

# US - Russia Seminar

on

## Venture Capital for Technology Business Growth



Russian Ministry of Industry,



Science, and Technology

**BISNIS** [www.bisnis.doc.gov](http://www.bisnis.doc.gov)  
Business Information Service for the Newly Independent States



**RVCA**  
RUSSIAN VENTURE CAPITAL ASSOCIATION

**U.S. – Russia Seminar**  
**on**  
**Venture Capital**  
**for**  
**Technology Business Growth**



U.S. Department of Commerce  
Technology Administration  
Office of International Technology

**U.S.-Russia Seminar**  
**On Venture Capital for Technology Business Growth**

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## FOREWORD

On March 15, 2002, the Technology Administration of the U.S. Department of Commerce and the U.S. Civilian Research and Development Foundation for the Independent States of the Former Soviet Union (CRDF), in partnership with the Ministry of Industry, Science and Technology of the Russian Federation and the Department of Commerce's Business Information Service for the Newly Independent States (BISNIS), hosted the U.S.-Russia Seminar on Venture Capital for Technology Business Growth, in Washington, D.C.

The Seminar brought together U.S. experts in venture capital development and Russian policymakers, technologists, and representatives of Russia's nascent venture capital industry for a spirited discussion on venture capital development and its role in supporting technology business growth in the United States and Russia. The goal was to provide a forum for U.S. experts to share their experience in creating and managing venture capital investments and for Russian experts to share their plans to encourage a robust venture capital industry in Russia. The panelists acknowledged the role that venture capital investment could play in fostering technology-led economic growth in Russia, but also noted the complexity of creating in Russia an open, transparent, and risk-taking business environment that is needed for venture capital investment to succeed.

This document provides a summary of the Seminar presentations and discussions. The Seminar agenda, list of panel members, summary of discussions and Seminar presentations follow. We hope that you find it useful. For further information, please contact Ms. Cathy Campbell, International Director, Technology Administration, at (202) 482-6351 or [ccampbell@ta.doc.gov](mailto:ccampbell@ta.doc.gov), or Dr. David Giebink, CRDF, at (703) 526-9720 or [dgiebink@crdf.org](mailto:dgiebink@crdf.org).

A handwritten signature in black ink, appearing to read "P. J. Bond".

Phillip J. Bond  
Chief of Staff and  
Under Secretary for Technology

A handwritten signature in black ink, appearing to read "Gerson S. Sher".

Gerson S. Sher  
President and Executive Director  
U.S. Civilian Research and  
Development Foundation

**U.S.-Russia Seminar**  
**on Venture Capital for Technology Business Growth**

March 15, 2002

Room 4830  
Department of Commerce

8:30 AM – 3:00 PM

- 8:30 – 9:00 AM      Registration**
- 9:00 – 9:15 AM      Welcome and Introductions**  
**Phillip J. Bond, Under Secretary of Commerce for Technology**  
**Gerson Sher, President and Executive Director, U.S. Civilian**  
**Research and Development Foundation**
- 9:15 – 11:00 AM      Development and Current Trends in U.S. Venture Capital**
- 9:15 – 9:30 AM      Opening Remarks by Deputy Secretary of Commerce,  
Samuel W. Bodman
- 9:30 – 10:00 AM      Presentations (10 minutes each)
- Overview of U.S. Venture Financing (History, Current Trends, Impact on Technology Business Growth)  
  
*Mark Heesen, National Venture Capital Association*
  - What Do Venture Capitalists Look for in Global Investing Opportunities?  
  
*Kenneth Rind, Infinity Venture Fund, Member of the Board of Directors, CRDF*
  - Investing in Russia – Lessons Learned  
  
*Eva Baxter, U.S.-Russia Investment Fund*
- 10:00 – 11:00 AM      Discussion
- 11:00 – 11:15 AM      Break**

**U.S.-Russia Seminar**

**on Venture Capital for Technology Business Growth**

**11:15 – 1:00 PM      Development of Russia’s Venture Capital Industry**

11:15 - 11:30 AM      Policy Overview – Venture Financing for Technology Business  
Growth in Russia

Andrey Fursenko, Deputy Minister, Ministry of Industry, Science and  
Technologies

11:30 – 12:00 noon      Presentations (10 minutes each)

- Opportunities for Venture Investing in Russia

*Albina Nikonnen, CEO, Russia Venture Capital Association*

- Plans for Regional Funds

*Larissa Kopysova, ER-Group, Perm (Russian Regional Fund Manager)*

- Legal Aspects of Venture Financing in Russia

*Maxim Tikhonov, Baker & McKenzie, Moscow*

12:00 – 1:00 PM      Discussion

**1:00 – 2:00 PM      Lunch – Continue Discussions**

**2:00 – 3:00 PM      Discussion, Summary, and Next Steps**

Discussion Leads:

Phillip J. Bond, Under Secretary of Commerce for Technology

Andrey Fursenko, Deputy Minister, Ministry of Industry, Science and Technologies

U.S. – Russia Seminar on Venture Capital for Technology  
Business Growth  
March 15, 2002

Panelists

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U.S. Panelists

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Eva Baxter  
Investment Manager  
The U.S. – Russia Investment Fund

Samuel Bodman  
Deputy Secretary of Commerce  
U.S. Department of Commerce

Phillip Bond  
Chief of Staff to the Secretary of Commerce and Undersecretary for Technology  
U.S. Department of Commerce

Cathleen Campbell  
International Director  
U.S. Department of Commerce

Sarah Carey  
Attorney at Law  
Squire, Sanders & Dempsey L.L.P.  
U.S. – Russia Business Council

Jerry Feigen  
Director  
Center for Entrepreneurship  
Montgomery College

Ken Hagerty  
President  
Global Venture Investors Association

Mark Heesen  
President  
National Venture Capital Association

Christine Loomis  
Senior Vice-President

The U.S. Russia Investment Fund

Bruce Mehlman  
Assistant Secretary for Technology  
U.S. Department of Commerce

Jeff Milanette  
President  
Innovative Partners, Inc.

Kenneth Rind  
Board of Directors  
U.S. Civilian Research and Development Foundation

Gerson Sher  
President & Executive Director  
U.S. Civilian Research and Development Foundation

Robert Stillman  
President  
Milbridge Capital Management

Alfred Watkins  
Lead Private Sector Development Specialist  
The World Bank

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Russia Panelists

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Andrey Fursenko  
Deputy Minister  
Ministry of Industry, Science, and Technology of the Russian Federation

Igor Gladkikh  
CEO  
St. Petersburg Regional Foundation for Scientific and Technological Development

Tatiana Gordienkova  
Department Chief  
Ministry of Industry, Science, and Technology of the Russian Federation

Aina Izakova  
Vice-President  
AZAMAT Oil Corporation

Alexander Kashirin  
General Director  
“Academ-Partner”

Natalia Kazanceva  
Deputy Director  
JSC “Virus”

Larisa Kopysova  
Investment Director  
ER GROUP

Andrey Krivosheev  
Chief of International Sales Department  
Olvia Limited

Toktosun Madiarov  
President  
AZAMAT Oil Corporation

Albina Nikkonen  
CEO  
Russian Venture Capital Association

Maxim Tikhonov  
Senior Associate  
Baker & McKenzie

Sergey Zaytsev  
Manager  
Olvia Limited

## **U.S.-Russia Seminar on Venture Capital for Technology Business Growth**

**Record of Meeting  
March 15, 2002  
Department of Commerce**

**Prepared by  
Sean O’Leary  
Program Assistant, Next Steps to Market  
United States Civilian Research & Development Foundation**

**Mr. Phillip J. Bond**, Undersecretary of Commerce for Technology

--Welcome and introduction of Dr. Gerson Sher, U.S. Civilian Research and Development Foundation (CRDF) and Dr. Andrey Fursenko, Russian Ministry of Industry, Science, and Technology

**Dr. Samuel W. Bodman**, Deputy Secretary of Commerce

--Opening Remarks

- Venture Capital (VC) is the linking of a person or a group of people with an idea for a new business and individuals or firms looking to invest capital in new business. These two then work together to build the business to make it successful
- Lessons for Russia from experience of U.S. VC: 1) VC takes a long time to develop into a mature system (Five decades in the U.S.), 2) The new VC market in Russia must be led by the private sector, which has the desire to make money (the driving force of the market), and 3) VC is a process about more than money; it is also about creative business ideas, transparency, “rule of law,” confidence in the legal system, and trust between people (VC is usually minority shareholders in a new company and reliant upon majority shareholders to take their interests into account)
- Russia has made great strides toward a market economy in the last 10 years, but it has more work to do. The U.S. Department of Commerce is willing to work with Russia and to offer advice where it is needed

### **American Perspective**

**Mr. Mark Heesen**, President, National Venture Capital Association.

--Economic Impact of Venture Capital on the U.S. Economy

- Venture funded firms account for 7.6 million employees and have annual revenues of \$1.3 trillion.
- Venture Capital spiked at the end of the 1990’s with funding totaling almost \$100 billion per year, but has recently returned to pre-spike levels of around \$10 billion per year.

--Fundraising and Investment

- 50% of VC funds originate in pension funds and the other 50% comes from individuals, banks, insurance companies, university endowments, and corporations.
- VC is a long term investment and investment level follows the business cycle.
- There are three exit options: Initial Public Offering (IPO), Acquisition, or Failure. When successful, most firms exit through acquisition, not IPO because a company needs revenues for a successful IPO.

--Necessary Components for Successful Venture Capital Industry

- Entrepreneurial culture
- Developed legal system, including patent law and legal infrastructure
- Strong education and university systems to do basic research and develop researchers
- Angel investors that can get a technology to a stage where a venture capitalist will be interested in it

**Dr. Kenneth Rind**, General Partner, Infinity Venture Capital Fund

--What do Venture Capitalists look for?

- Risk factors, such as legal, economic and accounting, crime, corruption, or any thing else that will prevent a company from “going public”
- U.S. federal law requires a prospectus to include risk factors for IPO

--What do Venture Capitalists want?

