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## VENTURE INVESTMENT AS A BACKGROUND FOR INNOVATION DEVELOPMENT

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The article deals with the venture entrepreneurship as a phenomenon and explains the nature of venture investment. The author pays attention to an issue of attracting venture capital to finance newborn projects in the modern world and defines the stages which can appear in the process of venture capital investing. Current state of startup ecosystem, its constraints and incentives are described in the research. The key facts and important differences about the startups are outlined in the paper. Fact which is of a current concern is that the ecosystem is getting more competitive and the investors are getting more cautious about choosing the project to invest in, that is why the conditions are stricter year by year. The paper summarizes the types and forms of venture investment and justifies the benefits of their use in building up and developing an enterprise. The features of attracting venture investments are identified and the specifics of the venture investor-consumer are determined in the context of innovation development. The mechanism of venture funds and their types are analyzed. The main factors influencing the formation of ecosystem of startups in Ukraine are studied and legal aspects problems are explained. The paper names the most famous startups exchanges platforms and reveals investors algorithm to use such platforms nowadays. The research also considers the influence of coronavirus epidemic to attract money and figures out some possible consequences for venture investment trends, as a result – the key future threats of the market are named. Finally, the crucial importance of venture investments to cultivate innovation has been explained and proven by this research.

**Keywords:** startup, venture investment, venture fund, investor, entrepreneurship, innovation, startup ecosystem, startup exchange.

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### *Research Justification*

Venture investing is an effective tool for the development of many economies, under the current conditions, the development of the national economy does not meet the current trends of the global ecosystem, it is manifested both in the functioning of enterprises in the Ukrainian economy and in the formation of a strategy for attracting investment at the macro and micro level. Great technology, great data on behavior, great reputation as a though leader, great expertise, great advisors, are not enough to be market-fit, nowadays startups should have business model that solved a pain point in a scalable way. The success of companies depends not only on financial support, but also on quality marketing research, information resources, as well as material

and manpower resources, all of which can be provided in a timely manner with the help of venture investment. The field of venture investing is of a current concern and it is constantly analyzed, because there is no clear mechanism for integrating the Ukrainian market into the global ecosystem of venture capital.

### *Purpose of the Paper*

The purpose of the article is to research and popularize comprehensive venture investment as a tool to optimize the process of innovation development.

### *Main Material*

The current state of the world economy development implies the emergence of modern financial and organizational management tools for

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innovative enterprises. One such opportunity is the emergence of «ventures» for existence in a highly competitive environment. And venture entrepreneurship, as a phenomenon, could empower Ukrainian businesses by raising capital. The theoretical literature on the nature and defining specifics of venture entrepreneurship, as well as its types and forms, has not been sufficiently explored in Ukrainian literature. The success of companies depends not only on financial support, but also on quality marketing research, information resources, as well as material and manpower resources, all of which can be provided in a timely manner with the help of venture investments.

“Venture” translates as “risky business”. Venture business is a special business model where funds are invested in dozens of companies, half of which are closed, some return investments and one can provide ten times the profit and another one can provide one hundred times the profit. Usually, the profit will be formed according to the size of the risk and the period of investment. For many, “venture” means a project that will bring 10X to its investors, in order to recover the money for all lost investments. But various sources sometimes even give conflicting definitions of these concepts, such as scientists such as Yokhna, Kuteynikov, Morozov, Peresada and others.

Venture entrepreneurship is an initiative venture funded by venture capital raising aimed at significantly increasing the market value of invested objects, including through the acquisition, use and commercialization of research and development results, the launch of new competitive technologies, products, services [1]. Venture activity is, accordingly, an innovative risky activity that reflects a coherent system of financial relationships with respect to venture capital.

Sphere of venture capital and ecosystems has been analyzed by many Ukrainian and foreign researchers: A. Dagayev, T. Kalinescu, A. Kashirin, K. Campbell, O. Kovalyova, V. Koretska-Garmash, O. Krasovskaya, B. Pylypenko, N. Redina, D. Taradayko, N. Fonstein, L. Shilo, Y. Shipulina.

The world’s leading countries expertise shows that the startup entrepreneurship ecosystem includes the following important interconnected elements: higher education institutions and research institutions; venture capital market; innovative business support infrastructure; small and medium-sized businesses; regulations governing the activities of innovators, etc. An important component of the ecosystem for startup development in most developed innovation economies is the availability and development of innovative business incubators and accelerators. Accelerators are gaining ground in Ukraine, along with the growing demand for startups

for relevant services for their rapid growth.

