



## International Journal of Economics and Financial Issues

ISSN: 2146-4138

available at <http://www.econjournals.com>

International Journal of Economics and Financial Issues, 2015, 5(Special Issue) 231-237.

Economics and Society in the Era of Technological Changes and Globalization



# Business Angel Investment in Russia: Problems and Prospects

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### ABSTRACT

Russian state policy is aimed at the formation of the national innovation system. Stimulation of the innovation activities of entrepreneurs is crucial in terms of innovative development of the country. In many ways, it is determined by the availability of financial resources in the early stages of the innovation project. At the same time, a high level of risk determines the reluctance of traditional investors to make investments at this stage of development of the company. Funding for the seed stage of the innovative project can be often provided by private investors only. In this regard, the role of business angel investments, which are a powerful financial resource for the seed stage of the project, increases. Business angels can provide financial assistance when traditional investors, such as banks and even venture capital funds, refuse. The analysis of statistical information on the development of business angel investing in Russia was carried out to achieve the goal. The article deals with current trends and prospects of development of business angel investing in Russia, defines their role and importance for the development of the Russian economy. Special attention is paid to the problems faced by private investors who wish to finance the early stages of innovative projects.

**Keywords:** Business Angel Investment, Venture Funding, Innovation Activity

**JEL Classifications:** O12, O16, O32

## 1. INTRODUCTION

In modern conditions, the effectiveness of government policy is largely determined by the level of its innovative development. This innovative activity of the country contributes to the dynamic development of its economic system and increase in competitiveness in the global market. Innovations are the basis for sustained economic growth. The state policy of the Russian Federation is aimed at the active formation of the national innovation system of the country. At the same time, the target indicators stated in the “Strategy of innovative development of the Russian Federation for the period through to 2020” have not yet been achieved. In particular, domestic expenditure on research and development in 2013 amounted to 1.13% of gross domestic product at the required level of 1.5% (Afonasova, 2014).

Experience of other countries shows that the increase in innovation activity is largely determined by a number of components: Firstly, by the existence of favorable legal environment that ensures the reliability and protection of the interests of all the participants in innovation activity. Secondly, by the development of innovation infrastructure that promotes the implementation of innovative processes. Thirdly, by the government support of science and education, which are the main sources of innovation? Presence of all the above elements stimulates the innovative activity of entrepreneurs.

In recent years, there have been many efforts aimed at the development of the innovation system of the country. In particular, huge funds are allocated from the budget for R and D (research and development) financing. According to the Organization for Economic Cooperation and Development, Russia ranks eighth

(out of 37 countries selected for analysis) in absolute terms of R and D spending. At the same time, more than 80% of the total expenditure on research and development is allocated from the federal budget. In order to promote the development of venture business, Russian Venture Company (RVC) was established in Russia in 2006, which funds innovative projects, both at the expense of public funds and by attracting private investors. Since its inception, RVC has approved 175 companies for investments in excess of 15 billion rouble. In addition, a network of regional venture funds, which play a significant role in the innovative development of the regions, is created.

However, the main disadvantage of venture funding in Russia is its weak focus on the early stages, in particular, on the seed one (Nefedev, 2014). According to RVC, the share of investments in innovative projects at this stage was just over 7% of the total in 2014. In addition, there is an annual reduction in the amount invested in seed projects (71 projects in 2012, 57 in 2013 and 46 in 2014). At the same time, the problem of attracting financial resources is the most acute at this stage. During this period, neither banks nor even venture capital funds tend to provide funding for an innovative project in the absence of the possibility of clear business planning and risk calculation. The seed stage funding problems can be solved through the involvement of business angels. They are ready to provide their money when even venture investors refuse.

## 2. METHODOLOGY

The study of business angel investment was based on the works of Russian and foreign scientists. Issues of determining the economic role of business angel investment, its development trends and challenges of functioning have been studied by foreign experts from the United States, Germany, Britain, Sweden and other countries. Russian experts also made some contribution to the study of issues related to the definition of the nature of the business angel investment, the role and influence of business angels on the Russian venture industry. However, the problems of development and transformation of the market for business angel investments in relation to Russia and possible directions of activation of the private financing of innovation projects still have not been studied in depth yet.

The following main methods were used in the work: A systematic approach, inductive and deductive methods, comparison method, analogy method, method of analysis and synthesis. The basis for the analysis were the statistical data and analytical materials presented in the reports of RVC, as well as the market research of venture capital investments in early stage conducted in 2013 under RVC order by the Russian Public Opinion Research Center, where, in particular, the results of the survey of participants of the Russian market of business angel financing were provided.

