

SPECIFICATIONS OF THE VENTURE CAPITAL INVESTMENTS IN THE UKRAINIAN IT INDUSTRY

Ukrainian venture capital market formation has started in the beginning of the second decade of the century and started developing very rapidly ever since. Ukraine has always had a long history working on innovations that were influential in many spheres of economy such as aerospace, machine and shipbuilding, and computer science. Among all the industries, which provide a considerable share in the GDP gross value of Ukraine, the information technology or IT industry is the most dynamic and promising one.

The technology industry itself should reinvest the money into its development so that it attracts more financial support for its growth. The recent several years have brought many difficulties to the Ukrainian economic situation and damaged its image greatly. Despite such conditions, Ukrainian tech product and outsourcing companies are still growing in a slow but stable pace. Currently, the market consists of over thousand companies that employ almost 100,000 tech specialists who serve clients from all over the world. Ukraine is also a valuable residence place for many global tech players who have put their research and development centers in Ukraine. They are situated not only in the capital but in the regions as well.

The political situation in the country is rather complex still. However, thanks to the industry specifics its players weren't affected by the situation too much. It is an obstacle for faster growth, though, as international clients might not be sure about the country's stability. According to many international experts the industry has the potential to expand ten times more from what it is now. Ukraine's tech industry has the biggest advantage – its talented workforce.

However, successful and effective changes in business law should take place before that happens. The proficiency in English of the workforce in the tech industry is much higher than in other industries. It is still not as high as it is in some other CEE countries, hence Ukraine still has places it should push harder. Since 2014, Ukraine managed to climb higher in many business rankings that evaluate quality of business processes, transparency and easiness. Many international players still get attracted to place their companies in Ukraine due to low tax levels.

The legal environment is still ought to be improved. There are still laws that have significant flaws and place barriers for the tech companies in many tech-related fields. Intellectual property legislation should be significantly improved for the companies and individuals to have more protection. It can be summarized that Ukrainian technology industry is developing in a very good pace. However, a big positive impact could be made if the international sources of venture capital were attracted to Ukrainian technology companies to help them grow further.

The goal of the research is to reveal the current state of venture capital influx into the Ukrainian technology industry, how the venture investments are being dispersed through the technology sector of Ukrainian economy and what conditions the sector needs to flourish. *The objectives of the research:* Given the current issues that Ukrainian technology market is facing, there is an acute need of

resolution the following issues: 1) need to improve the state of the technology industry of Ukraine, inspecting possible ways of its further growth, raising the global venture market awareness about the current growth of the Ukrainian technology market, raising the investment attractiveness of the market, as well as the country generally; 2) lack of the effective ways of optimizing the venture investments distribution over the technology market, finding the new ways of investments like the syndicate investments instead of single investor's contribution, gathering the new approaches to investing in the high-risk enterprises at the early stages of development; 3) weak governmental support of the venture market and technology industry, inspecting the examples used by the current hubs of technological breakthroughs and concentration of the venture capital in the world.

Subject of study is the investments flow into the Ukrainian IT industry, the trends, issues and specifications of the investment processes. *Object of the study* is the venture investments market activities within the boundaries of the Ukrainian technology industry.

Sources overview: Ukraine's venture market has actually emerged into a real functioning market not too long ago. Hence, the topic has been researched since 2012 only. Some organizations and private individuals have started covering the topic. Namely, Jaanika Merilo's [88] of the Ukrainian Venture Capital and Private Equity Association [94] research on the venture market players' activities. As the institution dedicated to shaping the direction for the private equity industry by promoting investment opportunities in Ukraine the research investigates and focuses on the causes for the private equity investors and the state regulatory institutions to improve the current investment and business climate in Ukraine.

The core issues and barriers for the further development are represented in the research. In addition to that the source breaks down the structure of the current venture investments market of Ukraine that is investing into the IT industry, outlining the key players, such as business angels, the accelerators and the incubators, technology companies themselves, private investment companies, venture equity funds and the investment banks [94]. The InVenture venture investment fund's annual overview of the Ukrainian venture market of the first half year of 2015 has also given the detailed examination of the current tendencies in investment growth into the IT companies and the IT product startups [86].

Due to the research, the first six months of 2015 have shown a great activation of the Ukraine-based venture capital firms, namely private equity funds that developed from the technology companies that come from Ukraine too. The American Chamber of Commerce "Doing Business in Ukraine" [95] research of 2014 discussed the openness of the Ukrainian economy to the foreign investments and the possible barriers to such investments. Due to the research it's the regulatory permissibility that harms the image of Ukrainian businesses that could have drawn many venture deals to the Ukrainian borders. The need for the conversion of the investments made in the foreign currency stops many companies from investing. The research scrutinizes the possible issues with the condition and offers solutions that could improve the situation.

