

Mergers & acquisitions

Sustainable prospects

Mid-market M&A in Russia in 2008-1H 2009



Contents

Key trends for mid-market M&A in Russia in 2008-1H 2009	4
Quick facts	4
Macroeconomic trends	5
Overview	7
Industries	10
Utilities	10
Real estate	12
Retail and consumer	14
Banking	16
Oil & gas	18
Mining	20
Other sectors	22
Domestic and cross-border activities	23
Deal drivers	25
Challenges	26
Trends	27
Contacts	28

Key trends for mid-market M&A in Russia in 2008-1H 2009

- Significant decrease in M&A activity on the back of the global financial crisis
- Substantial discrepancy in value perception between sellers and buyers
- Increased cash requirements
- Increased share of equity swaps
- Constrained debt financing
- Distressed M&A may play a significant role in the mid-market over the next few months
- Sustainable M&A activity for the mid-market

Quick facts

Russian mid-market M&A market in 2008: Quick facts	
Top three inbound investing countries by volume	Germany, Cyprus, USA
Top three inbound investing countries by value	Germany, Cyprus, USA
Top outbound destination countries by volume	Finland, Canada, Germany and Italy (equal transaction volume)
Top three outbound destination countries by value	Finland, Canada, Germany
Top three industries by volume	Utilities, real estate, retail & consumer
Top three industries by value	Utilities, real estate, retail & consumer
Average deal size equal to or below USD 100 million	USD 72.3 million
Proportion of deals below USD 100 million	54.2%
Average deal size over USD 100 million	USD 164.6 million
Proportion of deals over USD 100 million	45.8%
Largest transaction	Alfa Group Consortium, the Russia-based financial and industrial conglomerate, acquired a 50% stake in IVI-93, the Russia based construction and real estate company, for USD 250 million

Russian mid-market M&A market in 1H 2009: Quick facts	
Top three inbound investing countries by volume	Sweden, Cyprus, USA
Top three inbound investing countries by value	Italy, France, Sweden
Top outbound destination countries by volume	Kazakhstan (the other seven countries have one transaction each)
Top three outbound destination countries by value	Kazakhstan, Ukraine, Cyprus
Top three industries by volume	Utilities, oil & gas, banking
Top three industries by value	Utilities, oil & gas, banking
Average deal size equal to or below USD 100 million	USD 70.4 million
Proportion of deals below USD 100 million	58.7%
Average deal size of over USD 100 million	USD 167.8 million
Proportion of deals over USD 100 million	41.3%
Largest transaction	Comstar-United TeleSystems, the listed Russia-based integrated telecommunications provider, acquired the regional operations of Stream-TV Group, the Russia-based provider of pay-TV and broadband internet services, from Sistema Mass Media for USD 246 million

Source: PwC analysis

Macroeconomic trends

Following in the steps of Western Europe and the US, the global economic crisis had a negative impact on the Russian economy in the second half of 2008, resulting in a fall in GDP and other major macroeconomic indicators, as shown in Table 1.

The Russian GDP growth rate fell from 8.1% in 2007 to 5.6% in 2008 and it is expected to be negative in 2009. This drop is primarily caused by significantly reduced levels of industrial production, investment and construction activity as well as a slowdown in consumer demand. In addition, falling oil prices hit the Russian budget hard in 2008. As a response to this, the Central Bank of Russia devalued the RUB against the USD and EUR.

At the same time, Russia witnessed an increase in foreign direct investments during the period from 2006 to mid-2008 thanks to a growing domestic market and political stability. Given that the financial crisis hit in 2H 2008, investment into Russia has slowed down considerably.

Inward direct investments amounted to USD 70.3 billion in 2008, a y-o-y growth of 28% as compared to 2007. Mineral resources extraction, utilities, manufacturing, retail, real estate and construction were the favourite targets for both domestic and foreign investors.

