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**ELECTRON LECTURES**

on discipline **«Venture business»**

(11 lectures)

**Component (**optionally**)**

**Type of classes (**lecture**)**

6M050600 – «Economy»

Karaganda 2018

**Theme of lecture № 1. Innovative activity: Introduction to venture investment**

**Plan of lecture:**

1. **Introduction and basic concepts of innovative activity**
2. **Subjects of innovative activity**
3. **Innovative management and marketing**
4. **Introduction and basic concepts of innovative activity**

In recent decades, as most of the countries of the world reduce the size of the bank loan rate, and speculative profits in the financial and banking sector become less secure and profitable, many financial institutions and private owners of capital are forced to turn their face to direct investments in the real sector of the economy, including Number to such form of investments, when one or another amount of invested funds is exchanged for a certain share of a new enterprise. Until the middle of the XX century. Of all types of business that could bring super profits, only the trade in oil, weapons and drugs, as well as the maintenance of gambling houses, were known. As a rule, these types of business are illegal, connected with criminal groups and are inhumane. However, in the second half of the XX century. Was convincingly demonstrated the possibility of such a type of business, which, not yielding to the above-named for profitability and risk, is aimed at creating and maintaining scientific and technological progress. This is the so-called venture business (from the English ventur, a risky business, a risky business), which in the most general case consists in allocating direct investments to small and medium-sized firms that develop and produce predominantly high technology products and services based on high technologies. The essence of venture business in accordance with the meaning of the word "venture" is that a certain amount of money is invested in a new, yet unknown to anyone and has not proven itself, which naturally is a very risky step. At thesame time, to finance a new company, capital is drawn not from the state budget, but from private sources, that is, it is entrepreneurial (it is provided by entrepreneurs and they are managed by it). The main goal of venture financing is to ensure that the financial capitals of some entrepreneurs and the intellectual capabilities of others (original ideas or technologies) are combined in the real sector of the economy in order for the new firm to make profit for both businesses. It should be noted that up to now, due to the complexity and complexity of the concept of "venture business", there is no generally accepted international interpretation of this term. Below are the most common terms related to this type of business. Venture business is a venture business carried out on the principles of venture financing primarily in high technology high-tech production areas; The interaction of two entrepreneurs - one with capital, and the other with the idea and energy for the realization of a certain scientific and technical idea and profit.

Venture financing is risky long-term (5-7 years) private equity investments in the newly created small high-tech promising enterprises (or already well-established venture capitalists) focused on the development and production of high technology products for their development and expansion for profit from the increase in the value of the invested funds. Venture capital is a risk capital used for direct private investment, which is usually provided by external investors to finance new, growing firms operating in the field of high technology high-tech industries; Capital in shares and not quoted on the stock market at all stages of the formation of the firm. Venture investments are an instrument for obtaining a share in the ownership of a firm; They have a profitability above the average level, but at the same time they are carried out in conditions of uncertainty creating a risk. Thus, the ideology of venture business is a risk in exchange for excess profits. Usually, money is invested in a rather large number of projects, one part of which (investors know this in advance) will end in direct losses, the other part will allow us to pay back, and only a relatively small number of projects will bring huge profits. Obviously, it is possible to obtain superprofit only by being the owner of the share capital, and not by the creditor. Therefore, the usual form of venture capital participation in the new business is the acquisition of a block of shares (then crediting is not excluded in the course of events).

The subjects of venture business include:

- the subjects of the most venture activity (the main subjects of venture finance);

- entities that do not participate in venture activity, but who are subjects of financial relations of venture activity (non-main subjects of venture finance). The main subjects of venture business:

- Venture firms,

- Individual investors,

- Financial intermediaries.

Venture firms (venture companies) are risky firms whose products are risk-related innovations in the scientific and technological sphere - new types of high technology high-tech products or services; Usually, ventures serve as the initial stage of product development, engaged in the selection and development of a scientific or technological idea, its approbation, the creation of models and models for their subsequent transfer to the stage of industrial production. Venture firms are divided into two types: - established by the initiators of the venture project (scientists, designers, inventors).

Venture firms of the first type (established by the initiators of a venture project) can be of two types: - independent, organized on their own financial and production basis (they carry out an independent financial and scientific and technical policy, after the shares are sold their independence is limited by the size of the stake); - functioning within the framework of an intra-company venture business.Such firms are established by employees of the parent company, which provides financial and production support. They do not have independence in financial, industrial and scientific and technical policies. If the project is successfully implemented, they can become structural divisions of the parent company, or withdraw from its trusteeship and become independent firms. In case of failure, the parent company may refuse to provide further support, including from providing their employees with previous or similar jobs. Venture firms of the second type (established by a large industrial company) can also be of two types: - functioning as a structural division of the company. They do not have financial independence, they are completely dependent on the financial, production and scientific and technical policies of the company. Such firms are usually created by large companies for R & D and OTP, development and development of inventions created in the parent company, after which mass production of a new product is being established on its basis. As a consequence, the existence of such firms (they are usually called incubation) is Episodic; - Firms established by a large company as independent firms that implement independent financial, production and scientific and technical policies. They develop both new ideas of the parent company, as well as ideas received from outside. Both types of venture firms function within the framework of an internal venture business, which in organizational terms is a specialized corporate unit that has its own budget and engages in intra-company risk financing. As part of the intra-venture venture business, venture capital firms also operate as a result of the sale of inefficient research units to their employees by corporations, which is achieved through the issuance of imaginary shares of risk capital called "phantoms" and only circulating within the firm (with success on the market such shares are exchanged To the real ones).

Innovative activities are activities aimed at creating and practical use (bringing to the consumer) of new or improved products, technologies, services or organizational solutions: administrative, industrial, commercial or other nature, providing an economic (social, environmental or other) effect. Innovation - created and practically used (brought to a consumer) new or improved products, technologies or services, and also organizational decisions of administrative, industrial, commercial or other nature, providing economic (social-environmental, or other) effect. Thus, innovation is the result of innovative activities.

The concept of "innovation" is sometimes mistakenly identified with the notion of "something new" which is not the same thing. Innovation is scientific knowledge with novelty and significant differences from existing knowledge; result of a scientific research, technical development, experimental work, designed documented (discovery, invention, know-how, technical documentation for new or improved product, standard, etc.) or submitted in a material form (layout, experimental or experimental model). "Something new" is transformed into innovation only after it is brought to consumers. Finds practical application.

Usually the development of innovations is preceded by the development of innovative ideas that represent a body of knowledge about basic properties and principles about creation of innovation (new types of products or technologies), including concepts, the construction of theories, experimentation, classification and generalization of the results obtained, processing and assimilation of information. It can be said that innovative ideas are the prototypes of innovation, not materially embodied yet, who are transformed into innovations in the result of materialization (for example, as a result of creating a sample of the product from its drawings).

New products and new technologies are the most promising innovations, since they provide the greatest economic or other effect. In this respect, new services (for example, housing and communal services, transport, communication services) and new organizational solutions (for example, new systems of labor organization) are less significant.

Usually new products and new technologies are considered as two different types of innovations, called respectively product and process innovations. Product innovation is associated with the creation and practical use of new or improved products. Process innovation is associated with the creation and practical use of new or improved technologies (technological processes). It should be noted, however, that the term "process innovations" is more correctly attributed not to new technologies in general, but to new technological processes as one from component technologies, as the other component - new technological means (equipment, rigging, tools) are actually product innovations. Taking into account the made comments, new technologies should be referred to as technological innovation. Product innovations are otherwise called innovative products. Similarly, technological innovations can otherwise be called innovative technologies. Technological innovation is often the basis for creating product innovations. Indeed, the production of many types of new products is simply impossible without the use of new technologies.

The most important characteristic of innovations is the level of novelty. Thus, a firm that produces innovative products can receive substantial economic effect, if this product is fundamentally new, designed to meet previously unmet needs. Such products, belonging to the category of radical innovations, as a rule, have significant commercial potential, are highly competitive and have a great demand in the sales markets. To the category of radical innovations can also be attributed products, fundamentally new in comparison with the existing. In this case, new products can be considered as a fundamentally new substitute for traditional products. Innovative products that are classified as modifying innovations are less efficient in economic terms. This is an updated product that has improved or new additional properties compared to the existing one, which allows expanding its sales markets.

2.**Subjects of innovative activity**

The subjects of innovation activity include the organization of two types: who are directly engaged in innovation activities and which do not directly participate in innovation, but contribute to it, provide the general conditions for its normal implementation.

Organizations of the first type include:

- scientific organizations - research institutes, scientific research investigative units of production firms, engineering organizations universities and universities;

- engineering organizations - design and technology bureaus, design and technological divisions of scientific organizations, water companies and universities;

- production organizations - production firms, associations production firms, production units of scientific and engineering organizations and universities;

- commercial organizations - trading, advertising firms, exchanges, dimensional subdivisions of industrial firms.

To organizations of the second type, the aggregate of which forms an innovation-infrastructure include:

- specialized small innovative organizations - scientific and technical, consultative, expert and leasing companies, as well as technology transfer centers;

- specialized innovative complexes - innovative business incubators, scientific and technological parks, technopolises.

It should be noted, however, that such a division is not stable. So, residents of technoparks, business incubators are also engaged in production activities, producing products, as a rule, high-tech.In the case of creating innovative products, the main subjects of innovation activity are production firms that produce this product.

An important role in the activity of such firms is played by their specialized innovative units - departments, sectors, services or other in their form, structural units for the development and application of new technologies; development and mastery of the production of new products; protection of intellectual property, etc. Typical examples of such units are the department of innovative marketing, design, technology department, the department of new technology, automation, information technology, the patent department, etc.

Innovative units of this kind also include experimental-production units (workshops, plots, etc.).

The main purpose of innovative units is to intensify the innovative activity of production firms, increase production efficiency through the use of high technologies and develop new types of products, provide a market orientation of production, enhance innovation activity and innovative receptivity of enterprise personnel.

Scientific and technical firms are engaged in scientific and technical activities characterized by low material intensity: technical design, advertising and translation services, preparation of scientific and technical information, technological re-equipment, installation, adjustment and repair of equipment, etc. The most developed field of their activity is computer science, in particular, the provision of services in the creation and application of software, the training of computer literacy. Many of these companies are animated by brokering, providing services in the search for customers, the formation of a team of performers, the design of contracts, the inspection of works, etc.

The tasks that consultative expert firms decide include the forecasting of scientific and technological development, the development of recommendations for the restructuring of economic entities, the evaluation and feasibility study of scientific and technical projects and programs, the analysis of the results of scientific, technical, production and marketing activities of firms, the development recommendations on the training of personnel and effective organization of work of firms, analysis of commercial prospects for innovation, etc. Such firms often play the role of a link between have knowledge producers (academia) and consumers of knowledge (industry).

Leasing companies carry out leasing - a specific form of financing investments for the purchase of equipment, real estate, consumer durables and other elements of fixed capital. Leasing is an effective tool that gives consumers access to advanced technology in the face of rapid moral depreciation as a result of scientific and technological progress. In this case, the lessee is released from a one-time payment of the full cost of equipment, does not bind his capital, and the less or acquires a convenient form of selling the full cost of equipment.

Technology transfer centers are created with the purpose of activating innovation activity through the implementation of the mechanism of technology transfer - the process of transfer of technologies from the sphere of development to the sphere of practical use. The main content of the work of technology transfer centers is the information support of innovation activities and the activation of the exchange of innovations between their developers (scientific centers) and consumers (industrial enterprises).

Business incubators (small business incubators) provide under certain conditions and for a certain period of time, specially equipped for offices and production of premises for small companies that are beginning their activity, in order to assist them in gradually establishing and developing their business and gaining financial independence.

A feature of innovative business incubators is that in them the activity of small businesses is guided by the development and use of innovations of a scientific and technical nature

The main goal of incubators is to create an enabling environment for the development and support of small business entities through the creation of organizational and economic conditions that stimulate their activities.

Incubators carry out their activities in the following main directions:

- Renting specially equipped for offices and production of premises to small business entities that are beginning their activity;

- leasing (share use) of office equipment and other movable and immovable property.

In addition, incubators can provide small businesses with various services, while performing the functions of innovation centers.

These services include:

- evaluation and selection of business projects;

- search for partners, investors and creditors;

- Information services for small businesses; conducting marketing research;

- rendering consultations;

- assistance in the introduction of modern technologies, strengthening of the links of research and educational institutions with industry;

- training and retraining of personnel for small businesses.

Incubators such as innovation centers are most focused on the needs of small high-tech firms. Their main task is to connect ideas and inventions with capital and entrepreneurs, attract public and private funds to provide a "start-up period" for new implementation companies.

Technological parks (technoparks) are a special form of territorial integration of scientific, technical, educational and production activity in the form of a combination of scientific, design and technological, educational and production organizations or their subdivisions, who, within the framework of a localized territory, create favorable conditions for the implementation of innovative activities in the interests of developing the regional economy.

Technoparks are among the most effective organizational forms of innovation. The main tasks of park structures are the support of small innovative firms, the commercialization of the results of scientific and technical developments, the accelerated advancement of innovations in the sphere of material production, the development of new ideas in the field of innovation.

In the structure of the technopark, taking into account the directions and specifics of its activities, business incubators and various units that ensure the fulfillment of the main tasks of the technopark, including legal, information, patent-licensing, engineering, marketing, advertising and publishing, etc.

Technoparks serve for the development of high technology, high-tech production firms. They are unique factories for the creation of innovative venture capital firms.

In the world, technoparks based on universities and scientific research institutes, which act as founders of technoparks, have been most widely used. Their contribution to the creation of the technopark is scientific ideas, fundamental knowledge, inventions, scientific advice, provision of the adjacent territory, premises, equipment, libraries to the disposal of the park, etc. Interested in creating the technopark and large manufacturing companies that use it to solve technological problems , maintaining competitiveness. Their contribution to the technopark is financial and material support

At the same time, technoparks based on industrial enterprises can be created quite successfully. In the process of industrial restructuring, large business creates whole clusters of small and medium-sized firms that use the main company's infrastructure and coexist with it in symbiosis, acting as suppliers and contractors. In addition, they begin to produce products for other enterprises. Thus, sustainable industrial networks are created.

Technopolises are specialized geographically closed research and production complexes in which the scientific and technological complex, research activities, knowledge-intensive production and training of scientific, engineering and labor personnel necessary for the operation of such complexes.

The basic principles of the organization of technopolises:

- formation on the basis of large scientific centers;

- orientation of activity on the newest technologies;

- specialization in certain types of modern industries and industries;

- organic fusion of scientific and production potentials;

- active inclusion and enhancement of the role of small and medium-sized science-intensive firms;

- the creation of life-friendly specialists in housing, household and environmental conditions.

The necessary conditions for the effective functioning of technopolises - providing greater independence to local authorities in the regions where they are located and their active support from the state.

**3.Innovative management and marketing**

A special role in the innovative development of the company is given to managerial and marketing activities. For management and marketing as components of innovative activity, the names "innovative management" and "innovative marketing" are usually used.

Innovative management is an activity to manage the innovation process, related to the adoption of managerial decisions on issues of innovative development, the development of an innovation development plan, the implementation of an innovation development plan, primarily in the organization of the production of innovative products.

Innovative marketing is the promotion of management an innovative process associated with the development of innovative ideas and concepts of innovative products, the orientation of production to the needs of the market, ensuring the implementation of the plan for innovative development, primarily in the organization of material and technical support for the production and marketing of innovative products.

Often the concepts of "innovative management" and "innovative marketing" are identified with the relevant organizational structures of the firm - the management service and the marketing department. In addition, such generalized concepts as organizational and functional systems or simply systems of management and marketing are used.

The success of the firm's activities largely depends on the effectiveness of the implementation of the functions of such systems.

The main functions of the company's management system are:

- adoption of managerial decisions - formation of a sequence actions leading to the achievement of the objectives of the firm on the basis of an analysis of the situation in economic or other activities;

- planning - development, optimization and evaluation of alternative options to achieve the objectives of the company; development of plans, programs of economic activity or other activities, as well as measures for their implementation;

- organization - adjustment of actions of separate elements of the management system, achievement of mutual conformity of the functioning of its parts;

- accounting - receipt, registration, accumulation, processing of information on actual economic or other processes occurring in the firm, their results, used resources, etc .;

- regulation - adjusting the actions of individual elements of the system management taking into account changes in the factors of its external and internal environment.

The main functions of the marketing system of the company:

- market research - quantitative and qualitative analysis of the sales market that in order to study the demand for goods, the potential volume of the market, the competitive environment, prices that appear on the market;

- study of the company's production capabilities - identification of the firm's ability to conduct activities related to changes in the nature of production that are deemed expedient in market research;

- market orientation of the company's production - development of events, related to the change in the nature of the firm's production in order to meet the market needs identified in its research;

- development of pricing policy - formation of prices for goods and services based on the interaction of supply and demand;

- the sale of goods - the definition of channels and means of marketing;

- the formation of demand - the development and implementation of activities aimed at increasing the demand for goods, motivating interest in them from consumers;

- promotion of sales - development and implementation of measures aimed at increasing the frequency and volume of sales of goods, encouraging buyers to purchase them, and sellers to sell.

There are some differences in the functions of management and marketing for firms producing traditional products, and for firms producing innovative products. These differences are manifested in the content, implementation and interdependence of functions.

In the case of the production of traditional products, the main task of marketing is to ensure increased sales of products, which is achieved, first of all, through the development of new markets. After the estimated sales volume is determined, the main task of management is to ensure the production of products on an enlarged scale. This is achieved in the course of organizational and technical measures aimed at increasing productivity through the use of more advanced production technologies or improving the organization of labor or to attract additional production assets without any significant technological reorganization of the production system.

When the firm moves to the innovative path of development, the management and marketing functions change significantly, and the nature of these functions depends on the level of novelty innovation - the products produced can be modified, possessing improved properties in comparison with traditional products (modifying innovations), or a new one with fundamentally new properties (radical innovation).

In the case of modifying innovations, the main task of marketing remains in principle the same - to ensure increased sales of products that is achieved not only through the development of new markets, but also hardeningpositions in previously developed markets - thanks to the improvement of product properties as a result of its modification. After determining the principles of product modification and the expected volume of sales, the main task of management is to ensure the production of modified products on an enlarged scale, which is achieved in the course of organizational and technical measures, usually associated with technological reorganization of the production system.

In the case of radical innovations, the main task of marketing is to develop proposals for the creation of new products taking into account its commercial potential. Having determined the basic principles of creating new products and the anticipated sales, management solves the main task - to ensure the production of new products on a given scale, which is achieved in the course of organizational and technical activities, usually associated with a fundamental technological restructuring of the existing or the creation of a new production system

It should be noted that the innovative development of the firm does not endthe output of innovative products to markets. As a rule, during the production of products, its continuous updating takes place taking into account the changing market situation. In this regard, the company's innovative marketing service constantly studies various information sources, for each of which it develops analytical and evaluation documents and passes them to the units of the firm engaged in the innovation process. Such sources include:

- research of consumers;

- research of competing products;

- study of industry trends (analysis and evaluation of the nature of development

the main products of the industry and the main technologies used in the industry)

At the same time it is important for marketers to timely determine promising areas of scientific and technological development in order to outstrip the company's competitors in updating production and launching new products. This problem is solved by marketers together with researchers and developers of the company.

The most responsible work of marketers is connected with the study of the market sales of innovative products. Usually the first stage of market research is demand research, which consists in studying the potential consumer, his tastes, the structure of needs by consumer groups, the identification of unmet needs, the analysis of the motives for preferring specific goods. At the same time, targeted marketing methods are used when the seller delineates the market segments, selects one or more target segments from them and develops marketing techniques for each of them separately**.**

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**Theme of lecture № 2. Structuring of venture capital funds for investment in Central and Eastern Europe**

**Plan of lecture:**

**1. Commercial structures.**

**2. Objectives**

**3. Typical terms and conditions**

**4. Structuring of venture capital funds**

**5. Typical legal structures used in Central and Eastern Europe**

**1. Commercial structures.**

When structuring venture capital funds to invest in Central and Eastern Europe, as well as any other region, to link a number of issues related to taxation and law. As in the case of venture funds, there are no simple answers, and the optimal structure will depend on the requirements for the structure on the part of individual investors and the countries in which the investments will be made and in which the fund will be managed. As for Central Asia and Eastern Europe, in this case, in a market economy where foreign investment was tightly controlled, in a market economy. In this context, the problem lies in the uncertainty of the interpretation of possible tax or legal problems, since the development of laws tends to lag behind the development of the economy. Therefore, this chapter sets out the basic principles associated with such matters, as everything depends on the specific circumstances.

Risk capital and investments in scientific and technological development, often referred to collectively as venture capital, are becoming an increasingly important economic tool in the post-socialist countries of Central and Eastern Europe (CEE). Venture capital is used mainly to finance the activities of fast-growing firms and therefore plays an important role in ensuring the competitiveness of the industry as a whole. It is not by chance that countries with a developed market of venture financing (USA, Japan, Germany, Great Britain, Netherlands) act as the largest exporters of high technology products.

In addition to legal and tax restrictions, there may be different ways to approach the structuring of a fund from a commercial point of view. Self-liquidating fund

The most typical business activity of a venture capital fund is a self-liquidating fund with a limited life, which is often structured as a limited partnership. Some investors, who are, as a rule, organizations, take the obligation to contribute to the fund during its lifetime. As the fund invests, pays for its expenses, or pays compensation to the manager, this reserved money is gradually spent, and usually a relatively small amount of money is expended, but not reserved. Immediately after the use of funds, funds in the investment process are dissipated. When the investment is sold, and interest or dividends are received, they are immediately distributed among investors. Thus, the fund is self-liquidating, as its main investments are realized. Revenues from sales are not reinvested. Instead, when the fund in the venturi is invested, which usually happens in two to three years, the fund manager proceeds to raise funds for the new fund. In addition, the fund has a limited life - usually about ten years, and the main task of the manager at this stage is to realize all investments. Evergreen Fund Unlike a self-liquidating fund, some funds do not automatically distribute dividends and income from the sale of investments, but reinvest them in the following investments. This process can continue indefinitely or until the preset date of self-destruction. Sometimes they agree to take a decision to eliminate the consequences after a certain number of years. This not only hinders the fund manager, but also means that investors can not realize their own investments from the proceeds of the main investments, and they can realize their investments only in their background in the fund or after waiting for the day. Therefore, many of these funds are often listed on the stock exchange. Hence the problem: the price at which the shares of the investment fund go on the stock exchange is often discounted in relation to the net asset value. For some investors, the availability of quotes is important if they need to be able to establish the correct market value of their investment in the fund. This may apply to some insurance companies, pension funds and other institutions that operate in countries whose laws are supported by financially sound organizations, and therefore they must assess their assets on the basis of financial viability. In the US and the UK, it is usually not required that the fund be quoted. Club investment / agreement on parallel investments. Some associations are not structured as funds but are simply investment clubs or a series of management agreements concluded between investors and a specific fund manager. Under the terms of the agreements, the fund manager undertakes to invest directly on behalf of investors in specific companies. Advantages of this method include simplicity of registration of documents with investors. However, since there is no legal entity that established the fund, it is more difficult for a manager to control assets and it is more difficult to manage a process in which many investors participate.

**Not discretionary funds.**

All the structures discussed above assume that the fund manager disposes of the fund's resources at its own discretion. In some cases, especially when it comes to an agreement on concurrent investments, the decision to invest is made available to the client.

**Funds for individuals.**

Sometimes when structuring a fund for investments made by individuals, difficulties arise with taxation or regulatory issues. Often these funds need to be structured as companies whose shares are quoted on the exchange.

**Fund or holding company.**

 In some cases, it is not very clear whether a person wants to deal with a fund that will implement and liquidate investments for the purpose of individual realization of capital gains, or simply create a holding company that will save investments or be sold through an initial public offering of shares exchange. In some cases, the manager may decide to remain flexible in determining what is the goal: the implementation of individual investments or their retention and the creation of marketable securities.

**2. Objectives**

When structuring a venture fund, the manager or the founder pursue several goals. Limited Liability Investors want their responsibility for investing in a fund limited to the amount of their investment, as they will not take an active part in investment management. Avoiding an additional level of tax The main requirement is to get away from the tax that is paid for the first time by the fund when it receives a dividend or a percentage of the financed companies or realizes capital gains and the second time investors when they realize their investment in the fund. Therefore, the fund should, as a rule, be exempted from paying taxes or have transparency. The general principle is that the investor should not lose materially more than if he were making investments directly. In some cases, it is possible to go further and create a situation where the investor wins when he invests money through the fund, rather than directly.

**Suitability for all types of investors**.

It is desirable to have a single fund structure that is acceptable to all types of investors, whether they are exempted pension funds, insurance companies, banks, industrial or trading companies or individuals from any jurisdiction. This is not always possible because of the contradictions between tax and commercial requirements, but it is necessary to strive for this ideal. If this does not work, you can arrange for an investor of a certain category to contribute money to an interim fund, which in turn makes investments in the main fund, or create a parallel fund structure that will make investments and sell them in parallel to the fixed assets and will be managed as well as the basic fund. Alternatively, investors who are unacceptable to any of the fund's structures can be offered to co-invest in parallel with the fund, perhaps through the same nominal company that holds the fund's shares, and on the grounds that investors can not dispose of these shares, but simply adhere to the line of conduct of the fund. Manager's remuneration, which is optimal from a taxation perspective. Management fees need to be structured so as to minimize the impact on the fund of an irrevocable value-added tax. In addition, to the extent that the fund receives income and returns on capital used to pay compensation to the manager, neither the fund itself nor investors should be taxed on profits. Retained Compensation, Optimal in Tax View The retained consideration is usually structured as interest in the fund itself, although it can also be structured as a bonus by the manager. On the one hand, the fund should be optimal in terms of taxation of the fund itself, so that the fund, like the remuneration of the manager, does not suffer from an irrevocable value-added tax, and the profits received from the fund that relate to the retained remuneration are not taxed in the hands of the fund or investors; on the other hand, it should be optimal from the point of view of taxation of individuals or the management company that receives it. This is best achieved when the retained reward is a percentage of the capital in the fund itself. The ability to conduct marketing in search of suitable investors. In many countries, there are market laws that comply with the British Financial Services Act or the US Securities Act, which restrict the marketing activities of funds depending on their structure and the type of investors they want to attract. Since the restrictions are different, you need to choose the structures that allow you to apply to the desired investors. This is especially important when the fund wants to attract private investors.

**Simplicity of management**.

The structure should be easy to manage to the extent that this simplicity is compatible with the above goals. If such a correspondence is not observed, we need to think carefully about what is more important - a structure that is easy to manage or a structure that meets the set goals. For example, it is often used structures in which the fund is a resident of a country where there are small taxes or no taxes at all. As a result, the fund meeting has to be held outside the country in which investors work, and documents - to sign abroad.

**3. Typical terms and conditions**

 A typical term is from eight to ten years, providing for an extension of two to three years, which usually requires the consent of 75% of investors.

**Manager's fee.**

Usually it is up to 2.5% per annum from the initial obligations of investors, for Central and Eastern European funds this figure is usually higher. Sometimes the reward of the manager is tied to the index. However, large funds often set a figure below 2.5%. Sometimes the validity of an obligation is established, after which the interest rate decreases and correlates with the amount disbursed by the end of the commitment period. In addition, there is usually a provision that reduces the remuneration of the manager in accordance with the value of investments that are realized and distributed. - 55 - Gradual expenditure of funds and allocation Funds increasingly agree that the fund will be spent "as needed". However, some funds that have a commitment period allow spending only, for example, in the first five years of a fund's life. After that, only a part (say, 25%) of initial investment obligations and only "subsequent investment" can be spent. Many funds provide for the distribution of income and capital immediately after receipt, although sometimes the income is distributed once or twice a year. In the structures of limited partnerships, partners are required to pay taxes on their income and profits as if they received them at a time when the fund receives income or profit. Many funds have conditions that provide for interim financing, according to which, if the sale occurs within six months of investing, the realized funds may not be allocated but used for new investments. Another option: the proceeds are distributed, but can again be requested for transfer to the fund. Management Company / General Partner Many funds allow most (say 75%) investors to displace the manager / general partner from their position at any time, but if this bias is unfounded (ie, the manager is not charged with negligence or default) , he is paid compensation in the amount of remuneration for two or three years. Some funds provide for investors the possibility of terminating the contract by a majority of 75% of the vote in the event of the departure of the manager / general partner. Payments and Expenses Most funds agree at the initial stage of work to take on organizational expenses in the amount of, say, 1% of the fund. However, in many cases, the fund does not take on the payment of the fee for investing, and many investors, especially in the US, do not believe that some should take at least part of the cost of accommodation. Some current operating costs of the fund are paid by the fund itself. This includes fees for audits and expenses of any investor committee. However, investors are increasingly demanding that all other expenses be paid out of the manager's remuneration, although everything depends on the structure of the fund in question (it is unlikely that such a claim will be presented to a modest venture fund in Eastern Europe, but rather to the repurchase fund). Usually, the expenses of the fund for investment are paid by the company - recipient of investments. The question arises: should any expenses not paid by the recipients of investments be paid by the fund - the manager from the amount of management compensation. Another problem is who will pay for the failed investments ("stillborn investments"): many investors believe that this fund should be taken over by the fund, although there is an opinion that this will make managers too cautious. Again, this is hardly applicable in Eastern Europe, where costs are high, and the size of the funds is relatively small. Similar questions arise regarding the payments received. This includes the director's payments, the placement fee, the participation fee paid by the company or the attracted investors ("third party investors", the payment for the broken deal paid by the company (in respect of transactions that do not develop further.) Here, again, the funds are divided to those in which these payments are received by the manager, and to those in which these payments go to the fund, but investors are increasingly demanding that these payments go to the fund, with the possible exception of director payments, payment for syndication, if it relates to the withdrawal of "third party investors" and the payment for the broken deal if they correspond to the costs of the failed transaction paid by the manager. Again, one must proceed from the fund manager's structure: most likely a small fund with high expenses will be allowed to keep these payments, and the redemption fund - none Remaining Compensation Most funds pay a retained interest of 20% of the profits and incomes realized by the fund. As a rule, the retained remuneration is calculated on the principle of the "fund as a whole", when the retained remuneration is paid only after the investors return the amount of the initial investment and the payment of the "stake" (the agreed interest on the invested capital). Sometimes it is built on the principle of "from transaction to transaction", when the retained reward is paid, if the rate of return on any transaction exceeds the "bar". Usually, when a retained remuneration is paid on a "transaction-to-transaction" basis, it is required that the payment be made only after the unrealized investments are evaluated and the price is not lower than the cost. Some funds require that this amount should not be transferred to the contingent depositor until results are known on the basis of the "fund as a whole": in the latter case, it is better to follow the principle of the "fund as a whole," because it is more effective from the taxation point of view. Usually for a retained reward a bar is set, say, at 10%, accrued and paid only after investors receive a 10% return on investment. There are many different types of straps. In some funds, the amount of retained remuneration depends on the internal rate of return. For example, there may be a 15 percent retention bonus at a 10 percent internal rate of return and a 20 percent retention rate at a 15 percent internal rate of return. In many cases, the bar is set according to the rule, when the recipients of the retained reward "catch up". The proceeds are first placed at the disposal of investors, and they take the amount of the initial contribution to the fund plus the bar. Then the proceeds are put at the disposal of the recipients of the retained remuneration until they "catch up" the bar, so by the end of the "catch-up" period they have 20% of all amounts distributed over and above the initial investments made by investors. After that, all the proceeds are divided in the proportion of 80:20. Many investors require that at least 50%, and sometimes at least 75% of the retained reward falls into the hands of individual members of the management team, rather than the management company or its controlling group.

