METHODS OF ACQUISITION OF INNOVATIONS AND STARTUP FINANCING

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Калинин А. В. Методи залучення капіталу для фінансування інновацій.

У статті розглядаються основні проблеми, пов'язані з фінансуванням інноваційної діяльності підприємств. Автор обґрутує проблему фінансування інноваційної діяльності, як ключовий фактор, що стимулює інноваційний розвиток українських підприємств. Розглядаються проблеми інноваційної діяльності, потребують опрацювання механізму фінансування. Особлива увага приділяється питанням комерціалізації інноваційної діяльності. Актуальність теми обумовлена зростанням ролі фінансування інноваційних проектів у зв'язку з відставанням від провідних країн у розвитку інновацій. Саме відноситься до використання нових знань і навичок. Основою збалансованого розвитку є структура прибутку. Досліджується можливість структуаризації прибутку інноваційної діяльності у контексті інноваційного розвитку промислових підприємств.

Калинин А. В. Методи привлечения капитала для финансирования инноваций.

В статье рассматриваются основные проблемы, связанные с финансированием инновационной деятельности предприятий. Автор обосновывает проблему финансирования инновационной деятельности, как ключевой фактор, поддерживающий инновационное развитие украинских предприятий. Рассматриваются проблемы инновационной деятельности, требующие проработки механизма финансирования. Особое внимание уделяется вопросу коммерциализации инновационных проектов. Актуальность темы обусловлена возрастанием роли финансирования инновационных проектов в связи с отставанием от ведущих стран в развитии инноваций. Именно наращивающее использование новейших знаний и навыков...
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An important problem in the managing of technology is the financing of technological development and innovation. Even in large firms, technology managers often report that they have more projects they would like to undertake than funds to spend on them. There are a number of reasons for this phenomenon: low expected returns due to an inability to capture the profits from an invention, the uncertainty and risk associated with the project, and over-optimism on the part of managers. This chapter reviews these arguments in more detail and considers the evidence, both theoretical and empirical, on the extent of the problem.

Among the various financing options entrepreneurs can turn to when starting a new company is venture capital. Venture capital is money that is given to help build new startup firms that are often considered to have both high-growth and high-risk potential. These companies generally center on health care or new technology, including things such as software, the Internet and networking. In addition, a new breed of venture capital firms has recently formed to focus solely on investing in socially responsible companies.

Methods of financing. The majority of technology companies will look to raise equity finance i.e. issuing shares in return for cash. Sources include:

- Friends and family – commonly the first port of call for the initial funding requirement. The terms of the funding are not usually onerous and investor relations are generally easy-going. However, not all entrepreneurs have friends and family with spare cash to invest.

- Business angels – these are wealthy individuals, often entrepreneurs who have successfully exited other businesses, who are prepared to make high-risk investments, traditionally up to £750,000 into start-up and early-stage companies. They will often invest as part of a syndicate, some of which are now increasingly sophisticated and run much like a venture capital firm. If an entrepreneur concludes a deal with angel investors, she can expect her freedom to run the business to be curtailed (for example, investor consent may be required for key business decisions).

- Venture capital – for many companies, a venture capital (VC) investment will be their first experience of an institutional investor. This is an early-stage private equity investment, usually unleveraged by debt, and targeted at high-growth companies. Technology companies are therefore prime candidates. Some VC funds will make seed or early-stage investments (often of less than £1 million), and many early-stage VC investments are now made on a “co-investment” basis with business angels. However, the reality in the current economic climate is that VCs often require evidence of a business’s long-term potential, such as a growing revenue stream or customer base.

A VC will usually take a much more activist approach to an investment, and you can expect to require investor consent before taking key business decisions, as well as being subject to preferential terms ensuring that the VC receives its projected return in priority to the founders. Read more about venture capital.

Government funding – whether in the form of equity or debt, this plays a significant role in early-stage finance. Government-supported Enterprise Capital Funds are active in this area – these are funds comprising both public and private money which can invest up to £2 million in a company. The government is also establishing the UK Innovation Investment Fund, which should see a further £325 million of VC funding (again comprising public and private money) become available. Read more about government venture capital. Other sources of business finance. Whilst most early-stage companies will seek equity finance, other financing options are available. These include business start up grants and loans from the government, which are often made available on a regional, and sometimes local, basis. The Department for Business Innovation and Skills website (www.berr.gov.uk) is a useful
starting point for finding other funding options. For very early-stage companies, business incubators can also be an option, providing access to expert advice, shared resources and small amounts of seed funding.

