases/2024/10/global-vc-investment-lowest-level-in-7-years.html>, accessed on 19 November 2024

and Sharia Venture Capital Companies (the “**POJK 25/2023**”), along with Law Number 4 of 2023 on Financial Sector development and Reinforcement (also known as “**P2SK Law**”), further signifies the shift in Indonesia’s financial industry. The P2SK Law establishes a clear legal framework for venture capital firms that previously lacked statutory recognition. This is essential to ensure legal certainty and enhance public confidence in the venture capital sector. By providing a formal legal foundation, the law not only legitimizes the operations of these firms but also promotes a more structured and secure investment environment. The aim of POJK 25/2023 and P2SK law is to develop and strengthen Indonesia’s financial sector following the slow capital deployment in 2022 as investors are reacting towards the declining global macro environment driven by geopolitical tensions and the rapid rise of interest rates, which is aligned with the mandate of the P2SK law as it encourages greater participation from investors that ultimately contributes to the growth and stability of Indonesia’s venture capital ecosystem. Indonesia’s Financial Sector Authority further elaborates by declaring that:

“Over the past five years, Indonesia’s venture capital sector has demonstrated resilience within the dynamic global and domestic economic landscapes, albeit with a certain level of volatility in its growth. The global economy has faced challenges arising from events such as the Russia-Ukraine war and the trade tensions between the United States (US) and China. Additionally, the Indonesian economy is currently in the process of recovering from the repercussions of the Covid-19 pandemic. To ensure the continued resilience and growth of venture capital in Indonesia, a strategic approach to development and strengthening is essential.”<sup>8</sup>

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<sup>8</sup> Otoritas Jasa Keuangan, “Roadmap For the Development and Strengthening of Venture Capital Firms 2024-2028, (2024), page 6

Notwithstanding the challenges, Indonesia currently remains as an active market in the regional VC landscape. This is evident through the twenty per cent (20%) increase of deal volumes in the region as investors focus on opportunities in early-stage companies.<sup>9</sup> According to Bain and AC Ventures, this is due to:

“(a) [the] macro fundamentals in the country remain stable and the country continues to have the most promising demographic tailwinds of any ASEAN economy; (b) the digital economy continues to expand, with consumer and SME adoption growing steadily; ... [and, (c)] the diverse set of international and local investors deploying capital in the market.”<sup>10</sup>

In recent years, investment trends have evolved significantly, with a noticeable shift towards industries that prioritize sustainability, innovation, and digital transformation. Investors are increasingly focusing on sectors that address pressing global challenges while capitalizing on emerging market opportunities. This shift reflects a growing interest in aligning financial goals with positive social and environmental impact. As Bain & Company and AC Ventures highlight:

“[t]he current (2023 onwards) trend in investments leans towards ESG and climate tech, particularly electric vehicles (EVs) and battery technologies. Health-tech remains robust in a conservative deal climate, and there is an upswing in digitally native, direct-to consumer (D2C) brands maximizing the influence of e-commerce platforms and social media tools.”<sup>11</sup>

Indonesia’s Financial Services Authority has also issued the Roadmap for the Development and Strengthening of Venture Capital Companies for the period of 2024-2028 (the “**Roadmap**”), with the aim to strengthen Indonesia’s venture

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<sup>9</sup> AC Ventures & Bain Company, “Indonesia Venture Capital Report 2023”, (November 2023), page 23

<sup>10</sup> AC Ventures & Bain Company, “Indonesia Venture Capital Report 2023”, (November 2023), page 23

<sup>11</sup> AC Ventures & Bain Company, “Indonesia Venture Capital Report 2023”, (November 2023), page 15

capital regime. According to the Financial Services Authority<sup>12</sup>, the presence of venture capital in Indonesia:

“... is expected to fuel innovation and technological development, support startups in their nascent stages, empower MSMEs and cooperatives, assist businesses facing setbacks, drive research and development, facilitate business ownership transfers, and offer numerous other advantages.”