**4. Structuring of venture capital funds**

The main task that is put in structuring venture capital funds is to avoid an additional level of taxation (the so-called "double fee") that will arise if investors simply invest in a company that, in turn, will invest in the planned investee company. In this case it will be necessary to pay the tax also when the fund sells its part of the property in the company invested and when these revenues are distributed to investors or investors sell their shares in the fund. Also, according to the laws of many countries, the distribution of income from the sale of individual investments during the life of the fund is treated as a dividend, and not a partial sale of capital, thus the return on capital gains arising from the sale of an investment with a profit turns into ordinary income. Although there are investors, for example, some companies in continental Europe, for which this may be an advantage, the general principle of structuring venture funds is that the interests of the majority of investors are answered by a structure in which their position does not change (or at least not get worse) regardless of whether they invest money in an investee company through a fund or directly. Sometimes, under certain fund structures, individual investors may find themselves in a better position than if they invested directly, but this usually applies to structures that are not acceptable to everyone. Double taxation can be avoided with the help of two types of structures: - exempt (or opaque) and transparent, which will be discussed in detail below. Another serious tax complication in structuring a venture fund arises from the fact that some countries in Central and Eastern Europe charge additional capital gains on the sale of shares by non-residents. These fees are usually withdrawn if a non-resident investor resides in a country that has an agreement to avoid double taxation with the country in which the money is invested. If the structure of the fund is not transparent, it is important that the country in which this non-transparent structure operates has such an agreement on avoidance of double taxation. However, the situation when the country has agreements on avoidance of double taxation and at the same time is a territory with a low level of taxation is relatively rare. If the structure is transparent, it is important that the country where the investment is implemented recognizes the transparency of the structure, and that each investor has an agreement with the interested country on avoidance of double taxation. And, finally, it is important to conduct the fund's affairs in such a way that, the fund is not a permanent institution operating in the territory of the country concerned, since in this case it is likely that he will have to pay taxes in this country. This will be discussed later.With the released non-transparent structure, the fund is not taxed on the income received by the fund: the tax is levied only when the profit is distributed to investors. Usually, this requires a company located in a "tax haven" (such as the Channel Islands or Cyprus) or a country that provides a special exemption from capital gains tax and, possibly, income tax (for example, BV in the Netherlands with benefits for Participation, investment trust in the UK and SCR in France). Here you can have four problems:

• If the fund is located in a "tax haven" it is unlikely that an agreement on avoidance of double taxation exists between the country of permanent residence of the fund and the country of permanent residence of the companies invested (or investors themselves). Therefore, there may be high tax costs, depending on whether the country requires the investee's residence from a non-resident investor to pay tax on capital gains in the absence of an applicable double taxation agreement or holds high taxes on interest income or on income from capital gains (which, if there is an agreement on avoidance of double taxation, would be significantly lower)

• Even if the fund has the advantage of being in a country in which double taxation treaties are in effect, there will very often be a tax on income in the form of interest on the distribution of profits between investors.

 • Profit distributed between investors during the life of the fund or even after the end of its activities may be taxed as a regular annual income, rather than income from capital gains, which can create difficulties for some investors.

• The country of residence of the investor may have legislation that complies with US legislation on a passive foreign investment company (PFIC) or UK offshore fund legislation, which may have a negative effect.

**Transparent structures.**

 In transparent structures, such as a limited liability partnership, investors are subject to a tax on the allocation of the investment fund and on their share of profits, regardless of whether it was distributed between them or not. As a result, in a fully transparent structure, each investor is treated as if he made the appropriate investment in every real company invested, and as if all income and profits from the company invested through the fund went directly from the investee company. This eliminates double taxation while at the same time preserving the opportunity for the investor to take advantage of the double taxation treaties concluded between his country of residence and the country of residence of the company invested. In each country, the question arises whether the transparency of this structure is recognized in this country. There may be problems. Poland, the Czech Republic and Slovakia are ready to recognize the transparency of foreign limited liability companies. However, Hungary may treat foreign limited liability companies as foreign companies and accordingly require the payment of a tax on the potential return on capital gains on the investment returns distributed between persons resident in Hungary. Therefore, it is desirable to invest in Hungary through a limited liability partnership that is a resident of a country that has a tax agreement with Hungary, or through a special branch-resident of the country in which there is a tax agreement, for example Cyprus. Even in places where transparency is recognized, it is necessary to do everything necessary to ensure that the fund itself does not create a situation in which its investors are treated as individuals who conduct business in a foreign country through a permanent establishment and are therefore obliged to pay tax in this country at higher tariffs than in its own. In Central and Eastern Europe, where the introduction of free investment markets laws begin to develop rapidly, you should carefully consult with local experts.

**Double taxation avoidance agreements.**

Many Central and Eastern European countries impose sales made by a non-resident tax on capital gains - this is only revoked if the country of origin of the non-resident has an agreement with the interested country of Eastern and Central Europe on avoiding double taxation. Therefore, it is necessary to choose a country in which low taxes are combined with an extensive network of double taxation avoidance agreements. Naturally, such a combination is extremely rare: in Holland, Cyprus and in the recently appeared Hungarian Offshore Company. Here there is a difficulty: in both cases, the use of a company can turn capital gains into ordinary income, which, in the case of the Netherlands, will be subject to high taxation on income as interest on the distribution of income (which can be reduced if double tax rates apply).Neither Cyprus nor the new Hungarian Offshore Company provides full exemption and in both cases the rate is from 4% to 5%. The use of transparent structures, such as a limited liability partnership, on the contrary, should preserve the opportunity to take advantage of the double taxation agreements concluded between the investor country and the country of Central or Eastern Europe in which the investment is made while maintaining the relationship to the profits from the allocation of investments as income from capital gains. Permanent institution No matter whether the structure used is transparent or non-transparent, it should be ensured that it does not work through an institution permanently operating in the country to which they invest money, if in that country the presence of a permanent establishment can lead to taxation that will not remove the application of the law on avoidance of double taxation. In such cases, the funds should be managed from outside - from a country where the presence of a permanent establishment will not lead to negative tax consequences. These countries include the Channel Islands and Cyprus, and may also include Great Britain and the Netherlands. Then the team working in Central and Eastern Europe will only give advice to the foreign manager, and decisions on investment or withdrawal of investments will be made in the country of the manager - as well as, in many cases, signing of agreements on the production or withdrawal of investments. This issue should be approached with special attention and be sure to consult with local experts. At the same time, it is very important to minimize the value-added tax for remuneration to the manager or to the fees paid to the manager by the local consultants. The best way is to place the manager in a country where there is no VAT, for example, the Channel Islands or Cyprus. Then, all fees paid to managing consultants or other local service providers will be outside the VAT zone, but with full cost recovery, and thus all costs related to VAT can be fully restored.

**5. Typical legal structures used in Central and Eastern Europe**

 For investments in Central and Eastern Europe, a wide variety of legal structures are used. Many of them have already been discussed in this chapter, but they include: Transparent structures Limited Liability Partnership. The main transparent structure is a limited partnership that can be created under the laws of England, the Channel Islands, Delaware or various "tax oases" such as the Cayman Islands or Bermuda. These structures are highly flexible and particularly suitable for self-liquidating funds. The main problems are that some countries do not recognize them as transparent and that they can not (at least without significant effort) be quoted on the stock exchange. Parallel investment: this was discussed above. Non-transparent structures British Investment Trust. This is a British investment company, which is a resident of the UK and whose shares are quoted on the stock exchange. Exempt from the British tax on capital gains on the condition that it meets certain requirements. Jersey Companies. These are numerous companies of "tax havens" that can be used and can be quoted on the exchange. The main problem is that they do not benefit from double taxation agreements, and if they want to invest in some Central or Eastern European countries and avoid local taxation, they should act through an intermediary company. Cyprus companies. Cyprus is a country in which both low taxes and the advantage that there are agreements on the avoidance of double taxation. BV in Holland. BV enjoys a privilege for participation and does not pay any taxes in Holland, provided that it owns more than 5 percent of shares in the main companies. However, there is a tax on income in the form of interest or dividends on "distribution" outside of the Netherlands. "Distribution" (even in liquidation) is treated not as an income from capital gains, but as ordinary income. All the main non-transparent structures are listed above.

**Types of venture financing**

There is no single definition of venture capital. In general, it can be described as an economic tool used to finance the company's putting into operation, its development, capture or redemption by the investor during the restructuring of property. The investor provides the firm with the required funds by investing it in the authorized capital and (or) allocating the related loan. For this he receives a stipulated share (not necessarily in the form of a controlling stake) in the company's statutory fund, which he reserves for himself until he sells it and receives the profit due to him.

For venture capital, unlike a loan, firm guarantees are not critical. More important for him is the presence of an attractive and real entrepreneurial plan, as well as management that can implement it. Long-term investments are made not only in the form of money, but also by providing concrete assistance to small and medium-sized firms, which facilitates their transformation into large companies.

Because of the increased risk, venture capital is provided at a higher interest rate than the loan, usually at a rate of 25 - 35% per annum (the exact rate is set upon detailed investment).

Venture investments can be divided into four groups: starting, during the development of the company, with the implementation of a certain operation, others.

Starting investments are the most risky form of investment. Sometimes they are divided into two sub-groups - pre-start and start-up funding itself.

Pre-start financing refers to the earliest stages of entrepreneurial activity. Often it is carried out before the establishment of the enterprise. An example is the financing of works on the creation of a prototype of a new product and its patent protection, analysis of the sales market or the provision of services, the legal provision of profitable franchising contracts and sales contracts, as well as the formation of an entrepreneurial plan, the selection of managers and the formation of the company, when you can go to start-up financing.

Start-up financing is an investment in order to ensure the beginning of the company's production activities. It is assumed that the products have already been designed, the collective of managers has been selected, and the results of market research have been obtained. The risk in this case is high, and the investments are unlikely to pay off before 5 to 10 years.

Financing for development, as a rule, is divided into financing its initial and subsequent stages.

The financing of the initial stage is designed to help small businesses with significant growth potential. As a rule, they can not provide development financing at the expense of a loan due to the inability to guarantee its return. Given the relatively high degree of predictability of investment results, the risk of capital investment in this case is slightly less than with start-up financing, but still significant. Often in this way, firms that exist less than three years and are not yet profitable are financed.

Financing at a later stage provides for the allocation of funds to enterprises with existing production facilities that have great potential for expansion, for example, through the commissioning of a new production line or the creation of a trading network in new territories. The risk of such investments is much lower than in the previous cases, and the payback period is much shorter (approximately 2 to 5 years). At the same time, venture capital is an alternative to classical lending.

Financing of a certain operation is carried out as a one-time act. As a rule, funds are allocated for a very short period of time (for example, for two years). Thus, for example, the purchase of enterprises for a specific client is financed, intermediate ("mezzanine") financing is provided to ensure the company's activity in the period between other types of financing, and funds (and this is of paramount importance) are provided for the acquisition of the enterprise by its management personnel.

There are varieties of venture capital that do not belong to any of the groups listed above. These include: rescue financing, providing for the allocation of funds for the implementation of activities that ensure the revival of the enterprise - a potential bankrupt; substitution financing, intended to replace part of the company's external resources with own capital; financing operations related to the company's entry into the securities market.

Venture investment is made through specially created funds managed by management companies. They can be independent or belong to financial institutions, but act as independent.

**World and European Venture Capital Market**

There are three major venture capital markets - the US and Canada, Southeast Asia, Europe. Typically, the European market means the market of Western Europe, but more often the attention of investors is attracted by the CEE states. The markets of Israel, India and Australia are also considered promising. On the potential of China, the opinions of experts differ and its capabilities are subject to debate. The rest of the regions (Middle East, except Israel, South America, Africa, etc.) are considered relatively unattractive for venture capital.

There is no exact accounting for venture investments in the regional context. According to reports, their total annual volume in 1997 was estimated at $ 20-25 billion, while the US venture capital market accounted for $ 12.7 billion, and Europe for 10 billion ECU (excluding investments in countries CEE).

In recent years, investors' interest in investing in venture capital funds is increasing, as can be seen from the chart showing the increase in the volume of venture capital in certain regions (according to data on the amounts of revenues that were planned in the relevant period).

Venture capital investments can be analyzed taking into account the stage of development of companies - investment objects by sectoral principle, and also depending on the volume of capital investments.

The US and Canada traditionally focus on financing primarily new and very young innovative facilities. Serious changes in their investment policy occurred in the 1980s, when a number of investments were made, resulting in large losses, under the influence of the excess money supply, which arose in connection with the entry of powerful pension funds into the venture capital market with a fairly small number of quality projects.

In this regard, some investors have stopped financing the initial stages of development of firms and moved to less risky financing of later stages. A number of firms began to finance separate transactions, others expanded the boundaries of their investment strategy and began searching for profitable projects in new areas of activity (for example, in biotechnology). In the 1990s, this policy led to a revival of industry and a sharp increase in the volume of venture capital.

In Western Europe, venture capital is used primarily for development purposes. However, as the financing of individual transactions increased, in most cases yielding lower returns, but associated with much less risk, venture capital in continental Europe began to focus on this area of ​​investment in the 1990s. In a number of countries, the growth of entrepreneurship on the basis of venture capital is largely caused by the increased interest of management personnel in the 1980s in acquiring the enterprises on which it is engaged. This structure of venture capital is typical today primarily for Britain and France. The exception for Europe is the Netherlands, where venture financing has become widespread and is organized in much the same way as in North America. In Germany, the structure of venture capital is something in between its structure in the Netherlands and France. Country differences in the use of venture capital illustrates the schedule of the structure of its investments in the United States, the Netherlands, Britain, France and Germany (Figure 3, according to 1995).

In the United States, investments in high technology prevail. In recent years, firms based on innovative technologies accounted for about 60% of all companies where venture capital was directed. As for Western Europe, venture capital investments are distributed fairly evenly between the sectors, and the financing of development programs covers a wide range of companies, not limited to firms that use high technologies.

The dynamics of venture capital investments on the West European market testifies to the long-term growth trend, which in recent years has sharply accelerated. In 1997, compared to the previous year, venture capital investments in this region increased by 42%.

**Potential of venture capital markets in Central and Eastern Europe**

The CEE countries are still significantly behind the West European countries in terms of the level of development of the venture capital market. Risk investments that became possible after the liquidation of the "Iron Curtain" were often undertaken in conjunction with mass privatization. At the initial stages of the transformation of the economy, there were no institutions with the capital and know-how necessary to implement venture investments in standard methods for Western countries.

Although the priority investments were nevertheless implemented, this was basically done in a traditional credit form, often without proper preliminary analysis. Many of the problems that banks of the Czech Republic and other countries with a transforming economy today have to face have resulted from the use of ineffective financial instruments for venture investments. At the same time, most experts agree that the venture capital market in the CEE states has great potential for further growth. This is primarily due to the need to create a developed information and distribution infrastructure.

In general, the penetration of foreign venture capital investors into the CEE market is caused both by external reasons (withdrawal of investors from problem regions, for example from South-East Asia, diversification of the investment portfolio) and internal reasons related to the attractiveness of this region for venture financing. In the latter case, we are talking about the following factors:

1. The transition of CEE states to a new stage of economic transformation.

The process of enterprise restructuring has begun. After some formally held privatization, genuine owners begin to appear.

In parallel with this, unviable economic conglomerates are breaking up, new structures are emerging. Venture investments are required to develop and expand the scope of newly established companies.

2. Improvement of legal norms and rules of trade.

Gradually, with varying intensity, the process of improving the capital market and legal support is gaining momentum. It seems that in the near future the necessary legal and trade rules comparable with those adopted in developed countries can be put in place.

3. The emergence of a new generation of managers.

After 1989, in CEE countries, millions of entrepreneurs emerged, most of them limited their activities to small businesses of a local nature or eventually ceased their activities. Nevertheless, a significant number of representatives of this group still survived. For the last 10 years, these people have learned to act in changed conditions and have formed a new entrepreneurial elite, which has become a positive factor for attracting foreign investors.

Over the next 20 years, with a stable political climate in CEE countries, the venture capital market will develop at an accelerated pace.

Currently, it is not possible to obtain consolidated data on venture capital investments in the CEE countries. On the basis of information published in the press, it can be assumed that in the last period the volume of such investments on average for the year is 160-200 million ECU (excluding the countries formerly part of the USSR). Considering the growth of venture capital investments in Western Europe during the last three years, one should expect that a wide field of activity for such investments will open in the future also in CEE countries.

The potential for placing venture capital in this region can be indirectly judged from the available data on the territorial distribution of US venture investments outside the American continent in 1997. They indicate that 61.2% of all investments were directed to Western European countries, and the countries of Eastern Europe - only 0.9%, while the actual investments in CEE were significantly lower than contractual indicators. This speaks, on the one hand, of the lack in the region of a sufficient number of facilities attractive to foreign investment, and on the other hand, about the great potential of venture financing.

Based on the above, it can be concluded that the sphere of venture financing in the CEE countries will gradually increase. The expansion of this area of ​​activity is inextricably linked with the increase in exports of goods. At the end of the initial stages of development, realized within the domestic market, enterprises that produce modern and attractive products for consumers will increasingly rely on exports. This opens up favorable prospects for foreign trade companies, which, thanks to their cooperation with venture capital funds, can obtain a cumulative effect that generates profits for all participants.

While Europe continues to be challenged by volatile markets, Central and Eastern Europe have weathered the economic downturns reasonably well. The region, perceived as an increasingly attractive private equity market, boasts considerable deal flow figures.

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* Portfolio assistance
* Venture capital

The volume of venture capital finance in developing countries has followed a steeply rising trend in recent years. Venture capital finance has a longer history in Asia, and at over $6 billion, the stock of venture capital outstanding in developing countries in that region is more than double that in Central and Eastern Europe (CEE). The distribution of investment is weighted toward start-up and turnaround finance in the CEE while expansion and mezzanine financing dominate in the developing countries in Asia. The industry distribution of venture capital is similar in both regions however. Compared to venture capital funds in industrial countries, venture funds in developing countries invest to a greater extent in private debt securities of portfolio companies. Deal flow is critical to venture fund investment performance. Deal flow tends to be higher for funds organized on a joint venture basis. Where parent companies are involved in the deal screening process, deal flow is significantly higher. However, where a parent company shares a fund’s operating costs, appraisal rates are higher, but so are droppage rates while initial screening rates are not significantly affected. Thus a parent company may add value to the venture fund in the critical investment identification stage via the parent’s business network but this is not assured and parent involvement may also raise costs borne by investors. Finally, deal flow depends on the caliber of the fund management and high management fees are associated with droppage rates that are statistically significantly lower. Investment performance depends critically on a fund’s investment policies. Investment policies that limit size of shareholding in individual companies tend to improve investment performance because they serve to both manage risks and preserve the performance incentives the investee company management has to maximize investment value. Investment policies that limit industry or company concentrations relative to fund capital or assets tend to be tighter the larger the size of fund but they are generally less critical to fund performance. Moreover, investment policies are responsive to market constraints. Where low screening rates indicate that deal flow may constrain a fund's activity, looser investment policies prevail. Investment performance also depends critically on how the fund is managed by the fund managers. First, funds that are structured to give the fund manager a share of the carry produce higher expected returns for investors. Second, fund managers that target investment sales by IPO rather than by corporate sale or merger also produce higher expected returns for investors. Third, fund manager time and effort spent on advising portfolio companies adds most value in industry funds where fund managers have superior market knowledge and expected returns are generally higher in these cases as a result. Finally, board representation does not appear to be a critical factor for investment performance nor does frequency of reporting from portfolio companies. Analysis of the incidence of investment renegotiation reveals that expected returns are lower in these events and that financial distress is typically involved. Active fund management is important in distress situations to restructure and renegotiate investments so as to maximize value. In the event of renegotiation, investment value is more likely to be realized via merger rather than IPO. In these cases, the portfolio company may not have achieved the financial performance necessary to make a xii successful IPO leaving recourse to a merger sale at a higher discount the only viable exit option. Active management of distress events is more likely when fund manager’s pay depends to a greater extent on portfolio performance or where a parent company is also involved in fund management.

Venture capital finance is intermediated external investment in small-and-medium-sized companies that offer the prospect of above average earnings growth coupled with above average levels of investment risk. The investment process consists of raising a fund, then screening, selecting, structuring and monitoring investments. Finally, investments must be sold and the capital repaid to investors. The experience with venture capital finance in developing countries is more limited than in industrial countries. Nevertheless, there are probably more than 250 venture capital funds operating in Eastern Europe and Asia and as many as 400 operating in developing countries worldwide. The relatively short history of most venture capital investments in developing countries and the inherent lack of documentation of private financing arrangements means that there is little published analysis at even a basic descriptive level on the scope of venture capital operations in developing countries.

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**Theme of lecture № 3. Capital Mobilization and Investor Relations**

**Plan of lecture:**

**1. The choice of a potential investor.**

**2. Determination of investor requirements**

**3. Capital mobilization and investor relations with the fund**

**1. The choice of a potential investor.**

Marketing Policy of Venture Funds Competition in venture capital markets in the late 1990s was aggravated and the venture capital manager had to show more and moreprofessionalism and sophistication in approaches to fund raising and investor relations. To attract, preserve and expand the number of investors, the venture capital manager must have effective marketing skills and the ability to work with people. This means that to achieve success, managers must most strongly offer their services through sound analysis and convincing arguments at all stages of the fund's life, from the decision to create a fund to planning the creation of a subsequent fund. In this chapter, four parts of this process are considered: the choice of a potential investor; Determination of the requirements of the investor; Creation of the fund and relations with investors.

The nature of venture capital is such that it can attract only a certain type of investor. Its illiquidity and obvious high risk mean that investors must possess large assets and be adjusted for long terms. As globalization opens up new opportunities for investment, competition among foundations exacerbated. Therefore, before creating a fund, you should thoroughly study the investment markets in order to identify and understand the needs of potential investors. There are a number of reasons why investors choose venture capital, the main of which are:

• High incomes. The most common reason for investing in venture capital. Expectations go back to the initial stage of development of venture capital, when often it was about annual income of 30%. Although many investors still expect to receive income from 20 to 25%, the majority will be quite quite stable 15% per year. Investors tend to compare income from venture capital with companies listed on the stock exchange, making a premium for obvious additional risk.

• Diversification. High risks in stock markets, especially in the UK and the US, make investors look for opportunities for alternative investments that are weakly correlated with investments registered on the stock exchange. This need is quite satisfied with direct investments in unregistered companies.

• Long-term prospects. By their nature, investments in unregistered companies are illiquid and assume profits higher than usual. Therefore, they are suitable for investors with long-term obligations, such as pension funds.

• Research and development. Emerging as a source of financing for technology companies at an early stage of development, venture capital can give large corporations a relatively cheap way to promote new ideas to the market. Now the situation has changed slightly due to the fact that venture capital is increasingly being used to finance companies of later stages of development and foreclosures.

• Employment. In recent years, small companies have successfully created new jobs, which can be a powerful incentive for attracting some investors, especially those related to the public sector. Although social motives may be in some contradiction with the traditional obligations of organizations such as pension funds, whose aim is to maximize revenues, many investors will consider venture capital funds that intend to work in this region as a way to get not only financial but And a certain social and economic return.

On the other hand, along with the positive aspects of investing in venture capital, investors see a number of potential problems:

* Lack of management resources. Selection and "careful study" of funds, as well as post-investment supervision of their work, takes a long time. For organizations that invest only a small part of their assets in venture capital, the expected profits may not justify the costs of maintaining the necessary staff.

• Inadequate benchmarks. Historically, it has always been difficult to assess the performance of funds for a certain period of time or in comparison with other funds. This is a serious problem for institutions that deal mainly with listed shares, although recent efforts to provide industry statistics may in time reduce this negative point.

• Illiquidity. This is a deterrent, especially for small investors with not very specific obligations. However, the growth of institutions willing to acquire secondary positions in venture funds, albeit at a discount tothe net asset value, has now reduced the severity of this problem.

At the same time, various types of investors - institutional, corporative and private - have very clear characteristic needs, which must be taken into account when collecting funds forof the fund. In all of Europe, banks, and behind them pension funds andinsurance companies, are the largest investors in venture capital, if you leave aside reinvestment earnings from growth capital. This classification is somewhat misleading, since many banks invest only through their own sub control companies of venture capital. If we consider the source financing of only independent funds, data on the ration show that the leading role here belongs to the pension funds, the same is confirmed by the US figures.

**Pension funds**

Pension funds have for a long time been large investors in independent venture capital funds and in the UK in the United States. Although in other European countries they play its significant role, we can expect that within the next ten- their influence will increase. Pension funds usually have long obligations and limited liquidity requirements, which makes venture capital an attractive way of investing.

Growth assets of pension funds all over the world since 1970 (only in the US from $ 250 billion to $ 3.5 trillion), makes them the main source of financing of venture capital, at the moment US funds have invested more than $ 20 billion in venture capital. Direct investments are considered by pension funds- as a category of property, and US funds seek diversification venture capital investment on a global scale.

**Investment companies**

In most countries, insurance companies manage the large stand tend to invest in Venture capital as an extension of its investment share capital. The uncertain nature of their obligations makes their less "perceptible" group of investors, than pension funds.

There are many cases when a venture company was close to receiving from insurance companies, but at the last minute that due to the recent hurricane, all new investments are suspended are used. In addition, in many countries, including the United Kingdom and the United States, There are restrictions for investment companies in from the way they assess their share in venture capital funds which does not always stimulate investment.

**Corporate investors**

For large corporations, venture capital is also participate in the research of new technologies, gain access to and possibly, acquire them in the future. Some corporations, such as Shell Oil, use their own venture capital firms.

Other companies with a wider range of interests, such as Monsanto, they prefer to invest.

However, the second strategy in the UK it has received less development than in the USA. Corporate investors investing in venture capital have more complex investment criteria and require more detailed information on portfolio companies than ordinary institutional investors.

**2. Determination of investor requirements**

Investors interested in venture capital, have the opportunity to select a wide range of funds. In order to convince investors of the merits of the corresponding fund, it is necessary to have an "agitation pack", which is based on an information memorandum. Their decision-making depends on six main points: quality analysis of market conditions; choice of a certain investment strategy; the composition of the management team; financial history of the company; structure of the fund and detailed conditions.

**Market analysis**

At the macroeconomic level, the investor needs to be convinced of the

the fact that suitable for investment companies exist, that the risk of political changes is low and that there are different options for the implementation of investments ("exit routes") and the return of capital to investors.

Although all these issues are beyond the scope of direct control fund, a venture capitalist must be able to demonstrate that there is a wide range of investment opportunities for which external financing will be an acceptable and desirable option. Investors can be particularly attracted by new markets, which offer opportunities for rapid economic development and allow for the conduct of strategic research and development.

In many countries, including Great Britain and Germany, the main way for venture capitalists to implement in-direct sales are direct sales. Therefore, the paramount importance acquire conditions favorable for mergers and acquisitions.

Investors also want to see evidence that the economy is oriented to the development of entrepreneurship. This includes such concepts as the presence in the country of the tradition of doing business and the entrepreneurial spirit, as well as positive administrative and tax structures. All these factors can convince or vice versa, dissuade a potential entrepreneur to start his own business.

Many believe that the reason why the German venture capital market does not develop as quickly as in other countries is due to the traditional reluctance of German entrepreneurs to have shareholders from outside. In other countries, high taxes on capital gains can lead to managers being more willing to live on wages than risking stability for the sake of capital gains.

**Investment strategy**

When the investor decided to invest in a certain country, its next task is to evaluate the various investment strategies offered by funds-competitors. It is at this stage of the venture company that it should state its "unique advantages" in terms of the investment stage of development and industry, the flow of transactions, the approach to decision-making and management.

The decisive moment for many investors is the question of the target for this fund stage of development of the company and industry. Here, the foundation should justify its decisions. Some prefer to work with early-stage companies or large-scale foreclosures and invest in a particular industry (for example, in biotechnology or the media). Others are generalists, investing in any industry and companies at any stage of development. It's hard to say which answers will be correct and which ones will not, but investors want to get a rationale for choosing a certain type of investment.  
Investors also want to see an active marketing strategy for the search for investment transactions ("flow of transactions"). Although many markets have already passed through periods when the demand for venture capital many times higher than supply - as, for example, in the US in the mid-1980s - investors still want to have confirmation that companies are looking for the best deals. Selection of investment transactions can directly, through intermediaries, or on the basis of previous investments. Investors need to make sure that the fund is not fully rely on no single source of transactions, nor on a high level of transactions, the source of which are other venture companies.  
Investors are also interested in how the company intends to conduct "Careful study" of potential funding facilities - especially for companies involved in international investment. Investors want to make sure that you can make inquiries about individuals and get an accurate financial picture of the potential investments. For investors, the issue of volume, the active or passive position will be occupied by the fund in relation to the management of its investments.

One extreme will be "keep your hand on the pulse" - an active approach in which the stakeholder of the venture company enters the board of directors of the investee company and participates in the development of decisions on all major operational and strategic issues.

The other extreme is the pass- investors, whose role is limited to monitoring the finances, to ensure that profits will meet expectations. The style of management depends largely on the investment stage and industry. Investors may be concerned about the staffing implications of adopting an active management style, since the time spent on participating in board meetings of portfolio companies will adversely affect the ability of the fund team to engage in new investments.

Another key determining factor is the structure of investments. Some funds will invest only if they can get a controlling stake of 51% or more; others agree only on a "smaller share". In a situation where funds have a "smaller share", investors want to have guarantees, both in relation to the right to appoint a director and to receive information about the management of the company, and in relation to the management of the company, in matters relating to the sale of assets and the issuance of new shares. At the root of this concern lies the importance that investors attach to the advantageous exit from the company in the desired time frame.  
Investors should be interested in the internal decision-making process of the manager. Investors want to be able to assess the contribution of each member of the venture team and for this they need to understand how the process of evaluating potential investments is going and an agreement is reached to make a decision. Typically, investors prefer to deal with structures that promote team cohesion, and not with those that can provoke conflict of interest of individual team members.

The degree of importance that investors attach to each of these issues varies considerably, so it makes sense to find out in advance the sympathies and antipathies of key groups of investors. Ultimately, it is the manager who must demonstrate that the strategy of his fund is well thought out and has more chances of success than the strategy of competitors.

**Management Team**

Many investors believe that the most important criterion for decision on working with the fund is the team of managers. Although the best parameter for evaluating the work of the team is undoubtedly the financial history, there are a number of provisions on the composition of the team itself, which must be brought to the attention of investors. Number of people working in the team, should correspond to the objectives of the fund - investors are unlikely to like that the fund of 500 million pounds is formed by a team of two people. Even if the fund plans to produce only five investments, each of 100 million pounds, with one of these two people, something can happen.  
Investors will be even more worried if it turns out that they plan to make 50 investments of 10 million pounds and join the board of directors of each company invested. In this case, there will be every reason to fear that money can not be invested in a given period of time

**Financial History**

Financial history of a fund is a benchmark by which investors can determine the size of the expected profits. For new funds, this may be one of the most difficult obstacles to overcome because investors naturally prefer to deal with groups that have the experience of group work and fund-forming with a similar investment strategy. However, in The United States, where investors face the problems of longstanding continuity, there is a sort of interest revival in new funds. Some investors are ready to support new funds hoping to get better conditions.