The "Handbook of Research on European Business and Entrepreneurship: Towards a Theory of Internationalization" edited by Leo Paul Dana [83] offers the European approach to improve the investment climate by active entering foreign markets. It also involves the common patterns for entering the European market and explains the theory of international entrepreneurship in Europe. The main concern of the research is affiliated with the one to be discussed in the offered research, namely, the need for fostering a positive image and building up the potential for entering new markets by the national small and medium enterprises, attracting foreign investments. It also inspects possible issues that may stand on the road to internationalization due to the political instability, turbulent economic conditions and the worsened image of the economy measured on the international scale.

The Dealbook of Ukraine [92] written by the representatives of the AVentures Capital private venture firm and the Ukraine Digital News [91] has executed a thorough research on the emergence of the Ukrainian venture capital ecosystem and the origins of the technology industry. The major concern of the recent years is still the unattractive image that country builds for its business by the unstable political decisions. A number of other publications that discuss the abovementioned issues have also been out discussing the actual state of the venture investments in the technology industry [84; 85; 87]. The issues, however, remain unsolved.

Methodology: Having developed the basis of the understanding the vector of the research, including having built the preliminary structure of the known facts and evidence that can support the summary of the research, it is necessary to estimate how the data will be collected to support the arguments of this research. There are numerous ways of exploring the tendencies of investment flow using the qualitative and quantitative methods to carry out the research. Among the qualitative methods, direct observation has been used. Among the quantitative methods, data collection and documentary analysis have been used. To create a well-researched picture of the Ukrainian venture investment market, the direct observation is necessary to get the real-time picture of the venture deals dynamics on the Ukrainian technology market scene. The venture capital firms and the companies that have received the funding from them within the boundaries of Ukrainian tech market establish the evolution history of the Ukrainian venture market. This history can be also examined through such secondary source as the "Dealbook of Ukraine" written and edited by the representatives of the Ukrainian venture capital firms and tech market related media sources. The deals examined in the "Dealbook of Ukraine" reflect the majority of venture M&A deals made on the Ukrainian venture market daily.

A good source of primary information where the documentary analysis has been applied as the method is the "Ukraine High Tech Report" that provides the up-to-date data about the Ukraine's technology companies, the providers of the IT services, products and outsourcing opportunities to foreign markets. The research in the source gives the opportunity for the documentation of the venture deals, the nature of investors and the companies who received the investments. This provides an opportunity to examine the most attractive spheres that attract investors, as well

as the amounts that are the most common for the early stage investments. Also, the direct observation of the activities of the most prominent venture capital firms of the Ukrainian origin, such as AVentures Capital, Digital Future and GrowthUP Group, give a substantial overview of the Ukrainian venture market behavior in general. In an effort to find the considerable range of feedback that can fuel the research on the given topic, it is essential to examine statistical information given on the volume of trade Ukraine has with the foreign countries, the consumers of the IT products and services. The examination of the dynamics in consumption of the tech services and products made in Ukraine brings to possibility of concluding on the current trends in global tech services and products consumption.

RESULTS

Despite the growing global trend of doing active research in order to find the most promising high-tech startups, most players of the Ukrainian domestic venture capital investments market have been acting quite cautious, awaiting to invest in the innovative high-tech oriented small businesses. The main problem is that internal investors act according to the pessimistic scenario. They take too much time to make an investment decision regarding one project or another. Even if they are in fact quite interested in some specific IT- idea for the startup or an established small business, it still takes too much time to evaluate what benefits in terms of positive cash flow it can bring. Hence, while taking these steps too slow, they significantly reduce the possibility of the timely displacement of the similar high-tech projects on the market and winning the competition. At the same time while domestic venture capital funds investors focus on the rapid rotation of the invested capital and seek the quickest payback period, rather than long-term strategic goals, they are provided legislatively guaranteed mild tax regime and limited liability granted to the participants of the funds. These conditions certainly should be used with more effect than they are utilized in Ukraine. However, our venture investment funds continue to invest in more stable and predictable for Ukraine industries, such as agriculture, food production and utilization, energy efficiency.

In 2010 we finally got a reason to believe that the orientation of venture capital investments on the high tech sphere is proved to be a promising step. According to the Ukrainian Association of Investment Business, the officially registered number of major collective investment institutions (CII), focused on risky projects in the IT sector during the third quarter of 2010 was 801 in comparison to the third quarter of 2013, when the number increased up to 1001. This was also accompanied by the increase of the net asset value (NAV) of the venture CII from 80,791.4 million UAH to 145,233.93 million UAH in the corresponding period (Figure 2).

The above presented data allows concluding that the positive trend in the development of venture capital investments market in Ukraine is a favorable factor for the concentration of capital in the sphere of IT startup venture investments. In terms of the currently weakened economy by the numerous unfavorable political factors, many benefits of investing in IT projects are hard not to see.