Unsurprisingly, obtaining funding at the present time can be a difficult and time-consuming process, and investors will drive a hard bargain on valuations. However, money is available for those businesses with compelling business plans. It is important to explore all possible avenues and to set you apart from the crowd.

Entrepreneurs often turn to venture capitalists for money because their company is so new, unproven and risky that more traditional forms of financing, such as through banks, aren't readily available. Unlike other forms of financing where entrepreneurs are only required to pay back the loan amount plus interest, venture capital investments most commonly come in exchange for ownership shares in the company to ensure they have a say in its future direction.

Obtaining venture capital is substantially different from raising debt or a loan from a lender. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of a business. Venture capital is invested in exchange for an equity stake in the business. As a shareholder, the venture capitalist's return is dependent on the growth and profitability of the business. This return is generally earned when the venture capitalist “exits” by selling its shareholdings when the business is sold to another owner.

Venture capitalists are typically very selective in deciding what to invest in; as a rule of thumb, a fund may invest in one in four hundred opportunities presented to it, looking for the extremely rare, yet sought after, qualities, such as innovative technology, potential for rapid growth, a well-developed business model, and an impressive management team. Of these qualities, funds are most interested in ventures with exceptionally high growth potential, as only such opportunities are likely capable of providing the financial returns and successful exit event within the required timeframe (typically 3–7 years) that venture capitalists expect.

Not all venture capital investments take place when a company is first being founded. Venture capitalists can provide funding throughout the various stages of a company's progression. Research from the National Venture Capital Association revealed that in 2010, venture capitalists invested approximately $22 billion into nearly 2,749 companies, including 1,000 of which received funding for the first time. Among the more famous companies to receive venture capital during their startup periods are Apple, Compaq, Microsoft and Google.

Venture capital funds come from venture capital firms, which comprise professional investors who understand the intricacies of financing and building newly formed companies. The money that venture capital firms invest comes from a variety of sources, including private and public pension funds, endowment funds, foundations, corporations and wealthy individuals, both domestic and foreign. Those who invest money in venture capital funds are considered limited partners, while the venture capitalists are the general partners charged with managing the fund and working with the individual companies. The general partners take a very active role in working with the company's founders and executives to ensure the company is growing in a profitable way.

In exchange for their funding, venture capitalists expect a high return on their investment as well as shares of the company. This means the relationship between the two parties can be lengthy. Instead of working to pay back the loan immediately, the venture capitalists work with the company five to 10 years before any money is repaid. At the end of the investment, venture capitalists will sell their shares of the company back to the owners, or through an initial public offering, for what they hope is significantly more than they initially put in. The most recent available statistics found more than 450 active U.S. venture capital firms that had each invested at least $5 million. The firms had an average fund size of nearly $150 million.

In an index of big-name companies spanning March 2008 through March 2013—which included the “Great Recession” and trillions of dollars in revenue swings—PwC put tech companies as a group at the top in terms of most valuable sectors (up 35 percent, to $1.82 trillion) and most improved. In its overall summary, the tech market has been “driven by product innovation and computerization.” At the top of global companies as a whole, Apple registered $416 billion as of March 2013, a gain of $290 billion and 40 spots from PwC’s 2008 rankings and besting oil titan Exxon. Internet search leader Google ranked third as of March 2013, with market capitalization of $263 billion (up $125 billion from five years ago) and leapfrogging 33 spots from the previous index in 2008. Microsoft slipped a spot from 2008, down to number eight, and had a reduction in market capitalization by approximately $24 billion to $240 billion as of March 2013, according to PwC. IBM gained 18 spots to reach ninth globally in 2013, bringing along $238 billion, an increase of $79 billion from 2008. Apple, Google and IBM were listed by PwC among its five biggest “risers” in terms of market capitalization. Troubled phone vendor Nokia, which in 2008 was ranked higher than Apple, didn’t register in the latest rankings.

Outside of the top 10, but still registering large gains, were Oracle (with $152 billion in market capitalization and reaching no. 30, up 32 spots) and Qualcomm (with $115 billion in market capitalization and reaching no. 44, up 56 spots). Aside from Microsoft, the two tech companies that slipped from the ranking in 2008 were Cisco and Intel, according to PwC. Cisco sunk 19 spots from 2008 to 51st this year, with $111 billion in 2013 or $33 billion less than in the previous ranking. Intel dropped nine spots to rank 53th in 2013, with $108 billion or $15 billion less in market capitalization.