Table 1. Selected macroeconomic indicators for the Russian Federation, 2006–2013

Indicator	Unit	2006	2007	2008	2009F	2010F	2011F	2012F	2013F
World economy									
World GDP growth rate	%	4.0	3.8	1.9	(3.1)	1.3	2.4	2.8	3.0
EU 27 GDP growth rate	%	3.2	2.9	0.9	(4.4)	(0.6)	1.1	1.6	1.9
Russian economy									
Russian real GDP growth rate	%	7.7	8.1	5.6	(7.0)	2.5	4.1	4.5	4.6
ICE Brent oil per barrel	USD	65.4	72.7	97.7	59.0	65.0	70.0	77.0	82.0
Exchange rate RUB to USD (average)	RUB	27.2	25.6	24.9	32.5	33.5	34.0	34.5	35.0
Exchange rate RUB to EUR (average)	RUB	34.1	35.0	36.5	44.1	46.4	48.1	49.9	51.5
Consumer prices (as of year-end)	%	9.0	11.9	13.3	10.8	9.3	8.1	7.2	6.9
Producer prices (average)	%	12.4	14.0	21.5	3.5	9.0	9.5	10.0	10.0
Inward direct investment	USD bln	29.7	55.1	70.3	35.0	50.0	52.0	55.0	59.0
Outward direct investment	USD bln	23.2	45.9	52.4	20.0	36.0	40.0	41.0	40.0
Export of goods and services	%	7.3	6.3	0.5	(10.3)	4.5	5.1	5.8	5.6
Import of goods and services	%	21.3	26.5	15.0	(9.6)	4.1	3.4	4.9	5.7

Source: *Economist Intelligence Unit*

Outward direct investments in 2008 have been considerable, amounting to USD 52.4 million: y-o-y growth of 14% as compared to 2007. Although both outward and inward direct investments are forecast to decrease by almost 50% in the current year, a quick recovery is expected as soon as 2010–2011.

Economic policy in Russia is primarily aimed at social, political and economic stability, the further development of the institutional structure of the market, and industry diversification. In response to the crisis, the government, in cooperation with the Central Bank, has developed an anti-crisis stimulus package which is aimed at minimising the scale of the crisis. In this context, the government continues to initiate change and introduce new methods of managing currency, fiscal, budgetary and tariff policy, as well as the financial market and the banking system. The state is increasing the role it plays in the economy, focusing particularly on the oil and gas, banking and defence sectors.

The government has approved a list of strategic companies that are entitled to receive state support in the retail, banking, oil and gas, metals and construction and transport sectors.

Support for small- and medium-sized businesses is a priority of the anti-crisis measures of the government. In 2009, RUB 40.5 billion will be allocated to this area, which is 11 times higher than the figure for 2008. The priority measures include measures to reduce the administrative burden and to foster competition.

Furthermore, a wide range of tax incentive measures was introduced by the government. The reduction of the tax burden on domestic industrial enterprises is a high priority aspect of the anti-crisis stimulus package: the profit tax has been cut to 20%. Companies investing in equipment have been granted additional depreciation privileges and tax benefits have been approved for priority research projects.

Competition from multinationals increases and this motivates Russian entrepreneurs to consider selling their businesses. Also, the crisis is hitting a lot of medium-sized companies because of price pressures that lead to reduced margins.

*Daniel Brooks
Tetley Tea*

Overview

In the years leading up to mid-2008, growth in the Russian M&A mid-market was robust (mid-market deals are deals with an enterprise value of between USD 50 million and USD 250 million). As Figure 1 shows, market participants saw an acceleration in the number and value of mid-market M&A deals in 1H 2008.

When the global financial crisis finally hit Russia in the 2H of 2008, M&A mid-market activity contracted within a relatively short period.

