An Insightful Perspective For Navigating Russia's VC Market

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Abstract:

This paper aims to offer readers ways of understanding and mitigating the risks posed by the current venture capital (VC) environment in Russia, whilst introducing readers to a historically lucrative asset class in a country renowned for its intellectual capital. Amidst often biased and disparate analysis within contemporary literature, we have examined the current research on Russian VC and conducted expert interviews to present a well-rounded, yet distinct perspective on operating in the industry today. We demonstrate that after weighing the primary Russia-specific risks (governmental, legal, operating) and unique selling propositions (technical talent, established scientific initiatives, a burgeoning adoptive middle class), there are two central operational strategies investors should deploy, particularly in the lower-risk technology sector: 1) concentrate on globally-oriented Russian companies utilizing local technical talent to deliver global products, or 2) concentrate on market-leading Russian companies focusing on a particular product or service for local consumption. Despite the added challenges, we believe that if approached properly, the Russian market has substantial opportunities in venture capital for the adaptive investor.

I. An Overview of the Russian VC Market

When conjuring up images of investing in Russia, the political uncertainties and complex business environment often discount the many benefits that emerge from a narrow analysis of specific sectors and risk-reducing strategies. This analysis aims to bring the reader's attention to ways of mitigating the risks posed by the current venture capital (VC) environment in Russia, thereby gaining exposure to a historically lucrative asset class in a country renowned for its intellectual capital.

Venture capital in Russia is a unique market that provides investors access to Russia's advanced engineering capabilities, bypassing the traditional complexities of Russia's public markets, which are largely illiquid and dominated by the natural resource industry.[1] Investment in the asset class grew 13 percent YoY in 2019 to reach $868.7m, reflecting the attractiveness of this space.[2] Although the number of deals decreased in 2019, down to 230 from 310 in 2018, the average investment and value per deal increased across the board.[3] Maturity stage deals increased 1.6x, to

[1] Maria Musatova, "Investing in Russia: Current Portfolio of Private Equity Funds and Impact of Global Financial Crisis," *The Journal of Private Equity* 12, no. 2 (2009): 78.
[2] "Dsight - Venture Russia 2019: Results" accessed May 30, 2020, https://www.dsight.ru/en.
[3] Ibid.

78m.[4] Seed stage tripled in average value per deal to $200k and startup stage deals expanded from $0.3m to $1.1m.[5] A stable number of 38 exits was also seen in 2019, up slightly from 37 in 2018.[6]

Investor types vary in Russia, but angel investors, state funds, and corporations are rapidly becoming more involved in Russian VC. In terms of the number of deals, the three largest types in 2019 were private funds, angel investors, and accelerators.[7] Although in terms of investment amount and value per deal, respectively, corporate funds ($192m | $8.4m), foreign investors ($218m | $14.6m), and private funds ($330m | $4.4m) greatly exceeded other segments.[8] Angel investors have however been growing rapidly in 2019, doubling both their segments' total investment amount ($42m) and average value per deal ($1.2m).[9]

Accelerators still play an important role in preparing Russian startups to gain traction in the local market. They offer a variety of services in Russia, but are known for targeted public relations and investor connections. Historically, they have been an important aspect in Russia VC, accounting for 30 percent of all deals in the Russian VC market, but 2019 marked a steady decrease in their activity.[10] The Internet Initiatives Development Fund (IIDF aka FRII) backed 29 projects, Starta Accelerator funded 11 accelerated startups, and Winno Moscow selected 8 startups to develop.[11]

Traditional accelerators are important in much of the world, but in Russia, large corporations take the lead through their permanent corporate accelerator programs. Some notable examples are Sberbank's SberUp supporting 500+ startups, Kaspersky Lab's iHub focused on cybersecurity, MTS's StartUp Hub, and Severstal's accelerator focused on metallurgy.[12] Sector-specific, multi-corporation acceleration programs have also developed in Russia, for example Build UP's focus on construction technologies. Finally, state-owned corporations are also becoming heavily involved in the acceleration/start-up partnership sphere with companies like Rosatom, Russian Railways, and VTB leading the way.[13] In terms of financing, many Russian startups have even begun to seek corporate funding, in contrast to sourcing capital from traditional venture-stage investors. While this trend has disrupted the central role of traditional accelerators, they are still important to the development of many Russian startups, especially in the way they assist with navigating diversification, business ecosystem development, and efficient spending management.