## 3. RESULTS

### 3.1. Economic Value of the Business Angel Investment

Currently, the business venture may be funded from such sources as venture capital, public investment and business angel

investment. The latter differs from the first by the fact that venture funds invest borrowed funds, while business angels invest their own. In addition, in contrast to the state participation, the business angel investment is provided on a reimbursable basis, and the investor not just provides financial resources to the company, but also assists in the implementation of the project, shares experience and connections. Business angels independently choose the head manager of the project (not the inventor, but the entrepreneur and manager) and are entitled to completely change the management team or the strategy of the project during its implementation (Radygina, 2008).

Thus, business angels are private investors who fund innovative projects at the early stages of development with a high level of risk in order to commercialize them. The volume of financing of such projects, as a rule, is not great and does not exceed 1 million Euros (Ramadani 2009, Macht and Robinson, 2009).

The business angel investment means long-term “seed” financing of risky innovation projects of venture enterprises for profit after they entered the market. At the same time, a business angel can receive not just percentage from sales of the innovative product or service, but also the revenue through the realization of previously received share in the company (Iruarrizaga and Santos, 2013).

Business angel investment has long been widely used in the US and in Europe (Zinecker and Bolf, 2010). In Russia, it is quite a new phenomenon, which has not yet found a proper use. However, experts estimate that rate of its growth exceed the rate of growth in venture capital funding. In the countries where the seed financing is an already established industry, their own infrastructure of business angel investment has formed, which includes certain basic components (Zhdanova, 2013; Nefedev, 2014; Klopotova and Vesnina, 2013).

One of the specific elements of this infrastructure is business angel syndicates. They represent the association of business angels' capital for further investment in venture projects. At the same time, a leading investor, who provides the largest share of investment, can often be identified in such transactions. In the US, such syndicates are fairly common. It is hard to find a deal financed by a single investor. The deals involving several business angels are now used in Russia as well (Mironov and Golovko, 2015). According to RVC, each investment project has an average of 1.25 business investors, while about 35% of deals are done with the involvement of co-investors.

The specific elements of the business angel investment infrastructure are nonprofit programs of financial support for innovative projects presented in the form of grants and concessional loans. In Russia, these programs are implemented by the state mainly at the expense of the federal budget.

An effective element of the business angel investment infrastructure is networks and associations of “business angels.” Their main task boils down to the investment intermediary, which helps both investors and entrepreneurs. Thanks to associations, business angels are able to find a quality project for investment, while

entrepreneurs can present their projects to a large number of potential investors at once. Thus, networks and associations of business angels are the link between investors and potential recipients of investment. The National Association of Business Angels has been operating in Russia since 2009, which in 2011 became a member of the European Association of Business Angels (Chistyakova, 2012; Komarova, 2009).

An important element of infrastructure where entrepreneurs have the opportunity to present their innovative projects is fairs and forums. There are similar sites in Russia as well. In particular, the fair “Russian capital for Russian innovations” has been regularly held since 2002.

Educational programs are an integral part of the business angel investment infrastructure. Their basic form is coaching trainings. The programs can be very long (up to 1 month) or only several days long. Their main goal is to increase the skill level of all the participants of the business angel investment. The National Association of Business Angels also provides similar programs in Russia.

An important element of the infrastructure is tech parks and business incubators, where innovative enterprises are able to realize their ideas on preferential terms. This in turn becomes a favorable basis for attracting business angels to finance projects.

In recent years, such element of the business angel investment infrastructure as an Internet portal has become widespread. This tool allows to place a large number of business ideas, investors, and professionals of various categories on one site.

In addition to the availability of infrastructure for active development of business angel investment, a favorable investment climate is required. This is explained primarily by the fact that business angels provide funding for the early stages of innovative projects characterized by high risks. In order to reduce it in the course of business angel investment, the following basic methods can be used:

1. Detailed study of the investment project and the obligatory participation of investors at all stages of its implementation.
2. Diversification of investments through various innovative projects.
3. Use of co-investment mechanism that allows not only to spread the risks among the participants of the investment process, but also to combine the experience and efforts to implement it.
4. Participation in federal programs of state support of innovation activity. In particular, the Seed Investment Fund was established in Russia on the basis of RVC, which provides funding only for the early stages of innovative projects, including with the involvement of business angels' capital.

