

# DOES VENTURE CAPITAL IN UKRAINE REALLY SUPPORT HIGH TECHNOLOGY SPHERE?

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***Abstract:** paper is dedicated to the sphere of venture financing in Ukraine. Main contradictions of the venture industry framework in Ukraine that have negative influence on its efficient development are defined in the paper. Complex analysis of current Ukrainian venture industry is done. Recommendations on how elaborate these contradictions and accelerate venture financing in Ukraine are provided.*

***Keywords:** venture capital, private equity, venture fund, joint investment institution*

## 1. INTRODUCTION

*State of art of venture industry in the USA, Europe and Ukraine*

Worldwide economic crisis had negative influence on the venture capital industry all over the world. Nevertheless today venture capital remains the powerful source of economic growth in many developed countries.

For example, in the USA in 2009 in spite of the fact that total venture investment decreased 37% in dollars and 30% in number of deals from 2008 total amount of venture investment was \$17.7 bn. US venture industry in 2009 funded 728 first-time companies in spite of the fact that earlier it is used to fund more than 1000 companies each year, but nevertheless this indicator is enough high. More than 60% of investments in 2009 were directed to the stage of expansion and later stage. The share of early stage investments was 26% and the share of start-up/seed investments was 9%. Biotechnology sector was leader by distribution of venture capital investments by industry sectors (20% of all venture investments were directed to this sector). In 2009 the majority of VC investments were directed to the following sectors: software (18% of all VC investments), medical devices & equipment (14% of investments), industrial/energy (13% of investments), media & entertainment (7% of investments), IT services (6% of investments). It means that 6 sectors got 78% of all venture capital investments, each of other sectors got 1-2% of all investments. Geographical distribution of venture capital investments is also not homogenous: two states (California and Massachusetts) got 61% of all VC investments in 2009 [1].

In Europe venture capital market is not so powerful as in USA, it is still highly fragmented, there is also funding gap, compared to the US market, but according to EVCA's data, venture capital in Europe is €5-6 bn a year on average. Compared to most other European

asset classes this amount is very small. That is why Europe's large institutional investors such as pension funds, asset managers, banks and insurers generally do not want to allocate investment expertise or resources to such asset class as venture capital. Actually today in Europe there is no institutional investors that could be the long term partners for venture capital [2]. During last years CEE countries (especially Czech Republic, Poland, Romania, Hungary and Bulgaria) tended to intensification of venture financing. The share of CEE companies was raised up to 11% of total private equity investment across Europe in 2009 in comparison to 5% in 2008. In comparison with the USA where biotechnology, software and medical devices & equipment are leaders of VC investments in CEE countries the communications sector remained the most popular in terms of number of companies financed [3].

Today in Ukraine there is essential amount of private money that could be invested into innovations. According to the different estimations potential volume of venture capital market in Ukraine is \$400-800 mln. [4]. At the same time there are about 700 venture funds in Ukraine. Formally Ukraine has 2 main elements of venture industry – financial capacities (private money) and intermediary players of venture industry (venture funds) but real situation is not so optimistic.

**The aim of the paper** is to find out main contradictions of the venture industry framework in Ukraine that have negative influence on its efficient development and make complex analysis of Ukrainian venture industry and to provide recommendations on how elaborate these contradictions.

### **Methodology**

Finding out main contradictions of the venture industry framework in Ukraine was made from the one hand on the base of study of legislation framework of VC market in Ukraine. Another methodological issue that we used as the base for our analysis is understanding of term “venture capital” in Ukraine and other countries.

The analysis of current situation of venture capital in Ukraine was made on the base of official statistical data of Ukrainian Association of Investment Business (UAIB) and on results of special survey and case studies, conducted by the author in the framework of research project “Development of the organizational-methodological providing of creation in Ukraine venture financing system”. The survey was conducted on the base of special questionnaire, developed by the author. Directors and top-managers of the medium and high-tech enterprises were interviewed. The sample included 200 in 3 most innovative regions of Ukraine: Kyiv (100), Donetsk (50), Kharkiv (50).