To attract investors, a venture company without its financial history needs to come up with a great ingenuity. This might mean collection of capital on the principle of “transaction-to-transaction” or through a co-investment club, which has a drawback of limiting freedom of venture companies and might be an administrative burden. Some companies start with collecting small sums via personal contacts and then enter wider institutional markets only after completing some investments, thereby giving potential investors an opportunity to form an opinion about the company.

For groups that have financial history, Tori uses a number of criteria, such as the level of profits in the past, the amount of money paid to investors and the profit margin. Investors look for opportunities to gain a stable profit at a certain time and where there are standards for comparison they choose funds with results higher than average. Investors will almost always judge the effectiveness of a fund according to its internal return rate.

Although net IRR is the most important indicator of efficiency, investors will often pay their attention to the value multiplier of the cost that fund returns to investors. This may important when a good IRR is the result of a significant implementations, performed in the early stages of the fund’s life. In this case, investors may prefer to have a slightly lower IRR in combination with much higher value multiplier. Investors also prefer funds with evenly distributed success rather than a fund high efficiency of which is built on a major success of one company. Effectiveness of this type to a large extent depends on luck and therefore cannot be repeated in the future.

**Fund Structure**

Attentive attitude to taxation and structure issues of a fund can encourage investors, who are satisfied with their strategy and their management, to take a step toward financing the fund. The main task is to avoid additional costs that may rise if the fund does not function well, be it administrative costs or taxes. In the worst scenario, unsuccessfully chosen structure of the fund can result in a double taxation – first is when the fund sells the investment, second is when the profit is paid to the investor, which is treated as an income rather than a capital return. In most cases investors need to make sure that the structure has tax transparency, requires low costs, does not present difficulties for management and is consistent with all legal limits.

From the taxation point of view, there are two optimal structures which usually use venture companies – a fund, based on “tax oasis” and a limited partnership. If a venture company is registered in a “tax oasis” (for instance, in the Netherlands’ Antilles), the fund’s income is not taxed when selling investments; only investors’ money is taxed. Limited partnership is completely transparent, as it considers investors as if they invested money directly in portfolio company, taxes are paid only during implementation, be it distributed or not. Obviously, investors are to choose between a structure that is optimal from the taxation point of view and a structure that is easy to manage, hence they need to think over some questions. For example, a team of managers is not chosen by the fund itself, but by a specially created management company that can provide and optimal mechanism for paying remuneration for managing other incentive payments.

If a fund hopes to attract international investors, it can entail a number of specific taxes and other legal problems such as the Erisa Act, which regulates the work of American pension funds. It is suggested to consider these issues beforehand, on the other hand, lawyer consulting is expensive and spending on them should be minimal until the fund closes.

**Terms and Conditions**

Venture companies want to believe that investors are eager to invest in funds because of their strategy and ability to give good profit. However, if the terms and conditions do not meet investors’ expectations, they most likely will not invest - even if they really like the fund. A set of terms and conditions includes many items and some details can differ significantly among funds, especially if they are aimed at different types of investment (Fig. 3.2.). Here are some argued questions.

**Fund Level**

Investors usually prefer the so-called “closed-end fund”. This means that after closing, fund’s level cannot be increased. The amount of money that the fund has set for itself to collect depends on several factors, such as the number of people in the management team, the amount and magnitude of the expected investment. While setting a target volume for the fund it is important to consider several moments related to investors. Typically, investors like when the target volume increases in contrast to funds that were ruled by previous managers. But this increase should not be too sharp, since it may raise doubts about the team’s ability to invest, unless there are significant changes in investment strategies. Investors are always worried with goals being set to form too large funds. Managers are motivated by the idea that the larger the fund – the higher the profit. On the other hand, venture companies may set a goal to form a fund large enough to attract much larger investors. Many of the large American investors would not invest less than $10 million, but do not want to have a share more than, say, 10% of the fund. This means that the level of the fund has to be no less than $100 million. Regardless of the target volume of the fund, it is necessary to determine the minimally acceptable level of the fund. Venture companies need to make sure, that with the level of the fund management fees will be sufficient to pay their employees and current expenses. Low level of a fund will inevitably affect the profits and on the company’s ability to raise funds in the future.

**3. Capital mobilization and investor relations with the fund**

Attempts to use the US venture capital model "directly" did not "work" either in Europe or in Asia. This is due to the fact that outside the US there is no necessary infrastructure for this, especially necessary for investment in the initial stages and in high technology. For the same reason, this model will not be able to work in Russia, the CIS countries and other emerging economies for a long time.

There is, however, a well-established and universally recognized "international" life cycle for the development of the venture industry. This cycle is defined as an increase in the level of penetration of venture capital into the economy of individual countries to a certain critical level, after which the venture industry passes into the stage of self-development. At the same time, the level of penetration of venture capital into the economy, achieved in the US in 1980, is conditionally accepted as a threshold level (critical mass), and the countries try first of all to reach this level, including with the active participation of the state, so that in the future The national venture industry has gained the opportunity of self-development at the expense of private capital.

Additional difficulties in Russia and the CIS, as well as in other emerging markets, are associated with a more acute state of environmental problems in these countries, which makes it difficult to successfully invest in many industries without the threat of potential conflict with society. The problems are also the unresolved issues of property rights, and exclusive rights, primarily intellectual property, excessive employment in traditional industries, the loss of traditional product markets, the absence for a long time of public and private investment in new technologies

All this requires a creative and very cautious approach to the implementation of the procedure of thorough study (dew diligence), to provide the necessary post-investment services and to ways to achieve the desired exit in an acceptable time frame. Given the lack of liquidity in local markets and the harsher conditions for selling their participation to those who are active in the same business - strategic investors, for countries in which the venture industry is still in its infancy, it is extremely important to carefully consider the issues on the future exit from investments even at the stage of preparation transactions. Since fund investors determine the effectiveness of investments using the internal rate of return (IRR), rather than the measure of how many times the revenues exceed the costs (ROI), the long-delayed outputs can make it difficult for investors in the local and global markets to participate in new funds.

Venture business is becoming more and more international every day, and it becomes necessary to understand how to use its formal and informal networks. By the end of the 1990s, when competition in venture capital markets had increased, venture capital managers had to be more inventive and professional in how to mobilize capital and build relationships with investors. Effective marketing and productive communication have become today for venture capital managers important factors that allow attracting, retaining and expanding the ranks of investors. For success, management needs to present itself well, based on careful analysis and convincing reasoning, at all stages of the capital mobilization cycle: from the first decision to form a fund until the next fund project is prepared.

**The process of capital mobilization can be considered in the following aspects:**

-The choice of the investor.

-Determination of the requirements of the investor.

-Foundation.

-Launching the fund.

-Relations with investors.

**Investor selection**

The nature of venture capital is such that it can be attractive only for investors of a certain type. Its illiquidity and high level of risks mean that investors should have large funds and be prepared for long-term investments. On the other hand, competition for investment is growing, as globalization opens up new opportunities for investment.

Therefore, long before the formation of the fund, it is necessary to conduct a thorough study of investment markets to determine and understand what potential investors want at this stage of economic development.

**Positive factors**

Investors choose one or another fund for a number of reasons, among which the most important are:

-High profitability.

-The ability to diversify the investment of assets under management.

-Long-term perspective.

-Financing of research and development.

-Increase in the number of jobs.

**High profitability.** It is the most common reason for investing in venture capital. Expectations have declined since the time when annual returns of 30-35% were often indicated. Although some investors are still looking for a yield of 20-25%, most are quite satisfied, if it is equal to a sustainable 15-20% per year. At the same time, investors often compare the income from investing in venture capital funds with the returns from portfolio investments, adding to them the premium for additional risks.

**The possibility of diversification.** The excessive dependence of investors, especially in the United Kingdom and the United States, on the stock market led to the fact that their attention was increasingly being attracted to alternative investments that are not dependent on the exchange market. Such a need is met by direct investment in the share capital of companies.

**Long-term perspective.** By their nature, direct investments are illiquid, so they require a premium to their profitability. For this reason, direct investment is attractive to investors who, like pension funds, have long-term obligations.

**Financing of research and development.** In its original form, venture capital investments in the early stages of development of companies and in technology companies could give large corporations relatively cheap access to new ideas in the market. Now this happens less and less, as the funds prefer to place venture capital in later stages of development of companies and buyback deals.

**Increase in the number of jobs.** In many developed economies, small businesses have recently successfully created new jobs, and this can become an incentive for investment, especially for structures associated with the executive branch. Although social goals seemingly do not lie in line with traditional obligations to maximize returns for institutional investors such as pension funds and insurance companies, many investors are considering venture funds aimed at local companies in new, mostly developing, markets as a tool for achieving not only current financial, but also long-term social and economic goals, as a kind of tool for developing markets for such investors for the future.

**Negative factors**

In contrast to the above-mentioned positive reasons for investing in venture capital, investors face a number of potential problems:

-Lack of professional managers for investment management in venture capital funds.

-Inadequate landmarks.

-Illiquidity.

**Lack of professional managers to manage investments in venture capital funds.** Selection of funds for investment and the conduct of a thorough examination procedure, as well as post-investment monitoring of the work of funds, require a lot of time and highly skilled work. For investors who use only a small part of their portfolios as venture capitalists, it is difficult to justify the need for additional employees, despite the future higher yield.

**Inadequate landmarks.** It has always been difficult to assess both the efficiency of the funds at a certain time interval, and the effectiveness of their investments in direct and venture investment funds relative to investments in other types of assets. This was a serious problem for portfolio managers, potential investors of venture funds, mainly dealing with portfolio investments. However, NVCA's efforts in the US and EVCA in Europe to provide the investment community with the necessary statistics on the venture industry and related guidelines for investing in venture funds help to make this problem less acute.

**Illiquidity.** This is a serious obstacle, especially for small investors. However, the growth in the number of asset managers - investors who want to have a low participation in venture capital funds with a discount on the value of assets - reduces the severity of this problem. Different types of investors - institutional, corporations and individuals - can have completely different requests that need to be taken into account when raising capital.

**Leading categories of investors**

Without taking into account reinvested capital, the largest investors in venture capital in Europe are banks, followed by pension funds and insurance companies. However, such a gradation can lead to false conclusions, since most of the banks prefer to invest not in independent funds, but only through their subsidiaries (captive funds). If only independent funds are taken into account, UK statistics indicate dominance of pension funds, which is typical for the United States.

In general, the leading categories of investors are:

-Pension funds.

-Banks.

-Insurance companies.

-Corporate investors.

-State structures.

-Individuals.

**Pension funds.** These investors have long been the largest for independent venture funds in the UK and the US. And although in other European countries they still do not occupy a dominant position (17.5% of total investments in 2007 and 25.2% in 2008, according to EVCA), in the next decade their significance will probably be increase. Usually, pension funds have long-term obligations to invest in venture funds (commitments) and a limited need for liquidity, so venture capital is of interest to them.

Growth of assets of pension funds after 1970 (only for the USA - from 250 billion to 3.5 trillion dollars by the beginning of the new century) led to the fact that they became the basis of the venture industry. At the end of the 1990s, US pension funds invested more than $ 20 billion in venture funds. Direct equity investments have become one of the standard categories of their assets for pension funds, and pension funds (especially in the United States) are trying to diversify their venture investments globally.

**Banks.** As already mentioned above, most of the banks prefer to invest not in independent funds, but only through their subsidiaries (captive funds). Nevertheless, banks also invest in independent venture investment funds, primarily sponsorships created by insurance companies and pension funds. In Europe, according to EVCA, the share of banks in 2008 was 6.3% compared to 11.5% in 2007.

**Insurance companies.** In most countries they are among the largest trustees and seek to invest in venture capital as part of expanding the diversification of investments and developing portfolio investment units. The less certain nature of their obligations leads to the fact that they make up a less stable group of investors of direct and venture investment funds than pension funds. In Europe, according to EVCA, the share of insurance companies in 2008 was 6.6%, down from the crisis in comparison with 8.1% in 2007. Many venture companies were very close to getting big money from insurance companies, but at the last moment they were told that "a recent hurricane (or flood) excludes any new investment." In addition, in many countries, including the United Kingdom and the United States, there are certain limitations on how insurance companies can assess their participation in venture funds in the portfolio of assets, which reduces their interest in investing in such funds.

**Corporate investors.** Venture capital was used by large corporations as a way to search for new technologies by accessing, through venture funds, access to technical innovations with the possibility of their subsequent acquisition. Some corporations such as Shell and General Electric or Microsoft and Intel created their own venture structures for this purpose, while others, with a wider range of interests such as Monsanto and Boeing, preferred to invest through other independent funds . The second strategy is more typical for the US and less for the UK and other European countries. In Europe, according to EVCA, the share of corporate investors in 2008 was only 2.9% - a slight increase from 2.4% in 2007. Corporate investors in venture capital funds usually have more stringent criteria for making decisions about investing and require more detailed information about the potential companies of the fund's investment portfolio than other institutional investors.

**Government sector.** Traditionally, it is very important, especially at the stages of the formation of the venture industry, the sector is still responsible in the US and Europe for a certain but decreasing share of investments in venture capital. The state, helping to strengthen the venture industry, can participate in venture business in several areas, for example, co-invest into funds through a fund of funds (the experience of Europe, Israel or Russia where the Russian Venture Company is created), invest through state venture funds, insure investors venture funds, etc., taking on a significant part of the risks and thereby reducing the risk to private investors of funds to an acceptable level. In the UK and Scandinavian countries, interest in venture capital investments is shown by local government agencies that direct financial resources to certain regional projects. In Russia there is also a large program of the "Ministry of Economic Development", within which about 30 regional venture funds are created. In Europe, the share of investments in venture capital funds from government structures is greater than in the US: the European Bank for Reconstruction and Development alone has made significant investments in venture capital in Central and Eastern Europe over the past few years. The approach of the public sector to investing in venture capital funds is not based on attempts to solve the problems of ensuring a high return on investment, but focuses, as a rule, on promoting the formation of a self-sustaining and self-developing venture industry. In Europe, according to EVCA, the share of government agencies in 2008 was 4.9% and in 2007 - 5.3%.

**Private investors.** Still a small but potentially important category of investors. Most of the funds for direct and venture capital investments have a structure that is convenient for institutional investors, with a minimum stake of at least $ 1.5-3 million. Such a high cost of an "admission ticket" is due to the fact that management companies are not interested in attracting to the fund of an unnecessarily large number of investors (as a rule, not more than 30-70), because otherwise too much of the time and effort of the management company will go on building and maintaining relations with investors (investor relations), whereas for the main the work of resources will be missed. So all but the richest remain outside the venture business. In Europe, according to EVCA, the share of private individuals in 2008 was 4.9%, which is only slightly more than 4.3% in 2007. Nevertheless, in the US and Europe, funds began to appear that are aimed specifically at private investment , since the advantages of rapid decision-making and a more sustainable investment policy are sometimes more costly than those associated with a large number of small investors.

In the United States, in addition to the listed above, there are the following sources of venture capital:

Gift funds (endowments), which in Russia received the name of the target.

Non-commercial foundations.

And also consultants ("gatekeepers") who play an important role in venture financing should be named.

**Endowments.** All the largest universities in the US have donations (also called "donation funds"): at the beginning of the century, 15 universities had donations of more than $ 1 billion, and in Harvard, the amount of such a fund reached $ 5 billion. These donations have even longer in terms of time and more specific obligations than pension funds, and today they are seeking to invest on a global scale. Thus, they become one of the most attractive sources of capital for private equity and venture capital funds.

**Non-commercial foundations.** They are smaller in size, but some of them became important investors in venture capital and, together with donations, already in the mid-1990s found themselves in the United States as the source of 12% of the aggregate funds of direct equity investment funds.

**Consultants or gatekeepers.** Financial intermediaries are often structures that have investment capital. Large consulting firms and asset management companies in the United States often have divisions engaged in direct equity investments. Over the past decade, the number of independent venture capitalists has also increased significantly. They all participate in the preparation and justification of investment decisions, from counseling to the management of "fund funds".

Recently, these sources have become popular in Europe. According to EVCA, the share of investments from donated and non-commercial funds in 2008 amounted to 4.5% - a significant increase from 1.6% in 2007. This figure is almost twice as high as corporate sector investments and comparable to that of their government agencies and from individuals.

Sometimes funds of funds are separately allocated as sources of capital. Their share in the total volume of investments in direct and venture investment funds in Europe was the second most important in 2008 after pension funds - 14.5% (compared to 11.1% in 2007). However, it seems that such allocation of funds of funds to a separate class of sources is not entirely justified, since they themselves are replenished from the same sources as venture funds.

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**Theme of lecture № 4. Search and selection of companies of venture business**

**Plan of lecture:**

**1. Flow of transactions**

**2. Factors crucial to success**

**3. Considerations for venture capital**

**1. Flow of transactions**

For venture capitalists, the "flow of transactions" supplies raw materials from which they will select a small number of entrepreneurs with whom they will go most of the way leading to wealth or poverty. Without the receipt of new transactions there is no venture business. For potential investors, the ability of a venture capitalist to generate a "flow of transactions" is one of the main criteria for assessing it, and when a venture capitalist wants to inquire about a colleague's health, he asks: "How is the" flow of transactions "going? In order not to miss interesting investment proposals, venture capitalists have three ways. They can sit in offices and consider what itself comes to them in the hands; They can take an active position, setting tasks and performing them; Or they can create a reference network consisting of individuals and organizations that will send entrepreneurs to them. Most venture capitalists use a combination of all three approaches. Rarely, which company refuses to deal with a direct request, but still the transaction received on the recommendation, has a much better chance of leading to an investment. But whatever the venture capitalist's main approach to generating a "flow of transactions", he needs to create an image in the market and communicate information about his services to the target customers. Basically, this process does not differ from the marketing of special financial services and refers to the complex category of marketing services that some companies provide to others.

Venture capital marketing Money is money, and there is no more truth in the world of venture capital of truth. Venture capital organizations vary considerably in investment objectives, in the choice of the industry, the stage of development and the geographic region, and the style of work. Entrepreneurs and intermediaries do not always know how to clearly define the financial needs of their company, either in terms of the amount or, especially, with regard to the most appropriate type of financial instrument. Venture capitalists often take it for granted that everyone understands the concept of direct investment, and they think that money is a commodity that is easy to sell. Experience proves the exact opposite. Providing venture capital is a very difficult financial service, and if an organization wants to succeed, it should carefully consider its marketing policy. Peter Druck (see note 1), believes that marketing is a separate area of work, including a number of specific activities. But, first of all, this is the most important.

Component of the whole business. This is a business from the point of view of the final result, that is, from the point of view of the client. Marketing asks the question: "What does the client want?" He does not say: "This is what our product or service gives." This position is especially difficult to occupy when the product you offer is a type of financing, the amount of which is limited, and the entrepreneur believes that this is exactly what he lacks to fulfill his dream. The problem is further complicated by the fact that venture capitalists view investors whose money they manage as their real customers, and the entrepreneurs in whom they invest money as an inevitable accompanying product. The venture capitalist is a financial intermediary: he has both demand and supply side clients. A one-sided approach, when clients are considered only by investors, can lead to the fact that entrepreneurs will be treated downward and the vital flow of investment opportunities will be interrupted. Venture capitalists in

both the US and Europe have already understood that, as venture capital markets develop, new funds are being formed, and competition is exacerbated. Therefore, it is important not only to be able to raise funds and act quickly, but to have an image on the market that attracts entrepreneurs. In the book Venture Capital (see note 2) David Silver describes how in 1981, Microsoft Corporation in Bellevue, Washington, turned 24 different venture funds, each of which offered venture capital. At that time, Microsoft was a very successful computer software company with annual sales of $ 7.5 million and pre-tax profit of $ 3 million. The founder of the company Bill Gates told venture capitalists that the company's venture capital is not needed, but is prepared to take $ 1 million in exchange for a 5% stake in Microsoft from a venture fund that is willing to make every effort to help Microsoft become a professionally managed growing company. The competition was won by Technology Venture Investors from Menlo Park California, who agreed to work closely with managers middle level, helping them develop professional management skills. As follows from the above, a venture capitalist, who wants to become a participant in the most profitable investment opportunities, must create an image and a distribution.

The first big corporate venturing wave surged up as early as the 1970s in the US. Corporations such as Exxon made disproportionately high profits on investments in promising, externally generated business ideas. Since the end of the 1990s, when euphoria over the new economy was close to reaching its zenith, big companies in Germany also started to be attracted by the phenomenal returns that can be realised in the venture business. In the meantime, there are over 20 corporate venture funds in Germany alone. Among the most well established are Siemens, Deutsche Telekom (T-Venture), and Bertelsmann, and they have also set up the largest investment funds. Now that the Internet and biotechnology markets have hit the hard ground of reality and the hopes of making fast money have dissipated, corporate venturing is more and more driven by strategic motivations:

Ensuring the future of core business investing in neighboring markets and appropriate technologies. The objective of this type of corporate venturing (CV) fund is to add to the existing range of products or to create new demand potential in order to exploit existing markets or to create new ones. Intel, for instance, invests in e-business start-ups that are in a position to trigger an increased demand for Intel processors, and in starts-ups in the wireless and optical communications technology sector with a view to releasing the semiconductor company from its dependence on the PC market.

Strengthening innovative power of the parent company by opening windows on new technologies being developed by dedicated young enterprises and by diminishing structural obstacles in the corporate innovation process. This type of CV subsidiary invests the major part of the capital provided in promising in-house ideas in order to bring them to market maturity faster by means of corporate spin-offs, without consideration to the interests of a specific division and without the burden of short-term profitability targets and corporate overheads. Innovation-oriented CV funds also invest in external start-ups in order to stimulate the internal R&D activities, or to incorporate competing ideas. Siemens, for instance, is one of the companies that regards its CV operations mainly as a motor for innovation.

In addition to equity financing, corporate venture capital offers most attractive additional services for start-ups. Openings for cooperation with the parent corporations are of particular importance for example, in the field of R&D as well as the use of their marketing expertise, distribution channels and corporate networks, e.g. for opening up international markets. Strategically oriented CV funds are also under less exit pressure than independent VC companies, which, in view of their investors' profit expectations, are pressed to achieve the fastest and most lucrative exit possible, preferably via the stock market. Especially in times when the finance markets are weak, start-ups therefore appreciate the staying power of corporate venture capital.

These benefits contribute towards the extraordinary rise in corporate venture investments in the US since the beginning of the year 2000, while the growth rate of independent VC financing has declined.

**2. Factors crucial to success**

In view of the rising popularity of corporate venture capital, international management consultants, Bain & Company, has investigated the question of how such a fund should best be managed in order to use its strategic potential to full advantage.

It discovered four factors crucial to success: integration into the corporate structure, CV process, remuneration systems, as well as the general venture capital success factors.

1.An appropriate CV structure

It is above all crucial to CV success to find the strategically correct balance between structural proximity to and distance from the core business and thus between the necessary latitude for the start-up to unfold, and the best possible exploitation of the potential for cooperating with the corporation as a whole.

CV funds that are dedicated to assuring optimum leverage for strategic investments in start-ups should be organized centrally by being placed directly under corporate management ideally directly under the CEO with the division formally included in the process of investment selection. For reasons of strategic coordination, at Intel Capital, one of the 18 corporate divisions is allocated to each Investment Executive. Dell Ventures has chosen a similar organizational pattern: each division has appointed a member of staff responsible for the integration of investments.

Innovative funds, on the other hand, should be as decentralized as possible and located at division level from an organizational point of view. Siemens has therefore set up a CV fund of its own in each of the core business segments that is restricted to its own core competence particularly with regard to technologies and markets. Siemens Venture Capital functions as a coordinator for these units and carries out investments that are of strategic importance to the corporation as a whole.

2. Selective CV process

The venture capital process can be broken down into the following stages: deal generation, due diligence, portfolio management and exit management. The design of the individual levels of value creation should be geared to the strategic objectives of the CV fund.

In order to obtain optimum strategic leverage, CV investments must focus on the company's core areas of business. Moreover, the divisions should be deeply involved in the investment process, particularly during the due diligence phase. At Dell Computers this process takes place in three phases: after the initial screening by Dell Ventures, the business divisions assess whether the investment fits in strategically with Dell; however, the final decision as to whether an investment is actually made lies with Dell Ventures.

In case of innovation strategy procedural emphasis is placed on the inclusion of the respective business divisions and of the R&D department during the entire investment process. In addition to the classic exits by going public or being sold, integration into the parent company is also an alternative.

3. Appropriate remuneration for CV management

In order to maximize the rate of return of investment, the management of independent VC companies will receive a fixed percentage of capital gains, the so-called carried interest. However, it will be difficult to justify such generous profit-sharing schemes to the staff of the parent company.

For this reason, in strategic CV programmes (including the innovation type) remuneration is frequently equivalent to that in the parent company. This carries the risk that top staff may leave the company, while experienced VC managers from elsewhere are hardly prepared to work for such modest pay.

It is, therefore, advisable for strategic CV funds to install a hybrid pay system that contains certain elements of a classic VC profit-sharing scheme, for instance in the form of a bonus corresponding to the performance of the investments, combined with the basic pay rate of the parent company.

4. Classic VC success factors

If they intend to be successful, corporate venture funds should also observe certain basic rules that have proved their worth in classic VC business.

First of all, the focus of investment activities requires clear definition. A CV fund should concentrate on attractive and strategically suitable market segments. On the basis of the experiences of the past year and in particular the problems incurred by pure Internet funds the classic portfolio approach, whereby a strict system of selection is maintained, has regained a good deal of ground.

Bainlab, the business builder of Bain & Company, has developed a two-stage process of portfolio analysis especially for CV funds. In a first step, the investments are entered in an evaluation matrix featuring value creation potential and ease of implementation as its criteria. By combining the two dimensions each portfolio company can be classified into one of four categories: "Stars", "High Potentials", "Quick Hits" and "Watch out". The second step is to investigate for the portfolio companies in each investment category whether they constitute a strategic fit with the corporate divisions or business segments. The purpose of this analysis is to divest oneself of less successful investments as early as possible, while supporting clearly discernible and potential portfolio stars with all available funds and management resources.

Disposing of investments that do not meet up to expectations or fulfill the criteria set and thus focusing on potential winners is one of the features of pro-active portfolio management and one of the key factors to VC success.

It is also important to give specific thought to the exit period and to the manner in which exits should take place even before investing in a company. In some cases during the past years investments were made in companies with very little exit potential (Trade Sale or IPO).

Furthermore, successful VC companies or funds are characterized by extremely flat structures and short decision-making processes. Next to well-conceived evaluation, time and speed are essential criteria for success if one wants to hold one's ground in the international VC market.

For [entrepreneurs](https://www.investopedia.com/terms/e/entrepreneur.asp) looking to raise capital for their start-up businesses, early-stage investors such as [angel](https://www.investopedia.com/terms/a/angelinvestor.asp) and [venture capitalist](https://www.investopedia.com/terms/v/venturecapitalist.asp) investors can be awfully hard to find, and when you do find them, it's even tougher to get investment dollars out of them.

Angel investors invest in small [startups](https://www.investopedia.com/terms/s/startup.asp) or [entrepreneurs](https://www.investopedia.com/terms/e/entrepreneur.asp). Often, angel investors are among an entrepreneur's family and friends. The capital angel investors provide may be a one-time investment to help the business propel or an ongoing injection of money to support and carry the company through its difficult early stages.

Angel investors provide more favorable terms compared to other [lenders](https://www.investopedia.com/terms/l/lender.asp), since they usually invest in the entrepreneur starting the business rather than the viability of the business. Angel investors are focused on helping startups take their first steps, rather than the possible profit they may get from the business. Essentially, angel investors are the opposite of capitalists. Angel investors are also called informal investors, angel funders, private investors, seed investors or business angels. These are affluent individuals who inject capital for startups in exchange for ownership [equity](https://www.investopedia.com/terms/e/equity.asp) or convertible debt. Some angel investors invest through [crowd funding](https://www.investopedia.com/terms/c/crowdfunding.asp) platforms online or build angel investor networks to pool in capital. The term "angel" came from the Broadway theater, when wealthy individuals gave money to propel theatrical productions. The term "angel investor" was first used by the University of New Hampshire's William Wetzel, founder of the Center for Venture Research. Wetzel completed a study on how entrepreneurs gathered capital. Angel investors must meet the Securities Exchange Commission's (SEC) standards for [accredited investors](https://www.investopedia.com/terms/a/accreditedinvestor.asp). To become an angel investor, one must have a minimum [net worth](https://www.investopedia.com/terms/n/networth.asp) of $1 million and an annual income of $200,000.Angel investors typically use their own money, unlike venture capitalists who take care of pooled money from many other investors and place them in a strategically managed fund. Though angel investors usually represent individuals, the entity that actually provides the fund may be a [limited liability company](https://www.investopedia.com/terms/l/llc.asp) (LLC), a business, a trust or an [investment fund](https://www.investopedia.com/terms/i/investment-fund.asp), among many other kinds of vehicles. Angel investors who seed startups that fail during their early stages lose their investments completely. This is why professional angel investors look for opportunities for a defined [exit strategy](https://www.investopedia.com/terms/e/exitstrategy.asp), acquisitions or [initial public offerings](https://www.investopedia.com/terms/i/ipo.asp) (IPOs).The effective [internal rate of returns](https://www.investopedia.com/terms/i/irr.asp) for a successful portfolio for angel investors ranges from 20% to 30%. Though this may look good for investors and seem too expensive for entrepreneurs with early-stage businesses, cheaper sources of financing such as banks are not usually available for such business ventures. This makes angel investments perfect for entrepreneurs who are still financially struggling during the startup phase of their business. But angels and venture capitalists (VCs) are taking on serious risk. New ventures frequently have little to no sales; the founders may have only the faintest real-life management experience, and the [business plan](https://www.investopedia.com/terms/b/business-plan.asp) may be based on nothing more than a concept or a simple prototype. There are plenty of good reasons why VCs are tight with their investment dollars.

**3. Considerations for venture capital**

Still, despite facing enormous risks, VCs do fork-out millions of dollars to tiny, untested ventures with the hope that they will eventually transform into the next big thing. So, what things prompt VCs to pull out their checkbooks? With mature companies, the process of establishing value and inevitability is fairly straightforward. Established companies produce sales, profits and [cash flow](https://www.investopedia.com/terms/c/cashflow.asp) that can be used to arrive at a fairly reliable measure of value. For early-stage ventures, however, VCs have to put much more effort into getting inside the business and the opportunity. Some key considerations for a VC when evaluating a potential investment:

1. Management. Quite simply, management is by far the most important factor that smart investors take into consideration. VCs invest in a management team and its ability to execute on the business plan, first and foremost. They are not looking for "green" managers; they are looking ideally for executives who have successfully built businesses that have generated high returns for the investors. Businesses looking for venture [capital investment](https://www.investopedia.com/terms/c/capital-investment.asp) should be able to provide a list of experienced, qualified people who will play central roles in the company's development. Businesses that lack talented managers should be willing to hire them from outside. There is an old saying that holds true for many VCs – they would prefer to invest in a bad idea led by accomplished management rather than a great business plan supported by a team of inexperienced managers.

