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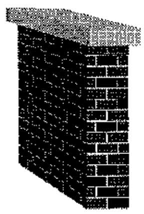
AMERICAN UNIVERSITY OF ARMENIA

COLLEGE OF BUSINESS AND MANAGEMENT

BUSINESS RESEARCH

VENTURE CAPITAL MARKETS



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1. INTRODUCTION

Economic history states that healthy economic structures are usually based on a complex network of large, medium-size and small enterprises. The intensity and quality of the relationships that exist between similar companies and industries – the input and output they give and receive, the exchange of experiences and ideas – largely determine the dynamism and the sustainability of economic development [1, p. 175].

Armenia, experiencing a hard transition towards a market economy, is still too far from meeting the above-stated description of a healthy economy. And one of the main and significant obstacles among many others that impede the creation and development of Armenian enterprises and other economic units is a scarcity of necessary funds [2]. Although the relative geopolitical stability in the region established after the cessation of hostilities in 1994 has allowed many international financial organizations to expand their activities in Armenia, they are mainly involved in assisting the Armenian government in the implementation of its structural reform program. And such organizations as the World Bank, International Development Association, International Monetary Fund, United States Agency for International Development, European Union, European Bank of Reconstruction and Development have been providing long-term loans to Armenia for special purposes: Armenian Dram stabilization, restructuring of former governmental institutions, loans for big and long-term projects, such as dam safety, electrical station construction, energy transmission, etc. [3, p.4].

Enterprises operating and expanding in transition period of Armenia face the following issues:

- Limited access to information on markets,
- Stretched managerial resources,
- Limited access to useful connections (government, consulting),
- Lack of direct access to financial resources.

The last problem enterprises face is a result of such fundamental issues that remain unsolved in the Armenian economy as:

- Absence of normally functioning financial markets,
- Grave financial position of the majority of commercial banks, lack of proper trust in the banking system, and, as a result, low level of mobilization of domestic savings as investment resources. [4, p.25].

Due to weakness of financial markets and banking system in the fund raising process, the Armenian economic units shifted their attention and expectations towards investment sources coming from abroad. Until recently, these sources were heavily based on the government sponsored lending programs for Armenia, and the portion of foreign direct investment was not significant. As an attempt to fill up this gap the present research was conducted to investigate worldwide venture capital markets and to identify those venture capital firms that are or can be interested in entering the Armenian market. Why was the research focused on venture capital markets? The reasons for that can be summarized as follows:

- In the absence of well-functioning banking system, venture capital firms can serve as an intermediary between the investors (or lenders) and enterprises (or borrowers).
- Traditionally, venture capital has been "early stage" financing for emerging growth businesses.
- Venture capital investments are generally for newer companies with little operating history.
- Venture capital is a catalyst for entrepreneurial activity not only in furnishing financial resources but also in providing management assistance and strategic guidance to emerging growth ventures.

Most of the Armenian enterprises can be thought as start-up or early stage companies that have an operating history of no more than ten years. So, venture capital investments can be appropriate for fund raising purposes as a new and lavish source of financing for emerging Armenian businesses. Besides, the lack of managerial skills necessary to run businesses in the market-oriented economy Armenia is shifting to can be compensated by business experience, industry and financial expertise, and contacts that management of venture capital firms bring to the companies they invest in.

2. METHODOLOGY OF THE RESEARCH

The present research was conducted based on the following methods and technical facilities:

- Interviewing officials and representatives of international and local organizations to determine the degree of possibility of venture capitals entry into the Armenian market.
- Gathering information on investment climate in Armenia.
- Searching venture capital firms via Internet.
- Contacting numerous venture capital firms, international organizations and visiting useful web sites to identify those that are or can be interested in entering the Armenian market and investing in local enterprises at any stage of development.

A sample of contact business letters e-mailed to International Equity Partners, and Charterhouse Group International Inc., with the description of investment climate in Armenia is presented in Annex A.

A list of contacted venture capital firms and international organizations is provided in Annex C.

3. VENTURE CAPITAL FIRMS: AN OVERVIEW

Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributions. Venture capital is an important source of equity for start-up companies.

Professionally managed venture capital firms generally are private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves.

Venture capitalists generally:

- Finance new and rapidly growing companies;
- Purchase equity securities;
- Assist in the development of new products or services;
- Add value to the company through active participation;
- Take higher risks with the expectation of higher rewards;
- Have a long-term orientation.

When considering an investment, venture capitalists carefully screen the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. They actively work with the company's management by contributing their experience and business prudence gained from helping other companies with similar growth challenges.

Venture capital and private equity firms are pools of capital, typically organized as a limited partnership that invests in companies that represent an opportunity for a high rate of return within five to seven years. The venture capitalist may look at several hundred investment opportunities before investing in only a fewer selected companies with favorable investment opportunities. Far from being simply passive financiers, venture capitalists foster growth in companies through their involvement in the management, strategic marketing and planning of their investee companies. They are entrepreneurs first and financiers second.

The criteria for selecting the right venture capitalists to approach include their geographic, industry specialization, stage of development, and size of investment preferences.

Professionally managed venture capital funds provide seed, start-up and expansion financing as well as management/leveraged buyout financing. In addition to these distinctions, funds may also specialize in technology sectors such as life sciences, while others invest in a wide array of technology and non-technology arenas.

Since the return on investment is critical, venture capitalists invest with certain criteria in mind. Many funds invest between $4-$8 million in any one venture over a three- to five-year period and look for companies with market potential of $75-$200 million. Since a venture fund typically invests only in 20-30 companies, each investment must be screened carefully. Venture capitalists will be looking for a 30 percent to 40 percent or more annual return on investment and for total return of 5 to 20 times their investment.