For getting more complete picture of Ukrainian venture industry series of case studies with experts in the field of venture financing in Ukraine, namely with the heads of private venture capital structures, venture funds and specialists of state authorities, in particular the Ministry of Economy of Ukraine was carried out.

## **2. RESULTS**

### *Legislative and methodological contradictions*

Today in Ukraine venture funds activity is regulated by the Law of Ukraine "On Joint Investment Institutions". There is no special regulation act on venture capital (financing). Before the adoption of this law the basic principles of operation of joint investment institutions in Ukraine was determined by the Council Directive of the EU № 85/611 of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities. But the activity

of venture funds remained out of the regulation. Our research proved that this law could not regulate venture industry in a proper way because it does not take into account specific of venture financing and venture funds activity.

In methodological aspect in Ukraine, there is the identification of venture capital and private equity concepts that is not true. To our opinion it is not right to identify the terms “venture capital” and “private equity” because venture capital it is a part of private equity; such misunderstanding leads to the future mistakes in evaluation of venture capital potential and its role in economic growth of the country [5].

### **3. ANALYSIS OF UKRAINIAN VENTURE INDUSTRY**

In May 1998, in Ukraine at the suggestion of the European Venture Capital Association section of venture capital of Ukrainian Association of venture business (UAIB) was opened. Promotion of development of venture investment in Ukraine is the main task of this section. Last decade the number of venture funds in Ukraine had strong increasing tendency. In 2003 there were just 3 venture funds in Ukraine. In 2006 their number increased to 377 funds, in 2008 - to 636, in 2009 - to 690. The majority of all JII (70%) is located in Kiev and they own about 70% of total JII assets. The share of other regions are much more modest, as the Dnipropetrovsk region locates only 8,10% of Ukrainian JII, which own 11.44% of their assets, Kharkov region respectively 6.73 and 7.9%, Donetsk - 2,6 and 4,2%, Odessa 1.94 and 1.51%. In other regions the number of JII is about 10% which have less than 4% of total JII assets.

Total assets amounted to JII was 10.60 billion U.S. dollars in 2009, the gain for the year was 30.47% (2.47 billion U.S. dollars), more than 90% of which came for venture capital funds (2.22 billion U.S. dollars).

Such positive dynamics of the assets volume, which, despite some reduction in their rates, significantly higher than the rate of economic growth in Ukraine in 2009 (-3.52% at current prices), has identified a significant improvement in the ratio of assets of the JII and GDP (from 6,67% to 9,02%). Despite the fact that part of the financial resources of the population and enterprises involved in Ukraine's banking system, nearly 4 times higher than the JII market, in terms of increasing the value of assets and their share in GDP, JII was more successful than banking sector at all. We tried to study are these funds really VENTURE funds. To answer this question we studied investment portfolio of venture funds.

In 2009 securities represented 70.2% of Ukrainian venture funds investment portfolio. But the share of shares among all securities was the lowest among all joint investment institutions – 20.5%. The structure of the investment portfolio of venture funds was the least transparent in comparison with other institutions; "other assets" were 24.4% of the portfolio that could not be measured in a proper way. Corporate bonds were 22.8% of all securities where venture funds invested in 2009. Insignificant increase in investments to real estate, cash and deposits was one of the negative trends in 2009 [6].

Assessment of sectoral distribution of venture funds securities in Ukraine is sophisticated because the sphere of investment for most securities is not determined according to the official data of UAIB. The second problem is that in 2009 potentially innovative industries (such as medical, telecommunications) were excluded from the list of investment sectors at all, that make assessment of innovative level of venture funds very problematic. While in the USA and in Europe the majority of venture investments is directed to such industries as health care (biotechnology) and information technology (software). E.g. in the USA in 2009 20% of venture capital investment was directed to biotechnology, 14% to medical devices

and equipment, 18% to the software and 6% to the IT services. At the same time in 2009 Ukrainian venture funds invested in consumer goods (5.80% of all investments), financial services (5.22%), industry (3.67%), raw materials (2.52%) and so on.