A clear definition of venture capital is difficult to form on the basis of available literature, but it is a capital that reflects the system of relationships between venture entrepreneurship subjects for the purpose of research, analysis and commercialization of innovations, which has the nature of long-term direct equity investments. It is possible to question the interpretation of it as the type of financial capital, because the one can invest an experience or network, depending on the type of investor. The characteristic of venture capital is its relative illiquidity, it will be necessary to wait at least 3–5 years.

Venture investments can be made by both individual investors (for example, business angels) and institutional investors (venture capital funds) or units of investment banks, funds (pension and insurance), large corporations, and a new form of recent decades – crowdfunding. Such investments are attracted for 2.5–7.5 years, on average, and should give the subject influence on the management of the company and the right to financial control of the newly established or part of the already existing company that attracts venture investments, like direct investments. Preferably, such investment takes place in the early stages of development.

As for venture funds, in Ukraine it is more often a form of limited liability partnership. Inside the fund are the managing partner and the «limited» partners – the investors who have invested their funds and may influence the managing partner’s decisions through the supervisory board. The general partner receives a management fee of 2–3% of the fund size and a percentage of the profit, usually – around 20%. There is a special type of fund – «evergreen», what means that profits are constantly reinvested in new projects, and traditionally the return on investment will be 5–7 years within the existence of the fund. In terms of profitability, the average ratio will be 2.5–3, if 5 is already a successful fund, very few funds show a result with a factor greater than 10. Another important indicator for the fund is annual yield, the standard is 25–30% per annum, but there are record highs of 914%, for example [2].

The specific of venture investing is that in addition to financial resources, other tangible and intangible resources can be invested, from know-how to investor experience and business relationships.

Object of venture entrepreneurship is a venture activity, in the process of which new technologies, goods, services are created and implemented.

Among the system elements of venture activities are the following:

- intellectual Property;
- innovative products or processes;
- innovative programs;
- venture projects;

- contracts between venture capital entities;
- shares of venture capital companies;
- new technology;
- goods;
- raw materials;
- the subject is the founder;
- the subject is the venture capital entity.

A business model of venture startup often has three obvious characteristics: firstly, this business model must have a high-quality unit economy, so the price of a product or service must far outweigh the cost; secondly, this business model must be scalable quickly; thirdly, this business model should have «built-in» protection from competitors. It is easy to see that turnover, profit and therefore the value of such a startup will grow rapidly.

Such not a complicated concept, for example,

explains why SaaS startups are so understandable to venture investors. They are profitable at the expense of practically zero marginal cost (services for each new client have minimal additional costs for the company), they are quickly scaled (due to lack of material assets – factories and steamers) and they are protected from competitors due to the need to cancel the subscription. Thus, it is a powerful team, a huge market, a lack of competitors and a clear business model. For the first time, the term “startup” appeared in 1939 in the United States, almost all high-tech enterprises concentrated near San Francisco, the first such startup was Hewlett Packard. For the Western markets, startup is a complex company where every professional is in their place, and there is an innovative technology that can quickly respond to new consumer demands – more flexible.