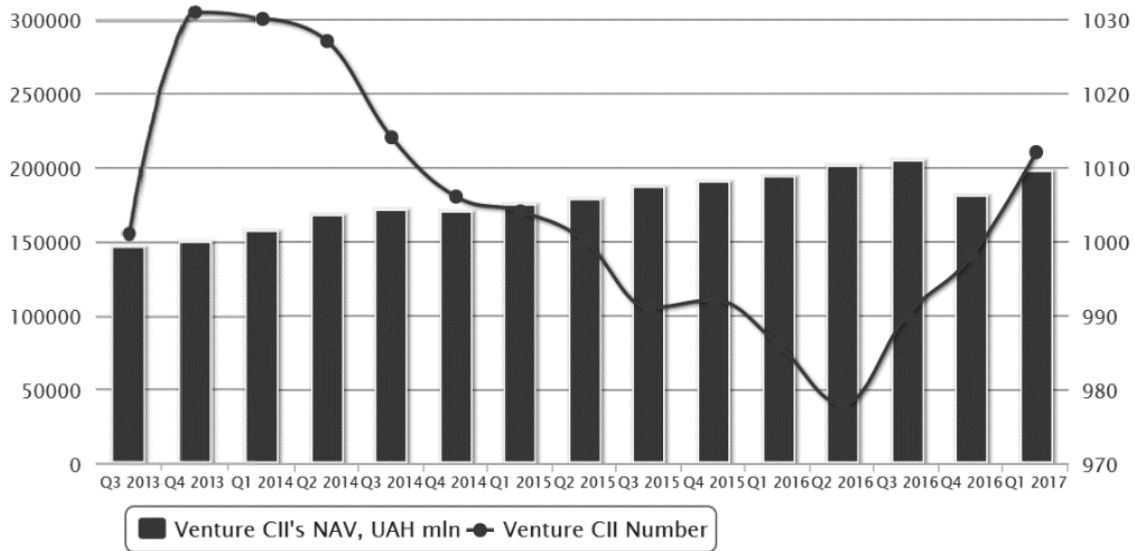


Figure 2: NAV of Venture CII, Q3 2013-Q1 2017

Source: [93]

Specifically, the main advantage lies in a relatively low investment cost starting \$10,000, with the profitability reaching often 100% or even higher. In contrast, the starting costs of real investments range from \$0.5-1 million and profitability rate is rather difficult to predict in terms of the current political and economic instability of Ukraine [90]. Development of the IT-sphere slightly depends on the geo-political conditions in the country. It is rather aloof from these processes and is not so much influenced by negative external factors.

Five years ago, venture capital market was undeveloped in Ukraine. However, it has seen a rapid wave of growth throughout 2012-2013. In 2013, the market volume has reached almost \$100 million. Within a year, the number of venture deals increased. However, the amounts of the deals decreased two times. Provided the political events of the beginning of 2014 do not happen again, such phenomenon is to be temporary. The decrease in the venture investment volume has been drawn and persists still due to the vague political situation on the east of Ukraine. Currently, political situation in Ukraine puts the biggest shade of negative image on the Ukrainian tech industry. It also makes the situation unclear for the foreign investors. Investors from abroad are not sure that Ukraine is a good place for the investments provided the situation in country is unstable.

The year 2015 saw there naissance of the Ukrainian venture and startup scene. A new decade of development has come with the number of the domestic investors and tech entrepreneurs. There are also angel investors, mostly foreign, however their share in many syndicate venture deals has increased. There was a wave of development of startup incubators, accelerators. In addition, many conferences linked together a range of industry associations. Currently, many education initiatives, schools that teach programming are being opened frequently. Judging by all this, it is sure to say that the foundations of the dynamic tech industry ecosystem have been laid. Foreign funds were the ones who fueled the earliest

stages of the Ukrainian startup community development. Since 2013, the number of Ukrainian venture investors has significantly grown and in over 70% of venture deals, the investors were of Ukrainian origin.

Throughout the turbulent 2014, the share of Western and Russian investors became very low and although some deals were closed, most investments came from the Ukrainian investors. Just six-year old, Ukraine's venture capital industry consists of many active players: incubators, accelerators, pre-seed, seed, Series A rounds and buy-out funds. However, Series B and further growth funds are not active in Ukraine. Only international venture capital players can help close this gap. For that, however, the legislative conditions for operating tech businesses should be improved by the Ukrainian government. Until 2013, there were no merge and acquisition deals. The first and the biggest ones were the acquisitions by Apax, Google, and Rakuten. The largest Ukrainian tech companies are getting mature enough too, so in the nearest future more nine-digit figures are expected in the deals. Throughout 2014 and 2015, there were many seed and round A deals. In 2011 the seed deals amounted to 24, in 2012 the number was 47 and in 2013 the number was 53. The volume got three times bigger, from \$4 million in 2010 to \$17million in 2011. It got even bigger in 2012 and 2013, \$13million and \$15million respectively. Such active fast growth is provided by the following processes: many venture clusters emerged, the venture capital funds and private equity investors, angels' number, both Ukrainian and foreign increased. The angel investors were quite active, backing over 50 startups in 2012-2013. The average amount of the deal was around \$150,000.