The table below illustrates the size of ownership required to support a 30% return on investment [5].

		Estimated Future Market Value of a Company in Six Years (millions of dollars)				
		$20	**$40**	**$60**	**$80**	**$100**
Millions of Dollars Invested	**2**	48%	24%	16%	12%	10%
	4	96%	48%	32%	24%	19%
	6	N/A	72%	48%	36%	29%
	8	N/A	96%	64%	48%	38%
	10	N/A	N/A	80%	68%	48%

As it was pointed out above, venture capitals provide financing in various stages of a company's development. The early stages of financing are as follows:

- *Seed financing.* Capital provided at the "idea" stage. The capital, which is usually less than $50,000, generally goes for product development and market research.
- *Start-up financing.* Capital used in product development and initial marketing. This is generally for companies that have been in operation for under a year but that have not sold their products or services commercially.
- *First-stage financing.* Capital provided to initiate commercial manufacturing and sale.

The stages of "expansion financing" include:

- *Second-stage financing.* Capital used for initial expansion of a company that has already been producing and selling a product. The company might not be profitable at this stage.
- *Third-stage financing.* Capital provided to fund major expansion, such as for plant expansion, product improvement or marketing.

Finally, there are two "special cases" of venture financing:

- *Turnarounds.* Capital provided to restructure or revitalize a troubled company that is generally at a more established stage of development.
- *Management / leveraged buyouts.* Capital provided to fund a management team or a group of outside investors to purchase a company or a subsidiary from a major corporation [6].

Depending on the investment focus and strategy of the venture firm, it will seek to exit the investment in the Portfolio Company within three to five years. While the initial public offering may be more desired type of exit for the venture capitalist and owners of the company, most successful exits of venture investments occur through a merger or acquisition of the company by either the original founders or another company.

4. INVESTMENT CLIMATE IN ARMENIA

As it was indicated in the 1999 survey by Ministry of Trade and Industry, among main local economic factors that hinder the development of enterprises in Armenia are obstacles in access to finance (because of high interest rates, shortage of mid- and long-term loans, difficulty in providing collateral), and lack of national business-information and business-vocational education system. To mitigate the financial part of the problem, the Armenian government adopted the Law on Foreign Investment on July 31, 1994. Due to this law Armenia with an economy that largely depends on foreign trade has an investment and trade policy which is among the most open in the CIS. Current policies do not restrict the flow of capital resources in product and factor markets.

Basic types of companies that can be established and operate in Armenia are described in the 1992 Law on Enterprises and Entrepreneurial Activity and 1996 Joint Stock Company Law. Foreign investors to make investments in Armenia may use the following legal forms:

A. Establishment of fully foreign-owned companies, or representations, affiliates, branches, or purchase of existing companies.

B. Establishment of new joint companies with the participation of Armenian companies or citizens, or the purchase of a portion of shares in an existing company.

C. Purchase of different types of securities officially recognized by Armenian legislation.

D. Procurement of permission for use of land, or a concession agreement for use of Armenian natural resources with participation of an Armenian company or Armenian citizens.

E. Procurement of other property rights.

F. Other allowed forms including those based on agreements with Armenian companies or citizens [7].

Approximately 1,350 partially or fully foreign-owned companies are registered in Armenia today. Over 70 percent of these are involved in trading activities.

Foreign investment incentives include:

* Ownership: 100 percent ownership permitted
* Admission: no screening and no specific approval/authorization for investment entry
* Land access: long-term leases are freely permitted
* Tax holidays: available for foreign investments over $1 million (USD)
* Import duty: no duties on statutory capital and raw materials
* Export duty: none
* VAT on export: refund is provided
* Income tax: no special incentives or exemptions
* Corporate tax: holidays for investment over USD 1 million
* Losses: losses may be carried forward indefinitely [8].

To attract foreign investment to the Armenian market, investment programs have been defined for priority areas of industrial development. The priority investment portfolio is made up of:

1. Metallurgy
2. Chemical industry
3. Radio-electronics
4. Jewellery
5. Construction materials industry [4, p. 22].

The reasons to invest in Armenia include:

- Liberal laws and tax regulations,
- Special regimes and incentives for investors and businesses,
- Government commitment to continued private sector development reform,
- Easy access to CIS and Middle east markets,
- Highly qualified work force with specialized scientific skills,
- Support of the Worldwide Diaspora [9].

5. TERMS AND CONDITIONS OF VENTURE CAPITAL FIRMS

This part of the research presents a summary of terms and conditions of contacted venture capital firms. The sample is selected out of over 675 venture capital firms that operate in the United States and Europe, based on the following selection criteria:

- *Stage of companies' development* venture capital firms prefer to invest in. Taking into account the lack of rich operating history of Armenian enterprises, there are selected those venture capital firms that primarily invest in start-up or early stage companies.
- *Industry focus.* This matter is important from the viewpoint of market attractiveness. Those firms are selected for Internet contacts whose investment focus concurs with priority industrial branches representing major opportunities for investment in Armenia (see Attachment: Investment_Climate.doc, page 26).
- *Geographic preference.* This selection criterion is used to identify those venture capital firms among others whose focus countries to invest in include CIS, East Europe and Middle East. The justification of such criterion lies in the consideration of the fact that Armenia is on the cross-roads of these regions and either has historical, political and economic links with them (CIS and East Europe countries) or has easy access there (CIS and Middle East countries).