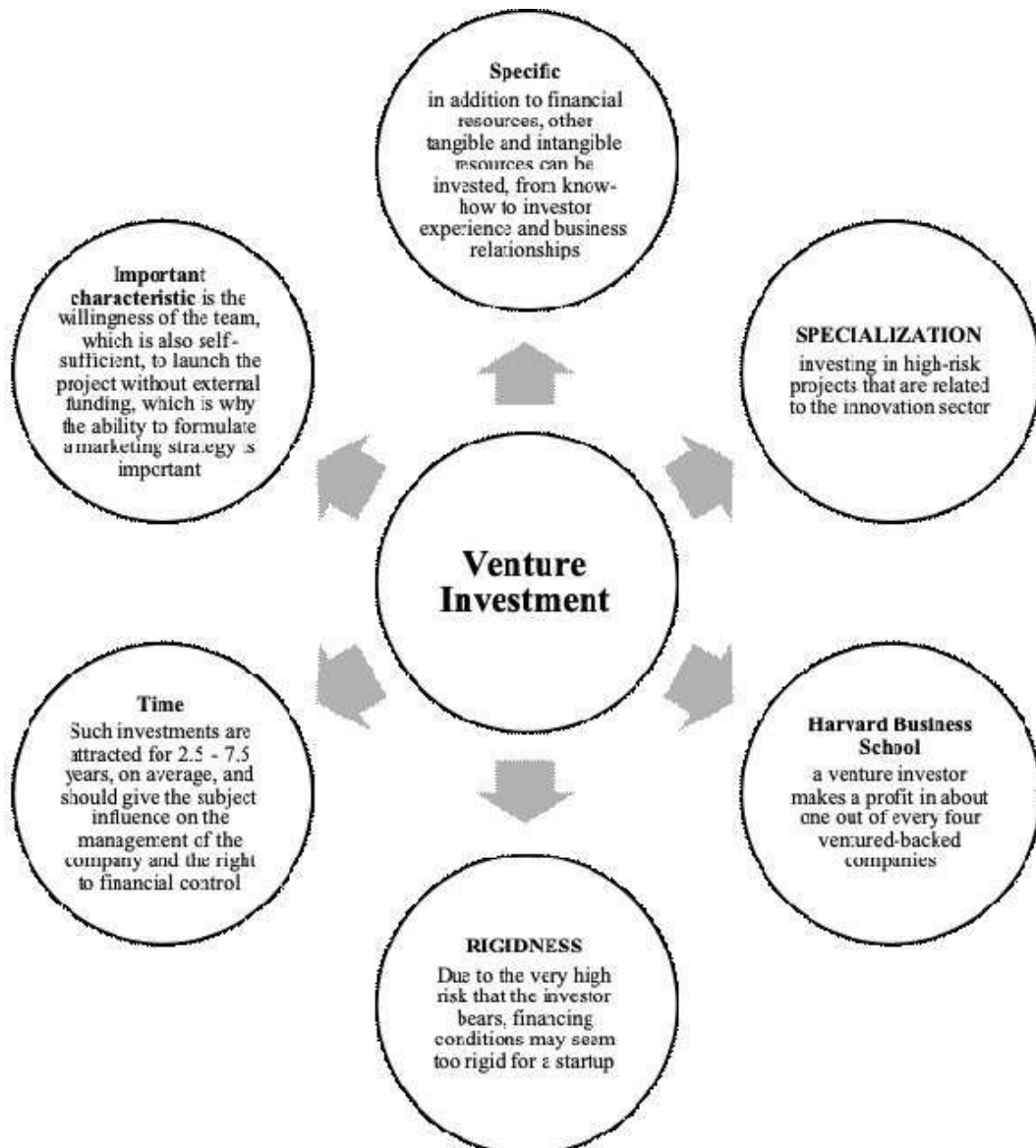


Fig. 1. Key Facts About Venture Investments Nature

Source: developed by the author based on the previous researches

In the process of attracting such investments it is necessary to understand that this happens on the rounds – stages of raising funds for the development of a startup. Traditionally, founders either invest their money at the start or use the friends, family and fools (FFF) source, but then the pool needs to be expanded for MVP or scaling or entering new markets. Even when attracting venture investments from friends, it is necessary to specify what the investor will receive if the project is successful; what percentage will the investor receive if it is a loan; what risks will be if the startup fails.

The minimum viable product is a working prototype of the final product that is scheduled to be launched. Having an MVP will help you reassure a potential investor and also let you know how to work on a product after test use, meaning customer feedback could be collected. To create such a product, it is necessary first of all to find the most important characteristic in the concept of the product and only sell the product without some additional features. It is important to minimize time and money costs, but for the outcome to answer the question of whether to continue – success criteria and result indices must be developed here.

There are three early stages of attracting investment for startups:

- pre-seed stage – at this stage, the main task is to test the hypotheses of the business idea, determine the vector of activity and turn it all into a minimum viable product.

- seed – go to this stage when the product is ready and the funds raised in this round go to the development, improvement of the product to bring it to the state of «market fit» – the product meets market requirements and solve a real problem for consumers in this market and they are willing to pay money for it (from \$ 25,000 to \$ 1 million)

- Round A – these funds will be used for the improvement and further development of the product, when the product already meets the requirements of the market, here the funds are collected for a professional and competent team, the start of mass production and full market entry. This round only happens if the viability of the product concept has already been proven in the seed stage. Investors can also support business scaling (from \$ 500,000 or more, often in tranches, with an average of \$ 13 million).