Finally, when looking at investment by sector, highlights of the Russian VC market center around technology, eCommerce, and transport and logistics, each of which make up 21 percent of 2019's total investment dollars.[14] Transport and logistics companies thrive on growing interest from large corporations, including Russian Railways, State Transport Leasing Co., PEC (cargo), and Delovye Linyi (Business Lines), while eCommerce, built on growing domestic consumption, has

4 Ibid.
5 Ibid.
6 Ibid.
7 ("Dsight - Business Intelligence for Investment Decisions" n.d.)
8 Ibid.
9 Ibid.
10 Ibid.
11 Ibid.
12 Ibid.
13 Ibid.
14 Ibid.

capitalized on a 3-year CAGR of 20 percent, growing the market to $26bn in 2018 (60% yoy).[15] Wildberries, Russia's largest eCommerce site, is a retailer that has made its founder Tatyana Bakalchuk Russia's second-ever female billionaire. While wild success has been concentrated among the top firms, there are many examples of small eCommerce firms gaining traction.

Most of the biggest U.S.-based VC investments in Russia came before the introduction of more potent Russia sanctions, following Russia's 2014 assertion of sovereignty over Crimea and its subsequent intervention in Syria. For example, Bessemer Venture Partners partnered with Skolkovo, in what Techcrunch called "Russia's Latest Answer to Silicon Valley," to gain access to a promising set of startup investments in exchange for public commitment to invest at least $20 million from 2012 through 2014. Accel Partners led a $20 million round for Russian online retailer KupiVIP in 2010, which was among the most popular foreign investments, along with carprice.ru, Avito, and ZenHotels. Avito also received investment, and next to Yandex and Mail.ru, it has been one of the most successful venture investments in Russia.[16]

The peak for U.S. investment was 2012, when U.S.-based VCs backed nearly 50 rounds for Russia-based startups, according to an analysis by Crunchbase.[17] Among the most prolific firms were Almaz Capital, which did well with its 2009 investment in Yandex, the Russian-language search engine that has since diversified into a powerful internet company. This level of deal making has fallen off significantly, even as Russian VCs have continued to plow money into U.S.-based startups and U.S. investors have continued to invest in Russian founders outside of Russia. While geopolitical risks especially have kept investors away from innovative startups in the extractive industries and other more contentious sectors, even technology investments have grown riskier with increasing threats to internet freedom.[18] Nevertheless, especially within the technology sphere, there are still some promising opportunities for foreign investors. Beyond eCommerce and transport and logistics, other popular investments in firms include: cybersecurity (17% of 2019 venture investment), business software (7%), education technology (6%), video-audio (5%), food technology (4%) and industrial technology (4%).[19]

Most VC investments have come in the technology field, and therefore in Moscow or St. Petersburg, but there are some attractive startup opportunities in other places: industrial innovators in Yekaterinburg or oilfield production pioneers in Tyumen.[20] Yet, for foreign investors, such opportunities pose significantly more risks, given the political and strategically sensitive nature of those industries. However, in the past couple of years, new startup categories attracting the most investment have shifted from eCommerce and fintech opportunities to startups in consumer technology and artificial intelligence.

[15] Ibid.
[16] Ibid.
[17] Ibid.
[18] Paul Tracey and Nelson Phillips, "Entrepreneurship in Emerging Markets: Strategies for New Venture Creation in Uncertain Institutional Contexts," *MIR: Management International Review* 51, no. 1 (2011): 26.
[19] ("Dsight - Business Intelligence for Investment Decisions" n.d.)
[20] Bat Batjargal, "Network Triads: Transitivity, Referral and Venture Capital Decisions in China and Russia," *Journal of International Business Studies* 38, no. 6 (2007): 1000.