The first Ukraine-based accelerators emerged in 2012. In 2013, many foreign accelerators joined by investing in over 50 projects. The average amount was \$40,000. The developed markets, however, have bigger checks for the seed and Series A deals. Usual seed amounts reached up to \$300,000 and up to \$4 million in Series A in 2013 (Figure 3). The number of Round A deals has increased and this has been caused by the gradual development of the investment and startup community. In 2011 there were only 5 Series A deals, and in 2013 there were 13. The invested capital grew from \$8million in 2011 to \$47million in 2013 (Figure 4). This amount made almost 55% of the total investment volume. Most rounds were below \$3million. Several deals regarding such Ukrainian services as ModnaKasta, All.biz, Megogo, Topmall amounted to almost \$10million in total. There were no C and D series deals. The main reason for that is the fact that Ukraine's venture capital industry is still in its early development stage. Only several companies among thousands present on the market rose more than three rounds altogether, including seed, A and B rounds.

The first year when Ukrainian startups received the first cash grants was back in 2013. The Global Technology Foundation that emerged then, provided eight grants that were valued as \$30,000 each. The Foundation was the entity of TA Venture, Bionic Hill, Almaz Capital, and Runa Capital as it aimed to accelerate software development in Ukraine. The primary motto was the increasing of Ukrainian tech industry's addition to the country's GDP. The year 2013 was, undoubtedly, the most effective one for the Ukrainian tech industry, as the record amount of Ukrainian

funds and individuals invested in the tech sector the record amount of venture capital. Before 2012, the share of foreign investors in the total deals was prevailing over the share of Ukrainian funds in the investment volumes. In 2013 the trend has changed as the Ukrainian venture investors invested altogether \$50 million into the country's IT industry.

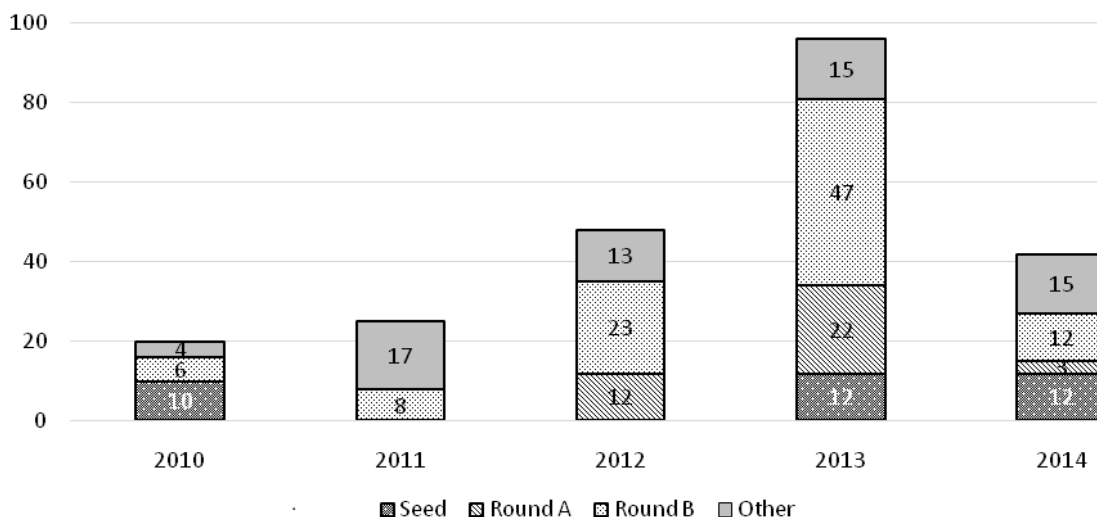


Figure 3: Total amount of investment, USD millions, 2010-2014

Source: [91]