The following are the later stages, denoted by alphabetical letters (B, C, D, etc.), which focus on further scaling, entering new markets, expanding product portfolios, developing a team, or even acquiring another startup or enterprise:

- Round B – focuses on scaling business, increasing revenue and market share, the round occurs only after certain indicators of development

- Round C – companies increase their shares and start earning profits, this is a time when cash flow can support and grow a business on its own.

At these stages, the requirements for financial performance and company reporting are increasing. And in round D there is pre-sale financing – that is, preparing the company for an IPO or selling it to a strategic partner. These are very large rounds with less risk and less return on investment.

Venture funds typically do not invest in the pre-seed stage, start with the seed stage and its rounds, when the team is already working on a minimum viable product and starting making first sales, and then the average size of the round will be \$ 1–2.5 million.

Particularly important for the development of venture capital is the involvement of TNCs in this process, which are buying up promising projects, for example – Apple reported the acquisition of 29 companies, and Google in the last nine months invested \$ 4.2 billion for the first half of 2019, by the way Google recently acquired a Ukrainian startup for \$ 50 million – Viewdle.

Among the benefits of venture investing are the following:

- the investor may be eligible to participate in the management and have a profit share if the project is implemented

- you can invest a small amount, then you can expand your share and have the privileges to buy

- no need to be a professional economist / financier to invest

- it is possible to choose the field and focus on a specific list of industries

- there is an opportunity to earn extra profits with minimal investment if the business is implemented correctly and in accordance with market conditions

But there are also disadvantages of venture investing:

- high risk of losing all investment;
- changeability + volatility of the environment that can eliminate investment efficiency;

- probability of disputes between investors and their exit from the project, which will significantly reduce the profitability of the company;

- instability of investment income or lack of it;

- the need for additional investment for development and scaling;

- profit is only possible in the long run.

Nowadays, in the age of digitization, there are so-called startup exchanges – these are special websites that are a platform for meeting startups with investors, where an investor can invest money and founders run their startups. According to

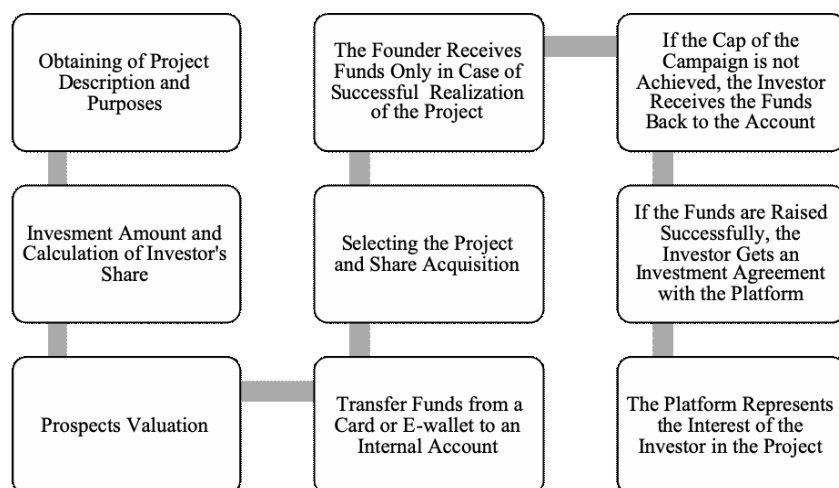


Fig. 2. Venture Investment Algorithm on Modern Digital Platforms (Startups Exchanges)

Source: developed by the author based on the previous researches

Crowdsurfer, there are now more than 250 platforms available for successful investment in startups, including AngelList, CrowdCube, Indiegogo, BanktotheFuture, Seedrs, etc. For the investor this process is as follows:

It is also important to understand that investors can be classified into different categories, both by the rounds in which they are active and by the industries in which they invest. As for Ukraine, we have a shortage of professional investors, when compared to other countries in Europe and the US, where competition is tougher.

The Western Venture Capitalists' investment formula is as follows: 30/40/30, which means 30% of the portfolio does not work, 40% are weak projects, 30% provide a relatively good result. For example, if of about 6–8 projects works out in a portfolio of 40–50, then such a Fund can be called successful.

There are also 5T concepts that venture capital funds use: T1 – the team, T2 – the technological component of the product, T3 – the market the startup is focused on, T4 – the current commercial status of the company, its activity, T5 – factors that should protect the business from external threats. The company team plays an important role, as it is the ability to dramatically change strategies and pivot.