- Partner with entrepreneurial spirit
- Financial and scientific infrastructure
- Unserved market
- Low taxes, low capital gains taxes, and the ability to re-patriate funds

--Government Initiatives to Encourage VC

- Reduce capital gains taxes
- Tax credits for investment
- Waive income taxes for start-ups
- Allow losses to offset ordinary income
- Lower taxes for management bonuses
- Free foreigners from taxes
- Allow non-taxable entities to invest (ex. Pension funds)
- Leverage opportunities
- Insure investors/lenders do not lose capital
- Lower R&D costs
- Create incubators
- Give grants for R&D
- Finance VC training
- Coax émigrés to return
- Establish industrial parks
- Improve liquidity/capital exchange
- Compatible reporting
- All immigration
- Allow Limited Liability Corporations
- Encourage foreign corporations to invest

- Promote successful entrepreneurs as heroes
  - Do not ostracize failures
- General observations
- Entrepreneurial activity is highly correlated to GNP growth
  - Russia must encourage science and engineering as professions
  - Russia must support basic research
  - Must develop a stable, predictable, and reliable tax system

**Ms. Eva Baxter**, Vice-President, U.S.-Russia Investment Fund

**Lessons Learned by Venture Capitalists in Russia**

--Management

- Investors must get to know their management teams
- Educate management on how to create value for shareholders
- Look for full-time managers (their futures are linked to success of company) and conflicts of interest
- Structure compensation appropriately
- Keep management focused on the overall strategy
- Do not hesitate to change non-performing managers

--Operation

- Do due diligence in corporate governance
- Assist management in business planning
- Keep managers grounded in reality
- Maintain attention to structure without over complication
- Investors must seek control for themselves or form partnerships with other investors
- Select partners with great consideration
- Do not go for informal deals; maintain legal paperwork
- Establish staged financing based on achieving milestones
- Have contingency plan and be willing to invest more than you planned to
- Investors must have a hands on approach with strict monitoring of business and be engaged in strategic decision making
- Strong corporate governance

--Macro view

- 
- Help legislators shape laws
- Defend your positions, but not over-aggressively
- Maintain good public perception through press

**Discussion**

**Dr. Andrey Fursenko**, Deputy Minister, Ministry of Industry, Science and Technology—What is the role of the U.S. government today, as opposed to its role in the initial stages of VC in the U.S.?

--**Dr. Bodman**—The Small Business Investment Companies (SBIC) help develop VC and, when VC becomes profitable, pays back the investment to the DOC. The U.S. government has also lowered capital gains taxes and invests in R&D through national laboratories partnered with private companies.

--**Mr. Heeson**—Government has a role, but it is entrepreneurs that are the driving force of VC.

--**Mr. Jerry Feigen**, Director, Center for Entrepreneurship—Government does not manage ideas. Government can play a role in the development of VC, but must step aside once the private sector “has” it.

--**Mr. Mark Minevich**, Managing Director, Principal MarkSoft Inc.—Government must provide education for business development, modeling, etc.

**Mrs. Albina Nikkonen**, CEO, Russian Venture Capital Association—How is the partnership attitude/trust formed?

--**Mr. Minevich**—It must be done in steps. People at different levels should be taught and can then go and teach other people at their levels which will allow ideas to take hold and spread.

--**Dr. Rind**—Émigrés should be brought back to Russia—they understand both Russian and Western culture and can serve as educational bridges.

--**Ms. Olga Ford**, Director, Greenberg Traurig—Good lawyers are needed to protect everyone’s interest.

--**Ms. Sarah Carey**, Chief, Squire Sanders and Dempsey—IP rights must be secured and ownership must be clear. VC funding should come from commodity markets—this is the great strength of the Russian economy today.

--**Mr. Ken Hagerty**, President, Global Venture Investors Association—There are two good examples that Russia can follow: 1) Israel, where the government assisted VC development by giving money out to interested people to train with American VC’s. These people then went back to Israel and founded VC companies and paid back the government. 2) Singapore

--**Mr. Randy Mitchell**, International Trade Specialist, APEC Affairs, Department of Commerce—Networking is critical to the development of VC.

--**Dr. Gerson Sher**, President, CRDF—Current entrepreneurs should be celebrated and a systematic approach to training and supporting entrepreneurs should be established.

--**Mr. Jeff Milanette**, President, Innovative Partners, Inc.—An entrepreneurial infrastructure must be developed. SBIR-like program grants can help.

--**Mr. Minevich**—Management specialists in all areas are critical to success.

--**Dr. Bodman**—Nothing surpasses the importance of being right—judging which businesses will be successful.

--**Ms. Carey**—Individual states have programs to attract investors and companies.

--**Mr. Robert Stillman**, President, Milbridge Capital Management—Russia must make itself competitive with the rest of the world in terms of attracting investment by either reducing risk or increasing the rate of return on investment.

--**Mr. Saunders Miller**, President, SBA-SBIC—All venture investing is local—investors usually live very close to the place of investment for ease of interaction.

## **Russian Perspective**

### **Dr. Fursenko**

Policy Overview of Venture Financing for Technology Business Growth in Russia

--Meeting of Council for Science and High Technology, the Presidium of the State Council and the Security Council to discuss the future of the economy

- President Vladimir Putin will chair the meeting. This meeting will develop the economic policy through 2010, including identifying priorities and a way to distribute resources to the most efficient.
- The meeting will discuss how to develop a high tech economy, including: establishment of legal atmosphere, development of infrastructure, investment financing issues (such as SBA, SBIR), educate qualified personnel, explain importance of high technology to the future of Russia, and work on tax incentives and issues.

--Steps to be taken

- Russia must invest in infrastructure and attract investors simultaneously
- Use the existing examples of developing VC from around the world and develop partnership with people in the field
- Government must create a favorable atmosphere to attract foreign investment

### **Mrs. Nikkonen**

--Beginnings in Russia

- VC funding began in the early 1990's
- In 1997, there were 26 funds worth \$1.6 billion
- In 2000, there were 40 funds worth \$3.7 billion

--Russian VC funding sources

- EBRD 72%
- US Government 27%
- Other 1%

--Problems that Russia has faced

- Lack of trust between VC and management
- Lack of knowledge of VC philosophy and principles
- No rules about investing and participating in the shadow economy

--Goals of the Russian Venture Capital Association

- Attract Russian capital to VC
- Create a department for VC in the Ministry of Industry, Science, and Technology
- Create a political and entrepreneurial climate
- Represent RVCA's members in Russia and abroad
- Support Russian VC market players
- Prepare specialists for VC businesses
- Create a Russian-American VC coaching center for to create knowledge, skills

### **Dr. Igor Gladkikh**, CEO, Regional Foundation for S&T Development SPb

--The VC Fair in Russia

- The purpose is to bring together companies and investors to exchange information on the investment climate
- Preparation of companies includes training seminars in different regions and distance training
- Because managers do not understand VC, training lasts six months and includes preparation of information that VC's need
- Annual company turnover ranges \$50,000-\$5 million

- Required investment ranges \$100,000-\$10 million
- Participants include investors (venture funds, corporations looking for strategic partnerships, and banks), government authorities, law firms, foreign VC associations, and international financial organizations
- The first Russian Venture Fair (2000) involved 28 companies and 40 investors with two companies receiving investment and one company receiving bank credit
- The second Russian Venture Fair (2001) involved 46 companies and 60 investors with 60% of the companies negotiating with investors
- The VC fair links entrepreneurs and investors that can form successful partnerships and brings business and government authorities together to exchange ideas and shape policy

**Ms. Larissa Kopysova**, Investment Director, ER-GROUP (Russian VC regional fund)

--VC in Perm Region

- Perm has strong human capital that is based on former defense industries, including aerospace systems and engines, chemistry, biochemistry, information technology, and telecommunications.

--Problems for VC

- No private VC in Russia
- Private citizens do not invest but save (savings are located abroad)
- Institutional investing is limited
- Lack of transparency
- Lack of expertise in international markets
- Managers do not want to lose control of their businesses
- Inefficient and confusing tax system

--Possible solutions

- Create Russian-Western partnerships to promote foreign investing through reliable and trustworthy partnerships
- Create public relations programs to promote VC
- Create systematic mechanism for investment, both private and institutional

**Mr. Maxim Tikhonov**, Senior Associate, Baker & McKenzie, Moscow

--Current Trends in Russian VC

- Investors include IBRD, EBRD, government funds, foreign private capital, some Russian capital, and foreign based Russian companies
- Growing numbers of small to medium size companies
- Gradual move toward transparency, from “gray” to “white”

--Key Issues for Investors

- Insure the legal paperwork is in place and clear—avoid informal agreements
- Define business to be invested in
- Define amount to be invested
- Define equity to be acquired and the level of influence that comes with this
- Define the appropriate mechanisms of investment—in-kind, direct cash investment, and indirect cash investment
- Define voting and corporate governance procedures

- Insure shareholder control over company
  - Establish exit strategies
- Factors for Successful Investment
- Openness of target—transparency
  - Clear business figures
  - Reasonable approach by both parties
  - Legality of transaction and documents
  - Attitude of target’s personnel
  - Policy of local authorities
  - Past investor experiences

## Discussion

**Mr. Fred Johnson**, Chairman, Santa Fe Technologies, Inc.—Has mezzanine funding been developed (term lender)?

--**Mr. Tikhonov**—Russia has not reached that level of funding.

--**Dr. Fursenko**—There are no specialized funds, as such, but existing funds are willing to look into these possibilities.

**Mr. Stillman**—Are companies willing to become transparent, which is an important aspect of complex exit strategies?

--**Mr. Tikhonov**—Yes, companies understand the need to become transparent for an IPO and investment purposes. Companies are becoming more secure knowing that its figures are not adversely affected by transparency. IPO exit strategies are frequently not possible because companies cannot go to the West. Many prefer buy-outs.

**Dr. Sher**—So far, Russian investors have stayed out of Russian markets and investment has been mainly by foreigners, although this type of investment is frequently looked down upon. Should foreign investors beware of this climate, especially as Russians are staying out of the market, or has this attitude passed?

--**Dr. Fursenko**—This is a problem. Foreigners may not understand the specific risks of investing in Russia and if Russians do not invest, why should foreigners? The largest investor in Russia is Cyprus because many Russians keep their savings in Cyprian banks. This looks like foreign investment, but is really Russian investment. The investment boom will not happen without Russian money, but the system must be made more transparent and the legal system must become more predictable.