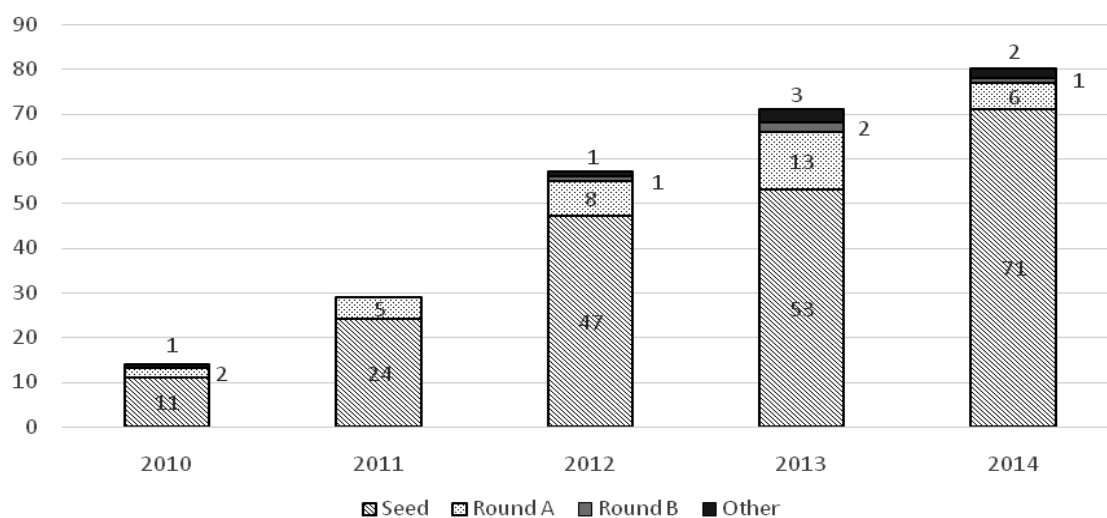


Figure 4: Total number of deals, 2010-2014

Source: [92]

That resulted in around 70% of the total invested capital being funded by the Ukrainian players. Such activation of investors' actions built up the first big success stories. One of them became the acquisition of Ukrainian high-tech startup Viewdle by Google. The Cupid service also founded by the Ukrainian has gone through the IPO. GlobalLogic, one of the five top outsourcing companies in Ukraine has been acquired by Apax Partners. These successful deals have led to even more acquisitions by the private equity investors, the technology business ecosystem has started

developing more, more seed accelerators emerged as well as more international media like Forbes, BBC and tech-oriented TechCrunch covered Ukraine's tech industry. Before the events of the winter 2014 the percentage of Russian capital in the total venture capital volume invested in Ukrainian high-tech market was higher than that of the current period. Throughout 2012-2013, foreign investment funds and private investors sent over \$50 million. Russian funds, Naspers and Almaz Capital, were the most active international funds. The funds from Russia invested over \$20 million in 2012-2013. European and U.S. funds, such as TMT Investments, Runa Capital, Imperious Group have been the most active.

Liquidity of the deals is high, but the number of merger deals is not high. Over the past five years the volume of liquidity events has grown up to over \$455million in 2013. Unfortunately, this high number is explained by just one deal as the acquisition of GlobalLogic by Apax Partners for \$420million. In the history of the Ukrainian tech industry this is so far the biggest liquidity event for the Ukrainian IT sector. It is important to mention other acquisitions, like the acquisition of Portmone e-payment service by the PE fund Dragon Capital's Europe Virgin Fun. The e-commerce platform Fotomaghas been acquired by a private investor. The VETEK Group acquired UMH Digital. The acquisition of Viewdle for an estimated \$45 million by Google and the acquisition of Lookserly for an estimated \$150 million by Snapchat have become the largest early stage startup acquisitions up to date.

Merger deals account only two mergers in 2012 as KyiAvia merger with Tickets.ua and United Online Ventures merger with Tochka.net. The initial public offering of the dating service Cupid in 2010 has become the only public offering of a service or product company seen on the Ukrainian tech market so far. Among the outsourcing companies, EPAM and Luxoft went public in 2012 and 2013. These two companies have large R&D centers in Ukraine. The number of engineers they employ exceeds 5,000 (Figure 5-6).

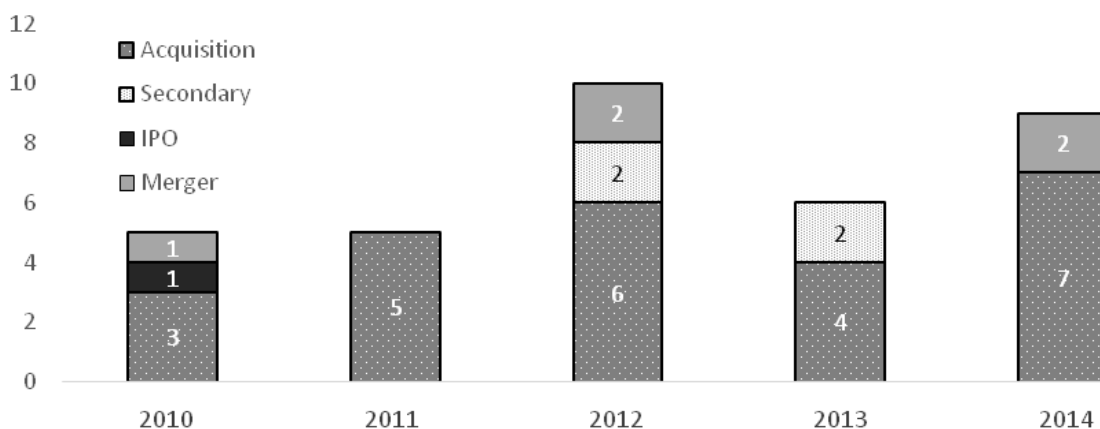


Figure 5: Total number of liquidity events, 2010-2014

Source: [92]

In 2013 many venture capital was invested into Ukrainian tech companies through the syndicate deals, where both Ukrainian and foreign players worked together. There weren't too many of such deals until 2014. However, in the end of

2013 there was a rise of this trend that marked the beginning of cooperation between Ukrainian and foreign venture capital investors.