The Roadmap aims to guide the future growth of the venture capital landscape in Indonesia through the practicing strategic approaches and programs that align with the current mark. According to the Roadmap, “[t]he country’s economic backbone relies on the presence of MSMEs, whose development serves as a vital tool for maintaining stable and robust national economic growth. Financial institutions, including venture capital, play a pivotal role in fostering the growth of MSMEs in Indonesia through crucial financial support.”<sup>13</sup>

Article 2 of POJK 25/2023 further supports the Roadmap by stating that:

“venture capital companies that carries out Venture Capital Business, are able to provide (a) capital participation, (b) investment through the purchase of convertible bonds, (c) financing through the purchase of bonds issued by the company; and/or (d) financing. Venture capital companies that focus on capital participation through the purchase of convertible bonds are allowed to carry out “financing through the purchase of bonds issued by the Business Partners at the initial start-up and/or business development stages and/or financing”.

The issuance of convertible bonds has emerged as a compelling choice for VC investors. Convertible notes are legal instruments allowing an investor to lend capital to a company with the intention that this loan will ultimately convert into equity. These convertible notes are especially common in early-stage companies

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<sup>12</sup> Otoritas Jasa Keuangan, “Roadmap For the Development and Strengthening of Venture Capital Firms 2024-2028, (2024), page 3

<sup>13</sup> Otoritas Jasa Keuangan, “Roadmap For the Development and Strengthening of Venture Capital Firms 2024-2028, (2024), page 6



that have yet to conduct equity-priced fundraising rounds.<sup>14</sup> In essence, a convertible note is a debt instrument issued by the company (borrower) to the investor (lender), which converts into equity upon the occurrence of a specified trigger event. The distinctive aspect of convertible notes lies in their structure as debt investments, which include legal provisions enabling their eventual conversion into equity in the company. The notion of convertible note is evident in Article 1 and 2 of the Government Regulation No 15 of 1999, where:

“a certain form of claim is any form of claim against the company that arises because... the company becomes has acted as a guarantor or guarantor of a third party’s debt, where the company has received benefits that can be valued in money... certain forms of claims can be compensated by the company through payment obligation of the price of shares of the company.”<sup>15</sup>

In contrast, equity financing in venture capital involves providing capital in startup companies in exchange for ownership shares, which gives investors a degree of control over the company’s performance. Unlike convertible note financing, equity financing does not require repayment; instead, it allows investors to take an active role in the company through the monitoring and decision making of strategic company decisions.<sup>16</sup> This concept aligns with shareholder rights under Law No. 40 of 2007 concerning Limited Liability Company, which grants shareholders the entitlement to information, participation and voting rights in shareholder meetings, dividends and asset distribution upon liquidation, along with other rights

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<sup>14</sup> KPMG, “Interpreting Convertible Notes Exploring alternative fund raising investments in Bahrain for Closed Joint Stock Companies”, (2023), page 3

<sup>15</sup> Government Regulation of the Republic of Indonesia Number 15 of 1999 on Certain Forms of Claims Which Can Be Compensated As Share Deposit

<sup>16</sup> Paul A. Gompers and Josh Lerner, “What Drives Venture Capital Fundraising”, *Brooking Papers: microeconomics*, (1998), Page 1511

established by law.<sup>17</sup> Given the rise of venture capital and the government's commitment to developing and strengthening Indonesia's financial sector, it is important to investigate the factors that drive investor preferences for using convertible notes or equity financing in early-stage venture capital investments in Indonesia, as well as the potential benefits these financing options provide to investors.

## **1.2 Formulation of the Problem**

1. What are the regulatory frameworks of VC companies in Indonesia?
2. What are the advantages and disadvantages of using convertible notes and equity financing for VC investors?

## **1.3 Objective of Internship**

The author's primary objective in undertaking the work experience at AC Ventures extends beyond the fulfilment of the dissertation requirements set by the Pelita Harapan University. The author's main objective is to immerse herself in the legal and financial aspects of venture capital investments, particularly within the Indonesian market. This internship is intended to provide the author with a deeper, practical understanding of how the legal mechanics in venture capital funding works, primarily through the use of convertible notes and equity financing. By participating in these processes, the author seeks to gain valuable insights into the complexities and challenges that arise in venture capital deals.