## Proposals for the Future

**Dr. Fursenko**—There is a need to develop something soon to show successes. A small working group should be created for further discussions to make concrete proposals.

**Mr. Mitchell**—Russians must seek out seed capital from angel investors (high net worth individuals), form angel network groups, and have people with ideas for companies to come to these meetings to make their cases for investment. This will help get Russian money back into Russia and encourage foreigners to follow suit. Russian businessmen will help build society.

**Dr. Rind**—Russia should follow other successful examples, such as Israel and Taiwan, by creating: 1) industrial parks to lure émigrés back, 2) develop programs like the Israeli program

“Yozma” or the American SBA and SBIC programs, and 3) government can help finance these programs and then sell the debt as bonds.

**Mr. Haggerty**—The U.S.-Russia Venture Fund, run by Patricia Clougherty of SBIC, is an excellent resource committed to the Russian Market. A similar model in Australia developed VC.

**Mr. Stillman**—All of the successful programs, either in Israel or Australia, have VC programs that either increase the return on investment or reduce risks. Russia must do one of these to show investors it is a good investment. Developing a program like SBIC could help.

**Dr. Sher**—Success needs to be demonstrated and then furthered. The results from the funds that have been invested need to be analyzed for successes and, then, these successes need to be publicized and given additional funding. The PR should focus on how these successes occurred and what criteria they satisfied to receive funding. Also, fellowship opportunities should be created in US VC companies, specifically for Russians who can learn and go back to Russia and teach others.

**Mrs. Nikkonen**—Fellowships need to be organized in the U.S., maybe using SBIR, and another possible idea is to create fellowships for scientists to be taught about VC and they can then return to Russia and teach other scientists how to commercialize their work.

**Ms. Natalia Kazantseva**, Vice Director on Economics, Virus, Ltd.—Probably the most important part of the VC Fair is to advertise your products, explain to people why they are important and useful, and their potential.

**Mr. Alfred Watkins**, Lead Private Sector Development Specialist, World Bank—VC is the end of the line. Russia needs to focus on deal flow because there is a lack of good deals, but not a lack of good scientists. How can technology be taken to the market? 1) Establish incubators where businessmen are trained and hired to bring a technology to the point where VC will be interested in it. 2) Establish technology transfer offices to commercialize technology. 3) Give basic training in general to regions where assistance is most needed in the basic commercialization process. The World Bank would like to participate, beginning with small pilot projects

**Mr. Sergey Zaytsev**, General Director, OLVA Limited—Companies must be grown from incubators.

**Mr. Feigen**—Russia needs an accountable person at high level in the government who can make decisions to develop this process.

**Mr. Milanette**—1) Take the examples of three or four successful incubators to share their success stories and how they developed relationships so they can teach others. 2) Continue to pursue VC Fair policies because of the high follow-on negotiation rate. 3) Create a database to put entrepreneurs and investors together, like ACE-NET, to match deals with investors.

**Mr. Haggerty**—1) Russia must cut its capital gains tax and pass a product man rule that allows institutional investors to invest in VC. 2) Russia should follow other successful examples, like Singapore, to develop VC.

**Ms. Tracy Rollins**, Department of Commerce, SABIT—BIZNIS has a “search for partners” program.

**Ms. Kopysova**—1) Promote successful relationships to give VC a “human face” because to most Russians, VC is abstract because they do not know anyone who is involved. 2) Dr. Sher’s and Ms. Nikkonen’s ideas for fellowships and a coaching center should be implemented.

**Mr. Tikhonov**—Need to take clients who can publicize and talk about foreigner’s success at VC fairs.

**Mr. Stillman**—Ivan Bortnik runs angel/early seed funding program, called “Bortnik funds,” that could be spread across Russia.

**Ms. Nikkonen**—The Bortnik fund is a government fund, which MIST supports. It is not a venture fund and has very limited resources. A working group should be created to weigh options and make more decisive steps.

**Mr. Gladkikh**—The St. Petersburg VC Fair is a good place to start publicizing VC because foreigners come to this fair to get a first hand look at the VC atmosphere.

**Mr. Minevich**—1) Establishing a working panel of global experts on VC is a good idea. 2) A database that is easily accessible for both investors and managers could help the process.



National Venture Capital Association

**US-Russia Seminar on Venture  
Capital for Technology Business  
Growth -**

**US Department of Commerce  
March 15, 2002**

**Mark G. Heesen  
President**

***The Economic Impact of Venture  
Capital on the US Economy ...***

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## **DRI-WEFA Study**

- Commissioned by NVCA
- Venture funded firms now account for:
  - ◆ 7.6 million employees
  - ◆ Annual revenues of \$1.3 trillion,
- These figures represent:
  - ◆ 5.9% of US payroll
  - ◆ 13.1% of US GDP
  - ◆ 7.9% of US company revenue

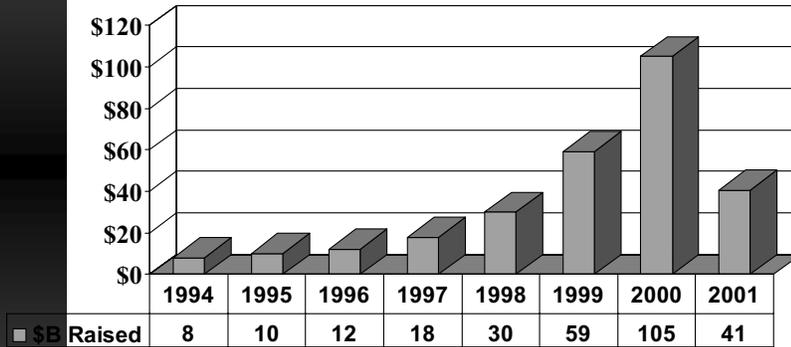
*Source: DRI-WEFA (analysis as of 8/2001)*

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## ***Fundraising***

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## Venture Capital Fundraising Was Strong Through 2000



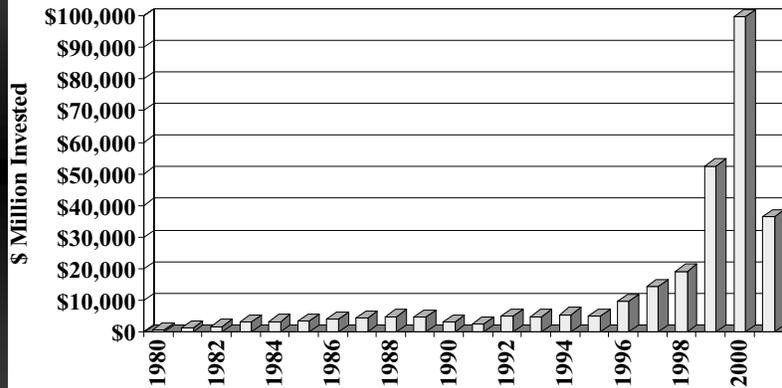
This does not include money available for investment by Corporate Venture groups.

*Source: VentureXpert™ Database by VE & NVCA*

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**Investment Marches On -  
Rumors that the Venture Industry  
has stopped investing are greatly  
exaggerated**

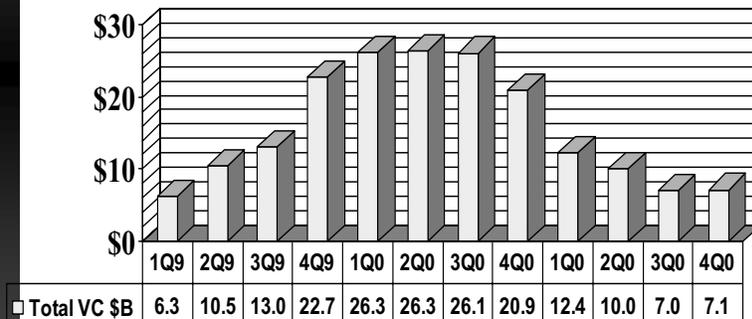
## The VC Industry has Grown Dramatically in the Past Few Years



Source: PricewaterhouseCoopers/Venture Economics/National Venture Capital Association MoneyTree™

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## Recent Quarters Portend a Return to Traditional Activity Levels



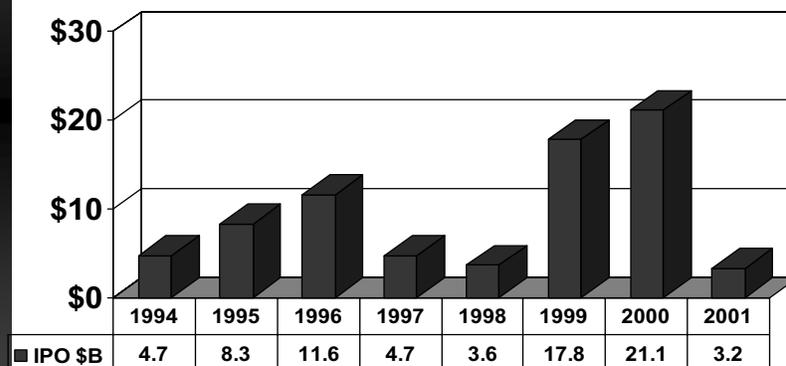
Source: PricewaterhouseCoopers/Venture Economics/National Venture Capital Association MoneyTree™

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***The Exit Scene - the strong emergence of acquisition successes in a volatile IPO market***

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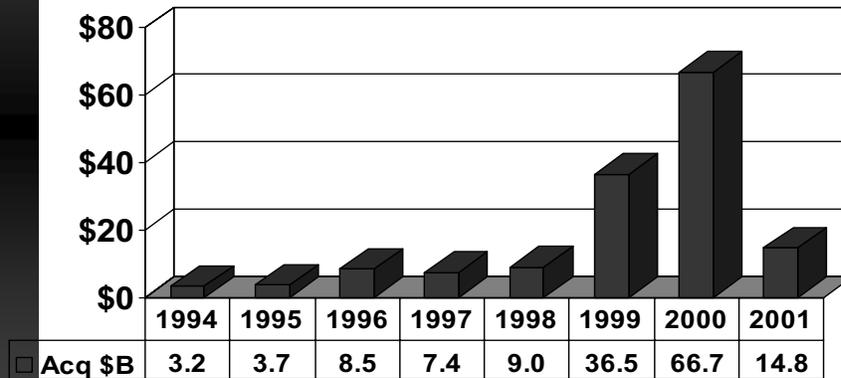
**After setting records in 1999 and 2000, IPO Markets are Quiet Now**



