

## **Analysis of Venture Capital Trends in Russia**

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### ***Abstract***

*The article discusses creation and development of venture investment mechanism in Russia. We analyze some tendencies of venture capital funds functioning which should be focused on the financing of development and production of high-tech products, for the period from the creation of the first funds of venture capital investment in 1994 to 2015. The study results may be of interest for business angels and venture capital funds, as well as for public authorities regulating the legal mechanisms to facilitate such investors.*

**Keywords:** *venture capital funds, venture capital investment, business angels, innovation, high-tech production*

### **1. Introduction**

An innovative model of development implemented by the Government of Russia causes the creation of its financing mechanism. One of the most effective tools for financing innovation in the world is venture financing. Creation of venture capital is realized through venture capital funds, in Russia the first of them were created on the initiative of the European Bank for Reconstruction and Development in 1994. In 1997 in order to create conditions for the development of venture capital investments Russian Venture Capital Association was established.

Today venture capital funds are a source of funding for the creation and development of high-tech knowledge-intensive industries and products. The need for long-term financing, the lack of own funds, the inability to obtain bank loans due to lack of collateral and credit history, high risk as a result of market uncertainty - that is the characteristic of an environment for the newly organized production.

### **2. Methods**

To analyze the activity of venture capital we use the method of trend analysis which allows to identify trends in the indicators characterizing the main results: the number of funds and their capitalization, capital structure, the amount of invested transactions, industry preferences for the period of existence of such funds since 1994 until today.

### **3. Our study**

In 1994-1995 allocated by international financial institutions \$ 700 000 000 were used to support small and medium-sized high-tech enterprises through the first by 11 funds. By 1997, there were already 37 funds, and their market capitalization amounted to \$ 2.6 billion as a result of the interest of institutional investors in the financial market emerging in Russia. 10 funds closed in the default period of 1998-2000, however, 7 new funds were created in 2001. By the end of 2004, there were 62 venture capital funds managing a capital of \$ 4.1 billion. In 2015, there were already 338 funds with a total capital of \$ 24.7 billion. Until 2005 foreign investors dominated in the structure of capital sources, about 90% until 1998 and 75% in subsequent years. Subsequently, the sources of capital were not disclosed, we only know the structure of the Russian part, in 1994 - 2007, for example, the state's share amounted to 15% of the capital of venture capital funds. By 2015, the activity of the funds with state participation in the market decreased.

The period of 1994-2004 can be characterized by low amounts of investments in the creation and development of small high-tech enterprises. Subsequently, the capitalization of funds has increased significantly, and in addition to the initial stages the funds began to finance the stage of product creation.

In general, venture capital market in Russia was the most active in 2012. However, already in 2013 the first signs of decrease appeared, and a high degree of uncertainty in the economy predetermined the reduction of all key indicators in 2015.

A major role in maintaining market played state support. Thus, about 35% of the number of new venture capital funds were funds with state participation. Their total volume was at the end of 2015 was 74% of the total capital of new venture capital funds. Funds with state participation are both state funds and funds established under public-private partnership.

Another 40% of venture capital investments were the result of activity of the Foundation for the Development of Internet initiatives. This fund is formed from extra-budgetary sources, however, the initiative of its creation came from the state. Priorities of this fund are educational, legislative and infrastructural projects.

As a result, the share of venture capital funds with state participation in the total venture capital investment by the end of 2015 amounted to about 25%.

The total volume of implemented investments in 2015 decreased slightly (95% of that in 2014) as well as the number of investments (83%. of those in 2014).

The devaluation of the Russian rouble has caused compression of capital funds and has led to decrease in the total capitalization of the funds: the total capital of direct and venture investment funds in the Russian market was \$ 24.7 billion (compare with \$ 28.9 billion in 2013). At the beginning of venture market development in Russia the situation was as follows: the cumulative market capitalization amounted to \$ 2.6 billion by 2001, \$ 3.2 billion by 2004, \$6, 3 billion by 2007, \$ 10.3 billion by 2008, \$ 15.2 billion 2010. At the same time the rate of growth of the total capital were very high: 25.6% in 2006, about 60% in 2007, more than 40% in 2008, 6 % in the crisis year of 2009, 22.6% in 2011, 28% in 2012, 6.9% in 2013 on the eve of the crisis. The pace of changes is influenced by scenarios of economy development by the Government. Non-completion of key indicators increases the degree of uncertainty in the implementation of the following project scenarios that immediately affects the behavior of investors.

Stage distribution of investments is defined by levels of risk and return. Since the best results are usually shown by companies at the expansion stage, it is their share which attracts the largest amount of funds: from 2/3 in the early development of the market in 1994-1998 to 3/4 in 2006 and 2/3 in recent years again. The share of funds invested in the restructured companies is stable, about 14-16% throughout the observation period.

The proportion of funds invested in the "seed" stage of business development is slightly increasing - from 2 to 6%, which is assessed positively, the feature is the predominance of state funds to support carrying out such projects. In recent years, the share of investment in the early stages significantly increased - from 5% at the beginning of development of the market to 22%.

The aspect of the industry preferences of investors in the seed stage is interesting from the perspective of business.