Business angel investment may have different types (Table 1).

Business angel investment, in contrast to venture capital, is provided by private investors who usually either have their own business or are leading managers of large enterprises, so they have

**Table 1: Types of business angel investment**

Type of business angel investment	Characteristics
Traditional investment	Investments are made in various areas not only in the period of economic growth, but also during the recession. There is a high level of diversification of the investment portfolio
Investing in high-tech	Investments are made by business angels in the field of high technologies. The investor is a specialist in a field where the capital is invested
High yield investment	Investments are made in various fields mainly at the times of economic stability. The investment portfolio is significantly differentiated. The investor does not take much part in the management of an innovative company

the opportunity not only to provide resources for the project, but also to provide non-financial assistance to innovative companies (Chahine et al., 2007). At the same time, the age composition of the Russian business angels is different from the Western European and American. If business angels' age in the US and Europe ranges from 45 to 65, in Russia it is from 30 to 55. In addition, as a rule, business angels do not advertise their activity, which is particularly characteristic of Russia.

However, the problem of the need to stimulate business angel investment in Russia is currently the most acute. This type of investment has a significant impact not only on the development of small business innovation, but also the economy as a whole. Its economic value is as follows.

Firstly, the business angel investment, as opposed to funding from venture funds, helps in the development of innovative business by carrying out the investment process in the early stages of the project. Due to the fact that small businesses, which lack access to traditional lending, start the realization of most innovative projects, this type of investment, in fact, is the only opportunity to implement their ideas (Aernoudt, 2005).

Secondly, business angel investment is dynamic on the one hand and more flexible on the other hand. Dynamism of business angel investment is determined by the fact that the decision on funding the innovative project is taken by business angels more quickly. This is due to investor's experience in running business and project evaluation. The flexibility of business angel investment is manifested through high levels of adaptation to changing conditions.

Thirdly, thanks to business angel investment, the process of further financing of innovative projects at a later stage is simplified. Due to the fact that the business angels provide non-financial assistance (market research, drafting a business plan, project management, etc.) along with financial, small innovative enterprises approach the early stage of growth ready (de Moraes et al., 2013). Accordingly, this increases their chances of receiving further investment from other sources.

Fourth, the business angel investment is predominantly territorial in nature, i.e., business angels direct their capital in companies

of the region in which they operate. This is primarily due to the need for constant monitoring of the implementation of the project. In turn, the territoriality of business angel investment allows for a more even distribution of resources within the region and contributes to regional innovation and economic development (Veselovsky, et al., 2014; Afonasova, 2013).

Thus, we can talk about the important role of business angel investment in the innovative development of Russia. At the same time, it is necessary to take measures for its stimulating and further promotion (Klopotova and Vesnina, 2013).

### 3.2. Current Status and Development Trends of Business Angel Investment in Russia

Funding for the initial stages of innovation projects with the involvement of business angel investment has long been widely used in the United States, which, according to experts, has by far the most developed national innovation system. According to the Center for Venture Investments at the University of New Hampshire, the number of business angels in the US is up to 250,000, who annually invest \$25 billion in more than 50,000 companies. At the same time, the number of business angels greatly exceeds the number of venture investors (225,000 vs. 700-800), while the amount of business angel investment per year is 10 times more than the venture. Business angel investment in Europe also actively develops and amounts to annual \$3.5 billion. For example, studies show that in the UK and Finland, business angel investment is 2-2.5 times more than the institutional venture capital investments (Mironova and Golovko, 2015). In Russia, business angel investment is underdeveloped. The size of these investments is significantly less than the venture capital (Figure 1).

Following the results of three quarters of 2014, the amount of transactions with the participation of business angels totaled to 17.1 million rub., which is 56% less than the same period of the previous year. The amount of venture deals over the same period decreased only by 27%. In total, business angels have funded 47 innovative projects over 10 months in 2014, whereas in the corresponding period of 2013 they funded 86 (<http://www.rusventure.ru/ru/programm/analytics/2014>). The decrease in the amount of business angel investment, aside from the unstable economic situation, was influenced by the transition of the largest business angels in the other categories of investors. In particular, in 2014, three active business angels began to work on behalf of the venture capital funds, who in 2013 invested more than \$4 million in venture capital projects. It should also be noted that in 2014 some private investors have turned their attention to foreign projects that are of higher quality compared with Russia. In addition, the share of business angel investment in 2014 accounted for 4.5-6% of the total venture capital investment, while in 2013 this figure stood at 10.8% (Figure 2) (<http://www.rusventure.ru/ru/programm/analytics/2014>).