Source: PricewaterhouseCoopers/Venture Economics/National Venture Capital Association MoneyTree™

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## Acquisitions are an increasingly important exit strategy



Source: PricewaterhouseCoopers/Venture Economics/National Venture Capital Association MoneyTree™

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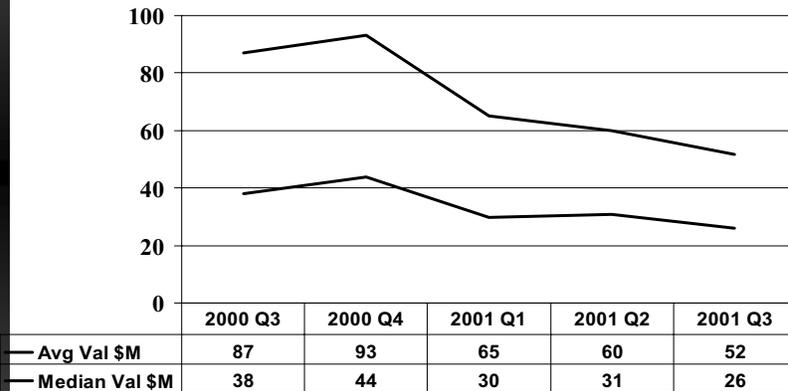
## Private Equity Returns - Over the Long Haul VC Returns 20-25%

<i>Fund Type</i>	<i>1yr</i>	<i>5 yr</i>	<i>20 yr</i>
<b>Early VC</b>	-36%	54%	22%
<b>Later VC</b>	-26%	22%	17%
<b>Buyouts</b>	-16%	8%	16%
<b>Mezzanine</b>	4%	10%	11%
<b>All Private Equity</b>	-21%	18%	17%

As of 9/30/2001 - Source: VentureXpert™ Database by VE & NVCA

- 12 -

## Portfolio Companies Have Been Devalued -- More to Come?



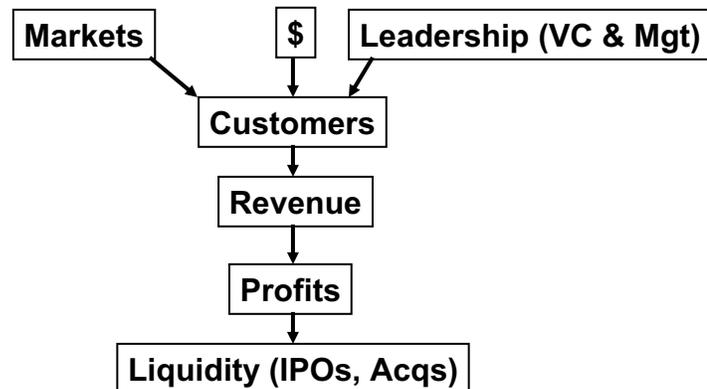
Source: VentureXpert™ Database by VE & NVCA

- 13 -

**No one has repealed the business cycle ...**

**Factors affecting the short term**

## Investment Food Chain Not All Segments are Healthy



- 15 -

## Companies Receiving First Venture Round (Series A) During Last Downturn (1/1990-6/1992)

- Artisoft
- Starbucks
- Intuit (FKA ChipSoft)
- McAfee
- Xpedite
- Palm Computing
- Cutter & Buck
- RF Micro Devices
- eFax.com
- Shiva Corporation
- Wind River Systems
- FTP Software
- CheckFree
- SPSS

- 16 -

## Current Policy Agenda

- Exemption of ISOs and ESPPs from Payroll Taxes
- Accounting Standards—new international effort (IASB) to force stock options expensing
- Broadband Deployment
- Trade Promotion Authority (TPA)
- Securities Litigation Reform

- 17 -

## Where do I go for more specific information?

- [Www.pwcmoneytree.com](http://www.pwcmoneytree.com)
- NVCA 2001 Yearbook
- VentureXpert
- [www.nvca.org](http://www.nvca.org)
- What's happening in my state/city?
  - ◆ State specific histories:  
[www.ventureeconomics.com](http://www.ventureeconomics.com) (click left tab "Statistics" and select most recent qtr)

- 18 -



*National Venture Capital Association*

[Www.nvca.org](http://www.nvca.org)

[www.aeeg.org](http://www.aeeg.org)

**WHAT DO VENTURE CAPITALISTS LOOK FOR  
IN  
GLOBAL INVESTING OPPORTUNITIES**

**KENNETH W. RIND  
U.S-RUSSIA SEMINAR  
MARCH 15, 2002**

**BUSINESS RISK FACTORS FROM WIMM-BILL-DANN FOODS  
OJSC PROSPECTUS OF 2/8/02**

- MOSCOW CITY GOVERNMENT MAY REDUCE PRICES IT PAYS
- DO NOT CARRY INSURANCE FOR (COMMON) RISKS
- MAY NOT BE ABLE TO PROTECT INTELLECTUAL PROPERTY RIGHTS
- FAILURE TO COMPLY WITH INCREASED GOVERNMENT REGULATION MAY INCREASE COST, CAUSE SANCTIONS, HALT PRODUCTION
- SMALL NUMBER OF QUALIFIED INDIVIDUALS MAY IMPEDE GROWTH
- INTERESTS OF SMALL GROUP OF CONTROL SHAREHOLDERS COULD CONFLICT WITH OTHERS
- GOVERNMENT MAY REQUIRE LICENSES THAT COULD CAUSE SIGNIFICANT NEGATIVE CONSEQUENCES
- DEFICIENCIES IN PRIVATIZATION RISKS OUR LOSING OWNERSHIP
- A 25% SHAREHOLDER MAY BLOCK CERTAIN TRANSACTIONS
- IMPLEMENTATION OF NEW FEDERAL OR LOCAL GOVERNMENT POLICIES OR STRICT APPLICATION OF EXISTING ONES MAY IMPACT
- MINISTRY OF ANTIMONOPOLY POLICY AND SUPPORT OF ENTREPRENEURIAL ACTIVITY HAS VAGUE POLICIES
- OUR PRICES MAY BE REGULATED BY UNCLEAR LEGISLATION
- INTERESTED PARTY TRANSACTIONS MAY NOT HAVE BEEN PROPERLY APPROVED

2

**ECONOMIC/LEGAL RISK FACTORS FROM  
WIMM-BILL-DANN FOODS OJSC PROSPECTUS OF 2/8/02**

- WEAK BANKING SYSTEM
- WIDESPREAD TAX EVASION
- HIGH LEVELS OF CORRUPTION
- PENETRATION OF ORGANIZED CRIME INTO THE ECONOMY
- LEGAL NORMS, AT TIMES, OVERLAP OR CONTRADICT
- NO JUDICIAL/ADMINISTRATIVE GUIDANCE ON LEGISLATION
- RELATIVE INEXPERIENCE OF JUDGES AND COURTS
- LACK OF INDEPENDENCE OF JUDICIARY
- GOVERNMENT DISCRETION ON CLAIMS MAY PREVENT REDRESS
- ARBITRARY GOVERNMENT EXERCISE OF POWERS, SOMETIMES CONTRARY TO LAW, WITHOUT HEARINGS OR PRIOR NOTICE
- MAY INTERFERE, NULLIFY OR TERMINATE CONTRACTS
- CORPORATE GOVERNANCE HAS PROVEN TO BE POOR
- ABUSIVE SHARE DILUTIONS, ASSET TRANSFERS, AND TRANSFER PRICING
- CONCEPT OF FIDUCIARY DUTIES NOT DEVELOPED
- TAXES ARE SUBJECT TO FREQUENT CHANGE (SOMETIMES RETROACTIVELY)
- NO CERTAINTY OF "DOUBLE TAX TREATY" TREATMENT

3

**OTHER RISK FACTORS FROM  
WIMM-BILL-DANN FOODS OJSC PROSPECTUS OF 2/8/02**

- INFLATION COULD DECREASE PROFITS
- CHANGES IN EXCHANGE RATE MAY HARM
- CURRENCY CONTROL REGULATIONS MAY HINDER
- CASH HOLDINGS MAY BE EXPOSED TO DEVALUATION
- TAX AUTHORITIES MAY CHALLENGE TAX "INITIATIVES"
- DEPOSITARY SHARES (ADSs) MAY BE SEIZED
- "PLACEMENT" MAY BE DECLARED INVALID
- MAY BE UNABLE TO VOTE SHARES
- MAY BE UNABLE TO REPATRIATE PROFITS FROM SALE OF ADSs TO RUSSIANS
- FINANCIAL TURMOIL COULD ADVERSELY AFFECT
- DIVISION OF AUTHORITY BETWEEN FEDERAL AND REGIONAL AUTHORITIES REMAINS UNCERTAIN AND CONTESTED

4

**ECONOMIC SITUATION FROM  
WIMM-BILL-DANN FOODS OJSC PROSPECTUS OF 2/8/02**

- SINCE THE DISSOLUTION OF THE SOVIET UNION, THE RUSSIAN ECONOMY HAS EXPERIENCED:
  - SIGNIFICANT DECLINES IN GROSS DOMESTIC PRODUCT;
  - HYPERINFLATION;
  - AN UNSTABLE CURRENCY;
  - HIGH GOVERNMENT DEBT RELATIVE TO GROSS DOMESTIC PRODUCT;
  - A WEAK BANKING SYSTEM PROVIDING LIMITED LIQUIDITY TO RUSSIAN ENTERPRISES;
  - HIGH LEVELS OF LOSS-MAKING ENTERPRISES THAT CONTINUED TO OPERATE DUE TO THE LACK OF EFFECTIVE BANKRUPTCY PROCEEDINGS;
  - SIGNIFICANT USE OF BARTER TRANSACTIONS AND ILLIQUID PROMISSORY NOTES TO SETTLE COMMERCIAL TRANSACTIONS;
  - WIDESPREAD TAX EVASION;
  - GROWTH OF A BLACK AND GREY MARKET ECONOMY;
  - PERVASIVE CAPITAL FLIGHT;
  - HIGH LEVELS OF CORRUPTION AND THE PENETRATION OF ORGANIZED CRIME INTO THE ECONOMY;
  - SIGNIFICANT INCREASES IN UNEMPLOYMENT AND UNDEREMPLOYMENT; AND
  - THE IMPOVERISHMENT OF A LARGE PORTION OF THE RUSSIAN POPULATION.