The terms and conditions of venture capital firms are summarized under several headings:

Investment Profile

Most venture capital firms from the list provided in Annex C intend to undertake investment in target companies or projects that have the following characteristics:

- Complete, top-quality and proven management teams with strong track records in the particular sector, including a demonstrated technical expertise and an excellent professional reputation.
- Operation in a market that is large and growing at 15-20 percent a year.

- Facing limited number of competitors in a given market.
- The potential to gain leadership positions in their markets.
- Strong operating contractual arrangements that have been agreed with the appropriate governmental authorities (e.g., concessions, licenses).
- An excellent asset base or the ability to develop a cost-efficient and competitive asset base as a result of capital infusion;
- Transparent financial structure and records; and
- Limited technological risk

Investment Criteria

Contacted firms require the following essential criteria for successful fulfillment of investment projects:

- Strong local sponsorship, with meaningful investment in project equity.
- A technical or operating partner with an established reputation and a substantial equity stake in the long-term success of the project.
- A supportive regulatory and political environment.
- A realistic business plan and a credible financing plan that meets the company's foreseeable needs.
- Investment returns that exceed the fund's return thresholds under reasonable assumptions.
- A clear exit strategy within the fund's life, e.g., an IPO.

Sector and Industry Focus

For purposes of the research, it was expedient to compose the sample of venture capital firms based on matching between their preferred sectors and industries, and Armenian priority industries. Such an approach identified the sector and industry focus of contacted firms as follows:

- Telecommunications Systems and Services: Fixed line and cellular networks; broadcast and cable television; international cable links; information technology and the Internet.

- Power and Energy-Related Facilities: Power generation, transmission and distribution systems; district heating networks and energy service companies.
- Natural Resource Development: Mining and minerals processing; oil and gas extraction, development and distribution; petrochemical industries;
- Water, Sanitation, Environmental Services: Waste and waster water treatment and distribution; other environmental services;
- Basic Materials/Infrastructure-Related: Includes cement; iron and steel; airport services; cable producers; industrial development; construction-related and other industries.
- Tourism.
- Agriculture.

Investment Profile

Investment size typically ranges from:

- $2-10 million in start-up, early-stage developing companies, and early expansion financing rounds;
- $10-40 million in companies with some history of operations;
- $20-75 million for later stage transactions.

Venture capital firms usually liquidate their investment in 3 to 7 years, based on clear exit strategy through initial public offering, sale to another company, share repurchase or recapitalization.

6. RESULTS OF CONTACTS WITH VENTURE CAPITAL FIRMS

Numerous venture capital firms have been contacted by e-mail since August 25, 2000. Unfortunately, the survey in this direction has revealed no much information. From all of these potential responders and sources of information there was only one feedback. Mr. William Gormly, the President of CIPF Ltd., a professional independent corporate Financial Advisor, wrote in his reply that the main problem he encountered in six developing countries - Bulgaria, Romania, Kazakhstan, Kyrgyzstan, Georgia and Egypt - was that the local companies or governments were completely inexperienced (Annex B1). So, he emphasized the lack of proper professional and vocational education in developing countries.

This conclusion coincides with the results of 1999 survey by Ministry of Trade and Industry of RA according to which lack of national business-information and business vocational education system is one of the main local economic factors that hinder the development of enterprises in Armenia. This is a crucial disadvantage from venture capitalists' point of view who generally invest in companies with strong management teams, as it can be seen in, for example, investment profile of AIG Emerging Europe Infrastructure Fund [11]. Another impediment on the way of successful investments is, according to Mr. Gormly, bureaucracy which is hardly can be overcome soon (Annex B2).

The results or, more strictly, the absence of results show the indifference of venture capital firms towards the Armenian market. Such an unpromising result in terms of attracting venture capital to Armenia was somewhat foreseen after visits to international and local organizations. Mr. Ashot Gevorgyan, the Vice-President of the Union of Manufacturers and Businessmen in Armenia, expressed an opinion from the outset of the interview that it was unlikely that foreign investors in general, and venture capital firms in particular, could be attracted to Armenia. However, he also considered it possible that some kind of investments, not very huge in size, could be made through joint ventures, using Armenia's comparative advantage in cheap but highly qualified work force [12]. In addition, both Mr. Artak Melkonyan and Mr. Areg Barseghyan believed that it was premature to think of possibility to attract foreign venture capital [13], [14].

According to Mr. Barseghyan, it would be expedient to establish local venture capital firms as alternative source of financing in much smaller investment size than that of International Finance Corporation. Currently, such a project is under way, conducted by Technical Assistance Trust Funds, and Regional Financial Markets Divisions and Financial Markets Advisory Department [15].

On the whole, all visited officials were suspicious about feasibility of attracting foreign venture capital firms. Some possible reasons of unattractiveness of the Armenian market will be explained below.

7. ANALYSIS OF TERMS AND CONDITIONS OF CONTACTED VENTURE CAPITAL FIRMS

The terms and conditions of the contacted venture capital firms reveal some potential future opportunities to invest in Armenia. However, they also show the main strong requirements that cannot be met by Armenian business environment at present.

Assuming that political, economic, legal and other conditions are favorable for venture capital firms to invest in Armenia, they can direct their investment activities in such spheres as:

- Telecommunication systems and services, information technology, Internet software and international cable links,
- Natural resource development: mining and minerals processing, construction materials and petrochemical industries,
- Environmental services: waste treatment and distribution,
- Infrastructure related materials, including cement, iron and steel, cable producers and other industries,
- Food processing, beverages and mineral water industries,
- Tourism.

