



Drilling for high-technology gushers

The Russian Venture Company, a fund of funds, begins operations

by Harry Kelly

The Russian economy has climbed from the depths of its 1998 crash on the back of its oil and gas industry. But what would happen to the economy if oil and gas prices retreat from the record levels of the past few years, or if production is unable to meet demand? The Russian government recognizes that Russia's hydrocarbons industry, however vibrant it may currently be, cannot by itself sustain future growth and foster economic stability.

President Vladimir Putin, recognizing that Russia's economy sorely needs to be diversified, has called on his government to develop paths to growth that do not rely on oil and gas. The government has responded with several initiatives that seek to leverage Russia's expansive science and engineering base, a hallmark of the Soviet era which remains vibrant in post-Soviet Russia. The most significant of these initiatives is the creation of a venture capital "fund of funds" which will administer a public-private partnership intended to accelerate the development of technology companies through the injection of several hundred million dollars of capital.

Macroeconomic indicators in Russia have never been stronger. GDP growth has averaged 6.4% over the past several years and is forecasted to maintain this pace during the next few years. The Ministry of Finance anticipates that in 2006 the federal budget will run a surplus for the fifth consecutive year. Russia's burgeoning economy has been noticed by foreign investors, who pushed foreign direct investment to \$26 billion in the first half of 2006, up from \$9 billion during the first half of the previous year.

No single factor has contributed more to Russia's improved financial statements than the insatiable demand for oil and gas, which has pumped cash into the economy and pushed foreign exchange reserves to almost \$275 billion. This cash surplus has enabled the government to make the ruble fully convertible, make an early repayment of all \$22 billion of its debt to Paris Club creditor nations, and feed its stabilization fund – designed to hedge the vagaries of the global energy market – so quickly that it is expected to reach \$80 billion by the end of the year. Oil and gas revenue also supports Russia's multi-billion ruble State Investment Fund, which the government created to finance public investment projects.

The contribution of Russia's hydrocarbons revenue to economic stabilization dwarfs contributions from Russia's technology companies. Somewhat surprisingly for the country with the world's third largest software developer population (lagging only China and India, but the trend suggests for not much longer), Russia's IT sector accounts for only 5% of national GDP. Technology leaders such as Intel, IBM and Microsoft have made substantial investments in Russia to gain access to a bevy of highly educated engineers and IT designers. Mr. Putin, however, recognizes that direct investment by foreign technology companies will not suffice to develop Russia's high-technology industry, and recognizes that diversifying the economy to generate significant revenue from sources other than natural resources requires government initiatives that stimulate technology development and also attract private capital, both from within Russia and from abroad.

During 2006, the government announced two public-private venture finance initiatives. The larger of the two initiatives, the Russian Venture Company (RVC), is a fund organized by the Ministry of Economic Development and Trade. The other initiative is a more limited fund organized by the Ministry of Information Technologies and Communications.

The private equity market in Russia is growing. According to the Russian Venture Capital Association:

- the total capitalization of all private equity and venture capital funds operating in Russia was \$5 billion in 2005, up from \$4 billion in 2004
- of the \$1 billion in capital raised in 2005 – an increase of 9% over 2004 – \$220 million came from Russian sources, representing a 250% increase over 2004
- among Russian sources, government agencies accounted for 45%, institutional investors 34%, corporate investors 13%, private individuals 7%, and commercial banks 1%
- seed and start-up (\$12.2 million) and early stage investments (\$16.5 million) into 14 companies totaled \$28.7 million in 2005, representing 12% of the total value of private equity investments made in 2005, down from \$36.8 million in 2004 (seed and start-up \$7.9 million, early-stage \$28.9 million), representing 16% of total value of private equity investments made in 2004

Venture activity in Russia grew during 2005, but in a global context the venture finance market in Russia remains quite small. The RVCA reports there were 14 seed and early-stage investments in 2005, but in any given year about 2,000 US companies and 1,200 European companies receive venture financing. And although most of the capital injected into private equity funds in 2005 originated abroad, Russia's increasing success in attracting foreign direct investment is not yet reflected in attracting venture investments. For example, in the first half of 2006 US venture capital firms made 150 investments outside the US. Of these, only one investment was made into Russia.

It is in this landscape that the Russian government has opened the RVC for business. It's a landscape waiting to be explored, with a dire shortage of start-up capital that hinders entrepreneurial wildcatting and thus no significant exits – no "gushers".

Structuring the RVC

The Russian Venture Company is a joint stock company, all of whose shares are, for now, wholly owned by the Russian government. The RVC's board of directors is comprised of three directors representing the government and two independent directors representing the venture industry. At least two state directors and one independent director must approve any decision to be taken by the board. The public-private character of the board reflects the involvement of the state, the private venture investors and the venture management firms that will direct the course of the fund.