5

**COMMENTS OF ARTHUR ANDERSEN FROM WIMM-BILL-  
DANN FOODS OJSC PROSPECTUS OF 2/8/02**

- DOES NOT POSSESS WELL-DEVELOPED BUSINESS AND REGULATORY INFRASTRUCTURE
- NOT FULLY IMPLEMENTED REFORMS:  
BANKING, JUDICIARY, TAXATION, REGULATORY
- RISKS PERSIST
  - CURRENCY NOT FREELY CONVERTIBLE
  - ONEROUS CURRENCY CONTROLS
  - LOW LIQUIDITY
  - HIGH RATES OF INFLATION
- POLITICAL SYSTEM IS VULNERABLE
- ACUTE FINANCIAL AND ECONOMIC DISTRESS
- CRIME, UNREST, CLAIMS OF OFFICIAL CORRUPTION
- LEGAL SYSTEM-INCONSISTENCIES, CONFLICTS, LACK OF GUIDANCE, INEXPERIENCE, HIGH DEGREE OF DISCRETION
- CURRENCY CONTROLS
- TAXATION - SUBSTANTIAL/NUMEROUS/FREQUENT CHANGES

6

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- TAXATION - SUBSTANTIAL/NUMEROUS/FREQUENT CHANGES

6

### **WHAT VENTURE CAPITALISTS WANT BEYOND WHAT OTHER INVESTORS DESIRE**

- DEDICATED ENTREPRENEURS WITH DRIVE AND VISION
- BUSINESS/SCIENTIFIC/ENGINEERING INFRASTRUCTURE
- POTENTIAL SUSTAINABLE LEADERSHIP POSITION
  - PROPRIETARY WORLD-CLASS TECHNOLOGY
  - EXPERIENCED MANAGEMENT TEAM
- LARGE WORLD MARKETS WITH UNSERVED NEEDS
- FINANCIAL INFRASTRUCTURE (LOANS, LEASES)
- EASY EXITS (IPO'S/MERGERS)
  - LIQUIDITY
- NON-TAXATION OF OPTIONS TILL EERCISED
- LOW CAPITAL GAINS TAXES ON LONG-TERM INVESTMENTS
- ABILITY TO REPATRIATE PROFITS

7

### **SELECTED GOVERNMENT INITIATIVES TO ENCOURAGE VENTURE CAPITAL ACTIVITY (INVESTMENTS IN QUALIFIED SMALL BUSINESSES)**

#### **TAXES**

- 1) REDUCE CAPITAL GAINS RATE
  - MORE FOR LONG-TERM CAPITAL GAINS
  - DEFER TAXES IF RE-INVEST IN QUALIFIED ENTITY
- 2) GIVE TAX CREDITS TO INDIVIDUALS/CORPORATIONS FOR INVESTMENTS IN :
  - QUALIFIED SMALL BUSINESSES
  - QUALIFIED VENTURE CAPITAL FUNDS
  - RESEARCH & DEVELOPMENT ACTIVITIES
- 3) WAIVE INCOME TAXES, SALES TAXES, PROPERTY TAXES FOR QUALIFIED START-UPS
- 4) ALLOW LOSSES TO OFFSET ORDINARY INCOME
- 5) LOWER TAXES FOR MANAGEMENT FEES/BONUSES
- 6) PERMIT OPTION GRANTS/EXERCISE WITHOUT TAXES
  - TAX ONLY WHEN CASH RECEIVED
- 7) FREE FOREIGN INVESTORS FROM TAXES (IRRESPECTIVE OF TAX TREATY)

8

**SELECTED GOVERNMENT INITIATIVES TO ENCOURAGE  
VENTURE CAPITAL ACTIVITY  
(INVESTMENTS IN QUALIFIED SMALL BUSINESSES)**

**OTHER FINANCIAL PROGRAMS**

- 1) ENCOURAGE NON-TAXABLE ENTITIES (PRUDENT-MAN RULE)
  - MODERN PORTFOLIO THEORY
- 2) PROVIDE LEVERAGE THROUGH PROVISION OF EQUITY/LOANS/GRANTS
- 3) ENSURE THAT INVESTORS/LENDERS WILL NOT LOSE CAPITAL
- 4) PAY FOR % OF R&D/NEW FACILITY COSTS/LABOR (TRAINING)
- 5) FUND INCUBATORS/COMPANIES IN INCUBATORS
- 6) MAKE GRANTS FOR GENERIC R&D PROGRAMS
- 7) ESTABLISH BIRD-F TYPE OF ACTIVITY
- 8) FINANCE TRAINING ABROAD FOR VCS
- 9) ESTABLISH AGENCIES TO PROVIDE CONSULTING/SUPPORT
- 10) RELAX BANKING REQUIREMENTS
- 11) COAX EMIGRES TO RETURN (e.g. HOUSING)
- 12) CREATE INDUSTRIAL PARK(S)
- 13) ALLOCATE PART OF GOVERNMENT-MANAGED PENSION FUND INVESTMENTS

9

**SELECTED GOVERNMENT INITIATIVES TO ENCOURAGE  
VENTURE CAPITAL ACTIVITY  
(INVESTMENTS IN QUALIFIED SMALL BUSINESSES)**

**NON-FINANCIAL PROGRAMS**

- 1) ENCOURAGE MILITARY/GOVERNMENT LABS/UNIVERSITIES TO SPIN-OUT PROJECTS
  - HELP ORGANIZE VC FUNDS TO FINANCE
  - FOSTER CO-OPERATION WITH START-UPS
- 2) IMPROVE LIQUIDITY/CAPITAL RAISING
  - CREATE EXCHANGES
  - LESSEN LISTING REQUIREMENTS
  - MAKE IT EASY TO DIVEST SHARES
- 3) ALLOW INVESTORS TO CONTROL INVESTEES
  - NO CAP ON OWNERSHIP
- 4) REQUIRE U.S.-COMPATIBLE REPORTING (SO CAN LIST ON NASDAQ)
- 5) PERMIT IMMIGRATION OF SKILLED TALENT
- 6) ALLOW LLC'S
- 7) ENCOURAGE FOREIGN CORPORATIONS TO:
  - OPEN DEVELOPMENT CENTERS, INVEST, ACQUIRE
- 8) MAKE SUCCESSFUL ENTREPRENEURS/INNOVATORS INTO HEROES; ENCOURAGE NETWORKS
- 9) DON'T OSTRACIZE FAILURES

10

**IMPLICATIONS FROM 2001 REPORT  
GLOBAL ENTREPRENEURSHIP MONITOR**

- ENTREPRENEURIAL ACTIVITY IS HIGHLY CORRELATED WITH GNP GROWTH
- MUST ENCOURAGE MORE STUDENTS TO PURSUE SCIENCE AND ENGINEERING
- GOVERNMENT NEEDS TO INCREASE SUPPORT FOR BASIC RESEARCH
- SOCIETY OUGHT TO IDENTIFY AND CELEBRATE ROLE MODELS
- ENTREPRENEURSHIP EDUCATION SHOULD BEGIN IN HIGH SCHOOL OR EARLIER
- LOW, STABLE TAXES HELP

## **Investing in Russia – Lessons Learned**

**March 15, 2002**

**Eva Baxter**

**U.S. – Russia Investment Fund**

## **Russian Private Equity Lessons**

### **Management**

- Get to know the management really well and foster close relationship based on trust
- Educate. Do not take it for granted that companies already have the mentality of creating value for the shareholders
- Always look for full-time managers and watch for conflicts of interest
- Structure compensation appropriately; options; founders' stakes stretched out in time
- Work very closely with management and keep them focused on the strategy
- Don't wait to change non-performing managers

## Russian Private Equity Lessons

### **Operational**

- Dig in during the due diligence
- Help the management with business planning
- Run reality checks.
- Extra attention to structure but do not over complicate it
- Seek control in the company for yourself or in partnership with other financial investors
- Select partners for investments with greater consideration (brokers, other investors, directors)

## Russian Private Equity Lessons

### **Operational**

- Water-tight legal paperwork
- Staged financing based on milestones
- Contingency planning - be prepared to invest more before the company can stand on its feet
- Hands-on approach, strict monitoring, engage proactively in setting strategic direction
- Corporate governance

# Russian Private Equity Lessons

## **Macro**

- Often have to incubate and back start-ups. Privatization deals are not the right choice
- Sometimes have to shape the legal framework working with the legislators
- Keep in touch with the government
- Do not initiate an aggressive approach but if faced with a troubled situation - don't give in, defend the position and stand up for the shareholder rights
- Beware of press. Public perception and PR

**RUSSIAN VENTURE CAPITAL ASSOCIATION  
(RVCA)**



**VENTURE  
INDUSTRY IN RUSSIA**  
realities and perspectives

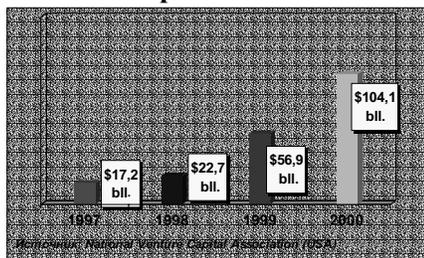
Albina Nikkonen



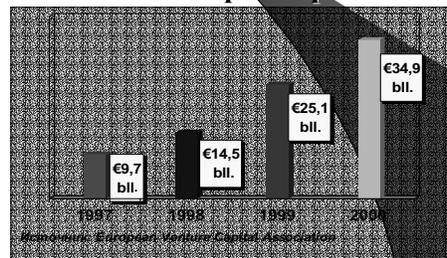
**RUSSIAN VENTURE CAPITAL ASSOCIATION  
(RVCA)**

**Investment growth dynamics  
in international market**

**Rapid growth of  
venture capital market in USA**



**Europe: exit to sustainable  
development path**



**Central and Eastern Europe Countries:  
Total annual investment  
in Poland, Hungary, Czechia exceed \$ 200 000 000**

Source: European Venture Capital Association



## The main sources of investment

- \* **Crediting** as a source of investment predominant for projects for export
- \* **Corporate bonds**: limited opportunities for the biggest investors
- \* **IPO**: the potential for the future
- \* **Strategic private equity**: shallow partnership niche
- \* **Private equity** - comprehensive investment source of projects in new markets



