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Szkoła Główna Gospodarstwa Wiejskiego w Warszawie
Wydział Nauk Ekonomicznych

Warsaw University of Life Sciences - SGGW
Faculty of Economic Sciences

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VENTURE CAPITAL AND ITS FEATURES IN UKRAINE

Iryna I. Mazur, Vitaliy V. Zyanko

Taras Shevchenko National University of Kyiv

Abstract. In the article the economic content and the purpose of venture capital has been investigated; its benefits comparatively with other forms of innovation projects financing were discovered; current situation of Ukraine's venture investment was analyzed; problems and prospects of Ukraine's venture capital funds were explored.

Key words: venture capital, innovative projects, forms of financing, development perspective

INTRODUCTION

The number of businesses that become venture capitalists have been rapidly growing in developed countries. More and more people are involved in venture business every day in different ways because of the prospects of quick and easy money in a relatively short period of time.

The selection of different sources of financing various projects (mostly innovative), their structure and specific means of attracting is the most difficult task for an entrepreneur as it will impact the financial efficiency of the project. If an investment project is accomplished by a newly established and provides for high returns of investments, the potential source of investment is mostly some venture capital that is exceptionally important for such innovation project. Innovation activities are business-related with taking risks significantly more than the other business areas, as there is no guarantee of a positive result. Nevertheless, in the areas requiring significant initial investment venture business is often the only possibility of entering the market due to the risks that are not allowed for traditional lending institutions.

For Ukrainian entrepreneurs the search for raising funds for innovation projects is being complicated by the instability of the current economic and

political situation in the country, lack of qualified specialists of venture capital management and the fact that the activity of venture funds hasn't been introduced legally yet (there is no law on venture capital funding). So, investigation of the characteristics of venture capital investment in Ukraine and the possibilities of its applying by domestic enterprises are very urgent.

RESEARCH METHODS

The investigation of the problems related with functioning of venture capital market and innovative development has been presented in a lot of scientific works of domestic scientists, such as Viktor Bazylevych [2008], Zacharias Varnaliy [2007], Vitaliy Zyanko [2013], Tetiana Kalinesky, Oleksandr Antipov, Viktoriya Koretska-Garmash [Kalinetskiy et al. 2009], Vasyl Kovalyshyn [2009], Iryna Mazur [2013], Oleg Kuzmin, Marta Naichuk-Khrushch, Olha Huk [Kuzmin et al. 2011], Ihor Lyutyi, Ruslan Pikus, Nataliya Prykaziuk, Kseniya Starovoit-Bilyonk [Lyutyi et al. 2010], Valeriy Osetskiy [2011], Galyna Philiyik [2008], Liliya Shylo [2010] and others.

The most noteworthy works of the foreign scholars studying the problems of venture financing of innovative activity are the ones by Bob Zider [1998], Constantine Christofidis, Oliver Debande [2001] etc.

However, the issue of venture capital investment requires further investigation, as well as improvement of definitions and systematization of theoretical and practical knowledge.

The aim of the given article is to investigate the contents of venture capital, its organizational structure and to identify the features of manifestation and prospects for future operation and development in Ukraine.

RESULTS

The term 'venture capital' (VC) is understood as an alternative form of investing for some cases where lenders are not willing to finance a business proposal. There is a huge difference between self-financing, getting a loan from a credit institution, selling a part of the enterprise's capital and venture investment. Attraction of venture capital is easy and fast, it doesn't require additional expenditures on the part of the entrepreneur (payment of loan percentage) and management is vested in the hands of the leaders of the company. Venture capitalist shares all the risks with an entrepreneur. While the involvement of own financial resources is limited, selling of a part of company's capital needs much time and the process of obtaining a loan from a credit institution is gravely and requires extra costs to cover the loan.

Venture capital is the main source of investing innovation businesses. Venture funds unite investors to undertake businesses with some growth potential. This is a very important source of funding for startups that don't have access to other funds due to the high level of risk, but potentially promise high profitability for their investors.