The two overseas tech providers on the list were also the two lowest ranked, though both showing considerable gains in rank and capitalization from five years ago. German-based SAP was no. 62 with $99 billion this year, up 50 spots and $37 billion from 2008. Taiwan Semiconductor Manufacturing Company, or TSMC, is no. 69 with $87 billion, up from its 2008 ranking of 138th and $60 billion in market capitalization.
Outside of the top 100 was Hewlett-Packard, with a $66 billion drop in market capitalization from 2008 to 2013, and Dell, which was not listed in among survey documents.

Interesting situation in a way country where company is based can influence a level of capitalization. In table we can see comparison of Apple Co. and its main production contractor Hon Hai Precision and we see that their level of market capitalization differs in more than 10 times despite their profits differs only 4 times.

Founders strive for and investors appreciate a “clean” capital structure for ventures that will eventually seek outside investment. There are a few terms you will hear when discussing the set-up of the capitalization structure of your business. Here is what they mean:

- **Initial equity**: At the time of incorporation, the founders of a business generally purchase shares at a nominal price per share, such as $0.0001 per share, paid in cash, since at that time the company has no operating history, few assets and thus little value. These shares are often referred to as “founders’ shares.

<table>
<thead>
<tr>
<th>Shareholder/option holder</th>
<th>Number of shares</th>
<th>Actual percentage owned</th>
<th>Fully diluted percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder A (CEO)</td>
<td>500,000</td>
<td>50%</td>
<td>42.5%</td>
</tr>
<tr>
<td>Founder B (CTO)</td>
<td>300,000</td>
<td>30%</td>
<td>25.5%</td>
</tr>
<tr>
<td>Founder C (Key Technical)</td>
<td>200,000</td>
<td>20%</td>
<td>17.0%</td>
</tr>
<tr>
<td>Issued and outstanding shares</td>
<td>1,000,000</td>
<td>100%</td>
<td>85%</td>
</tr>
<tr>
<td>Option holder 1</td>
<td>11,765</td>
<td>0%</td>
<td>1.00%</td>
</tr>
<tr>
<td>Option holder 2</td>
<td>3,000</td>
<td>0%</td>
<td>0.25%</td>
</tr>
<tr>
<td>Option holder 3</td>
<td>17,650</td>
<td>0%</td>
<td>1.50%</td>
</tr>
<tr>
<td>Unallocated options</td>
<td>144,056</td>
<td>0%</td>
<td>12.25%</td>
</tr>
<tr>
<td>Total fully diluted shares</td>
<td>1,176,471</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

If the founders had simply issued 50, 30 and 20 shares for a total issued capital of 100 shares instead of 1,000,000 shares, the ownership percentage for the company would remain the same among the founders; however, the company would have difficulty splitting the 17,6471 shares available for stock options among option holders, since legally, partial shares are not permitted. If you have incorporated your business with a smaller than desirable number of shares, you can modify your capital structure by “splitting” the current number of shares issued. Consult legal counsel to assist you in seeking the necessary shareholder approvals to make the change and to file revised articles of amendment, legally documenting the change.

What do potential investors see as a clean capitalization structure?

1. A limited number of classes of common shares being used for equity issuances and stock option grants.
2. A manageable number of shareholders, excluding insiders, holding stock options.
plan that provides potential financial advantage to all key employees who continue to work with the business to build shareholder value.

4. No obstacles to obtaining shareholder approval to issue the new investor shares in exchange for cash investment, nor to obtaining amendments to any legal documents or the capital structure accordingly. This is usually achieved by having a shareholders’ agreement, a voting trust or other legal documents to ensure that minority shareholders will follow suit with the majority.

Note that Canadian investors generally prefer to invest in Canadian-Controlled Private Corporations (CCPCs). A CCPC is a Canadian-incorporated private corporation that is not controlled directly or indirectly by one or more non-residents of Canada or public corporations (or any combination thereof). CCPCs enjoy benefits including the right to claim refundable cash Investment Tax Credits under the Scientific Research & Experimental Development program as well as potential tax advantages for founders and employees on the sale of their shares or stock options. Companies should seek legal or tax advice as to how to maintain their CCPC status. However, some U.S. investors may require the company to reorganize itself on a cross-border basis for their own local tax or operational reasons.

Entrepreneurs should seek professional legal advice when establishing or making changes to their capitalization structure. Choose legal counsel that has experience in setting up early-stage ventures and working on investment rounds for their clients. Hiring a lawyer may seem like a big expense for your start-up, but setting up your business incorrectly will cost you more in the long run.

Problems in modern venture financing. Corporate clients continue to withhold capital spending funds, investing only in areas that promise rapid payback or require modest sums to realize incremental improvements.