From the statistics of the unique information base of CrunchBase startups, we can conclude that the average startup attracts about \$ 25.3 million. and ultimately sold for an average of \$ 196.8 million, and the investor's income averages 676% (assuming 100% ownership) [2]. Also, according to a study of Belarusian scientists, the largest number of successful exits were recorded after 18 months of investment.

From a legal point of view, there is a significant problem, because there is no law that regulates this area, so it is acted by common rules, like signing an investment agreement (the document covers details of the goals for which the funds are allocated, as

well as specifying the characteristics and parameters, which will guide the startup) – the development of a system of reporting and control, the final result and terms, the loan agreement (only the process of using the received funds is regulated). It stipulates the development of a reporting and control system, the final result and terms, the loan agreement (only the process of using the received funds is regulated). There is an opportunity to prescribe the procedure in case of occurrence of circumstances in which the term of repayment will be reduced, indicating also the rate and terms of change of the indicator , or a simple partnership agreement – if several entities with the same rights invest and specify the procedure for the use of common property, methods of communication, the procedure for allocation of shares and the order of termination of the contract together with the scheme of payment of compensation to project participants on exit.

The initial stage of development of venture capital funds in Ukraine can be considered as the date of adoption of the first legislative act regulating the activity of joint investment institutions. Since 2001, the Law of Ukraine “On Joint Venture Institutions (Unit and Corporate Investment Funds)” of 15.03.2001 No. 2299-III, which was updated in 2012 by the Law of Ukraine “On Joint Investment Institutions” of 05.07. 2012 No. 5080-VI – as of now, January 6, 2018.

Unlike European funds, Ukrainian venture funds are not focused on investing in innovative projects and high-tech industries. An in-depth analysis of the largest venture funds by asset value and profitability, as well as the asset management companies of these funds shows that most of them are used as a tool for joint investment and tax optimization in the construction, financial and agrarian sectors. Currently, the Cabinet of Ministers of Ukraine has formed a fund that will invest UAH

50 million in domestic startups in the form of grants.

Venture capital can be invested through investment funds, through pools with several private investors – the advantage of the pool is the ability to invest not only financial but also some material resources. Such methods fairly distribute profits and reduce losses in the case of failure.

The world's most popular ways to exit from venture investing are:

- repurchase – sale of investor's share to company management;

- repurchase of shares by employees of the company or managers;

- direct sale to another investor or strategic partner;

- IPO – access to the stock exchange through public offering, this exit is the most attractive for the investor;

- compulsory purchase of shares by the management of the company if the cost of the project was formed at a lower level than planned;

- forced exit, more often in the conditions of liquidation of the company.

Venture investments are the way of an aggressive investment strategy that includes investments in shares of second, third tier, venture capital enterprises. The risks of such a strategy are very high, but the profit may also be high. Investment in startups has become very popular in recent years, with more and more investors recognizing the potential fortune to be made from supporting the right startup. Between 2012 and 2017, startup funding across all industries grew by at least 50%, with some industries like advanced manufacturing and robotics reporting nearly 1,400 percent more funding in 2017 than 2012. In 2013, the total funding for artificial intelligence startups amounted to about \$ 1.7 billion, which grew to over \$ 15 billion by 2017. Although it takes a team to create a successful startup, it is not uncommon for the media to fixate on the founder or the head of a successful startup, such as Steve Jobs, Elon Musk, or Mark Zuckerberg to name a few. Stanford University and Harvard University have the highest number of alumni who founded unicorns worldwide.

In the field of venture investing, as in any other sphere, the sociocultural features of the macromarketing environment are crucial, as personal relations are important for Asian countries. Before investing the funds, the fund conducts a thorough analysis and consults with experts of one or another industry. It also used to be said that if you were first to market with the right product at the right time, you could expect to take a 60% share of the market. Today, that figure is probably closer to 80% with perhaps 15% going to second place and a slim 5% of the total share spread between the rest of the field.

The figures are anecdotal, but the pressure to deliver market share is real for R&D teams across industries trying to grow and capture more market share by bringing new and better products to customers faster than their competitors. For startups working in a high-risk field like biotech, discipline and scientific rigour are essential for keeping the mission – and its funding – on track.