Before the cooperation between a venture investor and an entrepreneur starts, the entrepreneur must be able to give clear answers to the following questions:

- Is the business ready for involving new partners who would place specific requirements on the control and management of the company?
- Is the entrepreneur ready to explore what venture capitalists want (his own ideas may suit the author's needs, but may not be sufficient enough to attract a venture capitalist)?
- Is the entrepreneur ready to spend time looking for venture capitalists? Since venture capital is much harder to get than a bank loan. And the process of researching each other as potential new partners is time-consuming.
- Does the entrepreneur realize that he is likely to sell the bigger part of the company than that planned prior? And it's the venture capitalist who will set the rules and often a half or even bigger part of the business will be owned by other shareholders.

If the answers to these questions tend to be positive, venture capital is what you really need.

Venture capital investments will allow organizations to start a project, demonstrate its viability, and reduce the risk level that will enable being issued a bank loan at the next stages of the project development, which initially seemed to be impossible.

Venture investment is most suitable for companies requiring considerable amounts of capital at the early stages (seed stages) of the project and which aren't in the position to get indispensable assets from credit institutions. This is often connected with purchasing immaterial assets such as software or other objects of intellectual property rights, the exact value of which is difficult or impossible to determine beforehand.

Typically, venture capital is best suited for businesses that:

- have a real business plan able to convince a potential investor in its reliability and perceptivity of the company that provides the project,
- require the significant amount of money, which is difficult to obtain in the form of bank loans at the early stages of the project,
- passed the start-up period of formation and are ready for rapid expansion and growth,
- are endowed with good liquidity prospects,
- have an ideal risk-benefit ratio in the eyes of investors.



Venture investors don't require guaranteed monthly payments, which explain why venture investment is the most common form of financing technology and knowledge-intensive industries that develop rapidly. At the same time, it does not mean that venture investors finance innovative projects without any conditions. The attraction process of venture investment (venture capital) has substantial distinctions from getting borrowings or credit.

Lenders have legitimate rights to some percentages on the loan, independently of success or failure outcomes of a business project and venture capital is invested in exchange of a share of the business.

In other words, the return of venture investments depends on the growth and profitability of a business. This return usually takes place when a venture capitalist 'comes out' of the business project by selling his shares.

The terms of 'departure of investments' were complicated in Ukraine by the considerable amount of criminal capital in the economy that has had negative effects on the processes of interaction between entrepreneurs and investors, and so is a major risk for the domestic venture businesses.

The distribution of common risks between a venture investor and an entrepreneur, the long period of coexistence and open declaration the goals by the both parts at the initial stage of the co-work are the possible components of a feasible but not guaranteed success. However, it is this very approach that makes the main difference between venture capital funding and bank loans or strategic partnership [What is business venture].

Since most of venture investments are illiquid and require a long payback period, venture capitalists conduct detailed auditing before investing to increase the feasibility of successful investments.

Investments of venture capitalists are nothing else than a form of partial ownership, usually involving administrative and operational control of an enterprise by a venture capitalist. This type of investment is sometimes called tolerance money, and they generally issued for a period of 3 to 7 years. Often representatives of venture capitalists are the members of the Board of Directors of the company and have a significant impact on a decision-making executive body.

As a rule, companies that might become highly profitable in a relatively short period of time are financed by venture capital.

However, the amount of money invested by a venture capitalist can increase or decrease in the direct proportion to the success or failure of an enterprise. And yet, a professional venture capitalist can provide:

- financing that is available when other sources are unavailable due to the extremely high risk level,
- assessing the growth potential of a company that urgently needs large amounts of capital; if several venture firms have already refused to provide it, then

the business concept might be considered to be unable to satisfy the strict standards and, most likely, is wrong,

- issuing additional funding that can be obtained in a relatively short period of time and in sufficient quantities to finance the growth of a company at any stage after initial venture investments have been already issued.

It is advantageous for a venture capitalist because investing in perspective innovation companies in exchange for a package (usually not a controlling one) of shares he expects earning profit by selling his shares after a significant increase in their value in the case of a business success. This is the main motivational factor of his activities because the motivation is primarily determined by the obtained financial remuneration in the market economy [Zyanko 2013, p. 18]. The fact that a venture capitalist does not seek to acquire a controlling stake of shares of a company distinguishes him from other strategic investors who tend to seek control over businesses trapped into their scope. A venture investor hopes that the company will use his money as a financial tool for ensuring rapid growth and business development, understanding that the implementation of high-tech projects for various reasons are not always completed by predictable outcomes: according to the Western specialists - more than 50% of all innovation projects associated with high technology end in a failure; the experience of high-risk enterprises demonstrates that approximately 15% suffer failures; 25% lose more than they earn, 30% hardly make ends meet, and only 30% of firms that use venture capital earn extremely high profits that offset all the factual costs [Concept of...]. Calculation for obtaining the highest incomes is forcing venture capitalists to go to the exorbitant economic risks.