These are fields that have either good traditions and experienced, inexpensive labor force, or great potential to grow. Unfortunately, at present the situation is not so favorable, and there are many constraints and risks associated with them that prohibit venture capital firms from entering the Armenian market. These factors are as follows:

- Crucial dependency of industry on imported raw materials,
- A great number of very large enterprises that are ineffective and unpromising,
- A High level of economic risk, due to the specific, non-stable geopolitical situation,
- Shortage of energy resources, expensive energy,
- Closed borders with Azerbaijan and Turkey due to blockade,
- Small domestic market,
- High transportation and telecommunication costs,
- Strong dependence of economy on Russian non-stable financial-economic system.

The constraints mentioned above do not make it possible to earn required high return on investment as venture capitalists expect, which makes investments senseless. Besides, venture capital firms typically invest such amounts in their selected companies ($6-12 million, Commonwealth Capital Ventures, or $20-75 million, Advent International) that are too huge for the small Armenian market. In addition, the present regulatory and political environment is not favorable and supportive for investment. Finally, they require exits through, for example, initial public offering, which is currently impossible because of infant financial markets.

All of these constraints may explain the behavior and attitude of venture capitalists in respect with their investment possibilities in Armenia. But the most serious factor that prohibits venture capital firms from investing in Armenia is the country's high riskiness. The next paragraph will present the overall risk analysis of Armenia and its assessment from the perspective of investment activities: political, economic, legal, tax and operational.

8. ARMENIA: RISK ANALYSIS

Political Risks

The external and internal environment of Armenia is highly unpredictable and susceptible to any tensions and irregularities both in domestic and international arenas. The geopolitical situation is unfavorable for Armenia, bearing permanent threat to the country's overall stability. Located in South-West Transcaucasia, Armenia borders Azerbaijan, the Azeri enclave Nakhichevan, Georgia, Iran and Turkey. The unsolved Armenian Issue that has frozen Armenian-Turkish relations in all spheres of coexistence, the long-lasting conflict with Azerbaijan arisen out of the issue sovereignty over the mountainous region of Nagorno-Karabakh, the existence of historical Armenian territory Javakhk in Georgia, hung like the sword of Damocles over both Armenia and Georgia, make the political present and future of the country too hazy and uncertain. These unsettled issues are frequently exaggerated by various forces to keep the region constantly turbulent, and hence subjected to interference by third parties in the affairs of the region as a whole, and that of Armenia in particular. Recent developments in Javakhk or the rise of the issue of Armenian Genocide in the US Congress deteriorates Georgian-Armenian and Turkish-Armenian relationships, which, of course, will have their far-going repercussions in all spheres of Armenia's life. The geographic location and geopolitical situation is so unfavorable for Armenia that even nearness of the Middle East has its direct impact on Armenian affairs.

Another issue that has exacerbated Armenia's differences with its neighboring Georgia, Azerbaijan and Turkey is close political and economic relations with Russia. With the question of Nagorno-Karabakh unresolved, Armenia is technically still at war with Azerbaijan in spite of the cease-fire established since 1994. In sympathy with Azerbaijan, Turkey accompanies that country in maintaining a strict economic blockade. The Turkish border, which could be Armenia's gate to western markets, is sealed at present. As a result, Armenia depends on Iran and Russia diplomatically and economically.

The internal political environment of Armenia also gives ground for trouble. Consequences of the political violence taken place on 27 October 1999 still play a great role on the political atmosphere of the republic. Frequently changed high-ranked authorities and governmental structures, tensions and rivalry between the majority Miasnutiun bloc and the presidency, the ineffective activity of the National Assembly stricken with paralysis because of volatile allegiances in the legislative body that depend more on personal networks and power strategies than on issues, the problem of Nagorno-Karabakh which has an overwhelming importance in post-independence Armenian politics, set on stake the political stability necessary for economic recovery and growth.

So, all of these issues make Armenia highly risky country in political sense. Despite seemingly stable situation in the republic, latent political eruption because of too many unsettled problems creates unfavorable and unattractive business atmosphere, and withholds most potential investors from entering the Armenian market.

Economic Risks

Armenian economy of the past decade developed under devastating conditions. The destructive earthquake in Northern Armenia in 1988, the collapse of the Soviet Union, severe economic blockades imposed by Azerbaijan and Turkey because of the conflict over Nagorno-Karabakh, mass influx of Armenian refugees from Azerbaijan, the blocking of northern trade routes by the civil war in Georgia until 1994 entailed sharp economic collapse. The unsettled Nagorno-Karabakh conflict bogs down economic development. Being blockaded by Turkey and Azerbaijan, Armenia faces huge difficulties in finding alternative trade routes. Also, Armenia's economic dependence on Russian economic makes the country vulnerable to any crisis in Russia. Other two factors that hinder development of economy are the country's heavy dependence on imported energy, and high transportation costs which does not foster either exports or imports.

At present, the economy is undergoing a process of slow and uneven recovery, partially due to aid and loans from international organizations. Macroeconomic indicators have somewhat improved since 1995. However, the government faces continual budget crisis has deepened after the massacre in parliament a year ago. This demonstrates the vulnerability of state institutions and economy to internal political shocks. Such a situation is a subject of great concern, which increases the economic riskiness of the country, taking into account that repercussions of the massacre are continuing, and no end is yet in sight.