## Private equity demand growth

- \* Quality **change** of macroeconomic situation in Russia in 1999 – 2000.
- \* Dynamism of post-crisis **growth** makes offer of investment and demand for investment more attractive
  - è Long-term financial investors are interested in investing to growth
  - è Structural moves lead to appearance of new investment opportunities
  - è Growing demand of enterprises for investment for rapid growth and quality support
- \* Institutional reforms and corporate management : noticeable **progress** promotes improvement of investment climate



**RUSSIAN VENTURE CAPITAL ASSOCIATION  
(RVCA)**

## Direct investment fund in Russia: formation of market

- \* Total investment in 1994-1998  
**\$1.2 -1.5 billion**
- \* New fund formation  
**\$1 billion** to September, 1998
- \* Market leader:  
**Baring, Sun Group, Fleming, Framlington, Sputnik/Renaissance,  
Russia Partners, Agribusiness Partners, AIG - Brunswick, TUSRIF**
- \* The best/more noticeable investment deals:  
**Sun Brewing/Interbrew, Vypelkom, Svyazinvest, Gloria Jeans,  
Saint Spring, Irn Brew, Anopino, Volzhanka**



**RUSSIAN VENTURE CAPITAL ASSOCIATION  
(RVCA)**

## Direct investment fund: obstacles for business

- \* Lack of attractive projects
- \* Prejudice of Russian management against shared investment
- \* Insufficient knowledge of philosophy and principle of direct investment fund activity
- \* Too high business evaluation by investment recipients
- \* Grey financial and goods flows of enterprises of Russia and NIS
- \* Toughening of criteria by funds in post-crisis conditions
- \* Exit or business conservation by some funds



**RUSSIAN VENTURE CAPITAL ASSOCIATION  
(RVCA)**

## Direct investment funds: sector priorities

- \* Media
- \* Telecommunications
- \* Software
- \* Pharmaceutical goods production
- \* Food production
- \* Packaging production
- \* Retail
- \* Production of goods with high export potential
- \* Industrial infrastructure
- \* Production of other goods and services, targeted to ultimate consumer



**RUSSIAN VENTURE CAPITAL ASSOCIATION  
(RVCA)**

## Venture capital in Russia

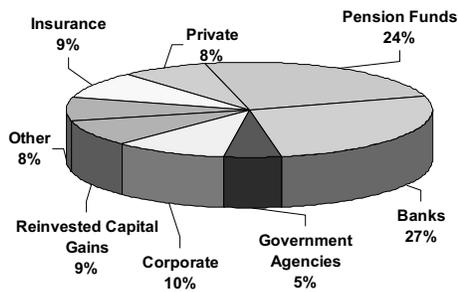
- \* The beginning of **90's**
  - 11** RVCF EBRD
  - 5** funds with IFC and EBRD capital
  - 3** funds with US capital
- \* The beginning of 1997 - RVCA was founded
- \* The end of 1997 - **26** funds - \$ **1.6** billion
- \* The end of 2000 - **40** funds - \$ **3.7** billion



**RUSSIAN VENTURE CAPITAL ASSOCIATION  
(RVCA)**

## Venture capital sources

**EC**



**EBRD  
72%**

**Other  
1%**

**US Government  
Agencies  
27%**

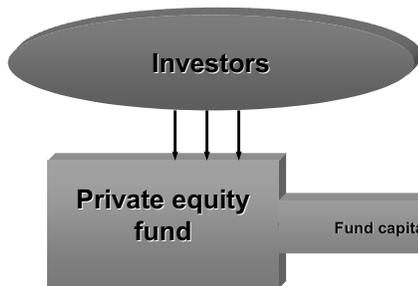
**Russia**



**RUSSIAN VENTURE CAPITAL ASSOCIATION  
(RVCA)**

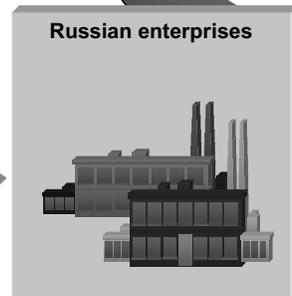
## Business organization

**Foreign offshore  
zone**



**Russian  
Federation**

**Managing  
Company**





**RUSSIAN VENTURE CAPITAL ASSOCIATION  
(RVCA)**

## RVCA mission

**TO PROMOTE THE FORMATION  
AND DEVELOPMENT OF THE  
VENTURE INDUSTRY IN RUSIA**



**RUSSIAN VENTURE CAPITAL ASSOCIATION  
(RVCA)**

## The RVCA goals

- \* **Formation** of favourable political and entrepreneurial climate in Russia
- \* **Representing RVCA member's interests** inside of Russia and abroad
- \* **Information support** of Russian venture market players
- \* **Preparation of the specialist** for venture business companies



РОССИЙСКАЯ АССОЦИАЦИЯ ВЕНЧУРНОГО ИНВЕСТИРОВАНИЯ  
(РАВИ)

## RVCA priorities

- \* **Collection and analysis** of existing practice of venture funds in Russia
- \* **Promotion** of venture industry
- \* **Construction** of full-value venture **infrastructure**
- \* Participation in **legislative** activity



*RUSSIAN VENTURE CAPITAL ASSOCIATION*

Russian Venture  
Capital Association

**RVCA**

Tel/fax +7 (812) 326 61 80

E-mail: [rvca@rfntr.neva.ru](mailto:rvca@rfntr.neva.ru)

[www.rvca.ru](http://www.rvca.ru)



# PROBLEMS AND PROSPECTIVES OF CREATION OF REGIONAL VENTURE FUND IN PERM REGION

SEMINAR

**“PERSPECTIVES OF RUSSIAN-US COOPERATION  
ON VENTURE ENTREPRENEURSHIP”**

WASHINGTON, USA  
MARCH 2002

LARISSA KOPYSOVA  
“ER-CAPITAL” JSC (PERM)

## *INTRODUCTION*

### **May - October 2001**

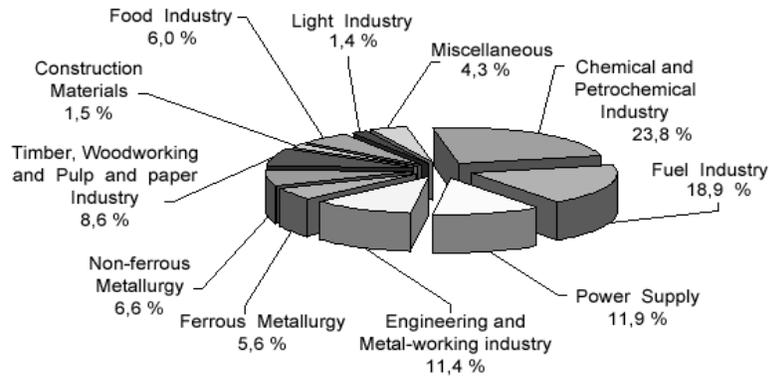
-  Organization of PermRegion delegation participation at the Second Russian Venture Fair.
-  7 exhibiting companies represented at the Fair.
-  3 of them presently are negotiating with potential investors.

### **June - December 2001**

-  Development of the concept to create a Regional venture fund.

## WHAT IS PERM REGION?

**Key industries of the Perm region in 1999**  
( share in aggregate region output, % )



## WHAT IS PERM REGION?

- ☞ The richest land; the cost of 1 square kilometer is up to \$2 million;
- ☞ Huge human and intellectual potential;
- ☞ High income level per capita;
- ☞ \$1 billion of investment to regional economy in 2001;
- ☞ Developed business assistance infrastructure.

## *CONDITIONS FOR INVESTORS*

-  **Strategically located – Region lies in the center of Russia**
-  **Developed industrial, transportation and telecommunications infrastructure**
-  **Investors' support by regional authorities**

## *FUND CREATION PREREQUISITES, OR HOW INVESTOR CAN EARN IN PERM REGION*

-  **Priority directions of innovation development:**
-  Space launch vehicles;
-  Engines for airplanes and helicopters;
-  Equipment for gas turbine power stations and gas-pumping machines;
-  Automated fuel-regulating equipment;
-  Navigational devices.

*FUND CREATION PREREQUISITES,  
OR HOW INVESTORS CAN EARN  
IN PERM REGION*

 **Prospective innovative sectors in the region:**

-  Ecology and resource saving;
-  Chemistry, biochemistry;
-  Information technologies and telecommunications.

*FUND CREATION PREREQUISITES,  
OR HOW INVESTORS CAN EARN  
IN PERM REGION*

 **Future fund capital distribution:**

-  **80 %** - to innovation branches capital
-  **20 %** - to commerce and service sphere enterprises capital

 **Return on investment 15% to 45%**

## *WHY THE CREATION OF VENTURE FUNDS IS NECESSARY IN RUSSIA?*

### **Key problems of Western funds in Russia:**

-  High political and economic risk;
-  Exit from the business;
-  Deal-flow problem;
-  Lack of understanding of Russian business culture.

**OFFER:** THE PROGRAM, STIMULATING THE CREATION OF VENTURE FUNDS IN RUSSIA.

## *KEY PROBLEMS OF RUSSIAN VENTURE FUND CREATION*

-  Organizational and legal form of Russian venture funds;
-  Lack of qualified personnel and programs to train them;
-  Lack of experience in organizing Russian private venture funds;
-  Lack of long-term resources for Russian investors.

## *POSSIBLE WAYS TO RESOLVE SOME OF THE PROBLEMS FACING RUSSIAN VENTURE FUNDS*

- ☞ Draw from Western experience;
- ☞ Establish cooperative training programs and internships for Russian managers of Russian venture funds (CRDF and RVCA);
- ☞ Develop programs to promote venture capital investment in Russia (CRDF and RVCA);
- ☞ Develop a program to create and support investment banks in Russia.