The analysis shows that 90% of the investment at the seed and early stages does not exceed \$ 5 million, with 64% of the total number of such investments in 2015 received by the sphere of information and communication technologies, 8% in biotechnology, 5% in industrial equipment. The most rapid growth of investment is in biotechnology, which is associated with the creation of large pharmaceutical clusters. Almost 100% of investments were provided by funds with state participation.

In the later stages of investment in industrial equipment are growing fast. However, the total volume of invested funds at all stages of is distributed differently: 37% (385.5 and 380.5 million dollars respectively) received by the transport and energy, 23% - by ICT sphere, 2% by biotechnology. This is due to the participation of major foundations with state participation in infrastructure projects.

The territorial distribution of investment is shown in the Table 1. Obviously, the Central Federal District dominates in this distribution over the entire observation period. The interest of investors in recent years can be moved from the North-West Region (which has been attractive for more than 15 years) to Siberia and the Far East due to the development and implementation of the state program for the development of these territories. In other districts, the statistics shows uneven investor interest in the venture capital market in their territories. The newly formed North Caucasus Federal District and the Crimean Federal District cause no interest for venture capital market yet.

**Table 1. The territorial distribution of investment**

	1994-1998	2006	2010	2012	2015
Central Federal District	39%	71%	67%	89%	63%
Northwest Federal District	26%	21%	24%	2%	23%
Volga Federal District	11%	0%	7%	1%	0%
Far Eastern Federal District	7%	1%	0%	7%	4%
Siberian Federal District	7%	5%	0,6%	0%	10%
Southern Federal District	8%	0%	1%	21%	0%
Ural Federal District	2%	25	0,4%	0%	0%

The total amount of invested deals in the period of 1994-2015 (see [1]) is shown in table 2.

**Table 2. The amount of deals 1994-2015**

1994-1998	1998-2003	2007	2008	2009	2010	2013	2014	2015
\$1162	\$1304	\$1017	\$1421	\$1000	\$2514	\$2915	\$1076	\$1042
mln	mln	mln	mln	mln	mln	mln	mln	mln

A significant part of these investments were funds of business angels - private investors who invested private money into risky assets. It is obvious that the progressive development of the economy ensured the growth of venture capital investment, and the economic slowdown led to a compression of the risky investments.

Industry preferences of venture investors throughout the study period (see [1]) also significantly changed, as shown in table 3:

**Table 3. Industry preferences**

	1994-1998	1999-2004	2006-2007	2010	2013	2014	2015
Information and communication technologies	23%	31%	24%	42%	60%	40%	23%
Consumer market	29%	26%	48%	11,5%	1,5%	10%	-
Financial service	2%	8%	15%	33,5%	16%	-	-
Energetics	14%	5%	-	4%	3%	3,5%	36,5%
Transport	1%	3%	4%	1%	2%	14%	37%
Industrial equipment	5%	7%	1%	4%	2%	-	-

Constant interest of venture capitalists is a sphere of information and computer technology, in 2015 left behind only by energetics and transport sectors.

Apparently, the interest in the energy sector is due to the state legislative policy of energy saving and energy efficiency, which ensures quick resolution of issues related to the implementation of projects at all levels.

Profitable and fast are projects in the consumer market. Therefore, the funds seek such an application that could simultaneously address social and image problems for the state. For example, Venture Investments & Yield Management has prepared the project of reconstruction of the former market in St. Petersburg. By the beginning of the 2018 World Cup it is planned to open Holiday Inn Express Hotel 3 \* (244 rooms), hostel Meininger Hotel Gruppe (158 rooms), as well as restaurants and shops in a building in the city center. The investment in the project is estimated at 3 billion roubles (see [2]).

Earlier, the investor planned to open a luxury hotel under the brand Crowne Plaza. Simultaneously, the fund plans to sell 9 hotels of Regional Hotel Chain (general fund of 1379 rooms) to Intourist, part of the financial corporation "Sistema". All the hotels operate under international brands, such as Park Inn by Radisson, Holiday Inn Express and Courtyard by Marriott. According to preliminary data, the value of assets is estimated at approximately \$ 100 million (see [3]).

#### 4. Conclusions

Other directions for innovative development are unstable: the interest in industrial equipment manufacturing waned, as well as to the financial services industry. Very minor investments were made in the pharmaceutical, biotechnology, ecology, despite the obvious potential of these innovative sectors of the

economy. Insufficient funds are invested in light industry and agriculture. The reason, apparently, is either insufficient rate of return or the length of the project duration and, hence, the term profit.

The state, correctly assessing the role of venture capital investors in the implementation of innovative development of the country, released by the Federal Law on the taxation of personal income and corporate profit tax revenues received from the sale or redemption of securities of Russian companies and shares, in high-tech innovation sector of the economy. The zero rate will continue until 2023. This privilege is supposed to attract business angels, as well as to provide investment growth in these sectors, which are associated with long-term completion of a cycle of scientific and production activities.

## **References**

- [1] Russian Association of Venture Investment <http://www.rvca.ru/rus/resource/library/rvca-yearbook/>
- [2] Vedomosti, <http://www.vedomosti.ru/>
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