Legal Risks

The legal system has been substantially reformed but the legal environment remains riddled with practical problems. The major drawbacks in the legal system are as follows:

- There is lack of reliable information, and changes in legislation are not always announced.
- Those laws that exist are not effective and sometimes remain only on the paper.
- The judiciary faces difficulties due to inexperience in modern commercial law.
- Certain sectors of the economy remain practically close to foreign investors, though they are open legally.
- The importance of contacts and corruption reduces the fairness of the legal system.

Tax Risks

Armenian enterprises face heavy tax burden. As a result, evasion and under-reporting is widespread. The government's disability to collect taxes makes foreign investors a titbit for the tax authorities to regain their lost income from local businesses. The tax regime has to carry radical changes if the state wishes to create more favorable tax climate for foreign investors.

Operational Risks

The main obstacle to foreign direct investment is unpredictability of the Nagorno-Karabakh situation with its unfavorable impact on operational environment. Another issue that troubles foreign investors is Armenia's bloated bureaucracy (see Annex B2). In most cases, the bureaucracy is complicated and time consuming which forbears operating in Armenia, especially when foreign investors encounter over-zealousness in the customs and tax inspectorates. To make Armenia more conducive to business, bureaucracy should be reduced urgently.

The third major stumbling-block is widespread corruption inherited from the Soviet Union and intensified as a result of the country's scattered transition and political-economic hardships. Bribes and favors are of great demand at all levels of the state bureaucracy. As it was estimated, 40.3% of Armenian firms bribed frequently, paying in average 6.8% of their annual revenues as "bribe tax", which was the second rate after Georgia amongst 20 CIS and Eastern Europe countries [16]. In respect of corruption, complaints by US firms operating in Armenia include, according to US Embassy in Armenia, the following:

- Non-transparent competition practices.
- Merciless attitudes of the Armenian tax authorities.
- Poor cooperation.
- Cumbersome procedures.
- Bribes solicited by customs officials.
- The unauthorized, unjustified intervention of law enforcement agencies into companies' daily operations [17].

Taking into consideration deep-rooted nature of bureaucracy and corruption, these problems are unlikely to be resolved in the near future. This puts Armenia among those countries that have highly risky operational environment.

Overall Risks

Based on above risk analysis, Armenia's overall risks can be assessed as significant. Being a country with less mature democratic system, Armenia faces further major tests in all aspects. Though it can be expected general stability in the medium term, the political stability cannot be guaranteed in the longer term as both legislative and executive institutions lack authority. Uncertainty in political system makes business time-consuming for investors. This creates a need to be aware of substantial longer-term risks to their investments.

Currently, the main risks to business relate to the operational and security environments. In the current context, these risks are controllable, but the business environment will not improve permanently until the issue of Nagorno-Karabakh is resolved. According to World Markets Research Centre, Armenia is ranked the 126th among 185 assessed countries following Papua New Guinea and walking side by side with Burkina Faso, Cuba and Zimbabve [18].

Such a significant inherent risk from potential investors' point of view will make Armenia substantially unattractive to venture capital firms.

9. CONCLUSION

At present, Armenia is emerging from a period of considerable economic problems caused by natural disaster in 1988, and social and political upheavals entailing the collapse of the Soviet union, severe war in Nagorno-Karabakh and long-lasting blockade. The Armenian government has undertaken measures to improve the situation through implementation of a wide program of market reforms. These measures include privatization of agricultural land and industry, introduction of a comprehensive system of taxes that is aimed to encourage export and foreign investment, reform of the banking system. However, it is early to think of Armenia as an attractive country to venture capital firms. To become so, there should be substantially reduced all or some of the risks and constraints discussed above. Of course, this is a long-term process, and Armenia should achieve the economic and political stability step by step through involvement in international organizations on the one hand, and through improvement of investment climate by implementation of more elaborated reforms in all spheres of the country's life.

Postscript

The present research was already completed when there were announced results of the survey conducted by Foreign Investment Advisory Service (FIAS) in November 1999. These results were announced at the Seminar on "Administrative Barriers to Investment in Armenia" held on 26 October 2000, in Yerevan. Unfortunately for Armenia, the findings of FIAS confirm the results of the present research. I would be happy if conclusions of my research were wrong, but the reality states the opposite. According to FIAS, the main obstacles for foreign investments are administrative in nature. Other factors impeding foreign investors' activities in Armenia are as follows [19]:

- "Brain drain".
- Lack of jobs.
- Small size of the country.

- Lack of access to the sea.
- Low purchasing power of the population.
- Difficulties in business registration and licensing.
- Lack of reliable printed source of information.

The suggestions for changing the situation include reducing corruption and interference of the mafia; improving judicial system, police and custom services.

As it was indicated in the Prime-Minister Andranik Margaryan's speech at the meeting with donor countries on 19-20 October 2000, the implementation of proper efforts would ensure the settlement of revealed problems and Armenia's prosperity [20].

God willing.

Annex A

Date: Thu, 12 Oct 2000 01:47:47 -0700 (PDT)
From: Karen Sughyan <karsugh@yahoo.com>
Subject: Business Research
To: info@iep-global.com, info@charterhousegroup.com

Dear Sir / Madam,

I am pleased to have an opportunity to contact you. I am a 2nd year MBA student at the American University of Armenia. I am engaged in business survey of Foreign Direct Investment possibilities in my country. This survey is conducted for the Armenian Development Agency, and the American University of Armenia. The scope of my research embraces venture capital firms operating worldwide that are or can be interested in entering the Armenian market. I would like to know if your organization has such interest. If yes, please indicate the terms and conditions that are appropriate for you to invest in Armenia.