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**Russian Venture Capital Association**

**Venture Capital Industry in  
Russia**

**Maxim Tikhonov  
Senior Associate  
Baker & McKenzie  
Washington, D.C., March 15, 2002**



**INVESTORS**

- **IBRD, EBRD, government sponsored funds**
- **Foreign private capital**
- **Russian capital - increasing**
- **Russian companies with investment into international vehicles**
  - ✓ **Cybico**
  - ✓ **IBS**
  - ✓ **Actis**



**PRIMARY AREAS**

- **Telecommunications**
- **Internet**
- **Food Production / Packaging**
- **Oil / Mining**
- **Publishing**



### **CURRENT TRENDS**

- **Small-to-medium size enterprises increasing**
- **Gradual move from “gray” to “white” business as a must for successful growth**
- **Investment into old structures vs. new structures**
- **Trying to reach ideal combination of:**
  - ✓ **Investor(s) with western management / industry training and country experience; and**
  - ✓ **Shareholder(s) / local management with local experience and knowledge of industry**
- **Generally favorable business climate**



### **KEY INVESTMENT STEPS**

- **Interest / negotiations**
- **Letter of Intent**
- **Legal / Financial / Business Due Diligence**
- **Investment Agreement**
- **Investment in Progress: share purchase, merger / acquisition**



## KEY ISSUES – PROJECT TERMSHEET

- **Definition of Business to be Invested Into**
- **Amount of Investment**
- **Equity Acquired**  
(percentage of shares / participation, type of shares)
- **Mechanism of Investment Contribution**  
(in-kind / cash, indirectly / directly)
- **Loan / Other Financing Provided**  
(other than investment contribution)
- **Voting Procedures / Corporate Governance**  
(on Shareholders' Meeting and / or Board levels)
- **Securitization of Investment**  
(Management / Shareholder control over the Company)
- **Exit – Sale of Shares via Public Offering or to Strategic Investors; or Sale of Shares to the Company on Certain Conditions**



## STRUCTURE OF DOCUMENTS

- **Letter of Intent**
- **Due Diligence Report**
- **Investment Agreement**
  - **Schedules to Investment Agreement:**
    - ✓ **Agreed draft corporate decisions on new shareholders, new version of charter, share issuances, major transaction consents**
    - ✓ **New version of Charter**
    - ✓ **Business plan / Financial forecast**
    - ✓ **List of outstanding company obligations**
    - ✓ **Environmental action plan (EBRD)**
    - ✓ **Draft share purchase / subscription agreements**
    - ✓ **List of purchased equipment (in-kind structure)**
    - ✓ **Payment schedule**



## CHARTER – CORPORATE GOVERNANCE CONTROLS (1)

- **No majority on shareholders level (50%+1)**
- **Minority blocking rights (25%+1):**
  - ✓ **Modifications to Charter**
  - ✓ **Charter capital increase**
  - ✓ **Reorganization/liquidation**
  - ✓ **Definition of authorized shares amount / value**
  - ✓ **Purchase of shares by the company**
  - ✓ **Major transaction approval (over 50% of balance sheet value)**



## CHARTER – CORPORATE GOVERNANCE CONTROLS (2)

- **Super-majority on Board level:**
  - ✓ **Any transaction with company assets above X amount**
  - ✓ **Contracts in connection with capital expenditures above X amount (real estate, equipment)**
  - ✓ **Grant of guarantees, compensations, security, loans above X amount**
  - ✓ **Long-term/onerous contracts outside company's ordinary business**
  - ✓ **Any contract where substantial competences, functions, tasks and/or capacities of executive bodies are delegated/transferred**
  - ✓ **Any amendments to financial forecast, accounting policies/dates, corporate bankers, amendments of financial facilities' terms**
  - ✓ **Decisions on material environmental issues**
  - ✓ **Commencement/settlement of any litigation/arbitration/ other proceedings in amount exceeding X**



**INVESTMENT AS IN-KIND CONTRIBUTION**

- Investment amount controlled by Investor
- Option: Equipment purchased by Investor and contributed into Investor's local SPV
- SPV gradually transfers 100% shares in exchange for target company's shares
- Money saved on customs duties and VAT
- End of the day – target owns SPV, in future – merges into one entity



**KEY ISSUES – MANUFACTURING COMPANIES**

- Real estate / key asset titles
- Privatization
- Structure of assets
- Formation of investor's stake
- Labor unions, excessive personnel
- Environmental compliance
- Licensing



## **KEY ISSUES – OIL COMPANIES**

- **License granted without tender/with violations**
- **License revoked on wide basis**
- **Privatization / corporate issues**



## **KEY ISSUES – IT COMPANIES**

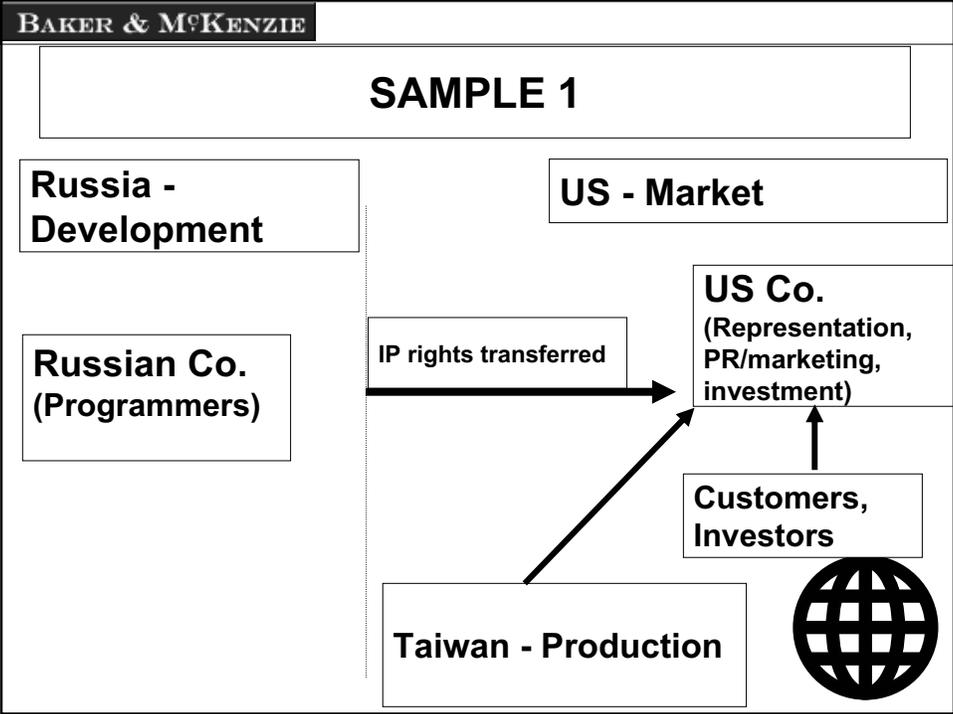
- **IP rights limited by territory**
- **Rights secured on certain territory – sales area important**



**BAKER & MCKENZIE**

### ISSUES AT LARGE

- Black cash
- Tax liabilities
- Real estate acquisitions
- IP rights registration
- Formal vs. real structures



**SAMPLE 2**

- **USD 6 mio for 32%**
- **1 mio – cash**  
**3 mio – equipment in-kind**
- **80% on Board for key issues**  
**(2 of 6 members from Investor)**
- **4 years – target exit term**



**SAMPLE 3**

- **US 1 mio for 49%**
- **Target’s shareholders create new entity**
- **Discrepancies**
  - ✓ **Legal vs. real structure of assets/shares**
  - ✓ **Formal vs. actual management structure**
- **Legality of real estate acquisitions**
- **Lack of IP registrations**
- **Tax risks / financial policies**
- **Alien work permits**
- **Further structuring – possible under conditions precedent**



## **EXIT**

- **Sale to Strategic Investor (Private/Institutional)**
- **Sale to other Shareholder(s)**
- **IPO**
  - ✓ **NASDAQ (USA)**
  - ✓ **ADR (USA)**
  - ✓ **NEWEX (Europe)**
  - ✓ **GDR (Europe)**
- **Conditions of Exit**
- **Liquidity of the Company**
- **Liquidation as Exit Option**
- **Exit Vehicle – Russian / Foreign**



## **IMPORTANT FOR SUCCESSFUL INVESTMENT**

- **Openness of target**
- **Business figures**
- **Reasonable approach by parties**
- **Legality of transaction / key documents**
- **Attitude of target's personnel**
- **Policy of local authorities**
- **Other investors' experience**



## Venture Capital Industry in Russia

By Igor Yegorov, BISNIS Representative in Northwest Russia  
and Polina Belkina, BISNIS Representative in Central Russia  
February 2002

**Summary.** As the economic recovery in Russia gathers pace, it has become more apparent that lack of financing is a major hindrance on the path for sustained upturn. Inability of the Russian banking system to provide adequate funding to many expanding companies hampers replacement of old capital equipment, investment in new technologies and personnel. This problem is even more acute for small and medium companies, as well as for the high-tech sector. Establishment of innovative and flexible financial infrastructure implies the development of the venture capital (VC) industry able to satisfy growing diversity of financial needs, as well as to provide the much-needed capital to expanding innovative companies.

However, the role of venture capital in the Russia's financial system has not been significant in the past 10 years. EBRD and other foreign investors created the majority of active VC funds. The total estimated investment by VC funds in Russia is \$350-450 million. But indeed, the initial impulse provided by foreigners needs to be supported by national capital in order to become a substantial resource of financing the economy. The Russian government has realized the need to support VC industry growth and is taking vital steps to establish a network of regional VC funds.  
**End summary.**

### Venture Capital as a Source for SMEs Development

1. A thriving SME sector and a good supply of innovative ideas are vital for VC industry growth. There is little doubt that venture capital in Russia will get an impulse to growth if several things happen: the government supports establishment and growth of SMEs in various industrial high-tech sectors; it becomes clear which economic sectors in Russia are a priority; growth of these sectors is supported by a range of private and government-led initiatives; a favorable legislative and tax environment for private investment is created; *financial infrastructure develops and* technological and managerial education is assured. Under these conditions VC would get a field for expansion into its traditional domain, i.e. in the growing high-tech sector. U.S. experience of VC industry development shows that it is important to provide sources of financing for VC funds, such as insurance companies, pension funds and private investors. It is equally important to develop the stock market to enable easier exits for VC funds.