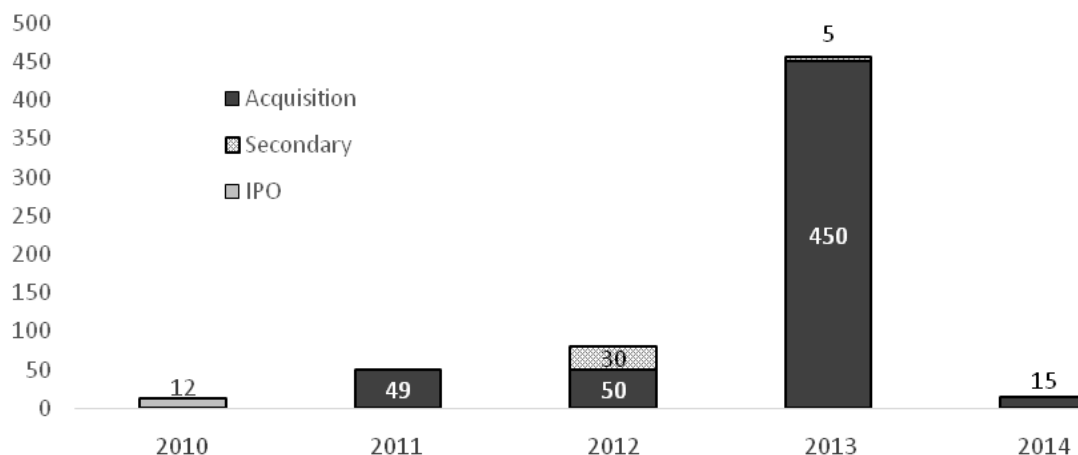


Figure 6: Total amount of liquidity events, USD millions, 2010-2014

Source: [92]

Although the political instability remained high in Ukraine throughout 2014, there were a high number of pre-seed and seed deals. The amounts weren't higher than the previous year, though. This change led to the decrease in the investment volume of 2013. The average deal check has decreased to \$270,000. The bad influence of the political and economic situation led to the contraction of the money present on the market. In 2016, the market is expected to fully recover from the conditions that worsened its image in 2014.

Worth a positive note is the growth of the investment activity in 2010-2013, both in the number of deals and investment money. The graph in the figure 5 illustrates the trend projecting various investment stages and liquidity events. The activity expanded across all investment stages, and the expansion in the investment volume can be attributed to the increase in the number of Round A deals. They accounted for 60% of investment volume in 2013.

One reason it is hard to determine the real growth numbers of the Ukrainian tech industry is the lack of transparency in many deals, meaning that many deal amounts are kept undisclosed. Due to the industry's experts' insides, the volume of the liquidity events increased twice from 2013 to 2014. The year of 2013 has seen the biggest influence on the tech industry from the side of the venture capital market. The transparency of the venture market is still a questionable topic, although Ukrainian tech and venture companies learn to share data, cooperate and exchange information and experience. Much larger number of technology-focused media resources started covering events happening on the technology market in Ukraine. Often the information leak has also contributed to the growth, paradoxically.

According to Ukraine's Dealbook, 70% of the venture deals that were closed in 2012-2014 were disclosed and up to 65% were disclosed in 2010. 2013 marked the year of the biggest transparency. Nevertheless, due to the industry experts an estimated amount of \$29 million makes up the number of the unreported deals. The

year of 2014 still saw an increase in Round A deals, the average check was many times higher than that of the disclosed deals. The estimation of the volume of unreported deals is shown in Figure 7.

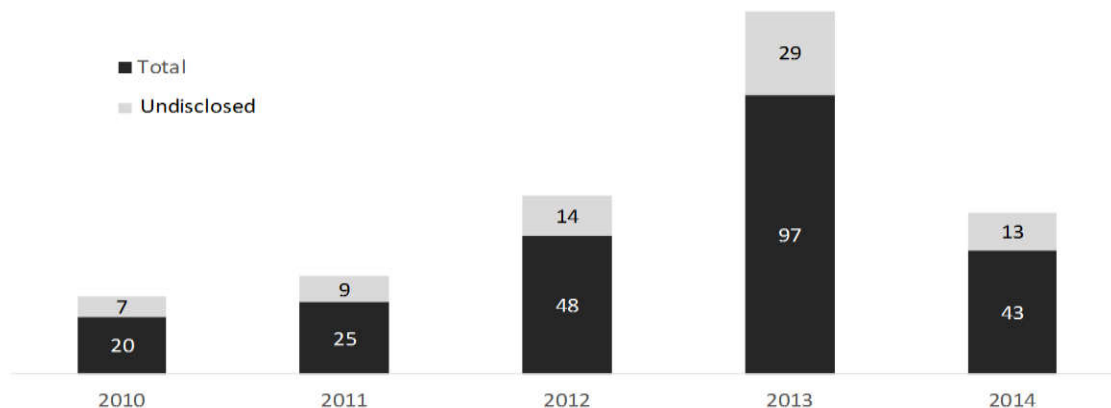


Figure 7: Estimation of unreported deals, USD millions, 2010-2014

Source: [91]