Thus, the share of business angel investment is still at a low level, while private funds account for more than 80% of the total amount of venture capital deals. However, their dominance is evident even in the information technology sector, where the amount of investment by private venture capital funds exceeds all other investors in times.

There are several groups of business angel investment: Private investors, a group of business angels, co-investments of business angels with venture funds and with public funds (Moscow Seed Fund, “Skolkovo” Fund, RVC funds), foreign investors. In addition to the decrease in activity of Russian investors in 2014, there is an almost 2 times decline in investments directed by foreign investors. At the same time, the number of deals of business angels with venture funds increased, while deals with public funds, on the contrary, decreased from 6 in 2013 to 2 in 2014 (<http://www.rusventure.ru/ru/programm/analytics/>, 2014).

However, there is a growth in the volume of venture deals in the early stages in 2014 (Figure 3). The volume of seed investments increased by 30% compared with the previous period. At the same time, the average volume of transactions in the early stages grows from \$550,000 to \$930,000 (<http://www.rusventure.ru/>

Figure 1: The ratio of the amount of venture deals and deals with the participation of business angels

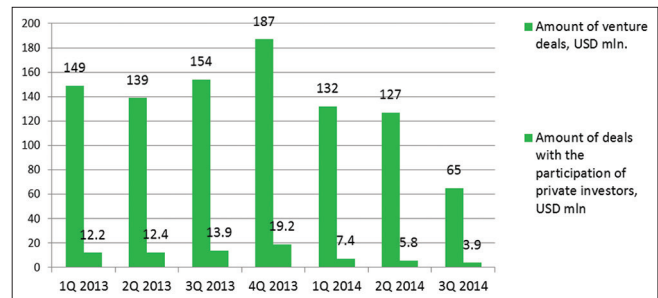


Figure 2: Structure of the venture deals by investor types

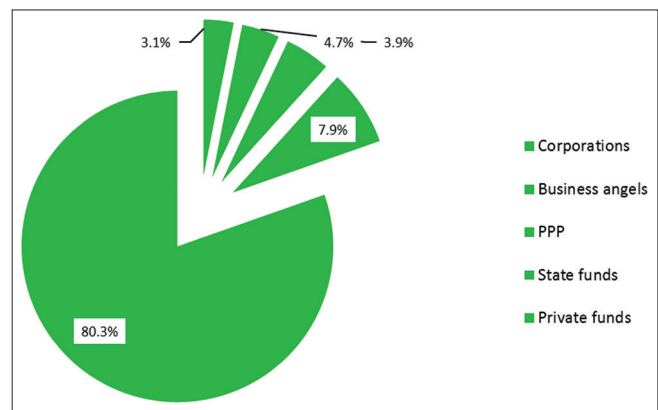
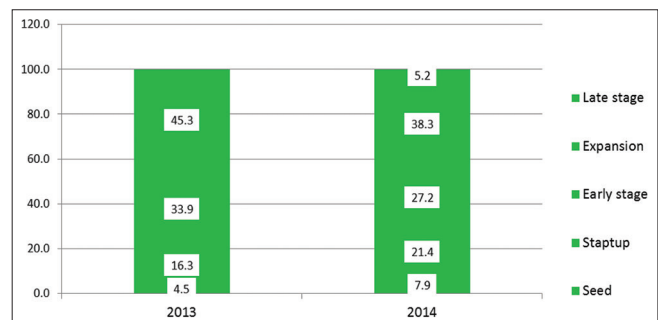


Figure 3: Structure of the venture capital deals by the company development stage, percentage (<http://www.rusventure.ru/ru/programm/analytics/>, 2014)





ru/programm/analytics/2014). This fact has led to an increase in total seed investments in spite of the reduction in the number of deals at this stage.

2014 saw a growth of business angels directing investments in several deals (Figure 4). While in 2013 there were only 6% of them, in 2014 there were 27%. This fact shows the maturing of the market and increase in the number of experienced members who carry out investment activities in innovative projects on a regular basis (<http://www.rusventure.ru/ru/programm/analytics/>, 2014).

The most notable centers of attraction of innovative financing in Russia are the Volga region, the eastern part of the Central region and Tomsk region. Here the most active players are Kazan and Tomsk, who have effectively developed investment legislation, which defines the guarantees and incentives for private investment. In addition, these subjects of the Federation implement the most active regional policy to support innovation economy (Mironova and Golovko, 2015).