2. Meanwhile, SMEs and, in particular, small high-tech companies, are not the basis of the Russian economy, playing only a minor role in development of innovative industrial products. For example, whereas SMEs contribute 72% to overall employment figures in the European Union, and 52% in the United States, Russian SMEs account for only 10% of the workforce. Moreover, according to the St. Petersburg Foundation for SME Development, 49.6% of SMEs in 1998 were in the retail and public catering sector; 14.5% - in industry; 12.5% - in construction, 5% - in scientific research, 19% - in other sectors. These figures show that only a minor portion of SMEs are active in industry and high-tech, which is not good for the Russian economy and hampers its ability to innovate and grow.

3. The small share of SMEs in industry and high-tech is largely due to the fact that they don't have easy access to financing to expand their businesses, although there are also other factors at play as well, such as taxation and lack of management skills. However, financing is cited by a majority of SMEs as absolutely vital for their growth. This problem is currently unresolved, as

viable financing options are limited to short-term bank loan, strategic partnership with strong firms or retained profit. Bond issues are just gaining pace and are mostly popular among large corporations as a substitute for bank financing. Equity markets are closed to small and medium companies. SMEs are also largely cut off from bank financing, as they often don't have any assets to pledge. This is especially true for high-tech companies since their main asset is intellectual property, which is very difficult to value. Leasing companies are also hesitant to provide services to SMEs for the same reasons as banks, as many leasing companies are bank subsidiaries or rely on bank financing.

4. Probably of the most interest to VC funds in Russia are high technology companies with good expansion potential. This sector has not attracted a significant amount of venture capital to date. But, as the Russian economy grows, there will be increasing demand for investment in high-tech companies. So, VC funds have a good opportunity to enter a potentially very lucrative segment of the Russian economy. A prerequisite for this is in the hands of the Russian government which should pay more attention to problems that hampered SME development before and reform financial system. Indeed, commercialization of available technology is seen by the Russian government as potentially very promising path for VC funds, which could provide much-needed support to management teams of fledgling high-tech companies.

### **Venture Capital Industry In Russia**

5. There are no official estimates of the size of the VC industry. However, since the number of VC funds operating in Russia is limited, it is easy to observe their activity. Based on the list of investment funds, published by *Rynok Zennikh Bumag* (Securities Market) magazine in 2001, there is approximately \$4-5 billion in 70-100 venture capital and private equity funds able to invest in Russia. However, only a small proportion of this amount is invested in Russia as these funds usually target a broader spectrum of Eastern European, NIS countries or emerging markets around the world. Moreover, only a few private funds which invest in Russia undertake direct investment of VC type and instead engage in large private equity deals.

6. As mentioned earlier, a natural consequence of underdeveloped capital markets is that the VC industry in Russia is not playing its vital role of nurturing SMEs. Many observers note the lack of adequate financial mechanisms tailored to economy's investment needs. Inability of the Russian financial system to provide capital for early-stage development and expansion of small and medium sized companies stems partly from the fact that there is little diversity of capital sources. Mostly importantly, personal savings are badly accumulated by the banking system, pension funds and insurance companies. Wealthy individuals, whose resources are vital for VC industry, often remain managers of their companies and thus often unwilling to diversify risk. All in all, the negligible role of VC in Russian investment to date at least partly results from an insufficient supply of domestic private capital and savings. So, the largest source of financing for VC funds in Russia is foreign capital, mainly provided by foreign government bodies and institutional investors. This is confirmed by the fact that EBRD (European Bank of Reconstruction and Development) is the biggest investor in the Russian VC industry to date.

7. The basis for development of the VC industry was laid by EBRD in 1994 when 11 regional VC funds were established with a total capitalization \$310 million and an additional \$207 million in technical assistance funds from donor-governments. Around \$200 million of the total capital was

invested in 76 companies (average investment is \$2.6 million). Regional VC funds, sponsored by EBRD, and some private VC funds, which operate in Russia, are members of the Russian Venture Capital Association. There are estimates that EBRD-sponsored funds and other VC funds invested around \$350-450 million. Of course, estimates may vary not only due to lack of official statistics, but also because some may view VC as a subset of private equity.

8. The United States plays an important role in supporting Russia's VC and private equity investment. Here are just a few funds, which are active or already "fully invested":

8. The U.S. Russia Investment Fund had been created in 1994 under legislation passed by the U.S. Congress. The Fund was provided \$440 million in public money. Delta Capital Management assumed management of The U.S. Russia Investment Fund in 1999. According to Delta Capital's web site, almost \$200 million were invested through the Fund in Russian companies. The target investment size ranges from \$1 million to \$10 million. Delta Capital participates in early and later stage investing and focuses on investments in three of the most dynamic market sectors in modern Russia: TMT (telecommunications, media and technology), financial services and consumer products and logistics. Among Delta Capital's financial investments are DeltaCredit (Russia's leading specialized mortgage bank), DeltaBank and DeltaLeasing.

9. America First, a management company, organized with credit support and a guarantee from the Overseas Private Investment Corporation (OPIC) a \$100 million Agribusiness Partners International (API) fund. According to the web site, the fund was invested in eight agribusiness/food processing companies in Russia, Kazakhstan, Georgia, Moldova and Ukraine. The companies include producers of cheese and dairy products, a sparkling wine bottler, soft drink and water bottlers, a packaging and labeling company and a glass bottle manufacturer. The Fund's biggest investment is in the largest poultry production company in Russia.

10. Financial institutions with a share of U.S. capital, such as IFC and EBRD, have participated in the formation of numerous venture capital and private equity funds active in Eastern Europe and Russia. These funds, just to mention some, include Alliance ScanEast Fund, First NIS Regional Fund, Baring Vostok Private Equity Fund, Sector Capital Fund and other. Some of the funds have already allocated all money, as others are still considering new projects. Successful investments were made into consumer goods manufacturing, media and financial sector, food processing, printing, financial services, logistics, internet, mobile telecommunications, oil and gas, transportation and infrastructure. It is reported in some sources that corporate venturing is a form of investment, which is used by some large Russian corporations, but it is very hard to obtain reliable statistics as investments are usually not publicized.

### **Russian Entrepreneurs Versus Equity Partners**

11. Efficient co-operation between a VC fund and a company is a crucial element of a successful investment. The company's management should understand and share VC fund's goals. This understanding is not common among Russian managers. Another problem is that the Russian SMEs are often not ready to work with a private VC fund due to lack of management skills. Many SMEs are simply unable to handle large amounts of investment. This resulted in some companies rejecting on several occasions an investment proposal due to their inability to comply with management standards. VC funds with technical assistance money usually spend an amount equal to invested amount on technical assistance program for a company. This is needed to bring corporate structure in order, upgrade accounting system and make the company's financial position transparent, obtain international audit, put monitoring system in place, etc.

12. Many Russian companies have realized the necessity to improve management and accounting and are investing significant amounts in purchasing of automated monitoring systems, consulting services and staff training. An important obstacle to venture investing is that many managers/ owners of companies have not yet realized that they have to surrender part of control in favor of equity investors to be able to attract capital for development and expansion. However, fund managers note that management level of many companies has grown substantially in the last couple of years and many projects are well prepared and transparent.

### **Regulatory Framework**

13. VC industry barely requires any special regulations for successful operation, but rather generally stable and favorable business environment. The Russian Venture Capital Association identified legal obstacles to venture investing in Russia. They include:

- Registration or approvals of such authorities at the State Registration Chamber, Antimonopoly Committee, Central Bank and Federal Securities Commission is required on all stages of the investment process. Procedures are cumbersome, allowing sometimes arbitrary decisions. It is necessary to eliminate excessive administrative control as it is an obstacle to private investment. Many procedures need to be simplified and clarified. For example, a set of documents required for registration of companies with foreign investment is not always clear. Another instance is that registration of stock issuance by closed stock company is too complicated, requiring a list of documents and long waiting periods.

- Corporate laws don't allow shareholders enough freedom in regulation of joint-stock companies. For instance, shareholder agreements, which are often needed by VC funds during investment process, are not legally binding, nor guarantee control rights to minority investors. Furthermore, there is no provision for convertible bonds in the civil code, making it difficult to register convertible bond issues.

- Taxation is an ever-lasting problem for Russian companies. It naturally affects venture investing. There is need for special provisions in the legislation allowing for privileged taxation of venture-backed companies and favorable taxation of prioritized industry sectors. For example, it is important to eliminate double taxation of investors in VC funds and to stimulate long-term capital investment. A general requirement is to base the taxation system on profit and not to introduce retroactive rules.

14. The government's stance towards liberalization of the economy has positively affected recent legislative changes and provided some relief to VC funds. For example, the Central Bank's foreign currency regulations were significantly amended lately to allow much easier capital movement to Russia and eliminating many limitations and approvals. The Russian government is also starting to play a role in the development of the VC industry. It adopted in the end of 1999 the Main Priorities of Venture Investment Development program for 2000-2005. The government's priorities are the formation of a favorable legislative framework and the establishment of organizational and financial infrastructures. The government plans to stimulate increased investment in high-tech companies by promoting venture capital. Concrete plans for government action are only starting to take shape. It is clear that, among other things, the government needs to focus on creating a stimulus for Russian capital to move into the VC industry and on attracting foreign VC funds.

15. In line with this policy, the Russian Ministry of Industry, Science and Technology is planning to participate in 15-20 regional venture funds over the next two years. The government invested RUB200 million (\$6 million) in the Venture Capital Innovation Fund (VIF) with a mandate to develop infrastructure for venture industry. VIF will act as a catalyst for Russian investment in VC funds, planning to participate in regional venture funds which would be selected through tenders. Three tenders to recruit a management company are already announced in several regions. VIF's share will not exceed 10% of their total capital. VIF is currently open to investors.

16. Still another direction of the government's policy for the promotion of VC industry growth is the development of the stock market. Exit from a venture-backed company is a big problem for VC funds in Russia. The liquidity of venture capital investments is poor due to the absence of an IPO (Initial Public Offering) market and the lack of confidence in Russian companies in the world markets, which often deters foreign strategic investors. Since venture industry is very young, there are quite a few successful exits to speak of. EBRD Representation in Moscow reports that eight companies were successfully sold by its 11 regional VC funds.

### **17. Contact Information**

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RVCA is also a good point of contact for Russian VC funds.

### **18. U.S. Government Contact**

For more information, you may also contact:  
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