II. A Perspective on Russian VC Risks

While we believe that heightened investment reflects the attractiveness of the Russian private sector, we highlight that state-backed funds (such as the Russian Direct Investment Fund) were responsible for 73 percent of private equity capital invested in the first half of 2019, which continues a years-long trend of state involvement in Russian business development.[21] The Russian private equity ecosystem was previously more diverse; the global buyout fund TPG Capital was formerly active in the region and Finland's CapMan raised two Russia-specific funds, in 2007 and 2013, but has completed only four deals since 2014.[22] Reflective of the retreat of foreign investors, the Russian Venture Capital Association last published an English-language year in review in 2016 (RVCA Yearbook).[23] As foreign investors have receded, Russian ones have stepped in to fill the void. We believe that sanctions only explain part of the reason for this precipitous decline in foreign investment in Russian private equity. While there are macroeconomic concerns dampening some forms of investment, we outline the following two major risks as obstacles for foreign involvement in Russian venture capital: governmental risks (including a lack of enforcement of property rights, limited shareholder rights, unfavorable corporate tax policies, and government interference in business) and operating risks (including limited managerial skills, absence of vetted financial statements, illiquid markets, and weak corporate governance).

Governmental risks in Russia are perhaps the most notorious obstacle, especially for Americans, marred by controversial instances of corporate raiding (whether on behalf of the government or an interested party) and imprisonment (such as with the 2019 arrest of Baring Vostok's Michael Calvey). Overall, investors see the Russian business environment as best defined by instability.[24] Unpredictable institutional, administrative, and legislative changes place significant demands on entrepreneurs, and while weak institutionalization is common in many emerging markets, Russia's historic reputation for corruption (ranking 80th of 180 countries on the Corruption Perceptions Index in 2019, the lowest of all BRICS countries) makes it the least desirable emerging market for investment, according to the Emerging Market Private Equity Association.[25]

The legal system in Russia is likely the biggest reason for hesitation among potential investors, according to the investors we interviewed. The lack of property right enforcement is particularly concerning for venture capital investors, especially as the telecommunications, manufactured goods, finance, and retail sectors, which rely on intellectual property, represent 75 percent of all private equity portfolio companies.[26] Furthermore, while firms may choose to be domiciled

[21] Alex Lynn, "Russian Private Equity Hangs in the Balance | Private Equity International," content, *Private Equity International* (blog), December 11, 2019, https://www.privateequityinternational.com/russian-private-equity-hangs-in-the-balance/.
[22] Ibid.
[23] Ibid.
[24] Darek Klonowski, "Private Equity in Emerging Markets: Stacking Up the BRICs," *The Journal of Private Equity* 14, no. 3 (2011): 30.
[25] Darek Klonowski and Daria Golebiowska-Tataj, "Using Performance-Based Share-Adjustment Mechanisms or 'Ratchets' in Economies in Transition: Evidence from Russia," *The Journal of Private Equity* 11, no. 4 (2008): 53; (Lynn 2019).
[26] Gugu Ndlwana and Ilsé Botha, "Determinants of Private Equity Investments across the BRICS Countries," *The Journal of Private Equity* 21, no. 4 (2018): 20, https://doi.org/10.2307/26497440; Musatova 2009.

offshore, shareholder agreements are not recognized under the Russian legal system as valid legal instruments, and reports of shareholder abuse are common.[27]

In terms of operating risks, bridging the gap between an investor's Western context and the reality of Russia may be challenging, given weak local management, absence of financial statements in accordance with international standards, scarce exit opportunities, and convoluted management relationships, among other cultural idiosyncrasies.[28] While still obstacles for investors, these issues should be considered less troublesome than government interference, as operating risks in this vein are common across many emerging markets, and investors can more accurately account for and hedge the threat of such operating risks in due diligence.[29] Governmental risks, on the other hand, are notable for their unpredictability.

Looking first at human capital, investors may be surprised by the traditional managerial culture in Russia, particularly given the country's heritage of exceptional technical talent.[30] Scholarship in the subject of Russian private equity investment emphasizes this shortcoming as particularly important for Western investors; however, we believe that the literature fails to consider the impact of initiatives like Skolkovo and the education delivered at schools like the Higher School of Economics (HSE), which have adopted Western business and educational practices for a Russian environment. Given that Skolkovo and HSE are relatively recent innovations, it will take time for others to follow their lead and for their full impact to be felt.