Apart from the financial assistance, cooperation with a professional venture capitalist allows the company to borrow his experience in the financial growth management, use the numerous venture capitalists' contacts that will help accelerate the development, reduce the risk and overcome problems that arise. The experience of successful owners of businesses shows us that skills and contacts of a venture capitalists are more precious than money invested [Zider 1998].

Venture investment typically involves four stages [Venture capital]:

- emergence of ideas,
- their practical implementation (launching),
- augmentation of scales,
- departure of a venture investor.

The process of venture financing in most cases consists of six sequential stages which roughly correspond to the stages of a company development [Corporate Finance 2008]:

- initial funding being characterized by low levels of cash flows that are essential for a new idea vital activity test; such financing is often issued by business angels,



- commissioning (start-up) is an early stage of a firm's life, which should carry the costs stipulated by marketing and developing new products,
- growth is the launch of the first batches of products or services and expansion of production capabilities,
- functioning of working capital is not profitable at this stage,
- extension is the increasing of investments in order to make the company profitable,
- departure of a venture capitalist.

Venture entrepreneurship is an effective means of stabilizing and developing the real sector of economy despite the fact that it conveys certain risks and disadvantages. In particular, venture business is carried out by a sequence of distinct stages. The starting point is the formation and acquiring of innovative ideas. The disadvantage of this phase is that the authors of innovations often overestimate the potential results of its activities and underestimate the real conditions and possible difficulties in implementing their ideas. Exactly for this there exists the second stage in which objective examination, estimation and analysis of all probable factors of influence on the development and implementation of innovations under the guidance of professional and qualified economists, financiers, managers and marketers should be performed.

Heads of venture firms watch scientific researches; look for prospective ideas financing of which should be reasonable. However, the risk is enhanced at this stage of activity because due to an even insignificant mistake a firm can invest money into a hopeless project or, conversely, ignore and miss a perspective idea. In practice experts and venture capitalists claim that they never invest money at the stage of development of an innovative idea through a very high degree of risk. Therefore, in order to minimize possible losses one should be extremely careful in performing a feasibility study of an innovation at this stage. Otherwise the market mechanism will automatically destroy the made innovation progress and established results.

A venture investor directly joins the project when a business plan or even an experimental model has been already compiled. Of course, during making the final decision environmental, technological, technical, social and other factors in addition to calculation of potential profitability are of the greatest importance. However, they usually become crucial for the Ukrainian economy only when the earmarked funds of different organizations are allocated, or when the investor pursues specific objectives (for example, the creation of the corresponding image on the market).

Direct practical implementation and the process of implementation of an innovative idea is an important stage. Initially, an experimental model is produced and then the trials are carried out and only if the comprehensive analysis of all the factors provides positive results innovation comes into the batch production

whereupon massive implementation follows. A venture firm as a joint owner of a business might raise the question of the sales of its part of an organization to other investors if the high level of profitability is achieved due to venture investments, because the main income is received by a venture investor from the growth of the market value of the invested object. On this stage venture investments are completed leaving a debugged process that will give ordinary income that will satisfy traditional investors.

Venture investing in Ukraine has been made possible after the adoption of the Law of Ukraine on joint investment institutions (unit and corporate investment funds) [Law of Ukraine... 2001]. Today venture investments are primarily used for optimization of asset management of financial and industrial holdings and reduction of tax burden (exemption from profits tax). Such situation is due to non-transparent and imperfect legislation, limited financing and, as a result, unprofitable investments into innovations under these conditions. Ukrainian legal regulation of venture businesses does not include such factors of influence as insufficient development of the insurance and stock markets and the banking system.

Venture investment in Ukraine is a form of direct investment and venture funds which are sources of venture capital in its classic sense are financed from pension and insurance funds. In fact it is bringing capital into companies having a chance to grow rapidly for a period of a few years (usually 4–6 years), in small and medium enterprises, in particular. This fact presents the main purpose of venture investment as the providing current assets to small profitable firms. Researches indicate that companies supported by venture capital are more prepared for assimilating innovations, developing faster and creating more jobs than large companies are [Brazhko 2013].