2. Size of the Market

Demonstrating that the business will target a large, addressable market opportunity is important for grabbing VC investors' attention. For VCs, "large" typically means a market that can generate $1 billion or more in [revenues](https://www.investopedia.com/terms/r/revenue.asp). In order to receive the large returns that they expect from investments, VCs generally want to ensure that their portfolio companies have a chance of growing sales worth hundreds of millions of dollars. The bigger the market size, the greater the likelihood of a trade sale, making the business even more exciting for VCs looking for potential ways to exit their investment. Ideally, the business will grow fast enough for them to take first or second place in the market. Venture capitalists expect business plans to include detailed market size analysis. Market sizing should be presented from the "top down" and from the "bottom up." That means providing third-party estimates found in market [research reports](https://www.investopedia.com/terms/r/research-report.asp), but also feedback from potential customers, showing their willingness to buy and pay for the business's product.

3. Great Product with Competitive Edge

Investors want to invest in great products and services with a competitive edge that is long lasting. They look for a solution to a real, burning problem that hasn't been solved before by other companies in the marketplace. They look for products and services that customers can't do without – because it's so much better or because it's so much cheaper than anything else in the market. VCs look for a [competitive advantage](https://www.investopedia.com/terms/c/competitive_advantage.asp) in the market. They want their portfolio companies to be able to generate sales and profits before competitors enter the market and reduce profitability. The fewer direct competitors operating in the space, the better.

4. Assessment of Risks

A VC's job is to take on risk. So, naturally, they want to know what they are getting into when they take a stake in an early stage company. As they speak to the business's founders or read the business plan, VCs will want to be absolutely clear about what the business has accomplished and what still needs to be accomplished.

Could regulatory or legal issues pop up?

Is this the right product for today or 10 years from today?

Is there enough money in the fund to fully meet the opportunity?

Is there an eventual exit from the investment and a chance to see a return?

The ways that VCs measure, evaluate and try to minimize risk can vary depending on the type of fund and the individuals who are making the investment decisions. But at the end of the day, VCs are trying to mitigate risk while producing big returns from their investments.

The rewards of a spectacularly successful, high-return investment can be spoiled by money-losing investments. So, before putting money into an opportunity, venture capitalists spend a lot of time vetting them and looking for key ingredients to success. They want to know whether management is up to the task, the size of the market opportunity and whether the product has what it takes to make money. Moreover, they want to reduce the riskiness of the opportunity.

Knowledge doesn’t automatically flow from start-ups to the large organizations that have invested in them—at least not in a timely manner. The barriers to knowledge transfer are many: The corporate venturing and business development groups may be located far from the firm’s central operations. Everyone is busy with day-to-day tasks. Companies cannot leave knowledge spillovers to chance. Nor can they simply put an operating manager on the board of each portfolio firm to be the parent company’s eyes and ears. A manager running a 2,000-person refrigerator assembly plant is unlikely to have much time to worry about a 10-person start-up that doesn’t seem to be working on problems of immediate relevance to the corporation.

One of the most successful methods I’ve seen for transferring knowledge from start-ups to corporate parents is the creation of linked units dedicated to this task. This was the approach taken by the U.S. Central Intelligence Agency’s venture-capital program, In-Q-Tel. Founded in 1999 to acquire novel technologies, the fund primarily made equity investments in young firms, many of which had developed products for the private sector—for instance, technologies for detecting card counters in casinos. It was difficult for people in these young companies to identify who in the intelligence community might be interested in their technologies, and it was hard for intelligence professionals to imagine how consumer-oriented technologies might be adapted to their needs—to see, for example, how software for identifying MIT students at the Caesars Palace blackjack tables could be used to identify Al Qaeda members. Moreover, communication between the start-ups’ executives and the Agency’s product developers was severely constrained by limits on sharing classified information.

To address this challenge, In-Q-Tel adopted a two-part structure: A Silicon Valley–based venture team closely mirrors a traditional group, in which general partners and associates scout deals, perform due diligence, prepare term sheets, and shepherd portfolio companies. A technology team in Arlington, Virginia, focuses on assessing new technologies, testing the appropriateness of portfolio firms’ offerings for the Agency, and interacting with intelligence officials. Unlike the venture team, which tends to be dominated by former entrepreneurs and new MBAs, the technology team consists largely of seasoned executives with experience in intelligence. The two units share information in a way that allows In-Q-Tel to learn what’s going on in Silicon Valley without divulging sensitive information to portfolio firms.

In-Q-Tel’s situation highlights an essential lesson: If corporate venturing programs are to succeed, corporations need to invest as much in learning from their start-ups as they do in making and overseeing deals.To people with little experience of company-backed investments in start-ups, it may seem contradictory to juxtapose the words “corporate” and “venture”—the one with its connotations of administrative complexity, the other with its aura of big ideas and big paydays. The apparent incongruity is probably one reason why corporate venture funds sometimes don’t get the respect they deserve within the VC community. Robert Ackerman, of Allegis Capital, once wrote disparagingly that when corporate fund managers arrive to make investment deals, “four guys get out of the car with their corporate tee shirts and singing the company song,” while the independent investors around the table see these naive fellows’ employers as “the dinosaurs we’re trying to kill, the market opportunity we’re trying to capture.”

But the data show that well-managed corporate venture funds can hold their own with independent VC firms, and even outperform them. For companies that have found traditional in-house research unequal to the task of generating valuable insights into next-generation technologies or the movements of the market, the creation of a venture fund might well prove to be what executives are always looking for—the breakthrough idea that changes everything.

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**Theme of lecture № 5. Technology, the manufacturing process, the risk of obsolescence, the choice between own production**

**Plan of lecture:**

**1.Risks, factors and influence for business**

**2. Technology as an important component**

**3. Use of an automated system and self-regulation system for personnel and business**

**4. Technical risk of the company**

**1.Risks, factors and influence for business**

The questions considered in the process of "careful study" can be divided into two groups. First, these are those that determine the success of the business, and the second - those that threaten the ability of investors to receive their share of profits. I will briefly discuss the factors that can really affect. Nevertheless, the list turned out to be long, and the reader will have to choose what is connected with his specific case. Three factors that are critical to business success are well known to everyone: management, management and management. This is the focus of "careful study." All other audits that will be discussed below will aim not only at establishing concrete facts, but also - by communicating with the company's environment - to determine the reputation of management, its style of work and professionalism. In the period of "careful study" it is necessary to form a kind of holistic view of management, in which, first of all, some facts should not contradict others. You can not invest money in a company if the information obtained from different sources does not coincide with one another if there are contradictions between the business plan and the history of the work of the members of the management team or between their words and actions. Because the business plan must provide a complete description all aspects of business, this will be the starting point and touchstone of the whole "careful study". Here are the sections that should contain a good business plan (see Note).

1. Brief initial data and the purpose of the plan: history, current situation, concept, tasks, initiators and key players

2. Description of the company's products or services

3. Description of markets, growth prospects, competition and other influencing factors

4. Brief description of the technology involved. The manufacturing process, the risk of obsolescence, the decision about own production or purchases

5. Marketing and sales strategy

6. Organization and leadership, professional career history, plans and strategy for hiring additional staff.

7. Financial history and evaluation of the prospects for turnover, profit, cash flows, financing.

8. Owners, structure, long-term contracts, considerations of financing and seizure. The plan determines the course of "careful study", my comments on the issues requiring verification will be tied to the above scheme.

Risks accompany the enterprise during their entire operation. When an enterprise starts its activities, there is already a risk that the product produced by it will not be sold for various reasons. All the risks of the enterprises lead to a decrease in the efficiency of its operations up to and including closure. Most of the risks of enterprises are economic risks. Consequently, under the economic risks of an enterprise, one can consider a combination of external and / or internal factors that lead to a reduction in production, a change in the market situation, loss of profit, a product or a business as a whole.

Technology, the manufacturing process, the risk of obsolescence, the choice between own production and purchases to deal with technology - both good and bad. This means that some investors will invest only in non-technological sectors, others want to invest exclusively in high technology. In any case, it is important to determine the role and status of technology in the business model.

• For redemption, technological lag is a threat, since it is difficult to determine in advance how much money will be required to develop a product. It is necessary to have a reserve reserve of finance, and this limits the possibility of using a "financial lever".

• For high-tech enterprises, technology is the cornerstone of their competitive advantages and requires skillful treatment. With all the promising prospects, the very process of technological transformation is slow. Before beginning to have a significant impact on the economy, it must pass through different stages in a number of stages: scientific research, laboratory testing, prototype creation, market entry, wide approval, dissemination to other regions, significant social and economic impact.

 • To determine the technological position of the company, you often have to look into the adjacent areas and see what is happening there. What are they working on in the relevant research departments of universities? What is used in more developed areas of industry or countries that used similar technologies before? What patent applications are filed, and what patents are received? What reports on technologies are made at the conferences? What new technologies do (usually newcomers) offer at trade shows? Technologies, developed for the military and space agencies, have long begun to penetrate into other industries. In the US, the research institutes of the Ministry of Defense and NASA have become a powerful source of new technologies and materials. The same thing happened in Israel, where research in the military industry contributed to the emergence of a large number of entrepreneurs working in the field of high technologies, such as communications, signal processing, optical technologies and computer networks.

• How short is the life cycle of the product in the industry? Does the company have the next generation of embryos or is it a one-off effect?

• Technology is often successfully used not where originally expected. How wide is the scope of the possible application of its own technology? Does the company have patents and exclusive rights? To whom do they belong? How much should you take the technology from other companies to produce the product? What are the chances of (capricious) competitors who will accuse you of encroaching on their intellectual property? Is it possible and does it make sense to buy (missing) technology elements?

• In addition to creating a prototype, what is the experience of mass production? What is more reasonable - to produce the product by yourself or to conclude a subcontract for production? What kind of investments will be required for production in large quantities (machine tools, production organization)? How much time will it take to ensure that the level of production commensurate with market demand (and how much time is needed for marketing!)?

 • If it is a question of a traditional product, then what is the state of the production base? What is the probability of the need for a change in production technology? Will automation of production help to reduce prices? Does it make sense to transfer production (or part of production) to countries with cheap labor? Is there spare spare capacity (does the company work in one, two, three shifts)? What is the scale of the action to increase productivity? AxaStenman B.V. considered itself as a company operating in the Netherlands for the production of goods for the bicycle and construction industries. Much attention has been paid to automation and efficiency. However, price competition in the world market eventually forced them to open production in the Far East and in Poland. As an added advantage, the company gained access to new (local) markets.

• In many countries, responsibility for non-compliance with environmental requirements for the production process, and for chemical contamination of the production area has become a serious problem. What is the situation in this case?

• What are the options for concluding a subcontract for production? Can I sell the technology in case the marketing of products is unsuccessful?

Risks related to the internal environment of the enterprise are the result of imperfections in its organizational and economic activities. These include:

· Mismatch of technology and technology;

• discrepancy between technology and qualitative composition of employees;

· Unclear definition of goals and objectives of production;

· Imperfection of the organizational structure;

· Lack of coordination between the activities of various services;

· Discrepancy of legal forms and forms of business management.

**2. Technology as an important component**

Technology and technology are the most important components of any production. When choosing a business, each entrepreneur chooses the optimal variant for him of a combination of technical and technological factors that provide him with a chosen mode of production. However, the technique can be replaced only when it will work for some time, determined by the period of its payback. The technology of production can be improved on existing equipment, therefore, first of all, it is necessary to analyze the newly emerging technologies for possible replacement by them existing in the enterprise.

In this case, there is a risk of obsolescence of the technology. There is also a risk of obsolescence of technology, which leads to the refusal of buyers to purchase the products of the enterprise. A similar product of other enterprises will be produced with lower costs, which will lead to a decrease in the profitability of the enterprise. Modern conditions for the development of scientific and technological progress require enterprises to introduce it into production in order to satisfy not only the needs, but the formation of new needs among consumers. Firms that have the opportunity to improve technology and technology, reduce the risk of running their own business.

The use of technology and technology is impossible without employees with appropriate technical training, able to learn and apply new technology. In addition, the technological structure of the production process itself requires a certain quantitative recruitment of workers of specific qualifications. This is due to the fact that the modern production process is very complicated and is carried out in the conditions of the total employee. Therefore, the structure of the workforce is also an important condition for reducing the risk in the enterprise. Perfection of technology and technology leads to the reduction of some specialties and the emergence of others. In addition, in the conditions of improving technology and technology, there is a tendency to reduce the number of employees in material production. To reduce risks at the enterprise, the practice of acquiring adjacent or new professions by employees is used, which makes it possible to use their labor when there is a risk of stopping the enterprise due to the lack of workers with the required specialty. Advanced training at enterprises is regulated and carried out in accordance with the updating of technical and technological conditions of production. An important aspect that characterizes the qualitative composition of the enterprise's employees is the compliance of employees with the positions they hold. In this case, the greatest return from their activities is observed, a sense of belonging to the enterprise develops, which increases motivation. When setting goals and objectives, it is important to determine exactly what the business concept is, corresponding to its main goal, and what needs to be done to achieve this goal. This is important both for the management of employees and for all participants in direct production. Knowledge of the tasks of production allows you to coordinate the actions of the entire collective of the enterprise in a particular activity, that is, each worker clearly presents the task before him and the way in which he can best be accomplished. When changing tasks or unclear formulations, there is a risk of inefficient use of factors of production, which will affect the economic performance of the enterprise. The organizational structure is also of great importance in terms of strengthening or preventing risks arising within the enterprise. First of all, the structure of the enterprise should be sufficient, that is, cover all production processes carried out by the enterprise. At the same time there should not be duplicating structures, since this complicates the management of the firm's activities. The organizational structure includes both the work, management and marketing functions of the enterprise. Imperfection of the organizational structure can lead to the adoption of wrong decisions, which can also increase the risk associated with inefficient activities of the firm and stay on the market. Imperfection of the organizational structure leads to a negative factor associated with the lack of coordination between the activities of various services. This factor has a significant influence on the rhythm of the process of production and marketing of products. This risk can be prevented by improving management in the enterprise, as well as with a clear delineation of tasks between individual units. Each enterprise is characterized by a certain legal form, depending on the size and form of ownership of the enterprise, as well as on the nature of the activity, from belonging to the manufacturing industry. Thus, the individual farm and various types of partnerships include a small number of workers who are not only able to complement each other in production activities, but also interchangeable. Therefore, the success of the activities of these enterprises is related to such a non-economic characteristic of the production structure as cohesion, mutual understanding and mutual trust between the members of the collective. In addition, the technology of these enterprises is characterized by small-scale or single-piece production. This requires high qualification of participants in the production process for quick adaptation to changing conditions. In such conditions of functioning of the enterprise, the most appropriate form of government will be one or another democratic form, adapted to changing the roles of direct participants in production. Otherwise, the enterprise will not be able to adapt to the changing market conditions. A large enterprise exists, as a rule, in the form of a joint-stock company and is created in the form of a fundamentally different legal form - a corporation. A large enterprise with a complex organizational structure has a specific form of business management. The responsibilities for managing large business are delegated to individual specialists who, together with the right of management, receive responsibility and responsibility for the decisions made. The activity of the administrative apparatus must be subordinated to the same goals of production, but before each division there are various tasks subordinated to a single goal. Lack of coordination of activities between different services can be characterized as a risk of the internal environment of the enterprise in the conditions of its emergence or reorganization. The theoretical scheme of creating an enterprise and its practical implementation do not always coincide, so an entrepreneur needs to foresee a sequence of stages in the establishment of an enterprise and the organization of its various services in order to reduce the risk. When the enterprise is reorganized, the coordination of the activities of various services may be violated. This is manifested in the duplication of the same functions by different services and departments; in the workload of the functional responsibilities of some departments and the underload of others. This reduces the quality of work not only for individual services, but for the entire enterprise as a whole. There is an imbalance in production, a surplus of raw materials and money resources, a disruption of rhythm. The risks of the external environment include an imperfect legislative base. In the conditions of the transition economy, with insufficiently perfected legislative base, problems arise in the business activity related to the possibility of double reading of certain legislative acts. Imperfection of existing laws, allowing their double interpretation, makes the position of the enterprise on the market unsustainable. A significant part of the enterprise is based on maintaining economic relations with other economic actors: suppliers, customers, the state, so that all market participants have to adhere to a unified "game rules". Moreover, these rules should not be changed, ie. E. The entrepreneur should not enter into economic relationships with partners by the same rules and to complete their transactions with them on the other.

However, the system of self-regulation, which arises from the constructive formulation of the goal, reinforced by a positive motivational set-up, is quite effective, but by no means the only element of the personnel error management system. Another, no less important element, can be an automated system for protection from failures.

**3. Use of an automated system and self-regulation system for personnel and business**

The automated system of protection against failures can be organized in three main ways:

1. Complete replacement of living labor with machinery.

2. Duplication of individual manual labor operations.

3. Automated control over the labor activity of a person in order to eliminate his possible mistakes.

The replacement of living labor with machinery can be carried out in two directions: mechanization of labor and automation of labor.

Mechanization of labor is a substitute for manual labor by the activities of machinery and mechanisms. Automation allows you to shift the intellectual work of a person, including management functions, to the shoulders of machines. In the practice of modern production management, mechanization and automation are reflected in the use of numerical control machines, automata, robots, flexible production complexes, and so on. This ensures a complete replacement of the less reliable factor of the production mechanism, i.e. a more reliable factor, i.e. machines and machines.

The method of duplication allows to increase the degree of reliability of the production mechanism, without excluding a person from it completely. It involves the replacement of living labor with machinery not throughout the entire production cycle, but only in individual cases. A good example of backup systems can be automated control devices, widely used in virtually all types of aviation and air transport. Such devices in certain situations take on the functions of the helmsman, allowing the crew to rest or tackle other, more important problems.

The use of automated systems for monitoring the activities of personnel provides the head of the organization the opportunity to reduce the number of defects and failures, not excluding a person from the production process. Such systems are widely used in working with computer equipment, for example, automatic spelling in the Microsoft Word program, as well as in managing complex production complexes. This makes it possible to defuse the psychological situation in the work area by forming both managers and performers of confidence in the reliability of their work. The regional administration has a significant impact on the activities of enterprises. Regional policy is based on the prioritization of certain sectors of the economy, so various kinds of business are developed in different economic conditions,some industries may be supported by the regional administration, and the other. Experience a significant tax or administrative pressure. Also the activity of the enterprise is influenced by the size of the market of its products and the place of the enterprise in this market. If the market has a local character, then the number of consumers is small and the activity of the enterprise in a competitive environment will be difficult. Even in conditions of its monopoly position in the market, business development will also be limited by consumers of its products. In such circumstances, there is a risk of a reduction in production. Preservation and development of production volumes will be achievable only in conditions of conquering the markets of neighboring regions. To significant external risks in the company's activities can be attributed to its territorial location. Different industries can differently refer to both the sales market and the raw material market. If an enterprise belongs to an industry that processes perishable raw materials, it is expedient for it to be in close proximity to its sources. For example, milk processing plants are better placed near its most massive producers: large farm and collective farms or have good transport links. Otherwise, production risks to remain without raw materials, which will cause interruptions and stopping the production process. In an ideal variant it is necessary to combine manufacture perishable raw materials and its processing. So, in the Netherlands, farms combine in their activities the production of milk and processing it into cheese, selling a finished product with a longer shelf life. If the enterprise produces the final product with a short shelf life, it is best to place it in close proximity to the consumer, which will allow it to be realized at the right time and avoid the risk of quality loss of the finished product. Typically, to reduce the risks associated with its activities, often enterprises insure their production assets from loss, the risk of new production, the risk of loss of product during transportation, etc. The best way to prevent entrepreneurial risk is to create an optimal management and production structure. This allows you to control the formation of production costs and ways to reduce it. Also, an enterprise must have a qualified marketing service. The activity of this service allows us to respond in time to changes in consumer demand, take into account changes in the competitive market environment, changes in the raw materials market, enter the market with a new product on time, identify general trends and directions for changing the qualities of the main product produced by the enterprise.

First, from a purely psychological point of view, the orientation of a person to any negative factor inevitably leads to the fact that a person will subconsciously strive for this factor. In this example, the orientation of the master of the site for marriage, even accompanied by a requirement to liquidate it, will lead to the fact that the master will think first of all about marriage, and consequently, unconsciously strive for it.

Secondly, the destructive setting of the goal, as a rule, is accompanied by a negative motivational attitude, which provides for the punishment of the employee in case of failure or improper performance of the task received by him. In this case, a sense of fear of marriage comes to the forefront, which can arise both from the site master and from the direct executors of the work. Fearing possible punishment for mistakes made, people will be in a state of constant tension, i.e., distress. And this in no way contributes to improving the efficiency and quality of work.

Thirdly, it is possible to eliminate marriage in completely different ways. On the one hand, it is possible to improve the technology of production or improve the skill level of employees, and on the other hand, you can simply refuse to produce products. In both cases, the goal will be achieved.

Of course, in the example given, the goal is elementary and any average statistical worker can independently correct it in his mind and make adequate actions. However, when it comes to the implementation of complex global programs, such as the development of new markets, the development of fundamentally new types of products, etc., subordinates may not always be able to correctly understand the meaning of the manager's demands.

Effective entrepreneurial activity, as a rule, involves the development of new technology and technology, the search for reserves, the increase in intensity of production. However, the introduction of new technology and technology leads to the danger of man-made disasters, causing significant damage to nature, people, production. In this case we are talking about technical risk.

**4. Technical risk of the company**

Technical risk is determined by the degree of organization of production, the conduct of preventive measures (regular equipment prevention, security measures), the possibility of repairing equipment by the company's own forces.

Technical risks include:

♦ probability of losses due to negative results of research;

♦ probability of losses due to unavailability of planned technical parameters during design and technological development;

♦ probability of losses as a result of low technological capabilities of production, which does not allow mastering the results of new developments;

♦ the probability of losses resulting from the emergence of new technologies and products of collateral or delayed manifestations of problems;

♦ probability of losses due to failures and equipment breakdown, etc.

Industrial risks are very closely related to technical risks. Production risk arises in the process of implementing any type of industrial activity, in the course of which entrepreneurs face problems of inadequate use of raw materials, increase in production costs, increase in losses of working time, use of new methods of production. The main causes of industrial risk include:

♦ Decrease in the planned volumes of production and sales of products due to a decrease in labor productivity, equipment downtime, loss of working time, lack of the necessary quantity of raw materials, an increased percentage of waste products;

♦ Decrease in prices for which the product or service was planned to be sold, due to its insufficient quality, adverse changes in market conditions, a drop in demand;

♦ Increase in the expenditure of material costs as a result of overspending of materials, raw materials, fuel, energy, as well as by increasing transport costs, trade costs, overheads and other incidental costs;

♦ an increase in the wage fund due to exceeding the planned number, or by paying higher wages than planned for individual employees;

♦ Increase in tax payments and other deductions as a result of a change in the tax rate to an unfavorable side for the entrepreneurial firm and their deductions in the course of activities;

♦ low discipline of supplies, interruptions in fuel and electricity;

♦ Physical and moral wear of domestic equipment.

A special place in the system of production risks is occupied by failures and errors in the work of personnel. The above problem is certainly one of the main negative factors of production activity and requires close attention from managers of all levels of management. The most important here is the attitude of managers to the mistakes of their subordinates. Such an attitude can take two main mutually opposite forms: constructive and destructive.

Unfortunately, most managers adhere to a destructive attitude. From the point of view of the destructive approach, the mistakes of the performers are viewed as an alien element not inherent in the normal production process, and therefore they must be disposed of as quickly as possible. At first glance, such a statement seems quite logical. After all, the mistakes of ordinary performers almost always entail losses and in the end can lead to a significant decrease in the efficiency of the enterprise. Thus, putting the destructive goals before the subordinates, the leader in advance pawns in the program of their actions the potential possibility of causing harm to the organization. And the more destructive goals are put before employees, the more often it is necessary to regulate the intervention of the manager in the process of performing production tasks. Taking into account the above, in our case it is more preferable to formulate the goal in this way: "take measures to improve the quality of the products." This formulation of the goal ensures the orientation of the site master and subordinate employees to a more thorough and conscientious performance of their duties. People will first of all think not about how not to make mistakes, but about how to improve the efficiency and quality of their work. Increase the production effect, obtained by constructive formulation of the goal, can be supported by a positive motivational attitude. The sense of a positive motivational attitude is to satisfy the manager with any immediate needs of the subordinate in case of successful fulfillment of the task received by him. Examples of positive motivational attitudes can be the increase of wages, the payment of bonuses, promotions, the provision of opportunities for further education and further training, etc. The application of the above measures allows the manager not to deal with staff errors, but to manage them, maintaining the amount of rejects and failures at the optimally acceptable level. This is ensured by the emergence and development in the organization of a system of self-regulation.

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**Theme of lecture № 6. Structuring the transaction and setting the price**

**Plan of lecture:**

**1. Structuring the transaction**

**2. Setting the price**

**1. Structuring the transaction**

The ubiquitous existence of transactions costs in the real world determines both the institutional structure within which prices are set and the level of prices.

In economics textbooks, the market is usually pictured as where the demand curve intersects the supply curve. It is simply a price-making mechanism without any institutional structure.

In the real world, the market consists of middlemen whose job is to reduce the transaction costs of producers directly dealing with consumers. Without the market, producers would have to sell directly to consumers. Assuming producers enjoy comparative advantage in producing than in selling, the consequent loss of output due to reduced specialization may result in lower income to producers and higher price to consumers. The fact that middlemen can increase efficiency by increasing producers’ income and lowering prices to consumers, however, does not guarantee that a market would exist because its provision is costly and requires entrepreneurial efforts.

A Tale of Two Fishing Villages

That a market does not always spontaneously emerge can be illustrated by the different experience of two fishing villages in China. Two fishing villages (DV and WV) are located on the north side of a lake while the city fish market is located on the south side of the lake. But only one fishing village (DV) enjoys a thriving fish market due to lower transaction costs. One reason for the lower transaction costs is the shorter distance between DV and the city market. The shorter transportation time reduces capital investment needed to preserve the fish during transportation. The other village (WV) is much farther away from the city market than DV. The boat trip from WV to the city takes four times as long and is much less frequent. Fish bought from WV must be better protected to preserve their freshness, thus requiring higher capital investment for any potential middlemen.

High transportation costs make WV less attractive to middlemen, but this does not necessarily prohibit them from going there. If a middleman is able to buy fish at a sufficiently low price at WV to compensate for the high transportation costs, there is no reason for him not to visit WV. Yet this scenario does not unfold. When there are few middlemen competing with each other, the middleman is more likely to over-report the cost of transportation and under-report the price of fish in the city. With few middlemen to choose from, the fishermen become highly skeptical of the price information conveyed by the middlemen, and they tend to bargain cautiously to avoid being cheated. This suspicion is abetted by the fact that fish prices tend to fluctuate from day to day. These two conflicting tendencies often tear bargaining apart. Hence a pricing mechanism cannot be established and the market fails to emerge. As a result, fishermen at WV sell their fish directly to the city market across the lake.

Thus, one initial higher transaction cost (i.e., transportation costs) compounds another transaction costs (i.e., agreement costs) leading to the virtual disappearance of specialized middlemen.

On the other hand, the initial lower cost of transporting fish from DV to the city encourages more middlemen to enter the business due to lower capital investment. The competitive bidding for fish among the many middlemen forces the fish prices in the city market to be accurately and quickly revealed to the fishermen. Transactions are quickly consummated as middlemen and fishermen can reach a mutually beneficial settlement price quickly in the absence of mistrust.

While the existence of any middlemen reduces transaction costs, these costs can be further reduced when middlemen are differentiated into moving and sitting types. For example, it does not pay the moving middleman to retail fish in the city market. If he retails fish occasionally in the city market, he must pay higher sales tax. And without a permanent space, he cannot establish his reputation. Also, he must invest in special capital investment (e.g., fish containers). Lastly, he would not be as visible or as knowledgeable about the wholesale marketplaces that he usually visits. On the other hand, the existence of sitting middlemen encourages the building a permanent physical space for transactions to take place and the assignment of permanent booths in which reputation to be rooted. By specifying rights and obligations, government regulation and enforcement further reduce the risk of transaction fraud.

When consumers and producers can freely meet each other to execute transactions at no cost, the market becomes a mere price-determining mechanism as modeled by neoclassical economics, and its institutional setting becomes irrelevant. The ubiquitous existence of transactions costs, however, means that the institutional structure of exchange does matter.

Structuring a transaction is the organization of a business transaction, which will be reflected in a legal agreement that determines the relationship between various parties that show interest in the company. A good deal structure should be consistent with the tasks of all parties involved and balance the risk-reward ratio. As a rule, the best structures are simple, require minimal participation of lawyers, suit all parties and provide for all possible accidents.

The structure of the transaction depends on the legal and tax climate of the countries in which the invested company intends to work. In this chapter, legal and tax issues are not considered, it is devoted to broader topics related to the structuring of the investment. In each specific case, to ensure that the structure of the transaction is acceptable, consultations of local specialists will be required. The issues addressed in this chapter include assessment, funding needs, financial instruments, as well as veto power, representation and management requirements.

**2. Setting the price**

Evaluation There is no clear method for evaluating a company. The cost will depend on a number of factors: the stage of the company's development, the economic situation and the development of the securities market, the company's position on

Market, the prospects of the market sector in which the company operates, the likelihood that the company will need additional money to achieve its goals, and, finally, competition between capital providers who want to invest in the company. Nevertheless, there are some technical methods that help to define the framework within which the company's value will most likely be located.

The stage of development of the company determines the availability of information on which the analysis will be built. The newly created company does not have a financial history; All that she has is a prediction based on the views of the company's management about what they can achieve. If such a company develops a new technology or creates a new type of services, then analogous companies that could be used as a benchmark for estimating forecast data may not prove to be. Companies that are at the initial stage of development who have developed a concept, product or service, but have not yet begun to search for a market, are likely to be unprofitable, expending the initial capital provided by the company's founders.

The financial history of the company does not provide an opportunity to determine the possible future results of their work. In both cases, the initial assessment will depend on qualitative factors such as the income expected by the investor, part of the company that the company's management is ready to give in exchange for the investment, and the investor's views about the prospects for the new concept, product or service. The investor must analyze the product and the market conditions to determine if there is a potential for creating a large company. If the market situation is low, then even the largest company on the market will be relatively small.

More developed companies that want to obtain capital to expand their business by creating branches, hiring more workers for production or sales, or extending the range of their product use can provide more complete financial information. This information can be analyzed, compared with similar companies and determine an approximate range of costs. It will be necessary to determine the pace of development of the company in comparison with competitors and to perform product and market analysis to determine the potential of the company.

The investor should also weigh his thoughts on the expected income and risk, and the manager to think about what part of the company they will be ready to sell to the investor. If the transaction is a ransom by external or internal managers, then it is most likely about a mature company with a full financial history. The investor will be able to conduct a complex analysis of the current financial condition of the company and compare the results of its work with the forecasts made by the managers.