Talking about the reported deals, the field of e-commerce received the biggest share of venture capital among other tech-related companies in 2013 and grew at a 49% rate year-on-year. There are now over 7,000 e-commerce stores in Ukraine. The estimated market size is close to \$2.5 billion. It is still one of the most potentially attractive segments of the Ukrainian Internet. Over 50% of the consumed goods are made of electronics, marketplaces, clothing, apparel, and online booking services. The segment of electronics remains the largest one, but it doesn't show a very rapid growth. It is rather modest and amounts to 30% year-on-year.

International e-commerce players increased their role in Ukraine. However, these global e-retailers still haven't placed their offices in Ukraine, explaining it with the same issue as a weak legislative base for the venture capital and tech businesses. Such services as booking.com, aliexpress.com, amazon.com and ebay.com provide services in Ukraine but do not place their subsidiaries here. The largest investment deals in the e-commerce sector of Ukraine are those made by Naspers (investment of over \$5 million in ModnaKasta); TA Venture (investment of over \$5 million in Label.ua); Flint Capital (investment of \$2 million in Topmall). One of the largest marketplaces in Ukraine, Prom.ua has been backed with \$2 million by Naspers in 2012. Clothing e-retailer Label.ua closed a \$1 million investment round with a private investor.

E-commerce is still in its very early stages of development as only in fall of 2015 the law on e-commerce has been passed by the Ukrainian Parliament and signed by the president that finally started regulating the e-commerce in Ukraine and now protects local consumers. However, the e-commerce segment of Ukraine's tech industry needs not only money and positive cash flow. The increase of Internet penetration, consumer adoption of the culture of online buying, and the development of online marketing offerings can make the segment much stronger and wealthier (Figure 8). In April 2016 EY company experts with the support of UVCA conducted a key quiz of main players in the market of direct and venture investments.

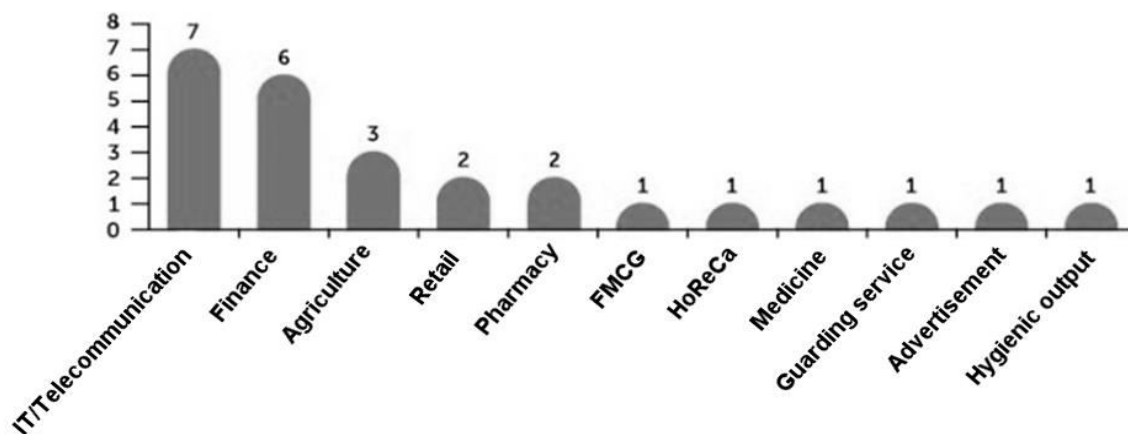


Figure 8: Public Deals of Private Equity by Sectors in 2011-2015

Source: [89]