The structure of business angel investment by industries is dominated by investment in consumer services (Figure 5). They account for 43%. Business and financial services take the second place - 25%. The least of investments goes into consumer products. Financing of information technology takes 13% of the total.

Business angel investment market now is still evolving, but a number of positive changes can already be noted. Firstly, the experts note the “maturing” of the market of private investment in 2014, which is due to reduction in the number of one-time

deals and an increase in the number of permanent investments. Secondly, due to increased competition for quality seed stages of innovative projects in the domestic market, there are incentives for the entry of Russian business angels at the international level. Thirdly, a number of educational programs, which are of interest to both beginners and already active business angels, are growing. This, in turn, contributes to the information security of business angel investment.

However, a number of deficiencies in this segment of the investment should be noted. First of all, this segment still remains closed from the information point of view. Most business angels wish to remain anonymous. This affects the attraction of new investors in this area, due to the insufficient number of success stories of investment. In addition, due to the deteriorating economic situation in the country, as well as the transition of the most active participants in this segment of the market to other categories of investors, there was a significant reduction in the number of deals at the seed stages of the innovative project in 2014.

## 4. DISCUSSION

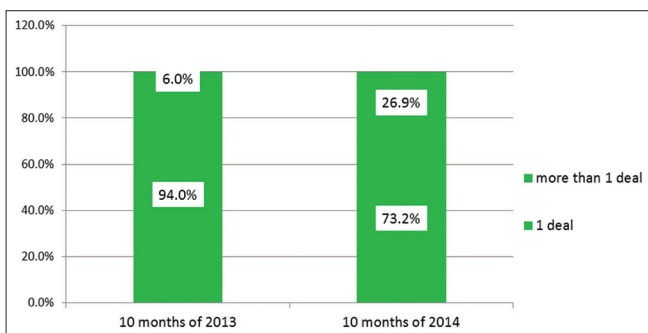
Despite the positive aspects in the development of business angel investment in Russia, one can identify a number of problems faced by private investors.

Firstly, the beginning businessmen in Russia still have a relatively low level of competence in the field of the feasibility study of the advisability of investing in an innovation project.

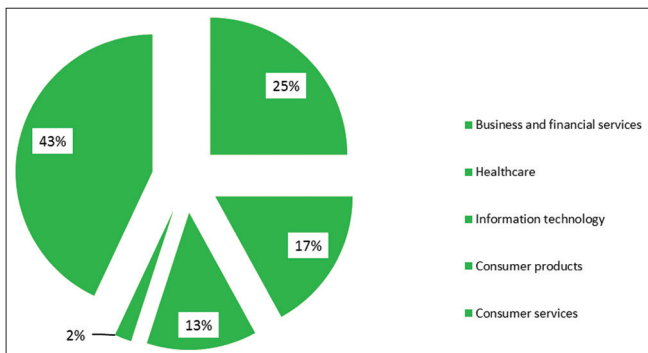
Secondly, lack of high-quality innovative projects, on the one hand, and the mentality of Russian investors, on the other hand, affect the willingness to invest not in the innovative, but in traditional areas, such as real estate, stocks of the mining and processing companies, consumer and financial market (Mironova and Golovko, 2015). Russian businessmen see the main source of income in these areas. In addition, the majority of entrepreneurs have no ideas about the features of the promotion of technological innovation in the market, which makes it more difficult to attract investment in innovative area, especially in the early stages of investment.

Thirdly, there are problems in the legal field. Among them we can mention the problems in the area of intellectual property protection. Despite the existence of laws on intellectual property complying with the relevant international standards, a mechanism for its protection is still not elaborated due to a small number of precedents. In addition, according to business angels surveyed by VCIOM (Russian Public Opinion Research Center) at the request of the RVC, there are gaps in the legislation for the protection of the interests of minority shareholders. To date, these shareholders are not able to exercise significant influence on the activities of innovative company to which they have provided their resources, due to the absence of the controlling stake. However, business angel investment is carried out on seed stages of the innovation project, coupled with a very high risk level that requires constant monitoring on the part of investors and also determines the need for a possibility to influence the fate of this project. Moreover, business angels are still not defined in the legislation as the subjects of the

**Figure 4:** Structure of business angel investment by the number of deals (<http://www.rusventure.ru/ru/programm/analytics/>, 2014)



**Figure 5:** Sectoral structure of business angel investment (<http://www.rusventure.ru/ru/programm/analytics/>, 2014)



Russian law, which also makes it difficult to protect their interests and affects the level of investment activity. In Russia, the only normative document regulating the activities of business angels in any way is an indication of the Central Bank of the Russian Federation dated April 29<sup>th</sup>, 2015 No. 3629-U “On the recognition of individuals as qualified investors and manner of keeping the register of persons recognized as qualified investors.”