The structure of the deal is likely to be more complex and, along with direct investment, will include debt financing, and maybe other tools that are understandable only to the initiated. The assessment will take into account the possibilities for planning tax revenues, which often arise when making transactions of this kind. Indeed, a company's valuation may depend on the ability to service a variety of used tools, as well as the tax climate. And, finally, the deal can relate to a solid and long-running company in the market, which is experiencing difficulties. It needs to change its policy and the position of the seller is almost hopeless: the inability to obtain new investments can lead to insolvency of the company and the loss of all.

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**Theme of lecture № 7. Deal structuring and pricing in Central and Eastern Europe**

**Plan of lecture:**

**1. Goals and interests**

**2. Rating**

**3. The need for funding**

**4. Financial instruments**

**5. The management of the Corporation**

**6. Management issues**

**7. Negotiations and the process of "careful examination"**

**1. Goals and interests**

Tradition of direct investments in Western Europe provide the basis for developing methods of structuring and evaluating transactions in Central and Eastern Europe. In the previous Chapter he writes: "the Structuring of the transaction is a business transaction that will be reflected in the legal agreement that defines the relationship between different parties with an interest in the company. Good structure of the transaction should meet the objectives of all parties involved and to balance the risk reward ratio. As a rule, the best structures are simple, require minimal involvement of lawyers, arrange all parties and provide for every possible contingency. This is a great principles, but to stick them in the countries of Central and Eastern Europe is not very easy, and as will be discussed below. There are many types of business transactions, but in this article under the "transactions" will mean mainly two types of operations: the first capital investment the development of private venture capital investor in the company, which has for some time exists in which there are revenues - 190 - dy ( if not profit) and which is generally owned by the people who run it; the second is the privatization of state-owned enterprises (which, as the same may include capital development).

**Goals and interests**

In evaluating and structuring the transaction need to understand the goals of various parties. The goal of the investor is to provide maximum income ( based on risk) and to hedge against existing risks through financial instruments, monitoring mechanisms and possible involvement in the transaction of its adherents – financial or enterprise with investors. Entrepreneurs or the management of the company, for their part, want to minimize the weakening of their positions, to maintain maximum flexibility, that is not to cede the right to manage the company and get the best deal. When the transaction involves only two parties control the enterprise and the investor, for these purposes it is usually possible to reach a compromise, provided that the parties acknowledge the market position of each other. There may be some disagreements about the route of the final output, but at least have the common idea of maximizing the company's value after investment. In the case of privatization, when most of the companies the government is selling, sometimes you have to consider a completely different purpose. If the government sells their ownership, he, like any owner, have a clear goal – to obtain for the company the maximum price. Reach agreement on what constitutes good market value, can prevent some of the obstacles of a psychological nature, but the goal remains the same. However, the state often faced with social problems, so negotiators often behave like madmen. The company can be a lot of workers far more than required by the current and even projected rate of business development. However, the state may not allow the new owner to fire most of the workers, because it is fraught with political complications. Therefore, the state will seek to maintain the current employment levels or at least to reduce the dismissal to a minimum or mitigate their consequences. Sometimes the state requires you to guarantee that workers will not be fired or sets a limit on the dismissal in percentage or time. In some cases, the state requires that the investor contributed an additional amount, often unsupported by any business plans, in the hope that it will help to maintain the current level of employment. Most government officials are smart enough to understand that you need something to sacrifice – or willingness to obtain the maximum price or a requirement that the investor went on to unreasonable costs, i.e. the costs of excess labor and/or to increase investment. However, in several countries of Central and Eastern European officials responsible for the privatization process, it was very difficult to donate any of these interests because they threatened large personal troubles. If everything went too well for investors, officials could blame the fact that they sold the company on the cheap. If the company, in the end, dismissed employees, officials were accused that they ignore the social interests of the state , even if the company boa - elk sell a very good price. These social concerns lead to very interesting talks about the future of corporate governance, because the government will insist on maintaining the significant rights to control the company, despite the fact that it sold all but one stock. Such action, giving its owner a major power, often called "Golden share". In the privatization process should also take into account the interests of the current leadership of the state enterprise. Let's say that the current managers of the enterprise – people are competent, and the investor wants to keep them. In this case, during the process of "careful examination" and in the course of negotiations they will have to balance on the thin line, representing the current owner, the state, and trying not to antagonize the new owner. How the managers will respect their interests is an interesting psychological exercise for the investor. Negotiation is the time to evaluate the company's management. The optimal situation is when managers speak from the standpoint of common sense, becoming a sort of referee between the government and the investor. Apparently, if the administering at the outset be on the side of the investor and no longer pose intersyndicale the owner, it's not the people, which the investor can rely on in the future. A great influence on the structure of the transaction render existing legal structures and resources. It is worth to pay special attention to several points. Legal codes of the countries of Central and Eastern Europe are, at best, an exact copy of the German corporate governance structure consisting of the management Board and the Supervisory Board. This structure gives the controlling company the almost complete freedom of action and the ability to bind the Corporation to obligations. As for investors, they can to some extent oversee, but hardly have any significant impact on the operation of the Corporation. Venture investor, accustomed to authority and flexibility of the Council's Board of Directors in English-speaking countries, to get used to this dichotomy is difficult. When things are going well, the Board of Directors of the English-speaking countries represents a potentially coalition Board of shareholders and managers. In addition, he has the ability to limit the ability of managers to bind the company to obligations to limit the likelihood of unexpected adverse developments. The next problem is the lack of "own shares or authorised but unissued shares". This could complicate the process of structuring, as it does not allow to achieve use of convertible preferred stock, warrants or options. The opportunity to insist on the conclusion of the agreement is another issue that needs to start at a very early stage. Even if the shareholders and the company agree to certain structural provisions, it is likely that these provisions will not be registered because the local notary doesn't consider them acceptable, or that thereafter those provisions will be deemed unenforceable. Another difficulty is the relative lack of legal advisers with experience in the field of venture investment, which could make the negotiation process more rational, representing properly the interests of the state, managers and entrepreneurs. The lack of competent lawyers leads to the fact that the investor has to spend a huge amount of time educating the rest of the participants features of the transaction, while in countries with developed financial markets, many of the structural elements of the transaction advisors are engaged. As can be seen from this entry, it is hardly a deal in Central or Eastern Europe would "be simple, require minimal involvement of lawyers, arrange all parties to anticipate all possible accidents". Deal that suits all parties and providing for all possible accidents, as a rule, is complex, demand - ing a large consumption of time and effort lawyers. The reason the investor will try to overcome these obstacles lies in the potential to profit higher than normal profits in the countries in transition from planned economies to market ones. For some people, privatization is favorable arbitration opportunity " to buy cheap property." For other fast growth (actual or anticipated) of such economies provides an opportunity to create a large company in a short time. In any case, the difficulty of structuring the transaction kompensiruet potential reward. The other essential element is the cost of entry into the company, the problem of evaluation.

**2. Rating**

Value, like beauty, subjective. The venture investor must determine the present value in the context of future cost, i.e. the cost that the company will be at exit and the likelihood of achieving results that will determine the output. This involves the attempt to identify and measure the depth of risk associated with the project, including the likelihood of their implementation and extent of possible disasters, and to provide for risks that are not amenable to detection or measurement. In venture investing, you need to come to an agreement on the value of the enterprise, which, at the time of investment may have very few traditional signs of the values, such as revenues and profits. This is a difficult test to a venture investor in any country of the world because the valuation of the company the entrepreneur is close to the amount that, in the opinion of the investor, the company may be worth in five years, at favorable succession of events. The current owner has no doubt in the positive outcome. He is confident that everything will be fine, the risks will be overcome and, respectively, believes that the refund to the investor is also guaranteed as a secured loan at the Bank (or slightly less). The investor from his own experience knows that if anything can be bad, and going bad. In Central and Eastern Europe is sometimes said that this view is too optimistic. It is not so; simply there are risks that in countries with developed capital market are not regarded as serious and, respectively, when processing transactions in Western Europe, are not taken into account, but should be taken into consideration in business operations in Eastern and Central Europe.

**The source of funds and its impact on refunds**

You should always remember that venture capitalists or Fund managers, direct investments represent only a small part of an infinite number of intermediaries operating on the international financial markets. As intermediaries, they collect money from various investors, mainly corporate, in the hope ( at least for the investor) that the return from the international direct investment will be higher than the income from the unrelated risk of investment in the domestic market and reward for the risk (or that the investor reads the risk). To raise capital for investment Fund managers in Central and Eastern Europe needs to convince investors that due to the high degree of risk expected income will be higher than on the domestic market in the country of the investor, especially than the income from direct investment. In countries with developed markets, most direct investment comes from the same country in which they ultimately invested. Financial markets in Central and Eastern Europe this phase has not yet reached, and reached soon, in the foreseeable future, the inflow of direct investments from abroad will be the norm. In addition, the expected return from direct investment in Central and Eastern Europe should be greater than the return derived from investments in the open markets, if any, in countries where the Fund Manager intends to invest the Fund, due allowance for the liquidity to pay on the open market. For investment institutions direct investment is part of the "alternative" asset class. "International" and often "new growing markets" are, at best, a subclass of the group of "alternative" assets. Funds for "direct investments in new growth markets" are very small, decided this very limited group of investment institutions and to ensure that investors have found it possible to consider such projects, the expected return must be very high. This was particularly obvious in 1997, when many investment institutes made a profit of more than 25% for each of the two previous years on the US stock market.

**Understanding of risk**

Doubt investment institutions the feasibility of direct investment in Central and Eastern Europe do not become less from reading what you write, some writers in the region. Malcolm Harper, an authority on enterprises in developing countries (but not necessarily at the "new emerging markets") writes: "Specialized venture capital or direct financing scheme, successfully used in the United States, are unlikely to meet the financial needs of enterprises in developing countries. An inexperienced owner it is difficult to understand even the difference between private investment and a loan he can obtain. The differences between short-term and long-term Fi - nasilovanie only add to their confusion. If we add the direct investment side, the resulting need for incorporation, common responsibility and common dividends, you can handle this is unlikely. ("Small business in the Third world, 1984). One could argue that a significant part of the investment opportunities in Central and Eastern Europe belong to "transitional" economies, not to what is usually referred to the concept of "developing" economy. However, the characteristics of the enterprises and infrastructure, not to mention the psychology of the current owners of the companies largely coincide.

**As understanding of risk by investors affect the deal**

In regions that are considered "risky" such as Central and Eastern Europe, the expectations of investors who have made money in the Fund, with responsibility dictates the need to set quite an aggressive - ing portfolio goal, and to compensate for alleged failures to focus on individual investments, where the expected IRR significantly exceeds the portfolio goal.

**Output options**

Although "exit" is the last link in the process of direct investment, this question should be considered at an early stage of analysis of prospective investments. The decisive factor in determining the fair value of the company is the value that can be realized in the future, when you exit. Given the relative immaturity and illiquidity of the most open markets in the region, the investor who expects a return based on the possibility not only to register a company in the local market, but also to get out of a considerable part of ownership in a reasonable period of time after its registration is in the minority. Similarly, the same lack of financial markets, which provides investors the opportunity to privatize the company at an attractive price, interfere with the management of the company itself to Fund the redemption (the use of borrowed funds, external or internal control) of the state or investors. In the future both of these situations can change for the better, but now you need to show real aggression in the calculation of returns based on the odds of the markets like NASDAQ or valuations based on the ratios of prices to income, emerging periodically on certain exchanges in Central and Eastern Europe. However, there is great hope that the new NASDAQ market will have a significant impact on exits from direct investments in Europe in General. This means that the most likely positive output, which should be considered by the investor, is a direct sale, as a PRA vilo, a strategic investor operating in the same industry industry. In the absence of real possibility of access by offering shares on the stock exchange, the only way to maximize the value of will be confident that at least two in - Vestor will be interested in this purchase. If RAS was selected as the most likely output, it will affect the rating and structuring. Assessment is clearly linked to the factors that are considered realistic for the industry. You can , at least, to find some same purchases on the international market and to know their options. If not, it will indicate that the industry trend of buying is not as great as we would like the investor. In the second, if in the industry there are companies listed on international exchanges, the investor can, at least, to determine the level of pricing for potential acquisition. The critical structural element is the ability to force the sale of the entire company in case of attractive offers. The requirement that the other shareholders out of the company along with the venture investor, is usually items that the tough discussion. With other financial investors agreement on this issue may depend on what is considered "entertainment". Under it may be implied from the inclusion of a minimum - term rates, which should be proposed in order to have a basis to impose a sale of the company. When the other shareholders are the founders and/or managers, there are discussions of more sensitive nature. Their motivation need to understand and accept, and if they are driven by the desire to create a company to pass on to her children, then the investor will not protect any law. In addition, if the transaction involved the Ministry of Finance and the state continues to own a stake, such a mechanism will be difficult to implement, because the law may require that the state could sell its stake only after the public tender, even if the share is one share. When structuring such transactions need to be creative, because the investor doesn't want the government to stop the transaction. This can allow state government to "shake out" of the investor additional amounts in excess of those agreed upon in the initial evaluation value.

**Stage of development: company and deal type**

You need to understand that the Chapter written by Clive Sherling, and this Chapter Masatoshi character in the sense that they claim to describe one activity – direct investment, which actually represents sobornost of mesopotamia.namely in Eastern Europe. Idevicedatalist that in Western Europe vary from the Xia - "seed" investments to buyouts internal or external control differ from each other primarily by the strength of the management, the possible presence of obligations to the yield, potential growth markets, complexity, competition, speed of technological innovation and maturity of the company. Each of these lice impact on deal structuring and pricing. As mentioned above, in Central and Eastern Europe there are two main types of investment: development capital, or torture to get connected to the economic growth of the region, and the privatization or "buying property on the cheap." While very few transactions are associated with the development of new technologies, the components of the normal field of activities of venture capitalists in the United States, and gradually receive their development in Europe. Those who support a strategy of capital development in Central and Eastern Europe, explain their position by saying: "when the sea - Liv lifts all ships". They try not to emphasize the fact that the rapid surge can throw loose ships on the shore, especially if a sharp blow the winds of change. Although many of the normal structure and legal provisions can provide the investor some level of security, there are factors that must affect the definition of investor value. In more developed financial market or the market with a longer history in terms of a free economy, investors often look for managers, "which dealt with this matter". The logic is this: if managers were able to earn money for other investors, creating the company and bivshy profitable exit, they will be able to do it again. In Central and Eastern Europe, this "had never been done before". All engaged in this business for the first time, and this means higher risks, requiring more substantial concessions. This is the point of view of the investor. The entrepreneur is understood that so far everything was going well, and therefore, no further significant risks are expected and, accordingly, to give a price is not necessary. The resolution of these contradictions requires lengthy discussions, and great ingenuity in structuring transactions. If the entrepreneur really believes that the implementation of the business plan related to minimal claims, the investor may make in the terms of transaction provide additional incentives or options for the purchase of the shares to the investor (1) in achieving the goals, which led to the increase in the value of the company or (2) upon acquisition by the investor of liquidity and certain internal rate of return (IRR). The privatization of the representatives of the Ministry of Finance usually co - crediticias all the attention on the value of the assets or the expected ability to generate cash flow and profits, not taking into account management or the potential risk of pre-existing obligations, and the calculation of the net asset value of the use as unit of measure cost of capital without taking risks. It should be recalled that the admonition caveat emptor (goslow - but let the buyer beware) was born in Europe, and that the legal structure in the countries of Central and Eastern Europe usually do not care about the protection of the investor or the buyer of the company, especially if the seller acts as the state itself. Protection of legally recognized interests is one of the main components of risk. Therefore, the less the investor may include in the terms of the transaction ensure proper protection of their interests, the greater is the concession in the price he can demand from a legal and market valuation of the company. In most cases, the state will argue against the most common statements and head - rhenium buyer. In addition, there is a potential threat of claims for the payment of taxes relating to the period when the company was owned by the state. At the same time representatives of the Ministry of Finance are unable or unwilling to give assurances that such an action is brought. Sometimes you can agree to reserve a portion of the agreed sale price of the company for a certain period of time to cover such obligations. In determining the proposed state rates and the initial valuation of the company, the investor must calculate the dilution to achieve acceptable incentives in the form of shareholder - tion of capital for the controlling company, to persons already working in the company, and for those who will be hired in the future.

**Stage of development: capital market**

Other significant differences between countries due to non - equality in the levels of development of financial and information markets, and legal structures and mechanisms in the right application. Another significant factor is the positive or negative attitudes to the role of business and investors, as well as concerning the role played by the state in imposing its conditions, regulating or controlling, and in some cases, and assuming the major powers in the implementation of these activities. Finally, the value and how the government perceives these roles reluctantly or with enthusiasm. This relationship is embodied in various legal and regulatory structures, as well as in less certain "accepted orders". All this has an impact on the ability of venture investors to do their business. Receiving unusually large profits on any market due to the inefficiency of capital markets and information , and especially with the ability of the Fund Manager to deploy capital when it is small, and prudently manage the investment, having access to internal information of the company's owners. In some Central European countries have already been cases of inefficiency of an opposite nature, which can be expected in all emerging markets regardless of whether new countries or new technologies when "too much money and too few deals" and pricing does not match the actual potential income risks. Veins churna investors need to "ride out" the cycles. Fortunately, given the - current pace of change in Central and Eastern Europe, these bubbles quickly burst, and the process of price formation is regaining the elements of common sense.

**Negotiations on the privatization of**

The current owners of shares can have an opinion about the value of the company because they are paying attention to the cost or "value" of assets and not on their ability to generate revenues. The company, which venture capitalist thinks bankruptcy might look valuable in the eyes of the current owners of shares, who have invested significant assets and believe that the new investors want to use the "temporary difficulties". With this attitude we have to face not only in Central and Eastern Europe, but because of the newness of the process there are too few officials that can look at these operations from a global perspective. However, in the countries of Central and Eastern Europe investor often has to deal with persons who are not owners, but only employees of the owner. They've always said that the assets of state companies is of great value, and their duty to protect public property from looters-privatisers. It is the psychological value of a company can even reflect Xia in the books of the company because the carrying value is the net book value of assets and is not a cost that reflects the technological backwardness, but the cost is the original cost of the assets, inflated with inflation. In some countries there is a more complex approach, using a combination of book value, replacement cost and discounted cash flow. Sometimes, however, the replacement cost will include the assets that the investor does not intend to include in the enterprise, for example, rest homes and concert halls or assets that no sane investor would want to recover, because technology has moved forward, and the new equipment will provide significantly better performance. Model discounted cash flow sometimes does not take into account different changing factors, such as the need to purchase inputs at world market prices, and is chustvenno controlled prices, or the need to revise the forecast of sales volumes, which still provide for sales to former customers who had been buying goods from con - kurantov company because they are cheaper and better, or who still have not paid for the already delivered goods, because long Bank - rotalis. To coordinate the positions of the company in the circumstances you need to have the patience of a Saint. It is often easier to agree on the valuation with a profitable private company with small assets than with state company with a solid, but outdated assets, which is losing money.

**Methods of evaluation**

In the simplest case, the value of the company with a stable income - DAMI in traditional industries will most likely should read the multiplier of the entire cash flow, dis - kotirovalnogo with the appropriate interest rate (financial factor), adjusted for risks, as suggested by the investor, may prevent the delivery of expected profits. These risks should include risks associated with the country, such as political or currency factors as well as risks associated with the company, for example, nelik - conspicuity and "smaller share" - the lack of control. As different from industry to industry are developing at different rates, have different when - he, with the help of which the investor is easier to compare their opinion about various companies in the industry. One of the most common techniques is the use of the ratio "price to income". However, it is quite difficult to apply in countries where incomes have the su - substantially transform because of the peculiarities of local accounting standards. If we assume that the output will be by way of "absorption" of the multinational company by the buyer, it is appropriate to make inquiries on how is estimated the acquiree in other countries, and which models calculate the value suitable for this case. For example, in the case of financial institutions, the cost is often determined by the ratio of price to net book value. Distributors better estimated using the relationship of costs to turnover. The goal of the venture investor is to determine at what point and after overcoming some obstacles, the company will become an attractive object - that of "absorption" and what would be the probable methods of calculating the cost at the final stage to get the right valuation at the time of the investment.

**3. The need for funding**

**Business plan**

Central and Eastern Europe, a carefully composed business plan submitted to the investor as a basis for making decisions about investments, is not the rule, but the exception. If the owner of the company is a private entrepreneur, it is usually the investor receives from the suggested two pages brief considerations of the owner about why his company is worth the investment. After that, the investor has to spend a lot of time to determine whether the appeal - valued investment opportunity. It is not that entrepreneurs do not know their company or industry – they just don't have the habit to write a business plan- either for themselves or for the investor. However, when it comes to privatization, the investor often receives "the book", prepared by consultants, local or foreign. To get this book the investor must sign an undertaking not to disclose information, but do not rely on it when making decisions about investments, i.e. caveat emptor. However, it is assumed that the investor does not have to meet with the company's management present or, at least, resolution of a consulting company , which further complicates the process of finding out what the real situation in the company and that in fact, he thinks the leadership on opportunities and issues - Mach in the future.

**How much money is needed?**

This question is almost always possible to answer: "More than you thought - those". The money will be needed and when business is bad, and when the company is developing very successfully and requires additional capital injections to support new business. In many cases, additional funds must be in the form of equity, because the banking sector in Central and Eastern Europe have not developed to such an extent to give loans to small and medium enterprises - 205 - businesses (SMEs). Honestly, it's banking problem in the world levels, because even in countries with developed financial market, the banks financing the SME sector tends to be conducted on the principle of "it is empty, then thickly". Banks completely refuse lending to SMEs, considering that they get the yield on the loan type, or worse, because of the risks associated with equity, then again the Bros are to Finance fast-growing companies.

**4. Financial instruments**

This section is largely based on the head of Clive Sherling and the reader can look into it to get basic information primarily on the following question. As noted by Mr. Sherling, the complexity of is - use of financial instruments depends on the degree of development of the capital market. In markets where the commercial paper issued by a Corporation, is a novelty, the likelihood that you will be able to come up with a complex financial structure, not to mention how to explain it to the representative of the Ministry of Finance or the entrepreneur that you don't trust, not worth the effort spent on it. The next question relates primarily to the structures that are already named are in the countries of Central and Eastern Europe. Since most funds invest in Central and Eastern Europe, structured as an offshore movements are not only possible, but should be included in the transaction structure offshore Corporation with locations Noi subsidiary company or companies. However, this discussion is beyond the scope of this Chapter.

**Equity**

Typically, the investor invests in the company through equity, although in some countries it is possible to use hybrids like the combination of equity and debt financing. However, be careful. Venture investor usually wants to invest in the company in the form of a "Corporation" where it cannot Pont - STI a loss in excess of investment made. However, in many countries of Central and Eastern Europe that is translated as "company with limited liability" may in fact not be. And if a company, for example, is not able to cover previously unpaid taxes from the assets of the company, the amount owed may be charged to the investor.

**Ordinary shares**

Most of the existing companies have ordinary shares that is, shares that are in the hands of the holders. Therefore, in the case of privatization through the purchase of state-owned enterprises shares, the investor buys what the state – that is, ordinary shares. In most cases, this will be available in the p - NII investor's financial instrument for the capital increase. It should also be borne in mind that if an investor acquires a stock at a price above its par value, in some countries, the company may require payment of applicable taxes. In structuring the capital increase for an existing frequent - tion of the company, the investor may find that the value of the company, which insists the current owner and/or managers can be improved by the requirement to impose restrictions on their ability to implement the action. Sometimes this can be done by contract, but in some countries you will need to convert these shares into "privileged" to be able to produce a "buyback" or make a option to purchase enforceable.

**Preferred shares**

All the special rights conferred upon the holders of some of shares that gives them "privileges" in relation to the holders of ordinary shares and not included in the contract and articles of Association, make these shares as "preference". These rights are an integral part of valuation because they can be used to support the rule of the "last arrived, first-out", which insures the risk of the investor. Negotiations about these rights are usually conducted when a transaction involves an increase of capital in private firm, and privatization. The idea is that if there is some event, then some shareholders will benefit over others. These rights must compensate the investors for certain risks or to give them a preferential right in the case of some positive or negative events. The specific features of the types of privileges are the subject of a separate Chapter on legal structures, but often refers to privileges in the event of liquidation, the distribution of dividends and vote on certain issues.

**Options**

Such instruments as stock options right to purchase from the company additional shares, in most countries of Central and Eastern Europe it is difficult to apply due to the lack of permanent share capital, which may be the subject of the option. If the investor has a minority stake and wants to have the option to purchase, it is necessary to conclude with other shareholders a contract that the investor will exercise its right of option, as they have pragalos - yut for permission to issue new shares. This specific provision should also be subject to binding arbitration in the case that specific performance is not available or cannot be applied. Sometimes options are provided to the management of the company as a promotion. If this involves the company to issue new shares arises et the same situation as when issuing new shares for the investor. Sometimes, however, the investor should buy additional shares from the company and then to provide the management of the company the option to purchase these shares. However, in the countries of Central and Eastern Europe there is no mechanism in writelink of stock options and specific mechanisms for the house - Jania taxes on the issuance or sale of the shares, but can be a significant problem of taxation of individuals and the company.

**Warrants**

The warrants in the countries of Central and Eastern Europe are relatively rare, the reasons are the same as those given in the section about options.

**Quasi-equity**

Shares, redeemable, can be used in several countries of Central and Eastern Europe. However, the requirements that must be met before a buyback can be Xia, are sometimes more restrictive than those to which when - off Western European investor. Convertible debt, for Central Europe the concept is new and although some legal and regulatory provisions in this regard do exist, at least in one country, the possibility of their use and related consequences makes this tool most places not very desirable.

**Debt**

In a Mature company that gets rid of cash, debt, pre - stawley investor, is sometimes a way to not only limit the risk of adverse developments, but also enhance the internal rate of return. In growing companies it is desirable that the debt has provided a financial institution, as the expected return will be much lower than one that requires a venture capitalist. Here the important role played by several components. First, in many countries private companies can be difficult to get a loan, especially on acceptable terms. This means that the investor is access to Bank credit may need to include provision for the debt or extension by shareholders - capital stock even for working capital. This can have a substantial impact on expected returns. Second, in economies with high inflation rates, which include most of the countries of Central and Eastern Europe, the debt in local currency will lead to a significant outflow of cash only if interest rates will not be significantly capitalized. On the other hand, the debt in any hard currency, be it dollars, deutschmarks, or yen, finish gives the company to the risk of currency fluctuations. Therefore, it is worth doing only in the case when the company can hedge against this risk by using major exports or the ability to respond to currency fluctuations the actual increase in prices, or differences between Sebasti bridge and the selling price.

**5. The management of the Corporation**

**Representation on the Board of Directors**

In Central and Eastern Europe the investor can effectively over - sidati their interests only if it will be "the investor added an estimation of the cost". This implies active participation in the work of the Board of Directors or the Supervisory Board, and sometimes even the Board of the company. The provision of capital often enabling it to compete successfully with other companies, but this may be a temporary phenomenon, if you control RAS spend money in vain. More important resource to a company's success is the ability of management to respond to the rapidly changing situation. The participation of the representative investor in the company, especially in regard to strategic planning, financial systems and control, marketing and sales, and sometimes organizational - ing structure, compensation Manager and talks about jointly by the enterprise that will give the company the necessary competitive advantage.

**The veto**

Of course, the requirements of the investor on the shareholder level or at the level of the representative investor in the Board of Directors to consent to certain major actions are the mechanisms through which it is possible to some extent to limit the possibility of surprises. However, limitations should be applied at the lowest level of legal force, so as not to delay the implementation of decisions. Action at the level of the shareholders to be used in the most extreme case, in part because a report of these actions shall be published in the local press and will be read by competitors.

**The annual budget**

In the course of negotiations on conclusion of the transaction should discuss and agree on the budget for next year. This is done not only in order to be sure that the investor and the managers have agreed to use the invested capital, not only to investor better understand the dynamics of the business; it also gives the investor an important opportunity to assess the knowledge of the managers of the business and their ability and desire not only to Express their opinions, but also listen and think. This is the stage which lays the Foundation for future relations and, although meetings of the Board of Directors will ensure the involvement of the investor in the company, it is often the investor's participation in the development of plans for the coming years will create such a personal relationship when you can be sure that the CEO of the company will share with investors their anxiety before they turn into emergencies.

**Reporting**

The investment agreement should include some clear commitments. The most important of them is provision of using certain specific time intervals of reports on financial and substantive activities of the company. The choice of intervals is a matter of the maturity of the company and its leadership, and knowledge of the investor dynamics of the industry and the company. Of course, providing the investor with relevant information in a timely manner will allow him to adjust the performance of the company. However, the investor is much more important to know what information is required for the adoption of the company's management decisions is prepared and regularly. If the company is unable to provide such data, it often means that management does not have a rational basis for action.

**6. Management issues**

The process of development of venture business in the United States and Western Europe was very long. Petropavlovskaya years - that-be entrepreneurs and managers took venture capitalists and venture investors. Many studied on concrete samples: the case of venture capital companies that have earned huge amount of money for managers, served to other entrepreneurs the impetus to be more willing to work with venture - owned by the investor. In Central and Western Europe, the experience of direct investments is very small, so one of the main challenges facing the venture capitalist is to acquaint local entrepreneurs with the requirements of venture investment. One of the most difficult tasks is to determine if the company's management to the requirements of venture capitalists who, ultimately, represent the interests of their own investors. For making decisions about the investments necessary to obtain the answers to three "simple" question, sometimes referred to as "test on th - davnosti share" whether managers and owners of the company de flow (1) information, (2) control and (3) extreme top. These questions are relevant not only for Central and Eastern Europe, they have a great value to Entrepreneurs, regardless of whether they founded their own company or represent the company managers turned businessmen, is not the most easy people to work together. Entrepreneur by nature an anarchist. He challenges the established order and breaks all the rules. These people do not know how to listen. If they are listening to what others say, they never bothered to start or change your business, because it is absolutely bcepred - tell them of imminent failure. It happens all over the world. The habit of stealth, hard prisivashya in Central and Eastern Europe during the Soviet Union and the "iron curtain" even more hinders the entrepreneurs to be open-minded. In addition, the environment in which the laws are very vague and literal adherence to known rules makes doing business impossible, many businesses have learned to circumvent the law. Therefore, owners and managers of companies show little willingness to share information that may damage their companies and them personally. Persistent demands of professional venture capital investors to tell the entire history of the company, especially with regard to the sources of initial capital is often for entrepreneurs an insurmountable obstacle, no matter how much they need to raise capital. Nowhere in the world, the entrepreneur does not like it when his freedom of action restricted. In the rapidly developing economies of some countries of Central and Eastern Europe the entrepreneur wants and needs to be able to respond quickly to rapid changes in the market. Therefore, the specific business plan is perceived as an unnecessary deterrent. Venture the investor to calculate expected return, need to know what direction the business will develop and what are the projected profits and revenues. Sometimes venture investor is personally involved in the management of the company and he doesn't like when there are deviations from the plan. This difference in approach can create large problems, since there can be no doubt that in Central and Eastern Europe, actual results will differ from the business plan. Finally, in several countries of Central and Eastern Europe have long valued the "art of the deal". To support the production was difficult and trade was a business easy and profitable. Connection values are not represented; the main task was to extract the maximum profit from each individual transaction. It was the kind of game in which each participant had the opposite purpose: "If something appeared, so it's something he took from me." For venture investors, this position is unacceptable because for all their activity, they can't fully control the business and, therefore, must trust the leadership of the company to manage it for the benefit of all investors.