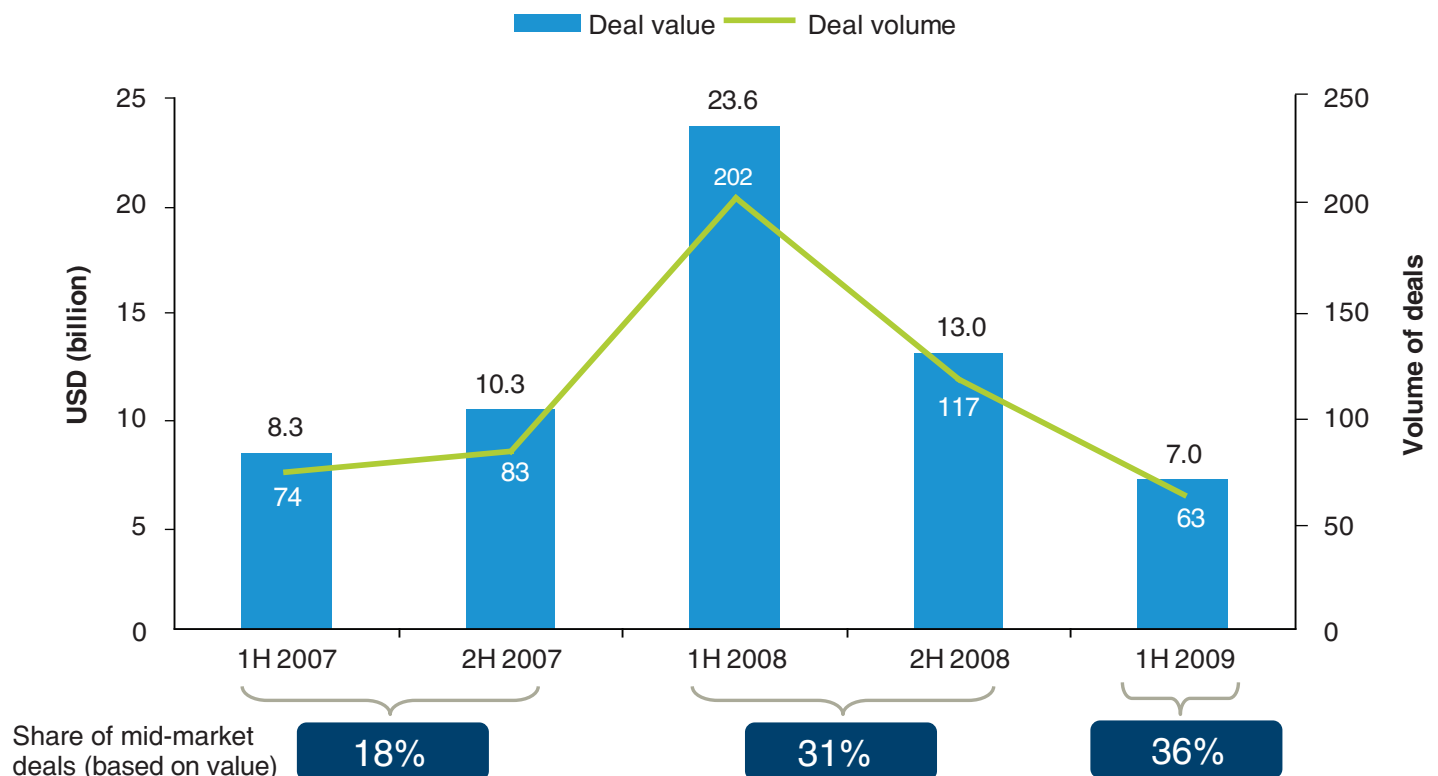
The number of M&A deals in the mid-market started to decrease in 2H 2008 and amounted to only 117 deals as compared to 202 deals in 1H 2008. Moreover, only 63 deals were made in 1H 2009. In value terms, the decrease was also significant: from USD 23.6 billion in 1H 2008 to USD 13 billion in 2H 2008 and down to USD 7 billion in 1H 2009.

Furthermore, the share of mid-market M&A deals of the overall M&A deal value in Russia has been steadily growing from 18% in 2007 to 31% in 2008 and to 36% in 2009.

The Russian market system is sometimes fairly immature with only 20 years of history as a capitalist country. However there are many opportunities. If investors are able to think about mid-term and long-term prospects, the M&A market will have a bright future.

*Shigeru Mukoyama
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Figure 1. M&A mid-market deals in Russia, 2007-1H 2009



Source: PwC analysis

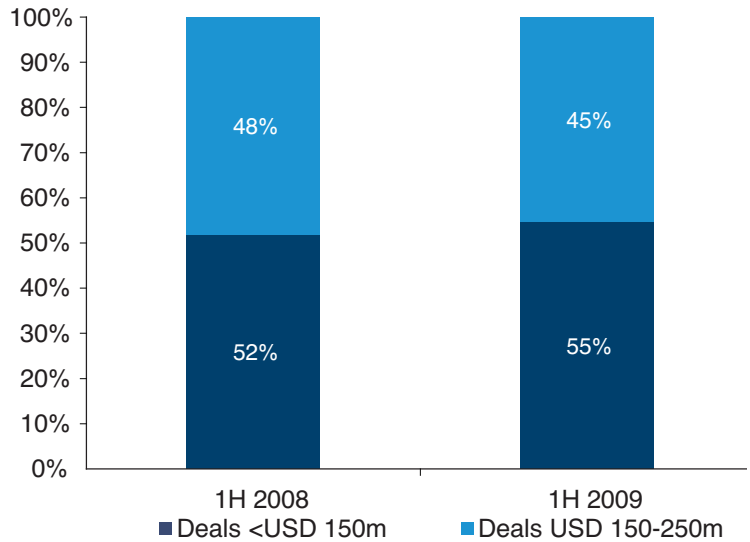
Over the period 1H 2008 to 1H 2009, the average size of a mid-market deal fell slightly, from USD 117 million to USD 111 million.