Fourthly, the problems in the field of tax legislation should be noted separately. So far, the issues of provision of tax benefits in the implementation of business angel investment are not sufficiently elaborated. At the same time, the availability of tax breaks and incentives in the US and Europe is one of the catalysts for the development of venture capital business in general and the business angel investment in particular. According to Stanislav Sazhin, the founder of “Doctor at work,” which became one of the best startups in Russia, “the problem of tax legislation is that these royalties prevent these business angels from actively supporting the projects. The money invested by private investors in startups should be exempt from the tax on personal income, social security contributions and other taxes - then investing in startups would be beneficial. It is clear that the angels working in the legal field will be able to invest much more money in the company if they have the appropriate privileges (Sazhin, 2014). According to experts, it is advisable to use tax incentives such as a change in tax rates (tax rebates), tax deferral and inclusion of angel investments in rediscout of the taxable base as part of the business angel investment.

The fifth problem of business angel investment in Russia is information vacuum. Business angels do not particularly wish to advertise their activities not only in our country, but also abroad. Most individual investors do not trust each other and, therefore, do not wish to share information not only in the case of failed investments, but also in the case of successful investments. This in turn affects the motivation of potential business angels to invest in the early, risky stages of the innovation project ([http://www.rusventure.ru/ru/programm/analytics/docs/201302\\_vciom.pdf](http://www.rusventure.ru/ru/programm/analytics/docs/201302_vciom.pdf) 2013).

The sixth problem hindering the development of business angel investment in Russia, noted in the course of the VCIOM poll of business angels, is the possibility of obtaining grants at the early stages of an innovation project. The reason for this lies not in the availability of grants as such, but in the fact that entrepreneurs, who have received the grant funding at the early stages of the innovation project, greatly overestimate the value of their business in the future. This makes it impossible to search for potential investors at the later stages of the project. In addition, persons engaged in innovation and receiving funding from public funds are not interested in the commercialization of the results. It is easier for them to prepare appropriate documentation and obtain public funding in another technology than to take steps to increase sales of the existing one. At the same time, a private investor wants to see the results of scientific activities in the form of profits from the sale of the resulting innovation. Due to this, it is necessary to clearly think through the mechanism of cooperation of private investors and public funds in the early stages of the innovation project.

Finally, the seventh problem identified by the key players in business angel investment in a survey conducted by VCIOM is the inability to predict a clear “exit” from the project. In all developed countries, the main objective of business angel investment amounts to receiving the excess profits after the “exit” of the investor from the project through the sale of the company to others - usually to investment funds. In Russia, most entrepreneurs in need of financing their innovative projects are not ready to sell the business 3-7 years after the date of investment. This in turn is one of the key instruments of return for the investor. In addition, the sale of the business is also influenced by the lack of habit of the acquisition of the company by large investment funds for the sake of technology or an idea.

## 5. CONCLUSION

Around the world, up to 90% of funding at the early stages of the innovation project comes from private investors. Russian business angel investment is still developing. However, according to the National Association of Business Angels, about 45,000 private investors operate on the Russian market. According to forecasts, the number of business angels can be from 6,000 to 20,000 people by 2017. Thus, the Russian market of business angel investment has very good prospects. At the same time, its further development is largely dependent on the favorable investment climate in the country, the availability of effective legislation, including the tax incentives for business angel investment, the improvement of the information support of entrepreneurs in the field of high-risk investments, the further development and promotion of business angel unions and associations. It should be noted that the question of tax incentives need more serious consideration, since this is the most powerful tool in the development of the business angel investment. However, the implementation of these measures will increase the number of business angels in Russia, and, consequently, promote the growth of innovative activity of entrepreneurs who will have a real opportunity to attract financial resources to implement their innovative projects in the early stages. All this will lead to an increase in the number of innovations and their commercialization and, as a consequence, improvement of the economic situation in the country and increase in its level of competitiveness on the global market. Business angel investment can be an element that will finally give a boost for the creation of innovative economy in Russia.

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