Additionally, spending by the U.S. government -- a major buyer of hardware, software and services -- has been nearly frozen as the sequester limits (or even shrinks) information technology budgets.

Adding insult, tech companies’ foreign sales divisions in Europe and Asia are noting a high degree of spending caution.

How bad are business conditions? Based on updated second-quarter guidance, tech companies are expecting revenues to decline 5% year on year in the current quarter, according to Bloomberg. With the exception of a few quarters in late 2008 and early 2009, we haven't seen a drop like that since the dot-com implosion.

In response, major institutional investors have been steadily reducing their exposure to this struggling sector. Even as the Standard & Poor’s 500 Index (SINX +0.14%) has risen 13% since Labor Day, the SPDR Select Sector Fund Technology ETF (XLK +0.28%) has not appreciated at all.

Counter intuitively, the rotation out of tech stocks creates a compelling opportunity. Though this sector is beset by near-term challenges, results should start to rebound later this year.

In most years, companies’ chief information officers (CIOs) are allocated a certain portion of funds to work with. They often aim to spread out spending evenly over the course of a year, but every few years, spending gets off to a slow start as caution builds. However, CIOs know that when it comes to annual budgets, they must use it or lose it, and spending could spike sharply as we head into the fourth quarter.

That phenomenon, known as a "budget flush," was very pronounced most recently in 2009, as IT spending started off on a dismal note but finished with a bang. Notably, the SPDR Select Sector Fund Technology exchange-traded fund got off to a slow start in 2009 but finished the year with a 51% gain (compared with a 23% gain for the S&P 500).

Of course, we can’t say for sure that global economic conditions won’t weaken further this year, so a budget flush is not a given. Yet the primary reason for IT spending by both governments and enterprises is that it’s a great productivity enhancement tool.

The U.S. government, for example, aims to deliver the same level of services with a reduced workforce, and the only way to do that is through technology-driven productivity increases. So deferred tech spending now should lead to a catch-up period later.

The relative under-performance of tech stocks has made them among some of the top bargains in the market. Many trade for only 10 to 12 times forward profits, and when you back out robust cash levels, those multiples fall into the single digits. Apple (AAP +2.26%, L +0.28%) is a great example of a cash-adjusted bargain: Shares trade for 10 times forward earnings, but less than 8 times when cash is excluded.

In this sector, it’s not wise to seek out the most inexpensive stocks. These are the only tech stocks in the S&P 500 that trade for less than 10 times projected profits, yet almost all of them are beset by company-specific woes that are unlikely to dissipate, even when tech spending rebounds.

In this group, only Xerox (XRX +0.20%, L +0.28%) holds appeal, due to its stunning free cash flow. I’m also a fan of Jabil Circuit (JBL +0.27%) for its outstanding management, but its hefty international sales exposure could be a problem in coming quarters. Keep an eye on this stock: If it moves into the lower teens (from its current $17.50), it should lead to a catch-up period later.

If you move up to the next wave of inexpensive tech stocks, then you have a better chance of latching on to companies that will more squarely benefit from the eventual IT spending rebound. These tech stocks all trade for less than 13 times the projected profits for their current fiscal year.

I remain a big fan of Cisco Systems (CSCO -0.04%), my top pick for 2013. Additionally, any time that stocks like Oracle (ORCL +0.47%), IBM (IBM +1.00%) and EMC (EMC +1.32%) are feeling the pressure of a
weak recent quarter, that's often proved to be a good entry point, as these market dominators have proved to snap back nicely once the trough passes.

![Picture 1. P/E ratio of biggest tech companies](image1)

![Picture 2. IT Spending Beneficiaries](image2)

Of course, another major theme among tech stocks is their stunning cash balances and robust free cash flow. It's no coincidence that these are the companies leading the charge in terms of huge stock buybacks and solid dividend hikes. Here's a quick look at the most cash-rich tech companies in the S&P 500, in the context of their market values.

![Picture 3. List of the most cash-rich tech companies](image3)

To reiterate, these stock's price-to-earnings ratios drop sharply when calculated on a cash-adjusted basis. The current rotation out of tech stocks gives these companies a chance to more aggressively deploy their cash into highly accretive stock buybacks. Risks to consider: It's tricky to find a bottom for this sector, and the year-end budget flush may not play out if the global economy stumbles, so you should own these stocks with a multi-year time horizon.