Sustainability is a global priority and depends on chemistry, say two world-renowned scientists. It is estimated that the Ukrainian economy has not received \$ 150 billion in the form of investments, and the last almost 20 years, is considered a time of missed opportunities. Therefore, to exceed \$ 1 trillion, according to Amelin strategy estimates, the Ukrainian economy must raise \$ 79 billion. foreign and domestic investment annually. Ukraine's need for foreign investment is estimated at \$ 234 billion. for 15 years [4]. Such growth is planned under the key condition that the share of R&D will be about 4% of Ukraine's GDP (2018 – less than 1%). According to other estimates, the country has the potential to receive from 120 to 270 billion dollars over the next 15 years. And it is possible that there are examples in the global economy, such as South Korea, which has grown 22 times in 12 years, thanks to investment in its economy, and Poland, which has managed to attract 200 billion euros in investment. Thus, an integral tactical step of our country's sustainable development strategy is to integrate and improve the Ukrainian venture ecosystem into the global one. Today's business environment can hardly be called favorable for increasing the volume of successful investment projects, because more than 50% of already completed investment projects are not implemented precisely through procedural and administrative obstacles, deterring foreign investors. Ukrainian profile associations, such as UVCA, the National Investment Council and the Investment Attraction Office, are designed to assess potential risks and propose ways to address them promptly, initiating changes to the legislative structure of Ukraine. The need to include venture capital in the elements of the national innovation system of Ukraine was reflected in the development of the Innovation Strategy of Ukraine until 2020.

Venture seed-stage financing is a vital step for many growing startups, the features of which have been revealed in the paper. However, venture agreements are now being hit during the coronavirus epidemic – decline by 22% in Q1 2020 compared to Q4 2019 is been forecasting [3]. This is due to a complication of economic factors – including uncertainty due to the spread of coronavirus. Investments from large venture funds are shrinking as they focus on managing existing portfolio

companies, not currently looking for new investment opportunities. As stock prices fall, investors of all types seeking to protect their returns may shift to more secure assets, such as bonds, gold, or later-stage companies investment.

Therefore, a venture company is usually understood to be a commercial scientific and technological company engaged in the development and implementation of new technologies and products with an indefinite advance income, that is, with a risky investment. Venture business has several advantages over other forms of innovative entrepreneurship: high flexibility, dynamism, etc. For many companies, venture capital is the main way to invest in innovation and their R&D. Large companies lack the flexibility of small firms, so there are difficulties when trying to develop new innovative products or services, expanding their market presence, or conducting advanced technology research. Investing in startups is an important step to stimulate new ideas and products in the corporate field.

### Conclusions

This chain of facts can easily bring us to the conclusion that startup is a technology company that is driving the expansion and growth of innovation. There are more unexpected stakeholders which are emerging in this area and traditional companies are also setting up their venture capital funds to remain competitive in the global market. Nowadays every startup should build up a feasible and clear marketing strategy to be competitive on the venture capital market. Thus, investing in startups, that are relevant to the industry and fit the market, could not be considered innovative strategies, these are survival strategies that aim to make the business feasible and growing before the market leaves the business far behind. The introduction of the nature of venture investment and its specific, based on the study of progressive foreign countries experience, will set the vector of development of the national venture capital market and explains all the benefits of such a process. The objective of the paper was to prove that Ukraine also needs to attract foreign investors and create appropriate ecosystem for its more efficient functioning, which will quantitatively and qualitatively change the potential of Ukraine and its place in the international market.

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### ВЕНЧУРНІ ІНВЕСТИЦІЇ ЯК ПЕРЕДУМОВА ІННОВАЦІЙНОГО РОЗВИТКУ

Кузнецова Ю.