See the attached file for information on investment climate in Armenia.
If you need more information do not hesitate to contact me by e-mail.
Your assistance will be of great importance for my research.

Thank you for your time and consideration.
Best regards,

Karen Sughyan

Attachment
INVESTMENT_CLIMATE.doc [10].

INVESTMENT CLIMATE: OPENNESS TO FOREIGN INVESTMENT

GENERAL OVERVIEW

Armenia's investment and trade policy is among the most open in the CIS. The Armenian Government is strongly outward-oriented and makes every effort to attract foreign investment. Foreign companies are welcome to invest in any sector of the economy and are entitled, under the law, to the same treatment as local companies.

The Armenian currency, Dram (AMD), is freely convertible under a managed float, regulated by the Central Bank of Armenia. Any currency can be freely converted in local banks at the prevailing rate of exchange. Armenian laws guarantee the right to freely repatriate capital without any limitations. Bank accounts in different currencies can be opened in Armenian or foreign banks. The export of cash in excess of $10,000 US is allowed only upon presentation of a contract or other documentation demonstrating that the funds have been legally obtained.

PRIVATIZATION

The privatization of state-owned industries began in 1994 after the 1991 land privatization scheme where most of Armenia's agricultural land was privatized. A voucher program was utilized to privatize approximately 5,000 large and small-scale enterprises. The privatization of some strategic enterprises was deferred to 1998-2000.

Employees of establishments offered for privatization have the first choice to buy shares with cash consideration or vouchers. Thereafter, the balance of shares, if any, is offered for sale through auction.

By mid-1995, about 1,110 medium and large-scale enterprises had been converted into joint stock companies with 20 percent of the shares allocated to employees. To date, financial intermediaries have played a limited role in the process of privatization. The first privatization auction, which included 10 medium and large-scale enterprises, was concluded in May 1995. At that time 740 small-scale non-agricultural enterprises were privatized and another 1,473 small enterprises were privatized by the end of 1995. By January 1, 1998, the privatization of approximately 5,900 out of 7,500 enterprises was completed, including over 1600 medium and large-scale enterprises.

To ensure a successful privatization process, the government has created the Ministry of Privatization. Following the successful privatization of ArmenTel in December 1997, the sale of other large enterprises is expected to follow. By the end of 1998, approximately ten strategically important large enterprises will be privatized through international tenders. Two of three major hotel facilities in Yerevan were also been privatized through international tender. Several well-known companies are expected to participate in the international tenders. The objective of the Armenian government is to enhance the competitiveness of Armenian enterprises, particularly through foreign direct investment.

The government has now terminated the voucher program for privatization. No new vouchers will be issued and future privatization issues will be for cash. This represents a significant competitive advantage for foreign investors, as the selling prices of the companies are likely to be relatively low and locally available capital is scarce.

INSTITUTIONAL INFRASTRUCTURE

To stimulate the promotion and protection of foreign investments in Armenia, the State Investment Promotion and Protection Board (SIPPB), headed by the Prime Minister, has been formed by presidential decree in 1997. The Armenian Development Agency (ADA) was also established in March 1998, by the Armenian government to provide the framework for the promotion of investment.

The SIPPB establishes the basis for the State investment policy. In particular, SIPPB advises the president and the government on measures necessary to create a competitive environment that supports investment inflow and provides sufficient protection for investments.

The ADA's primary task is to implement the government's investment and export development policies. The Agency will act as a "one stop shop" for investors and exporters and promote Armenia as an attractive investment destination. The government projects that the ADA will have a worldwide network of representatives and agencies in markets attractive to and attracted to Armenia. The London International Center of the ADA is in the process of being established in the United Kingdom, with the extensive participation and support of the Armenian Diaspora and the international business community. The US-Armenia Development and Trade Council headquartered in Washington D.C., opened its Yerevan Office in 1998 at the ADA headquarters. The purpose of this council is to facilitate economic development, networking, information exchange, and co-operation between U.S. and Armenian businesses. Several other partnerships are envisioned.

PROPERTY RIGHTS PROTECTION

Property rights are safeguarded by the Constitution of the Republic of Armenia, which was adopted in 1995. The Law on Property and the Law on Foreign Investment were also adopted to protect property rights.

The Law on Foreign Investment of July 31, 1994 regulates foreign investment in Armenia. The objective of the Law is to create an attractive environment for foreign investment. The following provisions are of the utmost importance:

In the event of a change in the relevant laws, an investor has the option to remain subject to the laws that were effective prior to the change for a period of 5 years.

Investments made by foreigners cannot be nationalized or confiscated, unless such nationalization or confiscation is done under extraordinary circumstances, as declared by the government and approved by the courts.

Should a court decision be made in favor of investment confiscation, the investor will be fully compensated in advance. Under the Law, investors will be compensated for damages, including loss of profits resulting from actions of the Armenian State and State officials. The legal regime governing foreign investors is the same as that of residents.

Foreign investors may establish the same forms of business organizations as domestic investors.

The company registration procedure that applies to foreign investors is the same as that for domestic enterprises.

FOREIGN CITIZENS' RIGHT TO ESTABLISH & OWN BUSINESSES

Foreign citizens may establish and own business enterprises in Armenia. Although they may not own land in themselves, they may lease up to 99 years or use by contract. Foreign investors enjoy substantial tax benefits.

Foreign investors may:

- establish fully foreign-owned companies, affiliates, branches, representative offices,
- purchase existing companies,
- establish new joint ventures with companies or citizens,
- purchase shares in existing companies,
- purchase different types of securities recognized by Armenian legislation.