The lack of company financial statements is another concern for investors, particularly as it is not uncommon for a Russian business to participate in activities that it intentionally leaves off its books.[31] The one potential benefit of this opacity is that the valuation of a company should be commensurate with the heightened risk associated with unaudited accounting. This offers the opportunity for enterprising investors and for Russian companies, as it offers a potential return to the upfront cost of standardizing a company's financial statements, which could potentially be a lucrative investment as potential acquirers or public investors may be willing to pay a premium to invest in a thoroughly audited company.[32]

The appearance of scarce exit opportunities presents a threat for investors, because the purpose of venture capital is to realize significant returns on initial investment within the desired timeframe, which only happens during a liquidity event, such as an acquisition or an initial public offering (IPO).[33] The Russian marketplace is considered particularly illiquid; as of 2014, just 10 companies accounted for more than 70 percent of the market capitalization of the Russian stock market, and most of these companies were related to natural resource extraction, rather than the four sectors that dominate private equity investments (telecommunications, manufactured goods, financials, and retail).[34] Furthermore, these industries are under-concentrated and lack significant players,

[27] Klonowski 2011, 30.
[28] Ibid.
[29] Ibid.
[30] Musatova 2009, 77.
[31] Klonowski 2011, 30.
[32] Musatova 2009, 78.
[33] Ibid.
[34] Josh Lerner et al., "Private Equity in Emerging Markets: Yesterday, Today, and Tomorrow," *The Journal of Private Equity* 19, no. 3 (2016): 9.

which limits the opportunity for a lucrative sale to a strategic acquirer.[35] In addition, given venture capital investments are often minority stakes, despite investment term sheet provisions such as drag-along rights, VC general partners have less control over the transfer of ownership of a company and may be forced into an unattractive exit, due to business partner relationships or other non-market forces.[36]

Looking more broadly at convoluted business relationships in Russia, weak corporate governance is a defining aspect of the Russian business environment, in which conflicts of interest among corporate management is seen as acceptable.[37] A Russian term, *svyazi*, encapsulates the country's business ecosystem and refers to one's personal connections that are used to secure favors through an implicit understanding of reciprocity, though falling short of explicit bribery.[38] The idea of *svyazi* exists in other emerging markets (*guanxi* in China and *jeitinho* in Brazil, for example) and is not unique to the Russian business context; however, foreign investors may nonetheless be concerned by the "high context" nature of doing business in Russia, in which transparency is regarded as a risk.[39] In order to compete effectively in Russia, one must have access to insights from people who are well-connected within the Russian business ecosystem and utilize *svyazi* effectively, despite the fact that many Western firms may consider this cultural dynamic unethical potentially to the point of legal liability.

III. Strategies and Recommendations for Navigating the Russian VC Market

An analysis of Russian VC investments over the past decade suggests that two primary strategies have been employed by venture investors: 1) invest in Russian companies focused on a particular product or service for the local market, which is large enough to justify investment as opposed to smaller emerging markets, or 2) invest in companies that sell to global markets, but base operations in Russia to take advantage of the post-Soviet region's strong technical talent, particularly in mathematics and coding.

The growth of Russia's middle class correlates with more VC opportunities and better returns. A burgeoning middle class provides a safe foundation for the first investment strategy targeted to take advantage of a growing domestic market.[40] Existing sanctions given the geopolitical dynamic detracts from this domestic market-focused strategy, but the downward pressure on valuations can provide discounts for VC investors using the latter strategy of exporting products/services on a global basis while capitalizing on the technical talent in Russia and its near-abroad.