У статті розглядається венчурне підприємництво як явище і пояснюється природа венчурних інвестицій загалом. Автор звертає увагу на проблему залучення венчурного капіталу для фінансування новонароджених проектів в сучасному світі і визначає етапи, які можуть виникнути в процесі венчурного інвестування. Поточний стан екосистеми стартапу, її обмеження і можливості описані в цьому дослідженні. Ключові факти та важливі відмінності стартапів також викладені в статті. Факт, який в даний час викликає стурбованість, полягає в тому, що екосистема стає все більш насиченою і конкурентною, а інвестори стають більш обережними при виборі проекту для вкладання коштів та/або часу, тому умови з кожним роком стають все більш жорсткими для нових підприємців. У статті узагальнені види і форми венчурних інвестицій та обґрунтовано переваги їх використання при створенні і розвитку підприємства. Автором було виявлено особливості залучення венчурних інвестицій та визначено особливості венчурного інвестора-споживача в контексті інноваційного розвитку. Також аналізується механізм венчурних фондів і їх види. Вивчено основні фактори, що впливають на формування екосистеми стартапів в Україні, і роз'яснені проблеми правових аспектів. У статті названі найвідоміші стартап-біржі для залучення інвестицій стартапами і розкритий алгоритм дії інвестора для використання таких платформ в даний час. У дослідженні також розглядається вплив епідемії коронавірусу на залучення інвестицій і з'ясовуються деякі можливі наслідки для процесу венчурного інвестування, в результаті — названі ключові майбутні загрози ринку. В цілому, це дослідження пояснило і довело важливе значення венчурних інвестицій для розвитку інновацій.

**Ключові слова:** стартап, венчурні інвестиції, венчурний фонд, інвестор, підприємництво, інновація, стартап-екосистема, стартап-біржа.

## ВЕНЧУРНЫЕ ИНВЕСТИЦИИ КАК СТИМУЛ ИННОВАЦИОННОГО РАЗВИТИЯ

Кузнецова Ю.

В статье рассматривается венчурное предпринимательство как явление и объясняется природа венчурных инвестиций. Автор обращает внимание на проблему привлечения венчурного капитала для финансирования новорожденных проектов в современном мире и определяет этапы, которые могут возникнуть в процессе венчурного инвестирования. Текущее состояние экосистемы стартапа, ее ограничения и возможности описаны в исследовании. Ключевые факты и важные отличия стартапов также изложены в статье. Факт, который в настоящее время вызывает беспокойство, заключается в том, что экосистема становится все более конкурентоспособной, а инвесторы становятся более осторожными при выборе проекта для инвестирования, поэтому условия с каждым годом становятся все более жесткими для новых предпринимателей. В статье обобщены виды и формы венчурных инвестиций и обоснованы преимущества их использования при создании и развитии предприятия. Выявлены особенности привлечения венчурных инвестиций и определены особенности венчурного инвестора-потребителя в контексте инновационного развития. Анализируется механизм венчурных фондов и их виды. Изучены основные факторы, влияющие на формирование экосистемы стартапов в Украине, и разъяснены проблемы правовых аспектов. В статье названы самые известные стартап-биржи для обмена и раскрыт алгоритм инвестора для использования таких платформ в настоящее время. В исследовании также рассматривается влияние эпидемии коронавируса на привлечение финансов и выясняются некоторые возможные последствия для процесса венчурного инвестирования, в результате — названы ключевые будущие угрозы рынка. В целом, это исследование объяснило и доказало решающее значение венчурных инвестиций для развития инноваций.

**Ключевые слова:** стартап, венчурные инвестиции, венчурный фонд, инвестор, предпринимательство, инновация, стартап-экосистема, стартап-биржа.

## VENTURE INVESTMENT AS A BACKGROUND FOR INNOVATION DEVELOPMENT

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The article deals with the venture entrepreneurship as a phenomenon and explains the nature of venture investment. The author pays attention to an issue of attracting venture capital to finance newborn projects in the modern world and defines the stages which can appear in the process of venture capital investing. Current state of startup ecosystem, its constraints and incentives are described in the research. The key facts and important differences about the startups are outlined in the paper. Fact which is of a current concern is that the ecosystem is getting more competitive and the investors are getting more cautious about choosing the project to invest in, that is why the conditions are stricter year by year. The paper summarizes the types and forms of venture investment and justifies the benefits of their use in building up and developing an enterprise. The features of attracting venture investments are identified and the specifics of the venture investor-consumer are determined in the context of innovation development. The mechanism of venture funds and their types are analyzed. The main factors influencing the formation of ecosystem of startups in Ukraine are studied and legal aspects problems are explained. The paper names the most famous startups exchanges platforms and reveals investors algorithm to use such platforms nowadays. The research also considers the influence of coronavirus epidemic to attract money and figures out some possible consequences for venture investment trends, as a result — the key future threats of the market are named. Finally, the crucial importance of venture investments to cultivate innovation has been explained and proven by this research.

**Keywords:** startup, venture investment, venture fund, investor, entrepreneurship, innovation, startup ecosystem, startup exchange.

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