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<sup>17</sup> Article 52 and Article 66 of the Law of the Republic of Indonesia Number 40 of 2007 on Limited-Liability Companies.



Furthermore, the author aims to leverage this opportunity to expand her professional network, a critical component in shaping her future career. Establishing connections with key industry players, legal experts, and financial professionals is expected to facilitate the development of long-term relationships that aims to support the author's career growth and provide ongoing opportunities in the venture capital and legal sectors.

## **1.4 Benefit of Internship**

### **1.4.1 Theoretical benefits**

The theoretical benefits of this internship is by bridging the gap between academic research and real-world legal practices in venture capital, especially in a growing and emerging market like Indonesia. The practical exposure to the dynamic environment of early-stage investments offers invaluable insights into the legal frameworks and strategic considerations that govern venture capital transactions. It allows for a deeper understanding of the complexities involved in structuring deals, whether through convertible notes or equity financing, within the specific legal and regulatory context of Indonesia.

### **1.4.2 Practical benefits**

This paper aims to provide the following practical benefits:

1. Academics: The comparative analysis of convertible notes and equity financing models involved in venture capital transactions aims to contribute to the academic understanding of how venture capital fundings are structured, particularly in the context of early-stage startups. This analysis

is expected to enhance the existing body of knowledge and provide a foundation for further research on legal financing in venture capital.

2. Society: The comparative analysis of convertible notes and equity financing models involved in venture capital transactions aims to offer practical insights into the advantages and challenges faced by investors and startups in Indonesia, helping to identify the most effective ways to structure deals while ensuring compliance with local legal frameworks.
3. Legal practitioners: The comparative analysis of convertible notes and equity financing models involved in venture capital transactions in Indonesia aims to offer practical guidance for legal professionals who are looking to navigate Indonesia's regulatory landscape and optimize investment structures based on legal risk and return. Additionally, by exploring the difference in the financing models, the paper aims to provide legal practitioners with a deeper understanding of the legal risks and considerations involved in venture capital transactions.

### **1.5 Location of Internship**

The internship activity as a prerequisite for completing the final project is carried out at AC Ventures, with the following details:

Address: Prosperity Tower, Level 37 Unit B, Office District 8, SCBD Lot 28, Jl. Gen. Sudirman kav 52-53, RT.5/RW.3, Senayan, Kec. Kby. Baru, South Jakarta City, Special Capital Region of Jakarta, Indonesia.

Telephone Number: +62 21 50123215

## **1.6 Internship Duration & Hours**

As a permanent employee of the company, the author has been employed since August 8, 2022, and continues to work with the company to the present day. The author's working hours are from Monday to Friday, starting at 09:00 and ending at 18:00 WIB, and are carried out on-site.

## **1.7 Writing Structure**

The writing structure of the paper will be systemized to the following:

### **1. Chapter 1: Introduction**

This section aims to provide a comprehensive overview of the research topic, outlining its importance, objectives, along with the benefits.

It also explains the details of the internship conducted by the author.

### **2. Chapter 2: Theoretical Frameworks**

This section aims to provide the foundational framework for understanding the key concepts, principles and theories relevant to the topic of the paper. The author aims to provide context for the topic by introducing the theoretical frameworks that will guide the paper and validate the findings of the paper.

### **3. Chapter 3: General Description of the Place of Internship**

This section aims to provide context on the author's place of internship. It offers insight on the mission and background of the company, including its organizational framework. It also describes the different divisions of the company, including the flow of workload.

### **4. Chapter 4: Discussion**

The section aims to assess the arguments presented in the paper. In this section, the author aims to examine the results in relation to the topic of the paper and provide a holistic discussion on the results of the comparative study. It also aims to address the strengths and weaknesses of each legal strategy for structuring venture capital investments in Indonesia.

#### 5. Chapter 5: Conclusion and Recommendations

This section provides a concise overview of the key points and findings discussed in the paper. It serves to summarize the essential concepts, arguments, and conclusions. This section aims to help the readers understand the flow of the paper and reinforce the major points in the paper. It also provides recommendations for future research or practical applications based on the findings and conclusions of the study, including suggestions on areas where further exploration is needed.