One method in which investors may invest in entrepreneurs who are serving the local marketplace, while at the same time serving their own needs, is by deploying capital in ventures that help encourage institutionalization. Institutionalization is a process that rewards societies with a "cultural toolkit" with which to reduce risk as the actions of others become more predictable by

35 Musatova 2009, 78.
36 Lerner et al. 2016, 15.
37 Musatova 2009, 78.
38 Klonowski and Golebiowska-Tataj 2008, 54.
39 Ibid.
40 Ndlwana and Botha 2018, 19.

enforcing consequences for non-conformity.[41] Institutions increase costs for non-conformers economically and socially by reducing their legitimacy.[42]

We believe that the institutional uncertainty that acts as a barrier to investors presents opportunities to entrepreneurs, and these leverage points should be key areas of interest for investors looking to deploy capital in Russia. As put forth by Paul Tracey and Nelson Phillips in their article "Entrepreneurship in Emerging Markets," institutional brokering, spanning institutional voids, and bridging institutional distance are three methods by which entrepreneurs can exploit policy shortcomings and offer value to investors.[43] *Institutional brokering* happens when entrepreneurs start ventures that reduce institutional uncertainty in a specific sector, acting as an intermediary to reduce the risk for a company or person trying to operate in an unfamiliar environment. *Spanning institutional voids* is used to describe entrepreneurial ventures that solve institutional problems. *Bridging institutional distance* refers to when entrepreneurs import and adapt solutions from separate contexts, for example implementing a Western business practice to fit the realities of the Russian marketplace.

Our research has also shown that if the goal is to focus on using a Russian company to sell globally, from day one an investor needs to design for the global market, which includes appropriately planning a legal structure. Several investors relayed difficulties in scaling and retrofitting domestically focused Russian companies for global markets. For VC investors, due to Russia's relative isolation after sanctions, the local market is ripe for implementing global best practices, which in Russia can be a foreign VC's highest value-add. Issues have arisen regarding Russian start-ups' ability to "go-to-market," which is why venture capital investors should also provide a foundation for selecting and hiring a strong sales team with established benchmarks for productivity, an often-cited weakness of Russian start-ups.

Looking at what strategies venture capitalists should employ, regardless of what kind of business they plan to invest in, one of the key findings from our research is that having a connection deeply embedded within the Russian business ecosystem is key to sourcing, diligence, and closing deals. Scholarship suggests that firms should co-invest with or employ someone who can navigate the country's distinct environment (particularly within the boundaries of sanctions).[44] For example, interpersonal trust is considered a key aspect of doing business in Russia, and personal network theory suggests that the relationship between investor and entrepreneur is made stronger by a third-party referral, which can help push past initial screens to play a role in investment decisions and the underlying trust and respect the parties have for each other.[45] In an environment where public institutions are often dysfunctional, personal relationships are regularly seen as the only reliable channels for getting things done.[46]

In addition, given the previously mentioned value-add of venture capitalists, as well as the uncertainty of local laws and cross-cultural negotiations, VCs should consider structuring deals

[41] Paul Tracey and Nelson Phillips, "Entrepreneurship in Emerging Markets: Strategies for New Venture Creation in Uncertain Institutional Contexts," *MIR: Management International Review* 51, no. 1 (2011): 23.
[42] Ibid.
[43] Ibid.
[44] Batjargal 2007, 1000.
[45] Ibid, 998.
[46] Ibid, 1009.

with a performance-based, share-adjustment valuation tool, or a "ratchet," which protects investors when a portfolio company does not meet agreed-upon financial benchmarks. This agreement enables investors to revisit entry valuation and adjust it retroactively if a company does not reach specific milestones.[47] The higher risk associated with VC investing in Russia is not only reflected in valuations, but also in the deal terms, such as ratchet provisions, that VCs can reach in negotiations with investors.

Turning to the final stage of VC in Russia, VC exits are often more difficult in challenging, uncertain markets, particularly in Russia. However, when planned appropriately, there have been a number of successful exits of Russian VC-backed firms to strategic corporates and public markets abroad, in part due to the weakness of domestic alternatives, including the Moscow Stock Exchange.[48] The importance of Chinese strategic and financial investors as exit options has grown significantly, especially Chinese firms that target the largest local players for acquisition, giving incentive to VC investors to focus on market leaders.

Given the structure of the VC model, if done correctly, the VC market in Russia can be a lucrative opportunity to source strong local talent and globally competitive technical expertise, provided the venture investor brings the appropriate cultural, legal, and sales expertise.