**7. Negotiations and the process of "careful examination"**

Thus, a qualitative assessment of the managers of the company becomes a venture capital investor who invests in the countries of Central and Eastern Europe, of paramount importance. The process of "careful examination" is not only the collection of facts, and the negotiation process is not confined solely to the search capabilities of the transaction. Both of these kinds of activities are part of the process of establishing a personal relationship that will define the lifestyle of the investor in the future. This is also the period of time during which the investor needs to set a clear idea about what additional resources are required the company to perform its intended task, and what "value" you can add the investor. Venture investors around the world are trying to differentiate from other types of financing, indicating that they "add value" to the company in which to invest. Of course, in many cases, this is the case. However, there are many examples where promises much more than running. In Central and Eastern Europe, partly because of weak infrastructure support companies, partly because of the absolutely retarded process of law enforcement, the investor is necessary to convince entrepreneurs or management staff of the company is that it is more profitable to work with him, comprative him. It is this involvement in "adding out - year" of the company, ultimately, protect the interests of investors better than any of the ideal structuring of the transaction flawlessly or composition provided legal documents. At the end of the process the investor should make sure that the transaction meets the investment parameters that the funding structure suits - 214 - and, most importantly, everything depends on the success of the business, satisfied and happy. In the future, will be enough reason to quarrel, so you should not start work with in order to spoil relations. In addition, all future disputes will be resolved much easier if the parties treat each other with sympathy. Sometimes investors have occurs last question, and if the answer is negative, then the transaction will not take place. Here it is: "I really want to have dinner with these people every month for the next five years?" If both parties can answer it in the affirmative, there is every reason to believe that during one of these Lunches from managers is celebrating a major increase in its own capital, and the investor is getting a good profit.

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**Theme of lecture № 8. Legal aspects of Venture Capital**

**Plan of lecture:**

1. Legal Things Every Entrepreneur Should Know

**2. Intellectual Property**

**3. Employment Issues**

**4. State of Incorporation**

**5. Accredited Investors**

**6. Election**

**7. Valuations**

**1. Legal Things Every Entrepreneur Should Know**

When a joint stock corporation is established, contributions to equity capital can be made in cash or in kind. All contributions that are made not in the form of a monetary payment of the par value of the share (plus premiums to the share, if any) are considered contributions in kind (such as assignment of rights or lawsuits, or transfer of real estate, equipment and other tangible and intangible assets). Deposits in kind must pass special audit of the registration chamber and be certified by certified accountants-auditors, as a guarantee that the nominal value of the deposit is covered by assets and, thus, when forming the share capital of the company, there will be no shortage. If no contributions are made to the nominal share capital in the form of cash or in kind, the initial shareholders (subscribers) bear responsibility for this. This procedure makes making contributions in kind by a process much more complicated and requiring much more time than contributing money, and can for a long time delay the registration of the company being created. Naturally, attempts to circumvent the rules on making deposits in kind should be stopped. Therefore, Article 32 of the Law on Joint-Stock Companies provides that any agreement entered into by the company within two years after its registration and obliging it to acquire assets (such as machinery and equipment) must be approved by the shareholders' meeting and registered in the companies register if the price Pays the company, exceeds 10% of its nominal share capital (acquisition after the establishment / Nachhgrundung). Any agreement of this kind should be in writing (if not required by notary registration, as, for example, in the case of the acquisition of real estate). The agreement enters into force only after registration in the register of companies. The Supervisory Board should check the agreement and report to the shareholders' meeting about this. In addition, an external audit is required by certified accountants-auditors.

The formal requirements for the charter of a limited liability company do not differ much from the requirements for the charter of the AG. Having become and any amendments must be notarized. A company can be established by one person. The minimum share capital is 50,000 DM. The minimum initial deposit before the company registration is 25% of the nominal share capital, but not less than 25,000 DM. If one person is established by GmbH, in addition to an initial payment of 25% of at least 25,000 DM, before submitting an application for company registration, it is required to present guarantees for the balance of the sum (Article 7, paragraph 2 of the Law on Limited Companies / GmbH -Gesetz / GmbHG). Such a guarantee can be a bank guarantee. The nominal value of shares may be different (but not less than 500 DM). The company begins its existence only after it is registered in the company register. Shares of GmbH can be settled only by a notarial agreement.

The charter covers at least the following issues:

• The name and official location of the company

• The purpose of the company

• Nominal share capital

• The amount of the contribution of each shareholder

• The special obligations of shareholders (if any)

• The period if the company is established for a limited period of time.

In addition, the company's initial executive directors must be appointed by decision of shareholders, and their names are submitted for registration. Contributions to equity capital can be in cash or in kind, depending on what is provided.

If deposits are made in kind, then a special report and documentation must be submitted to the board confirming the value of assets transferred by the company and treated as capital. But, unlike the law on joint-stock corporations, the law on GmbH does not contain requirements related to acquisitions made after the establishment of the company. To avoid complications of legal registration of the contribution in kind, the system was invented when the contribution was made in the form of money, and evidence of this was submitted to the registration chamber. Soon after the registration of the new GmbH, the amount of the monetary contribution was returned to the investor who contributed it as payment for the acquired property (real estate, machinery, etc.), which must remain in the company. The registration authorities considered this an attempt to bypass the legal rules for making deposits in kind. As a result, the contribution originally made in cash is considered invalid, as it is not actually at the disposal of the company. At the same time, the acquisition of property does not meet the requirements for deposits in equity, as it was formalized (and publicly announced) as a contribution in monetary terms.

There are a few legal issues that we've seen consistently become hurdles for entrepreneurs and their lawyers. While in some cases they will simply be a hassle to clean up in a financing or an exit, they often have meaningful financial implications for the company and, in the worst case, can seriously damage the value of your business. We aren't your lawyers or giving you legal advice here (our lawyers made us write that), but we encourage you to understand these issues rather than just assume that your lawyer got them right.

**2. Intellectual Property**

Intellectual property (IP) issues can kill a start-up before you even really begin. Following is an example.

You and a friend go out and get some beers. You start telling him about your new company that will revolutionize X and make you a lot of money. You spend several hours and make you a lot of money. You spend several hours talking about the business model, what you need to build, and the product requirements. After one beer too many, you both stumble home happy.

Your friend goes back to work at his job at Company Xlike.

You picked this particular friend to vet your idea because you know that your company is similar to some cutting-edge work he does at X-like. There is even a chance that you'd want to hire this friend one day.

You spend the next six months bootstrapping your company and release a first version of your product. A popular tech blog writes about it and you start getting inbound calls from VCs wanting to fund you. You can't stop smiling and are excited about how glorious life as an entrepreneur is.

The next day your beer buddy calls and says that he's been laid off from Company X-like and wants to join your company. You tell him as soon as you get funding you'd love to hire him. Your friend says, “That's okay—I can start today for no pay since I own 50 percent of the company.” You sit in stunned silence for a few seconds.

As you discuss the issue, your friend tells you that he owns 50 percent of the IP of your company since you guys went out and basically formed the company over beers. You tell him that you disagree and he doesn't own any of the company. He tells you his uncle is a lawyer.

As strange as this sounds, this is a real example. While we think the claim by your so-called friend is ridiculous, if he takes action (via his uncle, who is likely working for him for takes action (via his uncle, who is likely working for him for free) he can slow down your VC financing. If he stays after you and you don't give him something, it's possible that he'll end up completely stifling your chance to raise money. If you happen to get lucky (for instance, if your so-called friend accidentally gets hit by a bus), you still have the outstanding issue that Company X-like may also have a claim on the IP if there is an actual lawsuit filed and X-like happens to stumble upon piecing the story together.

There are endless stories like this in start-up land, including the history of the founding of Facebook popularized (and fictionalized) by the movie The Social Network. Our example is one extreme, but there are others, like students starting a company in an MBA class where two go on to actually start the business while the other two don’t, but terrorize the company for ownership rights later due to their claimed IP contributions. Or the entrepreneur who hired a contractor to write code for him, paid the contractor, but still ended up in litigation with the contractor who claimed he owned IP above and beyond what he was paid for.

When things like this co me up, even the most battlehardened VC will pause and make sure that there are no real IP issues involved. Responsible VCs who want to invest in your company will work with you to solve this stuff, especially when absurd claims like the examples we just gave are being made. In our experience, there's often a straightforward resolution except in extreme circumstances.

The key is being careful, diligent, and reasonably paranoid up front. When friends are involved, you can usually work up front. When friends are involved, you can usually work this stuff out with a simple conversation. However, when talking to random people, be careful of unscrupulous characters, especially those you know nothing about.

Some entrepreneurs, and many lawyers, think the right solution is to carefully guard your idea or have everyone you talk to sign a nondisclosure agreement. We don't agree with this position. Instead, we encourage entrepreneurs to be very open with their ideas, and we generally believe NDAs aren't worth very much. However, be conscious of whom you are talking to and, if you start heading down the path of actually creating a business, make sure you have competent legal counsel help you document it.

**3. Employment Issues**

The most common lawsuits entrepreneurs are on the receiving end of are ones around employment issues. These are never pleasant, especially in the context of an employee you've recently fired, but they are an unfortunate result of today's work context.

There are a few things you can do to protect against this.

First, make sure that everyone you hire is an at-will employee.

Without these specific words in the offer letter, you can end up dealing with state employment laws (which vary from state to state) that determine whether you can fire someone.

We've encountered some challenging situations in states that made firing people in the United States almost as challenging made firing people in the United States almost as challenging as firing them in France.

Next, consider whether you want to prebake severance terms into an offer letter. For instance, you might decide that if you let someone go, they will receive additional vesting or cash compensation. If you don't decide this at the outset, you may be left with a situation where you are able to fire someone, but they claim that you owe them something on the way out. On the other hand, determining up-front severance is about as much fun as negotiating a prenuptial agreement, and the downside to it is that it limits your flexibility, especially if the company is in a difficult financial situation and needs to fire people to lower its burn rate in order to conserve cash to survive.

Every entrepreneur should know at least one good employment lawyer. Dealing with these particular issues can be stressful and unpredictable, especially given the extensive rules around discrimination that again vary from state to state, and a knowledgeable employment lawyer can quickly help you get to an appropriate resolution when something comes up.

**4. State of Incorporation**

While you can incorporate your business in 50 states, there are a few preferred states to incorporate in, especially when you are planning to seek VC backing. Most VCs prefer one of three states: Delaware, whichever state the company is in, of three states: Delaware, whichever state the company is in, or whichever state the VC is located in.

Delaware is common because corporate law for Delaware is well defined and generally business friendly, and most lawyers in the United States are adept at dealing with Delaware law. If you are planning on ultimately having an initial public offering (IPO), most investment bankers will insist on you being incorporated in Delaware before they will take you public. More important, lots of obvious things that are difficult or not permitted in some states, such as faxed signature pages or rapid response to requests for changes in corporate documents, are standard activities in Delaware.

The only two disadvantages of being incorporated in Delaware are that you will have to pay some extra (but very modest) taxes and potentially comply with two sets of corporate laws. For instance, if you are located in California and are a Delaware corporation, you'll have to comply with Delaware law and some of California law, too, despite being a Delaware corporation.

Either of the other two common choices, the location of the company or the location of the VC, is generally fine also.

However, if a VC has no experience with your state's corporate laws, you'll occasionally find resistance for incorporating in your state. We view this as rational behavior on the part of the VC, especially when the VC joins the board because the VC then ends up being personally liable as a director under the state's corporate laws. Since these laws can vary widely, we always encourage Delaware as the default case.

**5. Accredited Investors**

Though this isn't a book about securities laws (which, if it were, would make it a dreadfully dull book), much of it is actually about selling securities to investors. There are lots of laws that you need to comply with in order to not get in trouble with the SEC, and thus that is one of the major reasons that you need to have a good lawyer.

Most of the issues can be avoided by following one piece of advice. Do not ask your hairdresser, auto mechanic, and bag boy at the grocery store to buy stock in your company unless they are independently wealthy. There are laws that effectively say that only rich and sophisticated people are accredited investors allowed to buy stock in private companies. If you try to raise money from people who do not fit this definition, then you've probably committed a securities violation. Normally, the SEC doesn't catch most people who do this, but it does happen sometimes.

If you ignore this advice and sell stock in your private company to people who don't fit the SEC's definition of an accredited investor, then you have a lifelong problem on your hands. Specifically, these nonaccredited investors can force you to buy back their shares for at least their purchase price anytime they want, despite how your company is doing. This right of rescission is a very real thing that we see from time to time. It is particularly embarrassing when the person forcing time. It is particularly embarrassing when the person forcing the buyback is a close family friend or relative who should not have been offered the stock in the first place.

**6. Election**

This is another “if you don't do it right in the beginning you can't fix it later” issue. The punch line of not filing an 83(b) election within 30 days after receiving your stock in a company will almost always result in you losing capital gains treatment of your stock when you sell it. We refer to this as the mistake that will cause you to pay three times the amount of taxes that you should pay.

The 83(b) election is a simple form that takes two minutes to execute. Most lawyers will provide the standard form as part of granting your stock. Some will even provide a stamped and addressed envelope, and the most client-friendly lawyers will even mail the form for you. Or you can just Google “83(b) election” and download the form yourself.

Note that you must send the form to the appropriate IRS service center.

We've had firsthand experience with this and it's a bummer when you are in the middle of an acquisition and you realize the 83(b) election is unsigned under a pile of papers on your desk. For a firsthand account of this, take a look at the chapter titled “To 83(b) or Not to 83(b)” in Brad's and David Cohen's book Do More Faster (John Wiley & Sons, 2010).

**7. Valuations**

Our last random legal topic that often rears its ugly head around an acquisition is Section 409A of the tax code, also known as the 409A valuation. Section 409A says that all stock options given to employees of a company need to be at fair market value.

In the old days before the turn of the millennium (pre-409A), the board of a private company could determine what the fair market value of a share of common stock was and this was acceptable to the IRS. It became common practice that the share price for the common stock, which is also the exercise price for the stock options being granted, was typically valued at 10 percent of the price of the last round of preferred stock. The exception was when a company was within 18 months of an IPO, in which case the price of the common stock converged with the price of the preferred stock as the IPO drew nearer.

For some reason the IRS decided this wasn't the right way to determine fair market value, came up with a new approach in Section 409A of the tax code, and created dramatic penalties for the incorrect valuation of stock options. The penalties included excise taxes on the employee and potential company penalties. In addition, some states, such as California, instituted their own penalties at the state level.

When Section 409A was first drafted, it sounded like a nightmare.

However, the IRS gave everyone a way out, also known throughout the legal industry as a safe harbor. If a company used a professional valuation firm, the valuation would be assumed to be correct unless the IRS could prove otherwise, which is not an easy thing to do. In contrast, if the company chose not to use a professional valuation firm, then the company would have to prove the valuation was correct, which is also a hard thing to do.

The predictable end result of this was the creation of an entirely new line of business for accountants and a bunch of new valuation firms. Section 409A effectively created new overhead for doing business that helped support the accounting profession. Although we have a bunch of friends who work for 409A valuation firms, we don't believe that any of this is additive in any way to the company or to the valuecreation process. While the costs are not steep, the $5,000 to $15,000 per year that a typical private company will pay for 409A valuations could easily be spent on something more useful to the company, such as beer or search engine marketing.

An unfortunate side effect is that the 10 percent rule, where common stock was typically valued at 10 percent of the preferred stock, is no longer valid. We often see 409A valuations in early stage companies valuing common stock at 20 percent to 30 percent of the preferred stock. As a result, employees make less money in a liquidity event, as options are more expensive to purchase since their basis (or exercise are more expensive to purchase since their basis (or exercise price) is higher.

Ironically, the IRS also collects fewer taxes, as it receives tax only on the value of the gain (sale price of the stock minus the exercise price). In this case, the accountants are the only financial winners.

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**Theme of lecture № 9. Post-investment management of the company. Active and passive participation**

**Plan of lecture:**

**1. Post-investment management**

**2. Realization of investments**

**3. Active and passive participation: for and against**

**4. Policy and strategy**

**1. Post-investment management**

This chapter is devoted to that part of the venture capitalist's work that continues after making an investment when the transaction is completed. This is called a post-investment period. From my point of view, the transaction is completed only after the withdrawal of capital back, if, finally, it will happen at all. Only then we will know if the deal was successful, whether we earned money and whether we achieved our goals. In the previous chapters we talked about the work that needs to be done before entering into a deal. It is extremely important that this work is performed in good faith. Errors made at the pre-investment stage can have a negative impact on the position of the venture capitalist regarding the investment and its final results. In the chapter dealing with the preparation of the deal, much was said about the future relationship with the invested company: the veto power, representation, protection of the rights of shareholders who do not have a controlling stake, an agreement between the shareholders, management and control. All this indicates that we, venture capitalists, having invested our money, we want to have the right to say our word in investment management. We want to participate. It is this participation in the work of the invested company that is the main difference between venture capital and other types of financing. The question arises: why do we want to participate and how deep should this participation be. When discussing the level of participation in venture capital management, "active" participation and "passive" participation are usually distinguished. "Active" is usually associated with the financing of companies at an early stage of development, "passive" - ​​with investments in companies of later stages of development. Clearly, everything depends on the degree of risk. Thus, we can answer the first part of the question: venture capitalists are involved in managing their investments in order to minimize the risk. Minimizing risk is a serious task for any investor. There is nothing new here. Unlike other types of investors, a venture capitalist can not withdraw his money. Bankers can close credit lines, and if they do it in a timely manner, they will not lose their money. Investors who play on the stock exchange, when difficult times come, sell their shares, and the most deft of them even manage to earn money. For most investors, risk minimization is reduced to the ability to move an investment, transfer money to a safer place. Venture capital has very low liquidity - the money invested by a venture capitalist, usually can not be withdrawn for a fairly long period of time. To reduce the risk to a minimum, you can only with the help of companies that have received these investments. This means that the venture capitalist should occupy a position that will allow him to influence the investment, the course of business development. He must also have the right to use this provision. If this can be achieved, then the second part of the question of why a venture capitalist participates in investment management can be answered thus: if a venture capitalist or an angel-business type investor can make the risk minimal, he also has the opportunity to make maximum profits. The whole point is to have a position that allows you to influence the change of affairs related to the investment, turning the bad into the good and the good to the best. Making the risk minimal, and profit - the maximum. This is the difference between venture capital and other types of financing. A very important question, perhaps the most important question to which a venture investor should answer is whether I can make the risk minimal and the profit maximize. If you managed to successfully solve the problems, which were discussed in the previous chapters, then you have already achieved a lot. The markets and technologies are analyzed, the financing mechanism is developed and the optimal transaction structure is built up, the legal status is checked. But there remain no less important questions: Do I really understand this business? Does this business attract me? Do I have reason to believe that I will be able to work with the company's management?When we spoke above about the tasks, a simple formula of the theory of capital gains was formulated - leaving aside the effect of borrowed funds, the main determining their changes between price and income in the period between the investment entrance and the exit. Before that, it was explained why the sophistication of sellers and intermediaries in Europe, otherwise, led to a "full price valuation" in public trades, as well as in private transactions, which allows using this method of exchange using a multiplier between price and income.

Therefore, we are again thrown out on the path of creating additional profit with the help of "added value" - the active process of transferring by the venture investor of the invested company their contacts, knowledge and experience, which every fund manager in his prospect always promises. TAAssociates five years ago, show that to properly finance the early stage, properly selected growing markets are more important than the management team or the personal contribution of the fund manager.

Most funds, at a minimum, introduce one member of their team or, at least, one of their appointees, to the board of directors. The risk of attracting an outsider is that he can "change" you (that is, start playing along with the company's management). In addition, a person from outside usually does not participate in the "careful study" program and is deprived of the opportunity to get acquainted with the company and its management. On the other hand, for funds with large portfolios and in funds, funds, the most interesting thing is that we, as professionals, can do is offer financial systems that allow the company's management to better perform their duties, and we need to control them. Meetings of the Board of Directors are not for us to look for deviations from budget figures and demand their explanations - thanks to "careful research" we need to know how the main business mechanisms and the ownership of financial and administrative information work. The meetings should be a place where options are discussed and solutions developed. The ability to provide more active assistance to a company depends, of course, on the personal "consistency" of the venture player. If you have connections at the international level, you can take advantage of the expansion of the company in the international space. If you have your managers, you can offer your proven footage. Your experience in the field of industry, technology, commerce and strategy, added to the company's internal resources, is also the way to a final capital increase. Mathematically, a 50 percent structure of the use of borrowed funds (ie, half the debt, half of the share capital) or a cost of 50 percent lower on entry has a much greater impact on the "internal rate of return" than a 50 percent increase in profits after the investment- other things being equal. The difference, however, is that given the characteristics of the company's cash flow and the pricing required by the market, profitability is likely to be the main area where fund managers can actively influence the ultimate efficiency of their portfolio companies, and consequently, on their exit opportunities and, accordingly, the realized internal rate of return. Hence - the comments I made earlier on the necessary skills that the team of the fund should have in the 1990s.

**2. Realization of investments**

The filtering process that follows the selection of companies of potential interest to the investor must be quick and efficient, given that usually no more than one in 100 selected companies becomes an investee. Good (and not "long") business plans are read; opportunities that are not supported by specific plans are rarely considered. The knowledge of the industry helps, as well as preliminary consultations with colleagues or members of the investment committee. From this point on, the rules are interpreted differently by different players - and each one fiercely defends his own version. It should be noted that there is an Anglo-Saxon approach borrowed from the United States, which is increasingly being used (but not necessarily accepted) by European players as a way to limit the risk of possible losses and unpleasant surprises. This approach focuses on the process of "due diligence" - a thorough check of all aspects of the company's activities. However, for most players, the main principle of moving forward is to quickly check with the business plan, familiarize yourself with the market for this product or service and start preliminary negotiations about the company's evaluation of other aspects of the transaction. The purpose of this "assault" is to determine the prospects of the company and / or its technology, the opportunities for its management (the main variable component) and the likelihood of achieving a convergence of views on the company's value with the seller and the company's tasks - with shareholders, if any and with which you will have to work in future. Perhaps, this is the key point of the process, when the experience of a venture "player" should help him quickly and accurately comprehend the company. If any of these components is lame and a relatively simple solution to the problem is not visible, we advise you not to spend money and move on to another potential object for investment. If the first three key components are obvious (although difficult to assess), then on the fourth - the coincidence of views on the tasks, perhaps, it is worth dwelling in more detail. Here, as in marriage, it is important that the partners, despite short-term differences of opinion, have a common system of values ​​and a unified view of medium-term objectives. In addition to the obvious difficulties in implementing the strategy, in the absence of common views (on changes in direction, refinancing, growth tasks, etc.), the exit may turn into a nightmare if among the shareholders there are disagreements over the final stages of the "game" and the completion time of the "game" , the output can not take place at all. This is one of the main reasons why the European Venture Capital, which has accumulated more than 25 billion ECU (at cost) in its "womb" can be compared to a pregnant woman who is waiting for her time to be born. There have been too many small syndicates in the absence of mechanisms that allow fund managers to change the management of the company or carry out forced sales some time after investing or in the event of unsatisfactory performance of the company. Venture "players" can be accused of entering the room backwards to see the exit all the time, but it's much safer than losing sight of them or dealing with partners (company management, other venture capitalists or - the most dangerous thing - corporate "strategic" partners), whose views on the work plan and exit routes do not coincide with yours! If all four main components of a potential investment suit you, you can proceed to a deeper review of the "evaluation". In addition to external factors, the "valuation" also depends on internal factors related to the structure of the transaction, which is formed in the negotiation process, based on the specifics of the company - "income", "cash flow" and investment profile. It is dangerous to build a deal relying only on smart financial engineering at the time of the investment. Smart use of "mezzanine" or "debt" can increase incomes on equity in the late stages. Smart protection from negative developments with tools such as "shares redeemable" can protect you from the mediocre performance of early stage investments or an uncontrolled shareholding. However, nothing can replace a sound commercial judgment, supported by a serious program of "careful study". Unlike the US, there are many approaches to this program in Europe. There are believers in it and not believing, using it and not using it, with all the intermediate variants and combinations. If you have successfully negotiated with sellers and other shareholders on the basic terms of the agreement, then before proceeding to the next stage of the investment process (or auction), you must try to collect as much information about all aspects of the company's activities and all participants in the transaction. If it is enough for some players in some countries that they went to school together with the father of an entrepreneur who wants to get an investment, most experienced venturists want to, once again, check everything connected with markets, technologies, competitors, learn the opinions of suppliers and consumers , check the reputation of the company's managers, talk with other experts, etc. While all that can be delegated to others, experience shows that it is wiser to do this with the resources of your fund at the highest level. First of all, it will make a more correct opinion; secondly, most to interpret the reaction of people and to probe the unclear moments that others will not notice or do not deem necessary to report, and, most importantly, it is a unique opportunity to thoroughly study the matter as an important part of preparing for adding value after the investment. Having said this, I immediately make a reservation: there are aspects that are best left to third parties. These are specific technical reports, accounting checks, legal expertise (and, of course, drawing up a contract). We should say a few general words:

• These reports should not be treated as "protection against adverse developments", but as an important information contribution to the process.

• Therefore, instructions for consultants, accountants and lawyers should be drawn up with their participation, after they understand the essence of the investment deal and feel themselves not as outsiders, but as part of a team of venture players.

• Ideally, the reports and the program of work of experts should focus primarily on the vulnerable aspects of the transaction, in order to minimize the time and money spent on what may ultimately prove to be an unprofitable investment opportunity.

• Allow invited external experts to offer new areas for investigation that pop up during their work. Many dangers come to light only when you begin to dig deeper.

• Try to build a scheme of payments for the services of a third party so that the main payments fall on the last stages of the process.

This will allow the company managing the fund not to go bankrupt, paying for the services of experts on too many unfinished transactions. While all of the above may seem to be the result of deep paranoia, US investment institutions noted a striking correlation between successful funds and funds, which are famous for the serious implementation of "careful study" programs. The usual arguments that are being raised against these programs by fund managers are money that needs to be paid in advance, time (usually at least four to eight weeks) and resistance from some potential investment objects that are more "easy" (less demanding) investor. If the transaction has safely survived the "thorough study" process, negotiations on "valuation", structure, agreements with shareholders and sales / purchase agreements, bank and mezzanine financing (which requires its own program of sale and careful consideration of the proposed conditions), etc. etc. it is assumed that it should be finally approved by the investment committee of the fund. After that, the transaction is completed and money is transferred. Here too there are options. Investment committees can be external and internal; more importantly, they can be permanent participants in the preparation of a transaction or get a full investment memorandum at the end of the process in order to simply make a final decision. The first approach involves constant quibbles to the "brainchild" of the investment team and a very high level of awareness at the end, which almost eliminates the risk of sudden change of opinion. In the second approach, time is saved, but there is a great risk that you will have to enter into discussions with poorly informed persons and get a refusal at the very end of the process, which will cost you a lot of money and shame.

**3. Active and passive participation: for and against**

We have already talked about the fact that active participation in the management of the company differs from the passive. At the dawn of venture capital investment, this distinction often became the subject of serious discussions. The terms "active" and "passive" were transferred to the definition of the type of venture investment company. In the end, they decided that a company, passively involved in investment management, can not be considered a real venture company. Toni Lorents, in his book "Venture Capital Today" describes the "active" and "passive" companies, and identifies the so-called "intermediate-type company," which he calls "reactive." He states that an entrepreneur needs to think carefully about which of these types is most suitable for him. An entrepreneur who does not tolerate interference in its affairs, hardly decides to seek financing from the Fund, which is famous for being actively involved in the work of the company, or has it active support. He can try to find a source of financing among the few venture capitalists who occupy a passive post-investment position. These funds receive reports from companies once a year or once every six months, may be entitled to a "spare" director and rarely come into contact with the invested companies. It is difficult to imagine the situation when an illiquid investment is made, and interest in it and participation in its management is reduced to receiving information once or twice a year. Even companies whose shares are circulating on the market are obliged to inform the public about their work at least twice a year; more strictly regulated markets require their registered companies to publish quarterly reports and notify their shareholders about the most important events. Who determines the degree of involvement of the venture capitalist in the company's work? Businessman? Hardly. The person who provides capital, assesses the risks associated with this and on this basis decides what instruments are needed to monitor these risks. If there is no necessary tool in the investor's "arsenal," no investment is made-or, at least, it should not be produced. In general, we can say that with emerging companies associated more risks than with mature. Indeed, the principle of "active participation" is more often associated with early-stage investments, and "passive participation" with investments of later stages. However, I believe that this approach is practically useless when it comes to the post-investment strategy. Here the most important is to find methods for reducing risks. These risks may lurk in the most invested company or outside of it. Even the very fact of investing can be a risk to the company, and through it, and for the investment itself. For instance, the redemption of using large amounts of borrowed funds could put the company in a difficult position in time when interest rates rise and the investment necessary to carry out in order to keep up with competitors. If the "passive investor" or the "late stage" investor is not interested in and does not participate in the company's work and, accordingly, does not understand anything in business, the development of the company can go at random. The conventional distinction between "active" and "passive" approach also denies one of the basic elements of venture capital, regardless of whether the capital invested in the company's early or late stage. I already said that from my point of view the deal can be considered completed only after the investment is realized. The venture capitalist achieves success only if he managed to realize his investment with profit. This is the most critical stage of the work and it is natural that the venture capitalist wants to take part in it. Moreover, he must have a position that will allow him to act, and not just react to what is happening, wait and observe. First of all, this provision must be legally guaranteed. But the right to decide whether to sell the company or register it on the stock market will be useless if the investor does not understand the business that the invested company is engaged in, is not familiar with the company's current position on the market and does not understand well what condition it is in at the moment. When it comes to maximizing profits, decisive is the time to exit - not to mention the situation when the investment was not very successful. Timely direct sale can save from loss and even bring (modest) profits. In terms of post-investment, in a dispute about which approach is better - "active" or "passive" - ​​too much emphasis is placed on involving the investor in the company's work. For a venture capitalist, the instrument of achieving profit, an instrument for achieving the goal, is not the company, but its investment in this company.First of all, you need to focus on managing your investment. Although a venture capitalist may at some point turn out to be one of the managers of an invested company, he should first of all be interested in the capital invested by him. The venture capitalist manages the investment and oversees the work of the company.

