Enabling Startups and Innovation in Russia and US

Anna Dvornikova, Managing Partner, TEC Ventures

Maria Sendra, Partner, Jones Day

Olga Loy, Partner, Jones Day
Advantages and Disadvantages of Investing in Russian Startups

• Business Advantages:
  • Russia is the largest internet and mobile market in Europe, it has growing opportunities in other high-tech industries, from innovative software to nanotechnologies and clean tech to biomedicine;
  • Russia has a large and fast growing consumer market (GDP per capita has grown about 13% annually from 1999 through 2010)
  • High level of science and technology
  • Lower labor costs (except in Moscow)
  • More startups, stronger entrepreneurs, quickly developing ecosystem

• Disadvantages:
  • Corruption and bureaucracy
  • A few years behind western start-up scene in terms of finance and marketing
Practical Business Issues of Investing In Russian Startups

• Identifying Investment Targets
  • Databases, contests and media sources
  • Russia Beyond the Headlines (RBTH) has recently introduced their Russian Startup Rating. The goal is to provide an objective assessment of the development level and dynamics of young technology companies established in Russia.

• Working with Incubators and Technoparks
  • Skolkovo, the state-sponsored tech hub nearing completion in southwest Moscow
  • Ingria, a prominent technopark and incubator in St. Petersburg
  • Kazan’s IT Park, one of the largest technoparks in Europe
Incentives For Start-Ups and Innovation

• Russian government’s measures to support investments in start-ups
  • State controlled institutions investing in innovating companies (Russian Corporation of Nanotechnologies, Russian Venture Corporation, etc.)
  • Tax concessions for companies with high degree of intellectual capital (reduction of IT companies’ social contributions from 30% to 14% until the end of year 2017; 0 profits tax rate for income received from disposal of shares in Russian hi-tech companies if certain conditions are met)
  • Russian Direct Investment Fund has $10 billion that it is investing in PE in Russia and aims to attract international co-investors.

• Skolkovo Project
  • Exemption of Skolkovo residents from VAT, profits tax and property tax and a reduction of social contributions to 14% for 10 years
  • Companies who want to participate can be physically located elsewhere
Practical Business Issues of Investing In Russian Startups

• Co-Investing With Russian Funds
  • May be more advantageous to new foreign investors
  • Funds operate in accordance with international standards, care about their business reputation
  • For certain strategic sectors (e.g. oil, gas, defense), investing with a co-investor may be the simplest choice as strategic approvals may be required from the government which may not be forthcoming.

• Differences In Dealing with Russian vs. U.S. Entrepreneurs
  • Level of experience
  • Labor costs
  • English language proficiency
Typical VC investment in the United States: various structures, VC may receive convertible preferred (or convertible debt) and common stock, E may receive common and options and profits interests (if Newco is an LLC)
Structuring Start-Up Investment in Russia with Non-Russian VC

- Using on-shore Russian JV
  - Russian side may be more familiar with the structure
  - May be cheaper than an offshore JV
  - Does not offer the level of commercial flexibility and certainty that a foreign VC expects
  - Russian courts do not have a good record of protecting shareholder rights generally and foreign investors rights in particular
Structuring Start-Up Investment in Russia with Non-Russian VC

- Non-Russian JV (Netherlands, BVI, Cyprus, etc.):
  - Partners are governed by non-Russian law, legal disputes can be resolved by non-Russian court
  - Structure can be complicated
  - Management split between two legal entities
  - For off-shore JVs, Russians are most familiar with a Cyprus holding company (due to reciprocal tax treaty with Russia), sometimes with a BVI Holdco on top

Diagram:

- Entrepreneur
- VC
- Non-Russian JV
- Russian Co

Services, ideas, and some $ to Non-Russian JV; $1 million to Russian Co.
Types of Russian Companies

- **Russian Joint Stock Companies**
  - open joint stock companies ("OJSCs" or "OAO" in Russian) and
  - closed joint stock companies ("CJSCs" or "ZAO" in Russian)
    - The main distinctions between the two are:
      - CJSCs may not have more than 50 shareholders
      - CJSCs may not issue shares by open subscription i.e. a public offer of shares
      - acquisitions of more than 30% of voting shares in an OJSC trigger mandatory tender offer requirements and
      - shareholders in a CJSC have pre-emptive rights (i.e. rights of first refusal) to acquire shares sold by the other shareholders to third parties

- **Limited Liability Companies ("LLC" or "OOO" in Russian)**
  - less regulated and rigid corporate vehicle. Unlike shares in Russian joint stock companies, issuance of equity or changes in capitalization of an LLC do not require registration with the FSFM
  - The law provides LLC participants with more flexibility in managing their internal affairs and structuring corporate governance
Acquisition of a Russian Start-Up: Possible Structures

- **Joint Venture**
  - Establishment of JV by Russian Entrepreneur, followed by acquisition of assets from Russian Co, followed by acquisition of shares in JV by VC
  - Generally the transfer of assets in Russia can be very difficult, mired in red-tape and bureaucracy and time consuming

- **Russian Co**
  - $1 million

- **Non-Russian JV**
  - VC
Stages of Proposed VC Investment

- Investor’s initial due diligence
- Preliminary investment structuring (Russian vs. Non-Russian JV, new formation vs. acquisition of existing co)
- Term Sheet
- Legal diligence and contract drafting
- Definitive document negotiation (JV Agreement)
- Formation of JV Company
- Acquisition of Assets
- Acquisition of JV Interest by VC
Exit Opportunities From Russian Start-Ups

- Relatively young market, exit opportunities are not as efficient as in the U.S.
- Debt markets are closed (albeit there is a flurry of bond activity at the moment) as are the capital markets. Russian stocks haven't done that well.
- Selling the company to a strategic buyer or VC/PE Fund
- Exit opportunities to Western corporation who are looking to buy market share in Russia
Other Business and Legal Issues to Consider

• Licensing Requirements
  – Certain types of business activities can only be carried out in Russia with a special license issued by authorized licensing bodies

• Land Ownership Issues

• Taxation

• Transfer Pricing

• Company and Labor Law
Thank You!

Спасибо!