INCENTIVES

The Law "On Profit Tax", (effective January 1, 1998), provides that where a foreign investor's share in the statutory capital of an Armenian company is at least AMD 500 million, the following allowances are made:

0% profit tax during the first 2 years of investment, effective from official registration of the investment;

50% profit tax, starting from the third year and until the tenth year after the initial investment.

Allowances on profit tax granted to foreign investors and banks prior to January 1, 1998, shall remain in force until the end of the validity period.

Losses can be carried forward without limitations. Deductions for profits tax purposes are allowed for most expenses.

EXPROPRIATION AND COMPENSATION

According to the Foreign Investment Law, in the event of a change in legislation, foreign investment may be subject to the laws concerning foreign investment existing at the time of initial investment for a period of up to 5 years, at the investor's discretion.

DISPUTE SETTLEMENT

According to the Law on Foreign Investment, all disputes that arise between a foreign investor and the Republic of Armenia must be settled in Armenian courts. Unless otherwise provided for by international law or by preliminary agreements between the parties involved, this process may involve:

the consideration of other disputes, not involving the Republic of Armenia,

other bodies entitled to settle economic disputes,

intermediary courts.

The Bilateral Investment Treaty (BIT) similarly sets provisions for dispute settlements between foreign companies and the government of Armenia.

EXCHANGE CONTROL

Unlimited amounts of hard currency may be imported and exported on condition that it was previously imported or legally obtained in Armenia. Foreign citizens engaged in economic activity in Armenia can freely
repatriate their profits from Armenia, (Armenian has signed Article VIII of the IMF treaty).

WORK AND RESIDENCY PERMITS

To be employed in the RA, foreigners must obtain either short-term (up to one year), long-term (three year), or permanent-stay (ten year) residency permits issued by the Ministry of Internal Affairs.

ACCESS TO CREDIT

Foreign entrepreneurs can make use of credit granted by both Armenian and foreign banks operating in Armenia.

TRANSPARENCY OF THE REGULATORY SYSTEM

Laws and regulations that affect direct investment, such as environmental, employment, health and safety regulations are non-discriminatory and apply both to foreign and domestic firms.

Armenian tax laws are designed to attract foreign investment into Armenia.

LABOR

Human resources are one of Armenia's greatest assets. There is a significant supply of qualified specialists both in research/engineering and production in domains such as electric and electronic components and devices, electrical components and appliances; software; electric motors and generators, optics (including space optics), apparel production, chemistry, architecture and construction, jewelry, arts and crafts and food processing. The labor force is highly educated and well trained, particularly in engineering and technology.

Moreover, the Armenian labor force is able to quickly adapt to new market conditions. Almost one hundred percent of the Armenian population is literate; 59 percent have completed secondary school and 13 percent have university degrees. Teams of qualified scientists who have conducted research in many areas of science and technology are especially significant. Foreign investors have observed that, although the labor force in Armenia may lack the knowledge of some new production technologies, it is skilled and educated enough to efficiently improve its qualifications.

CAPITAL MARKETS AND PORTFOLIO INVESTMENT

The Armenian government holds the improvement of the existing financial environment as a priority. The Armenian laws and regulations that have been developed over the past several years in this area are considered among the most liberal in the CIS.

The Armenian financial infrastructure has a wide spectrum of specialized institutions that includes bank, stock and commodity exchanges, investment funds and companies, insurance companies, consulting companies as well as numerous broker/dealer/audit offices.

In Armenia, there are three legally registered and operating stock exchanges – the Yerevan Stock Exchange, the Yerevan Commodity & Stock Exchange "Adamand", and the Gyumri Stock Exchange.

Despite the yet-to-be-completed privatization process, the Armenian stock market is rapidly growing, reflecting the strong governmental support. No restrictions exist for foreign investors to invest in existing companies and corporations and there is considerable foreign interest in Armenian governmental and corporate securities. Along with individual investors, a number of investment funds and companies are also present in the market; they are primarily active in the short-term government securities market.

Currently, there is a newly established insurance market in Armenia. Approximately 20 insurance companies offer coverage for financial risk, deposits, credit, exchange transactions, cargo transportation, etc.

BILATERAL INVESTMENT AGREEMENTS

The BIT requires equality of investment conditions for all investors, be they foreign or national. It protects investors against expropriation and nationalization as well as regulates dispute settlements between the companies and the governments of each party.

Armenia has signed bilateral treaties on investment and investor protection with 16 countries, (Argentina, Vietnam, Germany, Greece, Georgia, Egypt, Iran, Cyprus, China, Kyrgyzstan, Romania, USA, Turkmenistan, Ukraine, France, Canada). In addition, Armenia has signed up to the CIS multilateral convention on protection of investor rights.

FOREIGN DIRECT INVESTMENT

The government began land privatization almost immediately after independence in 1991, and in 1992, large-scale privatization programs were already initiated. The government views the implementation of its industrial privatization program as the first-step in stimulating economic growth and attracting investment. An open-door liberal trade and investment policy has also been adopted in order to develop an investment environment conducive to attracting foreign investment. As a consequence of these policies, exports have grown by approximately 23% per year between 1993 and 1996 and, after a slight decline in 1997, have continued to demonstrate growth in 1998.

A total of 1040 companies with foreign participation registered in Armenia between 1988 and December 1997, of which: 179, (17%), were registered in 1995; 288, (28%), in 1996; and 357, (34%), in 1997, indicating a substantial acceleration in the rate of investment inflow in recent years. A number of multinational companies have already started operations in Armenia including Bristol Myers Squibb, Castel, Coca-Cola, Caritas, First Dynasty Mines, Huntsman, IBM, Italtel, Midland Bank, Macmillan, KPMG, Amyot Exco, Pernod Ricard, Siemens, Rell, Levi Strauss, DHL and Federal Express.