**4. Policy and strategy**

The ultimate goal of each venture capitalist is to get profits above average, which reflect the risks associated with the production of illiquid investment. In Rome, different roads lead. There are venture capitalists specializing in "early stage" investments, there are typical investors of "redemption", there are venture capitalists investing only in a certain industry - both in "early stage" transactions and in "late-stage" transactions and, finally, there are general funds (usually non-independent), which invest money in everything. With all the differences, the goal is one - getting a rate of return is higher than a return from other, less risky types of financing. Whatever course the venture capitalist does not adhere to, his policy will change from investment to investment. For each investment, a specific policy is developed and a definite 256 strategy is chosen. For each specific investment, you need to decide: does this fit into my policy and which strategy will bring the expected results? The answers to these seemingly simple questions should be given by an investment memorandum. Is this the case in practice? The easiest way to say that a good memorandum gives these answers. On the other hand, I already noted that the only thing we can be sure of is that everything will not happen in the future as we expected. So, our strategy is built on our best estimates. What, then, is meant by strategy? The venture capitalist strategy for each investment includes everything that can and should be done to minimize risks and maximize profits. Since venture capitalists can achieve their ambitious goals only by realizing an investment at a profit, their strategy is directed entirely to the exit of their company. Which of the options will yield the maximum profit? When should I exit? And how to achieve this? The investment memorandum provides answers to these questions and in this respect is similar to the company's business plan. It describes the actions to be taken, as well as risks and opportunities. The investment memorandum defines the starting point of the investment. It is for this reason that it is compiled - and not only as a document on the basis of which a decision is made to invest. This document retains its importance during the entire investment period and serves for people managing investment, guidance on the basic principles of work. It should be regularly reviewed. It is best to do this on a quarterly basis and discuss the latest developments regarding the investment with people who participated in the development of the investment decision. Thus, the investment memorandum and quarterly bulletins should become the main documents in the dossier for this investment. It is important to distinguish between events related to the investment object and events related to the investment itself. A venture capitalist should know not only what is happening in the company, but also understand how these events can affect the capital that he invested in this company. In essence, the main thing is to establish a connection between the events taking place in the company and the events occurring outside of it, and to search in them the prerequisites for the possibility of exit. Here is an example. The company begins to give way to competitors. You can try to change the company and / or the level of investment to try to catch up and overtake competitors. But, on the one hand, it will be a difficult and risky business, on the other - the company is still an attractive target for acquisition, largely due to its current position in the market, where it controls important distribution channels. From the investor's point of view, it would be wiser to sell the company now than to try to "preserve" it as an independent economic entity. In this example, it is clear that, under venture management, venture capitalists must all from the very beginning subordinate one goal - the search for a way out of the company. First and foremost, they should use all their influence to ensure the financial management of the invested company at a level that allows it to be sold directly. This should be started immediately after the investment. Many potential direct sales are postponed or canceled due to the financial management of the company. At best, this situation leads to a decrease in the purchase price of the company. If the output of their company is supposed to be realized through an IPO, it makes sense to start applying International Accounting Standards or US Generally Accepted Accounting Principles beforehand. It seems obvious that a venture capitalist should invest only in a company where finance is managed, or will be managed in the very near future by professionals. In practice, everything is different. In most cases, problems or even bankruptcy of companies are the result of inaccurate or untimely submitted financial information. The above example also shows that a venture capitalist should know what the company's position is relative to its competitors. As already mentioned, the venture capitalist carefully analyzes this position before making an investment. It is equally important to continue to do this during the entire investment period. Finally, in the example above, the position of the venture capitalist allows him to change the company's strategy. In situations where a venture capitalist owns an uncontrolled shareholding, alone or together with a syndicated partner, this is not something taken for granted. A venture capitalist has the legal right to decide whether to sell the company even if he owns only an uncontrolled shareholding or he must convince other shareholders, often including the company's management, that a change in strategy is in the company's interests and, accordingly, in the interests of all shareholders. Owning information about the company plays a crucial role in venture management and, from my point of view, also helps to establish a good working relationship with the management of the invested companies. This example applies not only to investments in high-tech companies of an early stage, it may be non-technological companies of later stages. In any case, the decisive role is played by information. In principle, for a good investment management, the same in-formation, as for making a decision on investment. In principle, for a good investment management, the same information is needed as for making a decision on the investment. Sources are the same as those used during the "thorough study" - some of the information comes from the company - the investment object, part - from sources outside the company. But it is not enough to have information - it needs to be analyzed. Since the information and analysis on which the investment decision was made is set out in the investment memorandum, this document helps to determine what kind of information is needed for venture management and how it should be analyzed. The investment memorandum is also taken as a basis for comparing the earlier calculations with real facts. Venture management, like any management, is built on financial information. This information is important not only for a venture capitalist. Without it, the management of the invested company can not do. I have already said that all people believe that all the organizations are well placed to deal with financial information, but in practice everything is not so smooth. We must admit that quite often investors who ask for more accurate financial information are called "bankers" who do not understand what is important to the company and what is not. "A company is not just a column of numbers." This is correct, but it is even more correct that managers of a company who can do without accurate financial information can not be considered real managers! Quite often, participation of a venture capitalist in the work of a small company means the requirement to regularly provide standard information. The venture capitalist must do everything necessary to ensure that the company continues to provide this information even after the investment is made. It should include: • Monthly profit and loss reports • Quarterly profit and loss statements with balance sheets • Quarterly cash flow forecasts • Annual budgets These are the minimum requirements. For newly created companies and buyouts using borrowed funds, everything is decided by the availability of cash. In these situations, cash flow forecasts should be made monthly. Beginning companies fulfill this requirement very difficult. Venture capitalists too often make the mistake of showing "softness" and allowing companies to present their calculations with a delay. This problem has only one solution. The investment should be made on the basis of a budget that provides for a fully staffed finance department, regardless of the size of the company. Administrative information Administrative reports on the progress of the company should be provided at least once a quarter. They should contain a comparison of financial statements with figures in the budget, and an analysis of the discrepancies obtained. Companies, especially small ones, will have to expend a lot of effort on this. However, practice shows that compliance with this requirement is beneficial to the management company. They are forced to formally assess the development of their business and decide how they will act in different situations. The reports should also contain information about other issues related to the company's work. Such as changing the number of employees, the state of developing a new product, the most important new commercial prospects, the largest new orders and projects, etc. Pay attention to missed orders and projects. Depending on the type of business, the administration should report the backlog of orders and the proposed business. Sometimes this kind of information must be submitted monthly. The administrative report should also contain the viewpoint of the company's management on the development of the market on which the company operates. It is necessary to include in the report relevant information about competitors and new products, technologies and trends. The venture capitalist must be constantly aware of the events and changes taking place within the management and the second echelon of the company's management. On the most important events he should be made famous immediately. A very important type of information is the annual accounting report. An audit certificate should be attached to it. It is desirable that the venture capitalist has the right to veto when approving the annual accounting report. The same concerns the choice of the auditor. The auditor must provide the board of directors and shareholders of the pro-invested company with a letter with comments on the shortcomings of the accounting system of the company. A valuable source of information for the venture capitalist is also the minutes of shareholders' meetings and board meetings. They should be provided to him soon after the meeting, especially if the next meetings and meetings will not be held soon.

At this stage of investment management, a control subsystem is organized within the framework of a unified system of controlling at the enterprise. The process of tracking the correctness of the implementation of investment projects is carried out in parallel with the implementation of the planned activities. The main content of investment controlling is the comparison of the results of the project with the planned course of action. Corrective measures are taken when deviations are detected. Post-investment control allows:

- Ensure that the costs and technical characteristics of the projects satisfy the original plan;

- increase confidence that investment projects have been carefully developed and clearly evaluated;

- improve the evaluation of subsequent investment projects (6; p.60).

Of particular importance at the monitoring stage is the ongoing monitoring of project implementation, that is, the analysis and assessment of key indicators (indicators) of the project implementation, as well as the analysis of the correspondence of actual costs and other indicators to planned ones. The monitoring system for the implementation of investment programs is a mechanism developed at the enterprise to carry out ongoing monitoring of the most important current results of the implementation of all investment projects in the face of the ever-changing market conditions of the investment market.

The construction of a monitoring system for the implementation of investment programs is based on the following basic principles:

1. Selection for observation of the most important areas of investment activity.

2. Construction of a system of informative (accounting) indicators for each area of ​​implementation of investment projects.

3. Development of a system of summarizing evaluation (analytical) indicators for each area of ​​implementation of the investment project.

4. Establish the periodicity of the reporting database (informative and estimated indicators).

5. Analysis of the main causes that caused the deviation of the actual results from those envisaged.

6. Identification of reserves and opportunities for normalization of the implementation of individual investment projects.

7. Justification of proposals for changing the calendar plan and the budget for the implementation of individual investment projects

Current portfolio adjustments and post-investment controls are aimed at improving future investment decisions. They provide a summary of the investment projects of the portfolio.

**Active Management and Passive Management**

**Active management and passive management** is one of the most heavily debated questions in the asset management business. The question of whether a skilled asset manager is capable of consistently beating the broad market has important implications. If you can make more by investing with a skilled manager, choosing the right manager becomes of paramount importance. If passive management is your methodology choice, you will need to examine the long term effects of how you invest because the methodology will be different. While different schools of thought reach opposing conclusions, understanding the arguments that will help you to make the best decision are important.

**The Mechanics of Passive and Active Management**

Passive management means that you select in a broad market index and invest your capital in those markets. This can be accomplished through an ETF or a mutual fund, but the defining feature is that you buy the entire market. In this way, your returns will mirror what the stock market does as a whole. You do not make any changes to your portfolio, instead you passively follow the market.

Active management seeks to outperform the broad market in a variety of ways. This approach may be as simple as investing in certain stocks within the index, or as complex as pursuing a statistically-driven investment model that regularly trade in and out of positions. In either case, the defining feature is that a manager is making active decisions as to what instruments should be included and in what relationship. The performance of the portfolio will be affected by the return of the general market, but the difference between your return and the market return will be attributable to active decisions.

**Historical Data**

Research has shown that over the long-run, active managers underperform the broad market when making only long term investment decisions. Active managers underperform the broad market over the long-run, but the investment horizon that you prefer may be different. More importantly, the average manager underperforms, but some managers outperform. There are some asset managers that consistently outperform the market, and some that consistently underperform. Picking which manager will produce the best returns is very difficult.

Not all asset managers pursue long-only investment strategies. Hedge funds, for example, may give you short exposure to various market segments. These managers are less correlated to the general market and their returns are harder to analyze. All in all, the research is inconclusive on which is the best approach to take, so you will have to customize it to your personal level of risk.

**How to Proceed**

Based on the available research, the most reasonable conclusion is that a skilled manager can consistently beat the market, particularly if they take more than long-term exposure. Given this, a blended allocation between active and passive management is the safest approach. You should do careful research to select a manager who is likely to outperform, but also to select one who takes risks that you find acceptable. By pursuing a diversified approach, you increase your chances of achieve positive results.

Active management provides thorough monitoring of the market, prompt acquisition of financial instruments that meet the investment objectives, as well as a rapid change in the structure of the portfolio. The investor uses this strategy when he tries to get a higher return for the market average. The strategy of active management needs considerable expenses, because it is connected with information and analytical preparation of solutions, acquisition and development of its own software, technical and methodological support. That's why this strategy is chosen only by those investors who have sufficient capital and highly professional staff.

Passive management is typical for conservative and moderately aggressive investors. The main goals for passive management are to protect investments from inflation and obtain a guaranteed income with a minimum level of risk and low management costs. This type of management provides for the creation of well-diversified portfolios of securities, for which it is possible to calculate with high accuracy the profitability, risk and liquidity.

With passive management, the most common strategy for investing in stocks is the "buy-and-hold" strategy. The peculiarity of this strategy lies in the fact that its effectiveness depends to a large extent on the level of underestimation of shares and the selected period of time.

Another common strategy of passive management is the strategy of the index fund. It is based on the fact that the portfolio structure should reflect the movement of the selected stock index, which reflects the state of the entire stock market or its individual segments. Types of securities and their part are determined in the same way as in the calculation of the index.

Thus, when forming a strategy for managing a portfolio of securities, the investor should be guided by the basic principles of portfolio investment such as carelessness, profitability of investments, their growth and liquidity.

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**Theme of lecture № 10. Quoting as an exit of mechanism. Introduction IPO**

**Plan of lecture:**

1. **IPO (Initial Public Offering)**

**2. IPO Basics Tutorial**

**3. Why Have an IPO?**

**4. IPO Basics: Getting In On An IPO**

**5. IPO Basics: Don't Just Jump In**

**6. IPO Basics: Tracking Stocks**

**7. IPO Basics: Conclusion**

1. **IPO (Initial Public Offering)**

**IPO** stands for Initial Public Offering. Referred to as taking a company public, the IPO involves a private company offering its [shares](https://www.thebalance.com/stocks-4073971" \t "_blank)to the public for purchase for the first time. Thereafter the shares become listed on a [stock exchange](https://www.thebalance.com/how-does-the-stock-market-work-3306244) and trade in the open market.

Why Companies Go Public with an IPO

IPOs are typically used by newer companies who need additional capital to expand or by privately owned companies whose owners and [investors](https://www.thebalancesmb.com/angel-investor-2947066) wish to monetize their original investments (see [exit strategy](https://www.thebalancesmb.com/small-business-exit-strategies-2947988)).

If market conditions are right for the particular business at the time of the IPO, the original investors in the private company can make fortunes because the new stock is worth much more than their initial investments.

**How an IPO Is Created?**

Normally a private company that wishes to go public via an IPO on Wall Street does so by having investment bank (such as Goldman Sachs or Morgan Stanley) underwrite the share issue. Through negotiations, the company and the investment bank decide on how many shares will be issued, the type of shares, and the issue share price. Depending on the agreement, the underwriter may guarantee the amount raised by purchasing some or all of the shares and then reselling them to the public.

The investment bank prepares the IPO by submitting registration information to the [Securities and Exchange Commission (SEC)](https://www.thebalance.com/u-s-securities-and-exchange-commission-3305995), including details of the share offering, financial statements, management information, etc.

The SEC performs background checks on the registration to make sure all the correct information has been disclosed in the submission.

After SEC approval the company and the underwriter begin marketing the issue to customers by issuing a series of prospectuses which describe the company and the share offering (see Zipcar prospectus for an example).

At first, the shares are typically offered to larger institutional investors such as pension funds, life insurers, mutual funds, etc. who can afford to purchase large blocks of shares (usually at a discounted price). Eventually, the shares are listed on a [stock exchange](https://www.thebalance.com/what-is-a-stock-exchange-358113) and can be purchased by individual investors.

**Example of an IPO**

In the tech world, the biggest IPO ever (and the biggest in internet history) was that of Facebook on May 18, 2012. Founder and principal shareholder Mark Zuckerberg had resisted taking the company public for years and instead raised capital by private sales of shares to other companies such as Microsoft. At the time of the IPO Facebook had over 500 private shareholders and over 800 million monthly users.

A few months prior to the IPO, Facebook was intending to price the IPO shares at $28 to $35 per share. However, due to anticipated high demand, the number of shares to be sold was increased by 25% and the IPO price per share was raised to $38, giving Facebook a peak market capitalization of over $104 billion dollars.

Unfortunately, the price of the stock fell on opening day and continued to fall for the next two months, dropping below $20 per share in August 2012.

The shares did not recover to trade above the IPO price for over a year after the IPO.

IPOs Are Not Always a Success

While an IPO can be financially advantageous for business owners, success is certainly not guaranteed and there are several drawbacks. First, you may not be able to get your money out as fast as you would like. Investors may insist that all the money raised by the IPO be reinvested in the business. And a portion of your shares could be held in ​[escrow](http://www.investopedia.com/terms/e/escrow.asp)for years.

Second, your ownership position may be seriously whittled down and you may lose control of the company. To avoid this, owners who wish to retain control of a company after an IPO can do so by issuing [separate classes of shares](https://www.thebalance.com/examples-of-dual-class-structures-358090) that carry different multiples of the voting weight.

In the Facebook example above Mark Zuckerberg owned only 18 percent of the company after the IPO.

 However, the public IPO issued [(Class A) shares](https://www.thebalancesmb.com/how-do-i-set-up-share-classes-for-my-new-corporation-2948232) had 1/10th of the voting weight of the original private (Class B) shares. His quantity of Class B shares amounted to 57 percent of the voting shares and left him in control of the company after the IPO.

From an investor perspective IPOs can be a risky investment. Without historical information, it can be difficult to properly assess the share value of a company, and IPOs tend to be issued when market conditions are favorable. IPOs such as Webvan and pets.com that were launched during the dot-com bubble turned into spectacular failures when the bubble burst and both companies eventually went bankrupt.

**2. IPO Basics Tutorial**

The term [initial public offering (IPO)](https://www.investopedia.com/terms/i/ipo.asp) has been a buzzword on Wall Street and among investors for decades, and especially since the tech boom of the 1990’s. Back then, it seemed you couldn't go a day without hearing about a dozen new dotcom millionaires in Silicon Valley who were cashing in on their latest IPO.

After the [Great Recession](https://www.investopedia.com/terms/g/great-recession.asp) following the 2008 [financial crisis](https://www.investopedia.com/terms/f/financial-crisis.asp), IPOs ground to a halt, and for some years afterwards, new listings were rare. But since 2011 the number of IPOs has been steadily rising along with economic optimism. Lately, the IPO buzz has been around the so-called [unicorns](https://www.investopedia.com/terms/u/unicorn.asp), startup companies that have reached private valuations of more than $1 billion, like [Uber](https://www.investopedia.com/articles/small-business/122016/uber-technologies-inc.asp)and [AirBnB](https://www.investopedia.com/articles/small-business/010917/airbnb.asp). Will these companies go public via an IPO or stay private? Will the market value these companies as highly as anticipated? Will these startup founders get fantastically rich overnight?

IPO Basics: What Is an IPO?

An initial public offering, or [IPO](https://www.investopedia.com/terms/i/ipo.asp), is the very first sale of stock issued by a company to the public. Prior to an IPO the company is considered [private](https://www.investopedia.com/terms/p/privatecompany.asp), with a relatively small number of shareholders made up primarily of early investors (such as the founders, their families and friends) and professional investors (such as [venture capitalists](https://www.investopedia.com/terms/v/venturecapitalist.asp) or [angel investors](https://www.investopedia.com/terms/a/angelinvestor.asp)). The public, on the other hand, consists of everybody else – any individual or institutional investor who wasn’t involved in the early days of the company and who is interested in buying shares of the company. Until a company’s stock is offered for sale to the public, the public is unable to invest in it. You can potentially approach the owners of a private company about investing, but they're not obligated to sell you anything. Public companies, on the other hand, have sold at least a portion of their shares to the public to be traded on a stock exchange. This is why an IPO is also referred to as "going public."

 A privately held company has some benefits that are forfeited once it goes public. For example, its owners do not have to disclose much financial or accounting information about the company. In the United States, it is easy and relatively inexpensive to found a private company, and smallest to medium sized businesses are private. But large companies can be private too. For example, IKEA, Publix Supermarkets, Mars Candy, and Hallmark Cards are all privately held.

Public companies have thousands of shareholders and are subject to strict rules and regulations. They must form a [board of directors](https://www.investopedia.com/terms/b/boardofdirectors.asp) and they must report auditable financial and accounting information every quarter. In the United States, public companies report to the [Securities and Exchange Commission (SEC)](https://www.investopedia.com/terms/s/sec.asp). In other countries, public companies are overseen by governing bodies similar to the SEC. In addition, public companies must adhere to regulations and requirements set forth by the stock exchanges where their shares are listed. Being on a major stock exchange carries a considerable amount of prestige. Historically, only private companies with strong fundamentals and proven profitability potential could qualify for an IPO and it wasn't easy to get listed. Today, with competition among many stock exchanges, listing requirements have relaxed a bit.

**3. Why Have an IPO?**

Why go public, then? Going public raises, a great deal of money for the company in order for it to grow and expand. Private companies have many options to raise capital – such as borrowing, finding additional private investors, or by being acquired by another company. But, by far, the IPO option raises the largest sums of money for the company and its early investors. Some of the largest IPO’s to date are:

* Alibaba Group ([BABA](https://www.investopedia.com/markets/stocks/BABA)) in 2014 raising $25 billion
* American Insurance Group ([AIG](https://www.investopedia.com/markets/stocks/AIG)) in 2006 raising $20.5 billion
* VISA ([V](https://www.investopedia.com/markets/stocks/V)) in 2008 raising $19.7 billion
* General Motors ([GM](https://www.investopedia.com/markets/stocks/GM)) in 2010 raising $18.15 billion
* Facebook ([FB](https://www.investopedia.com/markets/stocks/FB)) in 2012 raising $16.01 billion

Being publicly traded also opens many financial doors: Because of the increased scrutiny from analysts and investors, public companies can usually enjoy better (i.e. lower) interest rates when they [issue debt](https://www.investopedia.com/terms/d/debt-issue.asp). Moreover, as long as there is market demand, a public company can issue more stock in a so-called [secondary offering](https://www.investopedia.com/terms/s/secondaryoffering.asp). Thus, [mergers and acquisitions](https://www.investopedia.com/terms/m/mergersandacquisitions.asp) are easier to arrange because stock can be issued as part of the deal.

For investors, trading in the open markets means [liquidity](https://www.investopedia.com/terms/l/liquidity.asp). If you are a shareholder of a private company, it is very difficult to sell your shares, and even more difficult to value your shares. A public company trades on a stock market, with ready buyers and sellers and known price and transaction data. The stock market is therefore referred to as the [secondary market](https://www.investopedia.com/terms/s/secondarymarket.asp), since investors are buying and selling stock from other public investors and not from the company itself. Public markets and liquidity also makes it possible for a company to implement benefits like [employee stock ownership plans (ESOPs)](https://www.investopedia.com/terms/e/esop.asp), which help to attract top talent.

Pros and Cons of an IPO

**Pros:**

* A large, diverse group of investors to raise capital
* Gives the company a lower [cost of capital](https://www.investopedia.com/terms/c/costofcapital.asp)
* Increase the company’s exposure, prestige, and public image, which can help the company’s sales and profits
* Public companies can attract and retain better management and skilled employees through liquid equity participation (e.g. ESOPs)
* Facilitating acquisitions (potentially in return for shares of stock)
* Raises the largest amount of money for the company compared to other options

**Cons:**

* Company becomes required to disclose financial, accounting, tax, and other business information
* Significant legal, accounting and marketing costs, many of which are ongoing
* Increased time, effort and attention required of management for reporting
* Risk that required funding will not be raised if the market does not accept the IPO price, sending the stock price lower right after the offering
* Public dissemination of information which may be useful to competitors, suppliers and customers
* Loss of control and stronger agency problems due to new shareholders, who obtain voting rights and can effectively control company decisions via the board of directors
* Increased risk of legal or regulatory issues, such as private securities class action lawsuits and shareholder actions

An IPO, to recap, is when the company sells stock to the public. If a firm can convince people to buy stock in the company, it can raise a lot of money. The IPO is seen as an [exit strategy](https://www.investopedia.com/terms/e/exitstrategy.asp) for the company founders and early investors to profit from their early risk taking in a new venture. Therefore, in an IPO many of the shares sold to the public were previously owned by those founders and investors.

The stock market is referred to as the “secondary market,” since traders buy and sell stock from other public investors, and not from the company itself. Only prior to the IPO does the company issue stock directly to shareholders. This means that when you buy shares of a company, you are *not* handing your investment money over to the corporation, but instead to whomever sold you their shares. When a company sells shares to the public, the company and its owners still typically retain a significant portion of the total stock, so some early investors and co-founders may still have a great deal of influence on the direction of the company despite there being a large number of new shareholders.

**4. IPO Basics: Getting In On An IPO**

When a company decides to raise money via an IPO it is only after careful consideration and analysis that this particular [exit strategy](https://www.investopedia.com/terms/e/exitstrategy.asp) will maximize the returns of early investors and raise the most capital for the business. Therefore, when the IPO decisions is reached, the prospects for future growth are likely to be high, and many public investors will line up to get their hands on some shares for the first time. Those who receive an IPO directly are able to purchase at the [IPO price](https://www.investopedia.com/terms/i/ipo.asp), which may be quite a bit below the market price when it eventually starts trading on an exchange. When more people demand shares of an IPO than the number of shares being offered, it is said to be [oversubscribed](https://www.investopedia.com/terms/o/oversubscribed.asp). Getting a piece of a hot IPO that is oversubscribed is very difficult, if not impossible. To understand why, we need to look at how an IPO comes to be, a process known as [underwriting](https://www.investopedia.com/terms/u/underwriting.asp).

When a company wants to go public, the first thing it does is hire an [investment bank](https://www.investopedia.com/terms/i/investmentbank.asp). A company cannot simply sell its shares on its own in an unregulated manner, and this is where [Wall Street](https://www.investopedia.com/terms/w/wallstreet.asp) comes in. Underwriting is the general process of preparing for and raising money via either debt or [equity](https://www.investopedia.com/terms/e/equity.asp). You can think of underwriters as [brokers](https://www.investopedia.com/terms/b/broker.asp) who stand between companies and the investing public, and who market and sell those initial shares. The biggest underwriters in 2016 were Goldman Sachs Group Inc. ([GS](https://www.investopedia.com/markets/stocks/gs/)), Credit Suisse Group ([CS](https://www.investopedia.com/markets/stocks/cs/)), Merrill Lynch ([BAC](https://www.investopedia.com/markets/stocks/bac/)) and Morgan Stanley ([MS](https://www.investopedia.com/markets/stocks/ms/)).

The company looking to go public will first need to meet some milestones before they can approach an investment bank. In particular: the company must develop an impressive management and professional team who will be able to steer the company once it’s public, grow the company's business with an eye to the public marketplace, obtain audited financial statements using IPO-accepted accounting principles, establish anti-takeover defenses such as [poison pills](https://www.investopedia.com/terms/p/poisonpill.asp), develop good corporate governance including an independent [board of directors](https://www.investopedia.com/terms/b/boardofdirectors.asp) and qualified officers, and time the IPO decision to take advantage of favorable IPO windows while avoiding going public during an economic downturn.

Once these criteria have been met, the company will meet with potential investment banks to discuss the amount of money a company will raise, the type of securities to be issued, and all the other details in the underwriting agreement. The deal can be structured in a variety of ways. For example, in a [firm commitment](https://www.investopedia.com/terms/f/firmcommitment.asp), the underwriter guarantees that a certain amount of money will be raised by buying the entire offer itself and then reselling shares to the public. In a [best efforts agreement](https://www.investopedia.com/terms/b/bestefforts.asp), however, the underwriter sells securities for the company but does *not* guarantee the amount raised. Investment banks are often hesitant to shoulder all the risk of an offering, so the lead investment bank can form a [syndicate of underwriters](https://www.investopedia.com/terms/u/underwriter-syndicate.asp) by soliciting other banks who each sell a part of the issue.

After all sides agree to a deal, the lead investment bank puts together a registration statement to be filed with the [SEC](https://www.investopedia.com/terms/s/sec.asp). This document contains information about the offering as well as company data such as financial statements, management background, any legal problems, where the money is to be used and insider holdings – and also the proposed [ticker symbol](https://www.investopedia.com/terms/t/tickersymbol.asp) that the company will trade under once it’s been listed on a stock exchange. The SEC then requires a [cooling off period](https://www.investopedia.com/terms/c/coolingoffrule.asp), in which they carry out due diligence and make sure all material information has been disclosed. Once the SEC approves the offering, a date (the “effective date”) is set when the stock will be offered to the public.

During the cooling off period the underwriter puts together what is known as the [red herring](https://www.investopedia.com/terms/r/redherring.asp) document. This is an initial prospectus containing all the information about the company except for the offer price and the effective date, which aren't yet known at that time. With the red herring in hand, the underwriters and the company market the company’s shares to public investors – building hype and interest for the issue. Underwriters often go on a [road show](https://www.investopedia.com/terms/r/roadshow.asp), also known as the [dog and pony show](https://www.investopedia.com/terms/d/dogandpony.asp), where big institutional investors are courted and early demand for the shares is evaluated.

As the effective date approaches, the underwriter and company sit down and decide on the [offering price](https://www.investopedia.com/terms/o/offeringprice.asp) – the price at which the company will sell its shares. This is the price at which the company will raise capital for itself, since after that initial sale, its stock will trade on the [secondary market](https://www.investopedia.com/terms/s/secondarymarket.asp) and the proceeds of share sales will go directly to whoever owned those shares and not to the company. The offering price depends on the company’s ambitions, the success of the road shows and, most importantly, current market conditions.

As you can see, the road to an IPO is a long and complicated one. You may have noticed that individual investors aren't involved until the very end. This is because small investors aren't the target market of the underwriters. Small investors simply don't have the amount of money needed by the company and therefore hold little interest for the syndicate. If underwriters think an IPO will be successful, they'll usually pad the pockets of their favorite institutional client with shares at the IPO price. The only way for an individual investor typically to get shares (known as an IPO allocation) is to have an account with one of the investment banks that is part of the underwriting syndicate, or with a broker who has itself received an allocation and wishes to share it with their clients. But don't expect to open an account with $1,000 and be showered with an allocation. You often need to be a frequently trading client with a large account to get in on a hot IPO. There are exceptions to every rule and it would be incorrect for us to say that it's impossible for individual investors to get access to an oversubscribed IPO. Just keep in mind that the probability isn't high.

**5. IPO Basics: Don't Just Jump In**

Once a company has completed its [IPO](https://www.investopedia.com/terms/i/ipo.asp), its shares are tradable on public stock exchanges. Newly listed shares have their own set of risks and opportunities that must be considered before buying stock in a company that has recently gone public.

It's hard enough to analyze the [fundamentals](https://www.investopedia.com/terms/f/fundamentals.asp) and [technicals](https://www.investopedia.com/terms/t/technicalindicator.asp)​ of an established company. An company about to IPO is even trickier to analyze since there is virtually no historical information to draw on. Your main source of data is the [red herring](https://www.investopedia.com/terms/r/redherring.asp) prospectus, so make sure you examine this document carefully. Look for the usual information, but also pay special attention to the management team and how they plan to use the funds generated from the IPO. Often, investors will look to the performance of similar companies who are already public for comparison purposes, but many times an IPO involves a company that has no good points of reference. Also, pay attention to the quality of the underwriters and the specifics of the deal. Successful IPOs are typically supported by bigger brokerages that have the ability to promote a new issue well. Be warier of smaller investment banks because they may be willing to underwrite any company.

If you look at the charts following many IPOs, you'll notice that after a few months the stock takes a steep downturn. This is often because of the expiration of the [lock-up period](https://www.investopedia.com/terms/l/lockup-period.asp). When a company goes public, the underwriters make company insiders such as officials and employees sign a [lock-up agreement](https://www.investopedia.com/terms/l/lockup.asp). Lock-up agreements are legally binding contracts between the underwriters and insiders of the company, prohibiting them from selling any shares of stock for a specified period of time. The period can range anywhere from three to 24 months. Ninety days is the minimum period stated under [Rule 144](https://www.investopedia.com/terms/r/rule144.asp) (SEC law) but the lock-up specified by the underwriters can last much longer. The problem is, when lockups expire, all the insiders are permitted to sell their stock. The result is a rush of people trying to sell their stock to realize their profit. This excess supply can put severe downward pressure on the stock price.

[Flipping](https://www.investopedia.com/terms/f/flipping.asp) is the practice of reselling a hot IPO stock in the first few days to earn a quick profit. This isn't easy to do, and you'll be strongly discouraged by your brokerage. The reason behind this is that companies want long-term investors who hold their stock, not speculative traders. There are no laws that prevent flipping, but your broker may blacklist you from future offerings or just smile less when you shake hands. Of course, institutional investors flip stocks all the time and as part of their everyday business. This double standard exists, so it is useful to be aware of it. Because of flipping, it's a good rule not to buy shares of an IPO if you don't get in on the initial offering. Many IPOs that have big gains on the first day tend to come back to earth as the institutional investors take their profits.