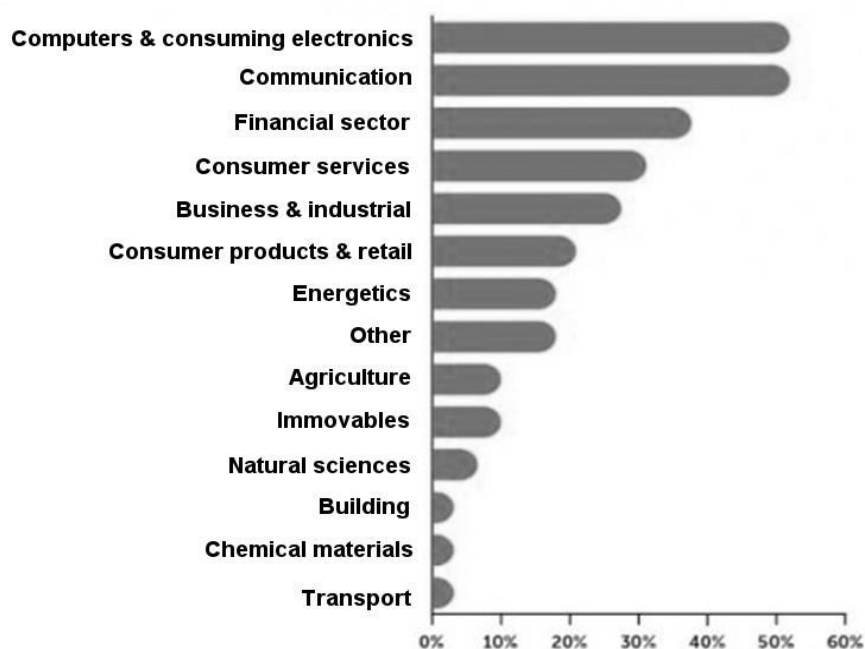


Figure 9: Industry preferences of major players in the market of direct and venture investments in Ukraine

Source: [89]

The results have been processed by EY analysts and presented in the review industry trends format prepared as a joint project with the company "Kyivstar" (Figure 9).

Most of the respondents constitute institutional investors: 20% of respondents are the representatives of private equity funds and 63% of venture capital funds. Also, business angels (6%) and business incubators / accelerators (11%) participated in the study. Among the sectors, which are most popular among respondents, special place is given to the segment of computer equipment, electronics and communications. There was not observed substantial increase in direct and venture investment market volume in 2015.

CONCLUSIONS

In order to summarize the above-mentioned points, given the current economic situation in the country, the venture investments in high-tech sphere currently strengthen its position as one of the most attractive, both in the short and in the long-term prospective, for the needed and longed for modernization and restructuring of the domestic investments market.

The critical importance is attached to the role of governmental intervention in the activities of the investment institutions, motivating private investors by channeling public funds in the field of IT, following the example the USA and Western Europe, effective usage of the national scientific developments and promotion of the venture capital market infrastructure. The first and the foremost change that would lead to the automatic and immediate advancement of the investment attractiveness of Ukraine is the stabilization of the political situation and the implementation of the successful reforms in terms of deregulation. Quite needed in order to improve the situation is the stabilization of the political situation the country is in. Especially, bad influence currently is the inability to have long-term business partnerships with the Russian venture capital funds, private equity investors, financial institutions that were sending some investments towards Ukrainian IT industry.

Due to the events of 2014, the majority if not all the investment flow has been cut tremendously, leaving a huge gap that should have been filled with the foreign venture capital from other countries. However, the image of the country torn apart by war still persists in minds of foreign business owners and investors, hence, it's the duty of Ukrainian government now to help make situation more calm and stable. Although the geopolitical situation is hard, inside the tech industry, the new type of venture investors and tech entrepreneurs are being nurtured on daily basis.

The number of new tech-related startups in e-commerce, financial tech, energy consumption tracking, real-time face modification, 3D printing and other unusual for Ukrainian traditional economy spheres are being listed among the world's most talked about startups.

Further research opportunities: The topic scrutinized in this research can be extended further by looking for the cross industrial links between the current geopolitical situation in the country and the levels of development of other industries in Ukraine. Considering the weakened status of Ukrainian traditional industries, like metallurgical, mining, machine building and many others due to the unstable conditions on the eastern part of the country, where the core companies of the mentioned industries used to operate, Ukraine's IT industry remains the one less likely to be weakened by such conditions. It is mobile and depends mostly on the availability of the stable Internet network and the skilled work force.

This point, however, needs to be researched more. Provided that the overall regulatory conditions keep on restricting local and foreign entrepreneurs from registering companies in Ukraine due to the inefficient legislative regulations that do not provide safety for the minority investors and other specifications of Ukrainian legislative system, it will be important to concentrate on researching

prospects of the development of Ukrainian venture capital market in such complicated conditions.

The question of the growth possibilities for the Ukrainian IT industry is quite debatable granted that there might be a shortage of growth level startup funding that in some projects declares the necessity of \$500,000-1,000,000 investment influx. The scope of such funding might be covered through syndicate deals where venture funds or private investors make a group cash influx.

However, another end of the issue is in the fact that Ukrainian venture capital funds community is growing too slow to bring the needed amount of funds to the startups that do need it currently. The possibility to attract new foreign investors is what many local venture capital investors are looking for.

Another arguable point is the fact that most Ukrainian tech companies have their headquarters abroad, while only their subsidiaries are in Ukraine. This situation pushes forward the obvious question as to how the venture capital should enrich Ukrainian tech industry while the majority of its players are registered as private entities abroad.

Hence, the only money Ukrainian subsidiaries get is dispersed via the teams located in Ukraine in the form of salaries only. There is no actual big money influx into the Ukrainian budget. Hence, the topic of this research needs to be pushed further into the legislative aspects of the Ukrainian tech industry development.

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