Action to take: Tech stocks may not be timely, but they offer compelling values and still stand to generate much improved results once IT budgets loosen. Even if that doesn't happen until next year, these bargains may not last that long. Remember, investors always look ahead, and by the time investors get a sense that IT spending is on the cusp of an upturn, these stocks will already have moved up off of their lows.

As for the venture financing in Ukraine we can admit that one of the good points about investing in companies in the Ukraine is that the economy has been experiencing steady growth which means it is likely sustainable. Economic growth has been consistent on many levels and indicates that the economy is well balanced and stable which are prerequisite to the constant growth that is expected to continue. Entrepreneurship is ambitious in the region and its geographic location helps create potential for businesses to succeed.

Another area that demonstrates the Ukraine may be prime for the VC industry is the new laws that have been adopted. The laws regarding both securities and capital markets help create a better economic picture, but the government is also demonstrating that they are concerned about protecting investors. There sense about creating a legal environment for the VC industry is very logical as well as consistent which helps give VC firms more confidence in their investments. There have also been several successful PE funds which demonstrate possibilities of success. All of this works out to help support the entrepreneurial nature for creating new businesses.

There are still several legal and regulatory sectors which hinder entrepreneurship. Some of the latest laws which have been created to help protect shareholders haven’t been officially adopted by Parliament. Another hurdle that must be overcome is the difficulty of exits however, IPOs are becoming more realistic which is a good thing.
Even though there are some regulations in place, there is not a developed system for seed investments which are financed by corporations or governments. This means that even though there is a great potential for investing in technology, the government does not offer enough real support for these types of seed investments in the field of technology, so the opportunities are somewhat wasted. The other difficult challenge is that the private equity and venture capital industry are still comprised of a relatively small investment base. Until recently, the domestic private equity industry was slowly developing a concentrated interest in buyout deals as well as real estate investments. The investment base for the PE market is still very narrow. All of this is perhaps due to the fact that there is an overall lack of expertise in VC matters and the industry is still young enough that there is not a good set of guidelines pertaining to industry standards.

There are some rather significant reasons to consider either private equity or venture capital opportunities in the Ukraine. Many of the former problems have already been addressed and there are many who are jumping out there to provide creative opportunities with risk factors which are at least reasonable.

Today backwardness of the venture industry in Ukraine is caused by weak legislative base, imperfect stock market, opacity of financial activity of the companies, lack of guarantees for the investor, absence of experts in management of venture funds, lack of tax privileges for venture investments. Successful experience of development of system and the mechanism of the venture investment, approved in other countries, certainly, can be and has to be used by Ukraine, however here it is necessary to consider and those concrete practical examples when experience of the USA, being postponed in pure form, without change of infrastructure surrounding it, the legal environment, etc. in the West European countries, it was unsuccessful and didn't give the necessary economic effect. In other words, it is necessary to adopt not simply foreign experience of creation of system and development of the mechanism of venture investment, and it is obligatory to adapt it for national features in legal area (so, for example, essential distinctions in legal systems of Ukraine and the USA at all won't allow to use separate elements of the American mechanism of venture investment in Ukraine), to prepare necessary infrastructure, including institutional, etc.

Creation of favorable investment climate, improvement of legislative base will promote growth of volumes of venture financing of the Ukrainian economy and it is possible to make recommendations about introduction of suggestions for improvement of tax regulation of venture funds - in definition of tax base on a profit tax for the venture funds which aren't relating to property complexes which is formed on the basis of the special contract; in establishment of a special mode of the taxation of payments on a salary in the companies which are professionally engaged in management of venture funds; in development of tax incentives for industrial corporations which invest in the venture funds which are carrying out investments on the main profile of activity of industrial corporations; tax privileges and preferences for small and medium-sized enterprises - on the VAT at realization of new types of production; on insurance premiums for the small and medium-sized innovative enterprises, from the organization property tax concerning the new equipment used in production of the knowledge-intensive types of production; privileges on a land tax for the scientific organizations and the innovative enterprises; releases from taxation on profit of the income on operations on realization of exclusive rights, additional preferences for the innovative enterprises at statement on the account and annual the accounting of intellectual property which is basis of innovations; subsidies for payment of percent on the bank credits, directed on acquisition of new processing equipment and creation of modern capacities.

Sources:


Keywords: innovative activity, innovations, venture capital, financial resource, financial support, innovation policy. Ключові слова: інноваційна діяльність, інновації, венчурний капітал, фінансове джерело, фінансова підтримка, інноваційна політика. Ключевые слова: инновационная деятельность, инновации, венчурный капитал, финансовый источник, финансовая поддержка, инновационная политика.