It's important to understand that underwriters and investment banks are *salesmen*. The banks underwriting an IPO want to sell their shares, so they want as much attention on and demand for those shares as possible. Since IPO’s only happen once for each company, they are often presented as "once in a lifetime" opportunities. Of course, some IPO’s soar high and keep soaring, but many end up selling below their offering prices within the year. Don't buy a stock only because it's an IPO, do it because it's a good investment and because you believe in the company’s future.

While a company can only IPO once, it can issue more stock at a later date through a [secondary offering](https://www.investopedia.com/terms/s/secondaryoffering.asp), which also uses the services of investment banks. Unless the demand for a company’s shares are quite high, a secondary offering may cause the price of shares to drop sharply as new supply is added to the market. It also may indicate that the company is on shaky financial ground and needs to raise more capital, but that they are unable to issue debt at a suitable cost.

**6. IPO Basics: Tracking Stocks**

Closely related to a traditional [IPO](https://www.investopedia.com/terms/i/ipo.asp) is when an existing company spins off a part of the business as its own standalone entity, creating [tracking stocks](https://www.investopedia.com/terms/t/trackingstocks.asp). The rationale behind [spin-offs](https://www.investopedia.com/terms/s/spinoff.asp) and the creation of tracking stocks is that in some cases individual divisions of a company can be worth more separately than as part of the company as a whole. For example, if a division has high growth potential but large current losses within an otherwise slowly growing company, it may be worthwhile to carve it out and keep the parent company on as a large shareholder, and let it raise additional capital from the public. For example, during the [dotcom bubble](https://www.investopedia.com/terms/d/dotcom-bubble.asp), many established companies that created internet subsidiaries spun them off, such as Walt Disney Corp. ([DIS](https://www.investopedia.com/markets/stocks/dis/)) which issued a tracking stock for its internet property Go.com. Telecom companies AT&T ([T](https://www.investopedia.com/markets/stocks/t/)) and Sprint also once created tracking stocks for their wireless divisions. These tracking stocks no longer exist, since they’ve either been acquired by other companies, or have gone out of business.

From the parent company's perspective, there are many advantages to issuing a tracking stock. The company gets to retain control over the subsidiary but all revenues and expenses of the division are separated from the parent company's financial statements and attributed to the tracking stock. Importantly, if the tracking stock rockets up, the parent company can make acquisitions with the subsidiary's stock instead of cash.

While a tracking stock may be spun off in an IPO, the mechanics are not the same as the IPO of a private company going public. This is because tracking stocks usually have no voting rights, and often there is no separate board of directors looking after the rights of the tracking stock. This doesn't mean that a tracking stock can't be a good investment. Just keep in mind that a tracking stock isn't a normal IPO.

**7. IPO Basics: Conclusion**

Let's review the basics of an IPO from this tutorial:

* An [initial public offering (IPO)](https://www.investopedia.com/terms/i/ipo.asp) is the first sale of stock issued by a company to the public.
* Broadly speaking, companies are either [private](https://www.investopedia.com/terms/p/privatecompany.asp) or public. Going public means a company is switching from private ownership to public ownership, where public shareholders get the right to vote in company decisions.
* Private companies typically have a small number of closely knit shareholders.
* Public companies can have thousands of different shareholders.
* Going public raises cash and provides many benefits for a company.
* Getting in on a [hot IPO](https://www.investopedia.com/terms/h/hotipo.asp) is very difficult, if not impossible.
* The process of [underwriting](https://www.investopedia.com/terms/u/underwriting.asp) involves raising money from investors by issuing new securities to institutional investors.
* Companies hire a [syndicate of investment banks](https://www.investopedia.com/terms/u/underwriter-syndicate.asp) to underwrite an IPO.
* The road to an IPO consists mainly of putting together the formal documents for the [Securities and Exchange Commission (SEC)](https://www.investopedia.com/terms/s/sec.asp) and selling the issue to institutional clients.
* The only way for you to get shares in an IPO is to have a frequently traded account with one of the investment banks in the underwriting syndicate.
* An IPO company is difficult to analyze in the market because there isn't a lot of historical info.
* [Lock-up periods](https://www.investopedia.com/terms/l/lockup-period.asp) prevent insiders from selling their shares for a certain period of time. The end of the lockup period can put strong downward pressure on a stock.
* [Flipping](https://www.investopedia.com/terms/f/flipping.asp) may get you blacklisted from future offerings.
* [Road shows](https://www.investopedia.com/terms/r/roadshow.asp) and [red herrings](https://www.investopedia.com/terms/r/redherring.asp) are marketing events meant to get as much attention as possible. Don't get sucked in by the hype.
* A [tracking stock](https://www.investopedia.com/terms/t/trackingstocks.asp) is created when a company spins off one of its divisions into a separate entity through an IPO.
* Don't consider tracking stocks to be the same as a normal IPO, as you are essentially a second-class shareholder.

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**Theme of lecture № 11. The exit options. Investment investigation.  
Plan of lecture:**

1. **Basic concepts of venture business**
2. **Subjects**
3. **Venture financing**
4. **The stages of development of the venture capital firm**
5. **Exit Strategies**

**1. Basic concepts of venture business**

In recent decades, as the size of the Bank loan rate declines in most countries of the world, and speculative profits in the financial and banking sector become less guaranteed and profitable, many financial institutions and private owners of capital are forced to face direct investments in the real sector of the economy, including this form of investment, when a certain amount of invested funds is exchanged for a certain share of the new enterprise.

Until the mid XX century from all types of business that can bring unlimited profit, was known only to the oil trade, arms and drugs, as well as the maintenance of gambling houses. As a rule, these types of business are illegal, associated with criminal groups and are inhumane. However, in the second half of the XX century has been clearly demonstrated the possibility of this type of business, which, not conceding to the above in terms of profitability and risk, aimed at creation and maintenance of scientific and technical progress. This is the so-called venture business (venture-risky), which in the most general case is to allocate direct investment to small and medium-sized firms that develop and produce mainly high-tech products and services.

The essence of venture business in accordance with the meaning of the word "venture» the fact is that a certain amount of money is invested in a new, yet unknown and unproven enterprise, which, of course, is a very risky step. At the same time for financing of new firm the capital not from the state budget, but from private sources, that is being entrepreneurial is attracted (it is provided by businessmen and they manage it).

The main objective of venture financing is to ensure that the financial capital of some entrepreneurs and the intellectual capabilities of others (original ideas or technologies) are combined in the real sector of the economy in order to bring profit to those and other entrepreneurs in the new firm.

It should be noted that until now because of the versatility and complexity of the concept of "venture business" does not exist generally accepted international interpretation of this term. Below are the most common terms related to this type of business.

Venture business is a risky business, carried out on the principles of venture financing mainly in high — tech fields of production; interaction of two entrepreneurs-one with capital, and the other with the idea and energy for the implementation of a certain scientific and technical ideas and profit.

Venture financing-risky long-term (5-7 years) investments of private capital in the share capital of newly created small high-tech promising enterprises (or already well-established venture enterprises) focused on the development and production of high-tech products for their development and expansion in order to profit from the increase in value of invested funds.

Venture capital is risk capital, used to carry direct private investment, which is usually provided by external investors to Finance new, growing firms operating in high-tech industries; equity, which is not listed on the stock market at all stages of the formation of the firm. Venture capital investments are a tool for obtaining a share in the firm's ownership; they have returns above the average, but they are also made in a context of risk-creating uncertainty.

In that way, the ideology of venture business-risk in exchange for super-profit. Usually, money is invested in a fairly large number of projects, one part of which (investors know this in advance) will result in direct losses, the other part will allow to reach a payback, and only a relatively small number of projects will bring huge profits. It is obvious that the super-profit is possible to get only by being the owner of the share capital, not the creditor. Therefore, the usual form of venture capital participation in a new business — the acquisition of a block of shares (then in the course of events is not excluded and lending).

**2. Subjects**

To the subjects of business venture concern:

- subjects of the most venture capital activity (the main subjects of finance

venture activities);

- entities that do not participate in venture capital activities, but are subjects of financial relations of venture activity (non-main finance subjects of venture activity)   
  
The main subjects of venture business:

– venture capital firm,

– individual investor,

– financial intermediary.

Venture capital firms (venture capital) — risk firms, products, activities which are risk-related innovations in the scientific and technological sphere-new types of high — tech products or services; usually venture are the initial stage of product development, engaged in the selection and development of scientific or technological ideas, its testing, the creation of samples and models for their subsequent transfer to the stage of industrial production.

Venture capital firms are divided into two types:

- established by the initiators of the venture project (scientists, designers, inventors);– established by a large industrial company.

The venture capital firms of the first type (established by the initiators of the venture project) can be of two kinds:

- independent, organized on their own financial and production public base (conducted by independent financial and scientific-technical policy; after the implementation of their shares, their independence is limited by the size of the stake);

- functioning within the framework of the in-house venture business. This kind of firms are established by the staff of the parent company, which provides financial and industrial support. They do not have independence in financial, industrial and scientific-technical policy. With the successful implementation of the project, they can become structural units of the parent company, or withdraw from its custody and become independent firms. In case of failure, the parent company may refuse to provide continued support, including from the provision of former or similar jobs to their staff.

Venture capital firms of the second type (founded by a large industrial company) can also be of two types:

- functioning as a structural subdivision of the company. They do not have financial independence, they are completely dependent on the financial, industrial, scientific and technical policy of the company. Such firms are usually created by large companies for R&D, refining and mastering of inventions created in the parent company, after which mass production of a new product is established on its basis. As a result, the existence of such firms (they are usually called incubator) is episodic;

- firms established by a large company as a separate entity firms engaged in independent financial, industrial and scientific-technical policy. They develop both new ideas of the parent company, and the ideas received from the outside.

Both types of venture capital firms operate within the framework of intra-firm venture business, which organizationally is a specialized corporate division, which has its own budget and is engaged in intra-firm risk financing.

Venture capital funds, as well as venture capital firms, have the status oflimited liability partnerships. Venture capital firm, acting as the main partner, is fully responsible for the management of the Fund, that is, it plays the role of the management company, contributing to the Fund no more than 1% of the funds. At the same time, investors become partners with limited liability and contribute 99% of the funds to the Fund without the right to dispose of the Fund. To delegate the management of the Finance and projects team in the person of the General partner, the investors receive 80 % of the profits.

Participation of investors in venture capital activities within the framework of the Fund gives them the following advantages:

– they do not need large amounts of financial resources to invest in the venture capital project and special skills in the management of the venture;

– they get access to valuable information about projects that are not accepted for financing, which can be used by them independently.

Not the main subjects of venture business are the following:

various enterprises and organizations providing services to participants of venture activity, performing works for them;

- banks (non-investors) in which accounts of participants of venture activity are open;

- the state regulating all types of entrepreneurial activity, including venture capital activity;

- individuals (citizens) hired by participants of venture capital activities.

**3. Venture financing**

**Venture capital and its sources.**

Venture capital has a number of features:

- represents financial resources managed by professional financial managers;

– it is used always strictly on purpose and, as a rule, it is not directed on financing of the zero stage of formation of the enterprise (formation of the prelaunch capital);

- in the form of a joint-stock company operates like its own funds, it does not need to pay interest;

- it is 100 % of borrowed funds (own funds used at the stages of formation of pre-start and start-up capital, as well as at the stage of buyback of shares in the stock market, are not the owners of the company venture capital.)

The moment of origin of venture capital is the transfer by investors of funds to the account of the financial intermediary or the company itself (with direct financing). Venture capital ceases to exist after the sale of the company's shares on the stock market by shareholders (investors).

Venture capital has a broad base of sources. All sources of venture capital are conditionally divided into two sectors: formal and informal. Sources of venture capital in the formal sector are:

- venture capital firms;

- venture capital funds;

- specialized funds to support small firms working in the field of science and technology;

– investment company;

- institutional financial investors (pension funds and insurance companies)

– nonfinancial company;

- industrial and financial groups;

- national and commercial banks.

The informal sector is represented by sources of venture capital such as:

- entrepreneur's personal savings;

- personal funds of relatives, friends and acquaintances;

- private funds given in debt;

– grants;

- endowment funds;

- donations of patrons;

- sponsors ' funds;

- funds of specialized funds to support science and innovation,

development of technologies, etc.;

Sources of funding differ among countries due to the nature of the financial industry of each state. In the EU, more than 50% of investments in venture capital funds come from banks and pension funds, insurance companies, industrial and financial corporations. With regard to Russia, it should be noted that under Russian law, pension funds are legally allowed to invest only in real estate, bank deposits, shares of the quoted enterprises, government securities. Among this list there are no venture funds. Today, the most developed private equity and venture capital industries are the USA, EU countries, Taiwan, China and Israel. In Western Europe, there are about 500 private equity and venture capital funds with an annual investment of 14.5 billion euros. As a rule, these institutions make investments in venture capital companies, which are in the middle and late stages of development, when the risks are minimal.

The most risky investors are business angels. They carry out investments at the early stages of venture companies ' development. They are often referred to as the most informed sector of the investment market. Most of them are independent individuals, often wealthy entrepreneurs who are constantly looking for new opportunities for interesting, high-yield investments. The main activity of business angels is concentrated at the initial stages of the company's life — product/technology development and launch to the market. As a rule, the threshold of marginal investments of such investor varies in the range from 100 thousand to 1 million dollars. USA.

The goals of venture financing are:

- for investors - achieving multiple capital gains by financing of new directions of development of production of goods and services, purchase of bankrupt enterprises, their withdrawal from the crisis and bringing to the level of highly profitable enterprises;

– for large companies — the mastery of a monopoly in the production of any products; ensuring survival in competition.

It is common to distinguish two types of venture financing: domestic and external. Internal financing is carried out at the early stages of venture firm development. In particular, the initial capital is created mainly from the personal savings of the founders. Subsequently, internal funding is provided at the expense of profits, selling assets, reducing working capital, of the commodity (commercial) loan receivables. Borrowed funds can also be used at this stage.With the development of domestic sources of financing is not enough and there is a need for external sources. External financing is divided into grant, debt and equity financing. Non-reimbursable financing is used by large companies for financial support for subsidiaries of venture capital firms established as structural divisions of companies or as independent firms engaged in research and development work. Grant funding for the project may also be provided by the state if it is of significant interest to the state. Other investors (banks, insurance companies, pension funds, etc.) participate in equity or debt financing. Debt financing is provided on the basis of venture lending and loans.Venture lending is a special form of venture financing in which venture capital is provided on the terms of repayment, urgency and payment on the basis of a loan agreement. The loans are also repayable, term, and pay financing. They are carried out by issuing securities (bonds). Equity (stock) financing is by issuing stock (common or preferred). It gives the investor the title of ownership in the enterprise, the right to participate in the distribution of profits of the project, in the disposal of its assets in proportion to the invested funds. With equity financing, investors do not expect a refund: they expect to receive their profits at the end of the venture process after the sale of shares in the securities market. For the project, equity (equity) financing makes it possible to plan the use of funds for the long term, without distracting a significant part of them for excessive risk insurance.

**4. The stages of development of the venture capital firm**

Considering that activity of new small hi-tech firm it is closely related to the acquisition of venture capital, for ease of perception of complex dynamics of the venture company usually distinguish three main successive stages: pre-investment, investment and post-investment, each of which has its own structure, essential features and characteristic content.

**Pre-investment phase**:

- formation of the project idea;

- search for funds and make a proposal;

- search for potential investors;

- preparation of the initial business plan;

- preliminary negotiations with potential investors;

- preparation of the final version of the business plan;

- preparation of the contract - agreement on the amount of investment, financing conditions of the project, options for withdrawal from the investment and profit distribution.

**Investment phase**:

- receiving the first tranche of the investment;

- initial stages of the company's organization;

- production of a prototype or a working model;

– carrying out marketing;

- release of the first trial batch of products;

- increase production and gain a certain segment of the market;

- advertising products to attract customers and increase demand;

- search for funds to exit the investment;

- preparing to exit the investment;

- joint choice of the most profitable exit option by the investor and the management;

- implementation of the chosen way out of the investment;

- receipt by the investor of the funds and profit invested in the company, and by management — opportunities to carry out further development of the company or its modernization.

**The post-investment** stage is characterized by the termination of the previous business cooperation and interaction between the entrepreneur, the management of the company and the initial investors and develops for the subjects of venture business in different ways:

-for the entrepreneur and management of the venture company:

- independent development of the company or its certain restructuring as part

of a larger company in the event of a merger;

- creation of a new company with partial profile change;

- preparation for the start of the formation of a new company in the related field of business;

- for the former investor:

- direction of profit and part of the returned venture capital invested in venture capital to venture capital funds;

– participation in the syndication of investments to Finance larger projects;

- independent investment in new firms.

Venture investors-businessmen believe that the investment can be considered successful if the rate of return for the entire period exceeds the average rate of return on the relevant industry and the average Bank interest on capital.

Buyback of innovative high-tech enterprise assumes, firstly, the purchase of the company by its management, and secondly, the purchase by managers of another company, the initial owner, the company itself, a strategic investor, as well as access to the open market.

So, in order to quickly return the invested funds to the venture capitalist, the owners of the company have to sell it or go out with the shares of the enterprise to the stock exchange. Otherwise, if they are unwilling or unable to do so, there is only one way out — to find and interest in a serious investment institution capable of refinancing or buying a share of a venture capital investor who is looking for a way out of the investment. This will allow entrepreneurs who are interested in venture capital for a long time to continue managing the company in accordance with the previously developed development strategy without entering the stock exchange or selling to a new owner.

Additional investments are required to implement any option out of the investment. Since at this stage the company's assets are already quite large, and the investment risk is minimal, there are a lot of those who want to buy the company or buy its shares.

The venture capitalist is less interested in a particular exit option — more important for him is the amount of profit, which is the main ultimate goal of the investor. Therefore, out of all possible options for exit from the investment, the venture capitalist will prefer the method that will provide him with the maximum profit.

**5. Exit Strategies**

There are two major paths to a successful exit of the firm. One is to sell the firm. This might be to another business (trade sale), usually a corporation in a similar or related field or to another Angel or VC Fund (secondary buy out), or to a wealthy individual. The second path is to list the firm on the stock exchange, an initial public offering (IPO).

**Initial Public Offering**

The requirements for listing a firm are quite onerous and expensive. Unless the listing results in a share price which can maintain a position at least as good as the sector index, the listing will not achieve an exit the shareholders anticipated (assuming the shareholders hold shares in the listed company). Just having liquidity of the shares via a market listing does not in itself guarantee the value achieved by the shareholders will be greater than an outright sale to a corporation.

Some private companies undertake an IPO, or a back-door listing (acquire an existing but dormant publicly listed corporation), with the intention of using it to raise funds or to sell shares. Typically, back-door listings are done with smaller companies. However, unless the size of the shareholding in public hands is significant, generally thought to be above $100 million, there is insufficient liquidity to create a market to sell shares.

Since few companies in private ownership can meet these requirements, an exit strategy aimed at an IPO is not a viable option for most privately held firms. That is not to say the smaller companies cannot exit through an IPO, but the above provides the best foundations for success.

Generally it will take a minimum of $500,000 in legal and accounting expenses for even the smallest and simplest IPO. According to KPMG Corporate Finance’s 2004 Australian Capital Markets survey, the average cost of raisings up to $10 million was 10.1%, falling to 4.7% for raisings greater than $500 million. If only a small amount is to be raised, this cost is very high for the funds received. At the same time, an IPO usually involves significant work for the top executives.

This has often been thought to be 50% of the CEO and CFO’s time over the six months prior to the IPO. This is a very significant burden on the firm and requires the rest of the management team to bear the burden of day-to-day management during this time. A USA listing would be more expensive in annual expenses due to the greater disclosure requirements.

The overall consensus of private equity advisors is that only four factors are considered key to a successful IPO. The first factor is the venture should have a strong competitive advantage and sufficient growth potential to achieve a $100 million capitalisation value within about five years of listing. Neither the current level of revenue or profit is considered significant compared to anticipated revenue and profit. This factor also goes a long way to explaining why low growth firms which have low margins either don’t make it to the exchange or have to be significantly larger before they can.

The next major factor is the depth and experience of the management team and the industry experience of the Board of Directors. Again this is not surprising when you consider that the shareholders are backing a group of individuals to take them to the size necessary to support the $100 million capitalisation. A new management team or one which has significant technical depth but little management depth is not going to be received well.

Knowledge of the IPO process itself by the management team is a major factor. This demonstrates just how important the roadshow to the brokers and the presentations to institutional investors are. Achieving significant share purchase commitments up-front is almost a necessary condition for a float.

Knowledge of retail and institutional investor risk and return requirements and being able to convincingly show growth potential is an imperative. Investors are typically risk-averse and will quickly zero in on potential risks in the venture.

The management team must be able to convincingly demonstrate knowledge of their business, their industry and how to mitigate possible risks.

Finally the firm must have the best possible advisors. The best advisors and investment bankers are expected to have the best due diligence processes, require the highest standards of preparation but also carry the highest level of credibility to the market. They are also very selective in who they represent.

Too many entrepreneurs see an IPO as a means of solving their own business problems rather than seeing it as a means where retail and institutional investors achieve a return on their investment. Without gaining the support of a significant number of retail investors and/or support from some institutional investors, the firm is likely to push themselves onto the market by satisfying the minimum listing conditions and then find that just being publicly listed does not solve their inherent problems. As we have seen many times – the market penalises those which don’t perform. In many cases, these firms would have been better to wait until they had more robust growth potential before listing.

It may not be possible for the major shareholders to exit at the time of the IPO or even within some years. Markets are very wary of public issues where the key managers sell off their shares completely. In a situation where the results are not achieved subsequent to a sale of shares, the inside shareholders could also face legal charges of insider trading.

A firm which wants to undertake an IPO exit needs to build the IPO profile above. So, to the extent that it cannot meet the requirements within the existing business, the additional attributes need to be developed or acquired. With 3-7 years to execute the IPO strategy and especially with Angel and VC financing, a firm may be able to achieve the necessary characteristics given the right starting point. Many companies which attract funding have already identified strategic acquisition opportunities to bring economies of scale and growth to the company.

In some sectors, building a company via acquisitions is a possible strategy.

Certainly in the years 2002 and 2003, firms in the biotechnology sector in Australia needed to undertake consolidation to gain additional resilience, product portfolio spread and critical mass. Too many biotechnology firms were undercapitalised, had very narrow product ranges and too little revenue spread from licensing to longer-term production products.

IPO strategy needs to show, in considerable detail, how the IPO prospect profile will be achieved. Underpinning the plan should be documented representations from respected accountants, lawyers, bankers and brokers who are willing to work with the firm on building the IPO strategy.

**Trade Sale**

Most Angels and VC Investors exit or harvest their investment through a sale to another firm. This is called a trade sale. Where possible, the Investor will seek a strategic trade sale to order to meet or exceed their return on investment (ROI) needs. A strategic sale occurs when the value placed on the business exceeds its fair market value (FMV). The FMV is most often determined by looking at the current business as an investment by an independent investor looking for a return on their money. The current profit is taken as indicative of the ongoing profitability of the firm and ROI. Since few owner/managers operate the business to maximise profits, this will normally undervalue the business.

A conventional sale based on an EBIT multiple would certainly be attractive to an Investor if a strategic sale was not possible. In that situation, attention needs to be given to increasing operating profit, decreasing risk and establishing a growth potential in order to secure the best price.

However, normally a strategic sale can be expected to achieve a sale priceconsiderably above a conventional sale price. The key to a strategic sale is to find a corporate buyer which has a need for the assets and/or capabilities of the firm. This strategic fit can come from any number of possible areas:

• customer base

• distribution channel

• brands

• patents, trademarks, licences

• key employees

• access to specialised knowledge and so on.

Strategic buyers most often come from within the industry in which the firm is operating. They can be suppliers, customers, alliance partners, joint venture partners or competitors. Sometimes the sale will be to a corporation not in the sector. They may want to acquire a presence in a market/geography as a foothold or may wish to diversify.

The Proactive Sale Strategy developed by the author defines a process which can be used for financial and strategic trade sales. This methodology has five major components:

• alignment of interests

• due diligence and good governance

• creating value for the buyer

• selecting buyers

• building relationships with potential buyers.

**(a) Alignment of interests**

In order to be prepared for a trade sale, especially when there is time pressure to set up and consummate a deal, the various stakeholders need toagree on the possible outcome. There is little point in progressing a deal if the Directors cannot agree on what they want, or the shareholders cannot agree on a reasonable price. A negotiator cannot go into a meeting to secure a deal if the interests of the major stakeholders are unclear. Experienced Investors usually have the Board focused on exit strategies from the first Board meeting.

The major stakeholders who are critical to executing a deal are:

• members of the Board of Directors

• management

• Investor along with other shareholders

• key employees.

The Investor needs to ensure that all stakeholders are focused in regard to the two extreme situations: a forced sale due to decline in the viability of the business or a planned sale over a longer term. Once the CEO has a list of requirements, opinions, conditions and issues which need to be considered, he/she can start to bring all elements together to arrive at a strategy which could be followed in these two extreme situations.

**(b) Due diligence and governance**

Nothing kills a deal quicker than an uncertain or immeasurable risk. Many people think the valuation on sale is due simply to revenue and profit. What happens in practice is the buyer conducts an extensive due diligence into every aspect of the firm’s operations in order to uncover actual or potential problems, risk and liabilities. Since each of these requires time and funds to resolve, the offered price is likely to fall as the review goes forward. At some point the risk,time and cost to fix the problems become so great that a deal is not possible.

The task of the Board from a directional perspective together with the CEO from an operational perspective is to establish the firm and its operations to minimise risks to the buyer. This includes putting into effect such things as:

• Standardised and documented contracts with customers and suppliers.

• Industry standard terms of employment, benefits and entitlements.

• Full ownership and tracking of intellectual property.

• Full compliance with industry, health, safety and environmental regulations.

• Comprehensive reporting, budgeting and planning systems.

• Policies, procedures and processes covering critical aspects of the operations.

• Industry knowledgeable accountants and lawyers.

The key to passing a business to a buyer is to put yourself in the buyer’s shoes and think through the integration and operations of the business afterthe acquisition. The task of the CEO and management team is to ensure that the business can operate effectively after the acquisition without imposing anundue burden on the buyer.

Included in the planning for a sale should be a consideration of the roles of the key employees. In most acquisitions some roles will change, some staff will be made redundant and some key employees are needed to ensure a transition of knowledge. How can you ensure that this process happens without disruption?

This means determining retention terms for some, redundancy packages for others and incentives for all staff to make the transition happen as smoothly as possible.

**(c) Creating value for the buyer**

In a financial exit, the firm needs to create value through the generation of future net earnings. Preparation for sale would focus on improving internal processes, reducing expenses, increasing revenue and margins, adding revenue growth and then seeking out opportunities for potential growth.

Strategic acquisitions occur because a corporation has a need for some asset or capability which the firm has. Generally this is something which the firm already leverages to create its own competitive position. As part of the Strategic Sale Strategy, the Entrepreneur needs to think carefully through the operations of the business and isolate those things it has and those things it does which could be used by a large corporation to resolve a threat or generate significant new revenue.

Assets or capabilities which create strategic value should be based on one, or several, of the following characteristics:

• difficult or time-consuming to copy

• protected by patents, trademarks or copyright

• only available through licensing or registration which is limited in supply

• unknown due to confidentiality or trade secrets

• requires specialist knowledge to acquire or utilise

**(d) Selecting buyers**

Financial buyers are often corporations undertaking a roll-up or consolidation strategy. They are looking for well managed firms in their sector which can add revenue and profit to group earnings.

A strategic buyer is a corporation which is prepared to pay a premium over fair market value because the business solves a critical problem for them or offers them a good opportunity for additional revenue and profit. The best strategic buyers are ones which can exploit an opportunity by offering a unique product on a much larger scale than the firm is able to with its limited resources. The Investor should look for corporations which can overcome whatever constraint is holding back the business.

Buyers normally come from within the industry, so start by listing companies in the same industry as the investee firm. You then need to select those companies which have the capacity and experience to do the deal. Corporations with experience at acquisitions and which have ample size and funding are much easier to deal with. The ideal buyer will typically be at least 8 times the size of the seller.

**(e) Building relationship with potential buyers**

Trade sales are mostly made between parties which already have some knowledge of each other. This could be informally through networking functions, between prior colleagues or could be a formal trading relationship such as a partner or distributor. Other relationships can exist through Boards of Directors or Boards of Advisors or equity participation. The key to a trade sale for an Angel or VC funded company, as with any other company, is to be prepared.

Any early stage venture is going to experience some turbulence and not everything will go according to plan. In terms of exit preparation think of the situations you may experience.

**1. You need to sell**

Not everything is going to go according to plan. Sometimes market conditions change and the business is no longer capable of reaching the targets initially set or may no longer be viable. Rather than let the firm become insolvent or bankrupt, the exit plan should be established early so that there is little delay in executing a trade sale. This way the maximum benefit can still be extracted from the failing business.

Often time is against you. If the management team has not put an exit strategy in place, they will have little time to prepare or to initiate discussions with potential buyers. If they have not set up the relationships in advance, especially with overseas buyers, it probably is not going to happen the way you would like. Without planning, the ability to attract a buyer who will pay a premium value for the company is significantly constrained.

By setting up relationships in advance and by knowing why the corporation would want to buy the firm and who to deal with inside the potential buyer, management can execute the acquisition discussion quickly. As long as the firm has several potential buyers, competitive tension in the deal can still result in a very attractive sale price.

**2. The firm is approached with an offer to buy**

Many Angel and VC funded firms are targets for acquisitive corporations. However, when the offer comes management may be unprepared. They are often unsure of an appropriate price. If management is unprepared and needs to go through extensive due diligence, this not only takes considerable time, but it uncovers risks to the buyer. Instead of closing a good deal the firm will end up with a disrupted business, staff who are stressed due to uncertainty and a price the shareholders would normally not have accepted. Management may also have talked themselves into the deal. Management will have taken their eyes off the ball and will have much to do to recover.

How much better would the situation be if the firm had already lined up several possible buyers? They can now announce that they are prepared to sell and take on all offers. Management will have prepared the due diligence files and can execute the deal quickly with little disruption. The staff understand the process and have incentives to ensure the best deal is done. The exit strategy should be canvassed with staff from an early stage so they understand the objectives of the Investor as a shareholder in the company.

**3. The Investor and management decide to sell**

Experienced Investors and good management should already know of the best potential buyers and through business operations should already be in a position to actually know those parties. If management have prepared the company for sale over many years, they are best placed to drive the exit process rather than have it drive them. The Investor and management simply need to decide on the timing.

It is a highly desirable characteristic of Angel or VC funding that the Investor exits the investment within a relatively short period. Few Investors like to have their funds tied up for more than five years in a venture. If the prospective investee firm articulates a viable and well-articulated strategy for a trade sale going into the funding negotiations, it will greatly improve their case and the Investor’s confidence for achieving the Investor’s exit objectives.

With the trade sale exit strategy outlined here, you can be reasonably assured that you will gain the best price you can and know the corporation doing the buying will make more money out of it in the future. If the Investor has a very good idea of the trade sale exit opportunity, he can spend the time assisting management to develop the business and build a strong case for the buyer. This focus makes it easier for the Investor and the entrepreneur to work together since they have clearly defined common objectives.

This process is well proven. If you think of the firms you have seen sold at large premiums, you will always find they created significant value for the buyer.

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