The federal government has allocated 15 billion rubles (\$560 million) from the State Investment Fund to capitalize the RVC. With this money the RVC will make investments of between 600 million and 1.5 billion rubles in up to 10 "closed share investment funds" for a 49% stake in each fund (making the RVC a fund of funds). Although the state will be acquiring a substantial minority stake in each fund, its yield from the fund over its ten-year existence will be capped at approximately 3% of returns.

Private venture investors will invest between 600 million and 1.5 billion rubles for up to a 51% stake in each fund, but they will receive approximately 80% of the returns generated by the funds. These investors will also obtain the right to purchase shares in the RVC.

Each of the funds will be managed by a private venture firm. These firms will evaluate potential investments and invest money into seed, start-up and early-stage innovation companies. The funds have been directed to focus on hot topics in high technology, including security, IT, telecommunications, biotech and alternative energies. (Certain industries are specifically excluded, such as hydrocarbons, real estate and, perhaps unnecessarily, erotica.) In return for managing a fund, each venture firm will earn a 2% management fee and approximately 20% of the returns. Furthermore, the individuals directing the firms will participate in the fund with a 1% stake or more, diluting the private venture investors. Like the investors, each firm will obtain the right to purchase shares in the RVC, but for the firms this right vests only after five years of rendering services to the fund.

The management firms will be chosen through a series of competitive tenders scheduled to launch in January 2007. Firms will have an improved likelihood of competing successfully if they indicate they will invest in at least eight companies, in diverse industries, over the next five years with an exit horizon of ten years or fewer. Relying heavily on professional venture managers reflects a sensible acknowledgement by the government that private firms are better suited than bureaucrats to evaluate an early-stage company and determine whether it can generate returns for investors. Similarly, the overall RVC framework was designed to simultaneously keep the federal government involved at the highest level of governance (this is Russia, after all) but relegated to a passive role as an investor and manager.

Organized in this manner, and backed by real money, the RVC plan is an example of sensible government stimulus designed to fill a void in an economy that, while stabilizing, has so far been unable to develop an innovation industry or take the next step in venture finance. An important element of the RVC structure is its use of federal money to attract private equity money to the development of high technology in Russia. If the work of this federal initiative can be coordinated with the work of Ministry of IT and Communication's fund and a separate regional venture fund initiative to develop technology businesses in several Russian regions, venture investors will be increasingly able to deploy capital with reduced risk.

The government has already declared its intent to coordinate the work of the RVC and the venture funds with some of its other technology initiatives, including its program of creating special economic zones offering tax relief intended to spur technology investment and its master plan to develop a series of technoparks. Mr. Putin has criticized his government for the slow implementation of the latter initiative, which calls for the development of seven technoparks in locations ranging from St. Petersburg to Novosibirsk. The government can, at least, point to some success in executing the plan: the St. Petersburg technopark is scheduled to open in 2008, and the World Bank has extended a \$100 million line of credit to support the project. Furthermore, the government seems open to adopting laws that could benefit investors and their portfolio companies, even if neither is located in a special economic zone or a technopark. German Gref, the Minister of Economic Development and Trade, has said that creation of the RVC would require amendments to applicable tax law and has not ruled out granting tax preferences to early-stage businesses.

Refining technologies into businesses

If the government allows this public-private partnership to operate as designed, the likelihood that the Russia venture industry will receive the kick-start it desperately needs will be significantly improved. True success, however, whether measured by returns, jobs created or the quality of the technologies brought to market, will depend on how the state, the private venture investors and the venture management firms can answer the following questions.

- Who will create the companies? Venture capitalists from Palo Alto to Helsinki know that there is no necessary connection between technology expertise and business expertise. A surfeit of technologists is not the same as a surfeit of entrepreneurs who are willing and able to develop a start-up company that would attract attention from serious investors, and the public-private partnership embodied in the RVC structure won't by itself germinate seed companies.
- Who will manage the funds? It is not presently evident whether the venture management firms who will seek appointments through the competitive tenders have a sufficient number of venture-savvy managers, with experience in Russia and abroad, necessary to evaluate dozens, or hundreds, of new technologies and emerging businesses. The RVC must consider awarding management of some of the venture funds to non-Russian venture managers to ensure the chances of attracting good teams.
- Who will manage the companies? Successful start-ups (and thus, successful investments) are borne of competent managers much more than clever technology. Whether in the United States, Russia or any other country, the success of a technology company depends on able managers that understand the needs of both their technologists and their investors. Unlike a programming language which can be learned from studying its manual, the path to creating successful start-ups can only be discovered through experience.

To ask these questions is not to suggest they cannot be answered. Technology companies are being organized throughout Russia, more firms are gaining experience in Russian and global private equity, and over time more managers will be groomed who can navigate emerging companies through their early stages and take their companies' products to market. But the venture capital business is not so much studied as lived, and the RVC structure provides companies, firms and managers the opportunity to develop critical experience. Over time this experience could generate attractive returns for investors, and as Russians follow the example of other Russians starting technology companies that develop into successful businesses, venture capital will help the technology sector in Russia reach its potential.

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