If we look at the list of companies that received venture funds investments in 2009 we can see that the majority of enterprises in general were not innovative. They were brokers and consulting firms, construction, trade companies and even Premier Palace Hotel in Kiev [6]. To our opinion such investments couldn't be considered as really venture investments.

In the framework of research project "Development of the organizational-methodological providing of creation in Ukraine venture financing system" we asked our respondents what was venture capital to their opinion. Almost half of the respondents (42.0%) considers that venture capital is financial source of innovation, which, unfortunately, does not exist in Ukraine; third of the respondents (31.5%) said that venture capital was just a fashionable term, which now often is used in mass media; 14.0% of the respondents consider that venture capital is real financial source for high-tech business, which is actively used by the Ukrainian enterprises, and only 9.5% of the respondent said that venture capital become the financial source of innovation for their firms.

Respondents who had used venture capital, were proposed to determine the extent of its usefulness: 8 respondents (50,0%) consider it extremely useful (without venture financing it would be impossible to implement a specific innovation project), 6 respondents (37,5%) considered it as just helpful; another two respondents indicated that it was no more useful than other financial sources. Most respondents who used venture capital (43.75%) did not received any help venture capitalists at all, only five respondents (31.25%) besides money were assisted in the project management, and four respondents (25,00%) received consulting services.

Among the 16 respondents, only 11 expressed a desire to use venture capital in the future, most of them would prefer to increase its volume, four of them said they did not know whether they use venture capital in the future (it will depend on the circumstances) and only one respondent mentioned that he did not want to use this source of financing. The reasons that respondents did not wish to continue to use venture capital, were the negative experience, frustration, lack of legal guarantees and methods of compliance with laws, problems that arise when searching for funding sources etc. Totally only 48% of respondents would like to use venture capital as a financial source of innovation, 42% are not sure, the rest of them have no such intention. Until now respondents were not used venture financing due to lack of information, lack of potential investors, or lack of own projects, which attracts potential investors.

Results of the research once again proved that the majority of innovation enterprises in Ukraine were engaged in engineering of different types (from road building to the aircraft), and only a small part of enterprises represented the most advanced sectors as biotechnology, nanotechnology, genetic engineering and pharmaceutical industries. The results of the survey also confirmed that level of venture capital usage in Ukraine is low. Only 8% of the respondents used venture capital as the financial source for innovations, whereas about 70% of respondents said that they had developments that could have practical interest for investors. It is proved that there is a gap between the demand of Ukrainian enterprises in innovation financing and level of such financing.

Experts that took part at the case studies were also enough pessimistic in their assessment of the venture capital financing in Ukraine. According to them, the system of venture financing in Ukraine today, is in its infancy stage. Despite the fact that formally in Ukraine there are about 700 venture capital funds, only few Ukrainian and foreign venture capital funds operate in Ukrainian high-tech sector. Venture capital investments are made to the most

profitable spheres such as construction, assets of public companies, etc., but it is obvious that such investments can hardly be considered as truly venture.

#### 4. CONCLUSIONS

In spite of the fact that Ukraine has enough potential for development of effective venture system, there are a number of contradictions that hamper this process. Ukrainian venture funds prefer to invest in high profitable sectors (constructions, financial services) that in most cases do not belong to the high-tech industry.

In order to enhance venture industry in Ukraine the special Law of Ukraine “On venture activity (financing)” should be adopted. The draft of such law was developed by the author. It is also important to attract pension funds and insurance companies as venture investors while today in Ukraine their role in venture financing is insufficient.

The next step should be creation of National Venture Fund, which can conduct two main functions: direct financing of venture projects and financing of venture capital funds through its participation in creating joint public-private venture capital funds. But creation of such fund may have sense only after elimination of legislation contradictions existing in Ukraine. Otherwise this fund won't be able to fulfill its main task – venture financing, it will finance high profitable but hardly innovative enterprises. The future studies are related to the development of the effective mechanism of venture capital financing in Ukraine.

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