IV. The Way Forward for Venture Capital Investment in Russia

For the foreseeable future, the global economic environment and the challenge of coronavirus will make it more difficult for foreign investors to entertain venture capital opportunities in Russia. Nevertheless, there are profitable opportunities to be found, just as there are Russian technologists and entrepreneurs ready and able to deliver innovative products to Russian consumers and the wider world. The challenge for foreign investors, as laid out here, is simply how to limit the many risks presented to make the investments worth the risk.

The risks are many and various. Sanctions will be a big, if unpredictable, challenge for years to come. So too will be limited exit options that restrict multiple projections and the upside on prospective valuations. Political risks abound, even in less sensitive sectors. Nevertheless, the right opportunity can still deliver returns, as seen with Avito, ZenHotels, and others. The consolation for bearing the atypical risks endemic to Russia are relatively affordable valuations and less competition for deals. While the dynamic nature of the political risks requires constant monitoring, we believe the best way to bypass and mitigate many of the inherent risks is to focus on the most attractive industry sector – technology writ large – and to invest in either 1) globally-focused Russian companies that take advantage of the country's strong technical talent to deliver global products or 2) market-leading Russian companies focused on a particular product or service for local consumption.

The first category of investment is better suited to financial investors, especially those who can help a Russian company diversify its footprint internationally to lessen domestic political risks in an era when Google and many other top companies have pulled their programming talent out of Russia for fear of internet censorship and intellectual property appropriation. Here a prime

[47] Klonowski and Golebiowska-Tataj 2008, 54.
[48] Musatova 2009, 78.

example is the story of Nginx, backed by the famous Russian VC Runa. The company was sold to the Seattle-based F5 Networks in May 2019 delivering a great return to most investors. Nginx provides web server software that powers around a third of the world's websites. A New York Times assessment suggested, "the deal, worth $670 million, was a triumph for Russia's tech sector, which is rich in talent but often impoverished by the country's stumbling efforts to market its world-class skills."[49] Russia lived up to its reputation for non-economic risks when in December 2019 the Russian police searched the Russian homes of the company's two founders and the company's Moscow office to obtain evidence to bolster a criminal case against the company for alleged intellectual property theft.[50] While the aggrieved company, Rambler, asked for the criminal case to be dropped, the story is a reminder to all of the risks of operating in Russia. Nginx had to issue a statement in relation to the suit saying its products are "stored on servers outside of Russia" and that "no other products are developed within Russia."[51] While the legal and political risk Nginx endured reflect the very real challenges of operating in Russia, the story is a happy one for investors, who managed substantial returns, and for the world, which has another important player supporting internet infrastructure.

For many strategic investors, there exists a second category of investment, which can be most attractive as a way for foreign competitors to buy their way into the Russian domestic market. This strategy of acquiring or partnering with market-leading Russian companies focused on a particular product or service for local consumption is a laborious but fruitful method. Alibaba's co-investment alongside leading Russian internet company Mail.ru Group, Russian telecom MegaFon, and sovereign-wealth fund RDIF was a prime example of successful cooperation with state-involved entities and foreign entities to develop something new. The creation of their joint venture, the AliExpress Russia JV, was a paradigmatic and particularly famous example that resulted in a new online retail platform created from local and international strengths. Having first sought approval from the government, Russia's Federal Antimonopoly Service (FAS), the above entities successfully integrated local expertise in the social and digital environment from MegaFon and Mail.ru Group, with strong international expertise from Alibaba's e-commerce business. The result was a global technology partnership targeting the local market with a product for local consumption, while managing to operate in compliance with Russia's data privacy policies. It is successful partnerships like the AliExpress Russia JV that accelerate local development with strong local talent but require mutual strengths from abroad.

Despite the added challenges, there are success stories and there are strong opportunities in Russia, given its great base of technical talent. Foreign and especially U.S.-based VCs, with their legal, financial, and entrepreneurial acumen, will continue to be very attractive partners for Russian companies seeking a way to serve international markets and diversify their Russian-based operations, leaving opportunities for bold investors willing and able to do the work necessary to responsibly manage the risks.

[49] Andrew Higgins, "A Rare Russian Tech Triumph, a Police Raid and a Backlash," *The New York Times*, December 17, 2019, sec. World, https://www.nytimes.com/2019/12/17/world/europe/russia-tech-nginx.html.
[50] Ibid.
[51] Ibid.

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