In 1995, Foreign Direct Investment was estimated at $18 million, in 1996 at $35 million, and in 1997 at $42.5 million. Foreign Direct Investment is estimated to grow by at least 40 % in 1998. New growth of Foreign Direct Investment is anticipated by the end of 1998 due to the privatization of larger state-owned enterprises, including hotel facilities.

The most common forms of FDI are:

- joint ventures to date, joint ventures with recently privatized companies,
- greenfield investments,
- participation in the privatization process.

BENEFITS OF INVESTMENT IN ARMENIA

Strong governmental commitment to economic and structural reform
Easy access to NIS, Middle East and European Markets
Legislation encouraging and protecting inflow of foreign investments
Fast growing economy
Stable local currency
Intensifying privatization
Highly-educated and inexpensive workforce
Liberal trade policy
Worldwide Diaspora

MAJOR OPPORTUNITIES FOR INVESTMENT

High-tech electronics engineering
Mining & Metallurgy
Electrical power systems
Chemical production
Light industry
Banking and financial services
Computer software engineering
Food processing and packaging
Tourism

Annex B1

From:"William Gormly" <cipfltd@att.net> | Block addressTo:"Karen Sughyan" <karsugh@yahoo.com>Subject:Re: Business ResearchDate:Mon, 25 Sep 2000 14:19:56 -0700

Dear Karen:

Thank you for your inquiry and congratulations on pursuing your MBA. I am familiar with American University and have visited their Cairo campus several times. Mine is not a venture capital firm but, rather, a professional independent corporate Financial Advisor. So you understand what that embodies I am attaching something that I usually send to respondents to our advertising in the International Herald Tribune and the Financial Times. As you will see I could represent Armenian firms who need capital (and, obviously, they all do) and attempt to raise that capital - at which I have been rather successful.

The problem I encounter, not just in Armenia but everywhere in developing countries, is the companies or governments are all completely inexperienced and rather naive in their expectations about engaging professionals. To put it another way, they are either broke or refuse to pay western professionals to do anything until it is completed. It is absurd that someone would think a professional would come 10,000 miles and represent someone – which requires an enormous amount of work - without getting paid.

So the real problem in Armenia, and the other countries, is education. Without adequate capital Armenia will struggle very badly. But until they have the courage to step up or are creative enough to locate money for professional fees, they will get nothing but non-professional firms desperate for income - not people with a track record. Those firms will fail.

If I can help some more, please let me know.

Good luck.

William M. Gormly
President CIPF, Ltd.

Annex B2

From:"William Gormly" <cipfltd@att.net>
To:"Karen Sughyan" <karsugh@yahoo.com
Subject: Re: Business Research
Date: Tue. 26 Sep. 2000 10:10:25 -0700

I do not maintain such a list (i.e., a list of venture capital firms interested in making investments in Armenia - K.S.). I approach every deal the same way, does not matter if it is a manufacturing firm in Toledo, Ohio or a Tennis facility in Armenia (which approached me, by the way). It is irrelevant. My philosophy is the major players will invest in any deal if it is: 1. Structured properly to protect their interests 2. yields significant enough believable revenue that an outstanding return can be achieved 3. Is ethical 4. does not involve criminal or immoral backers or activities 5. is controlled by people who are bright and quick and will not waste their time. The Morgan Stanleys of the world will take a look at anything if it submitted by a respected source, otherwise they will immediately can it. In my view the client is better served. The trouble with most funds, even those set up (if there were any) for Armenia, is they are fully invested or run by bureaucrats. That is precisely why I proposed a large Country Fund to the powers to be in Armenia - it is precisely what they need; forget the other stuff. The bureaucrats lost it somewhere. The country is in desperate straits. It is truly tragic and no one, except the youth, give a damn. Think what $35 million or more invested directly in Armenian companies, hundreds of them, would do for your country. I know this could be done.

Bill Gormly

Annex C

LIST OF INTERNET CONTACTS

Venture Capital Firms

1. Advent International Corp.
2. CIPF Ltd.
3. Commonwealth Capital Ventures
4. Charterhouse Group International, Inc.
5. Emerging Markets Partnership
6. Industrial Growth Partners
7. International Equity Partners
8. Microcell Capital
9. Opportunity Capital Partners
10. Oresa Ventures
11. Partech International
12. TA Associates Inc.
13. Venture Investors
14. Venglobal Capital
15. Worldview Technology Partners
16. Working Ventures

Other Contacts

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info@usabia.org	United States-Armenia Business and Investment Association
ibtci@ibtci.com	International Business and Technical Consultants Inc.

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[13] Interview with Artak Melkonyan, Manager of Armenian Operations for the Fund Manager, Caucasus Advisors LLC (October 4, 2000).

[14] Interview with Areg Barseghyan, Deputy Project Manager on Business Development, International Finance Corporation (October 2, 2000).

[15] www.ifc.org/ar2000/index.htm, IFC Annual Report 2000, Technical Assistance and Advisory Projects.

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[20] Կարևորվում է ներդրումների ներգրավման ու գործարարության ծավալման համար բարենպաստ պայմանների ստեղծումը [Creation of favorable conditions for attracting investments and developing entrepreneurship becomes important] (October 20, 2000) Hayastani Hanrapetutiun Daily, 192 (2662), p. 1.