In practice the most common form of combined venture investment is the one where a part of the funds is paid in share capital and the other is provided in the form of investment credit [What is business venture].

The weakness of intellectual property protection which affects the development of scientific and technological potential and inhibits the formation of a new innovative model of national economy [Bazylevych 2008, p. 385]; high risks and distrust of innovation projects; lack of favorable and stable investment climate; insufficiency of investors willing to invest money into high-risk projects can be attributed to the destructive factors of Ukrainian venture activity development.

Nevertheless, according to the Ukrainian Association of Investment Business, despite not very favorable conditions the numbers of registered Collective Investment Institutions (CII) per one Asset Management Company (AMC) is increasing in Ukraine (see Table 1). Although it is worth mentioning that in 2009 the absolute number of CII decreased relatively to its number in 2008. Also, there the number of AMC fell during 2009–2010: in 2009 – from 409 to 380 (–29 companies;



TABLE 1. Dynamics of number of AMC on one CII in 2008–2011

Index	31.12.2007	31.12.2008	31.12.2009	31.12.2010	31.12.2011
Number of AMC	334	409	380	339	345
Number of CII	2.5	3.04	3.16	3.62	4.10

Source: About Association of Investment Business (UAIB).

–7.1%); in 2010 – from 380 to 339 (–41 companies; –10.8%). However, the gradual recovery of the stock market is still there: the number of AMCs rose from 339 to 345 (6 companies; 1.8%) in 2011 [About Association...].

The structure of venture capital sources depends on the specific legislative regulation and entrenched in the financial area rules and regulations. However, for most countries the traditional sources of forming investment funds are the funds of investment institutions, private investors, pension funds, insurance companies and various governmental agencies and international organizations. In order to raise the competitiveness of domestic enterprises the Ukrainian government should encourage investors to invest in high-tech, high-technology production by means of state regulation of the commercialization scientific research and development [Mazur 2013, p. 7].

CONCLUSIONS

According to the authors, the main issues for Ukrainian businessmen in the search for investment sources and the ones a venture investor pays attention to when choosing a project are as follows:

- A successfully formed team of different specialists complementing each other;
- An experimental product, i.e. its prototype (a potential venture investor should see that he is approached with not only an idea);
- The information about competitors, their strengths and weaknesses (if you specify that there is no competition, such a gesture will be perceived by venture capitalists as a lack of an adequate level of competence or as a non-profit industry area as if the industry niche is still free it is most likely unproductive);
- The knowledge of the market (from bottom to top and vice versa);
- The presence of a business project, not a business plan as the latter is based on surmise at the last stage;
- The availability of a presentation (usually 10 slides, maximum 15, the first of which presenting yourself and your team).

It is important that one remember that business angels charge up to 20%, and ventures – up to 30% of the profit for their services. However, in most cases the

share of a business angel profit does not exceed 10%, and for venture fund this index is within the 15–20%. If the offered terms are different from the given above, you should consider continuing with the search for other investors.

According to the authors, the ideal option of project promotion in the market is to obtain the initial investment from business angels (the amount of investments ranging from 10 thousand to several million dollars). Then, in the later stages of the investees, where the financing amounts are much greater, it will be much easier to raise money from a venture fund (usually from 250 thousand to 20 million on one 'round' of financing).

Consequently, for sustainable economic growth in Ukraine it is advisable that a strong network of business angels and venture funds for attraction of investments in all types of Ukrainian businesses be created. And the development of these alternative forms of investment will let Ukraine be on the level of the leading countries of the world.

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VENTURE CAPITAL I JEGO CECY NA UKRAINIE

Abstrakt. W artykule przedstawiono istotę i cel wykorzystania venture capital; zaprezentowano korzyści wynikające z finansowania projektów innowacyjnych tym kapitałem, w porównaniu z innymi formami finansowania; dokonano analizy obecnej sytuacji na rynku venture capital na Ukrainie; przedstawiono problemy i perspektywy rozwoju finansowania venture capital na Ukrainie.

Słowa kluczowe: venture capital, projekty innowacyjne, formy finansowania, perspektywy rozwoju