The share of deals at the lower end of the mid-market segment (USD 50–150 million) increased in 1H 2009 from the respective period in the previous year.

As opposed to larger deals, where many companies experienced a decrease of more than 50% in value, the impact on the value of mid-sized companies was less serious.

Sector composition in the mid-market M&A segment differs from that of the total M&A market. The overall Russian M&A market is clearly dominated by such sectors as metals, mining, oil & gas and utilities. The mid-market, however, to a large extent consists of deals in the utilities, real estate and retail and consumer sectors as shown in Table 2 (the top three sectors accounted for 37.7% of the total value of the M&A mid-market in 2008-1H 2009).

Figure 2. Number of mid-market deals by size, 2007-1H 2009



The mental factor is important – Russians are relatively emotional compared to Western people even in regards to business matters. Many Russian entrepreneurs became overly pessimistic after the crisis hit the Russian economy. This led them to think of selling their business instead of trying to survive the crisis.

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Table 2. Sector composition of the mid-market M&A in Russia

Sector	1H 2007		2H 2007		1H 2008		2H 2008		1H 2009		2008-1H 2009
	Number %	Value %	Number %	Value %	Number %	Value %	Number %	Value %	Number %	Value %	Value %
Utilities	5%	4%	6%	5%	24%	26%	7%	7%	16%	17%	18.7%
Real estate	7%	8%	2%	1%	9%	10%	14%	12%	8%	7%	10.5%
Retail & consumer	12%	10%	13%	12%	10%	9%	10%	10%	8%	6%	8.5%
Banking	7%	7%	10%	8%	6%	7%	9%	10%	10%	10%	8.2%
Oil & gas	11%	10%	13%	13%	4%	3%	7%	9%	13%	15%	6.8%
Industrial manufacturing	8%	6%	7%	5%	7%	6%	8%	7%	3%	3%	5.8%
Transportation & logistics	4%	5%	4%	3%	4%	5%	6%	7%	6%	4%	5.6%
Mining	1%	1%	13%	16%	5%	5%	6%	5%	8%	7%	5.4%
Other sectors	45%	50%	31%	36%	30%	29%	34%	33%	29%	31%	31%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Source: PwC analysis

The sector composition of mid-market M&A deals in 1H 2009 demonstrates a shift towards deals involving companies engaged in raw materials production.

The majority of mid-market deals in 1H 2009 were in the utilities and oil & gas sectors, representing 17% and 15% of all mid-market deals in Russia respectively.

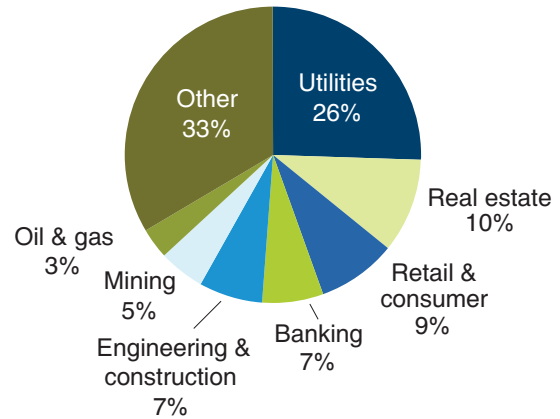
Moreover, the mining sector was among the key sectors by total deal value in 1H 2009, whereas the retail and consumer sectors, as well as engineering and construction, dropped in terms of value in the same period.

We believe that, as the economy begins to pick up, the retail and consumer sector will remain one of the most attractive for investors, including foreign buyers, of the Russian M&A mid-market, despite a decrease in M&A activity in the retail and consumer sector in 1H 2009.

Despite the overall and marked slowdown, the M&A mid-market demonstrated a stronger resilience to the crisis and, for a number of reasons, is also expected to recover faster than the rest of the market:

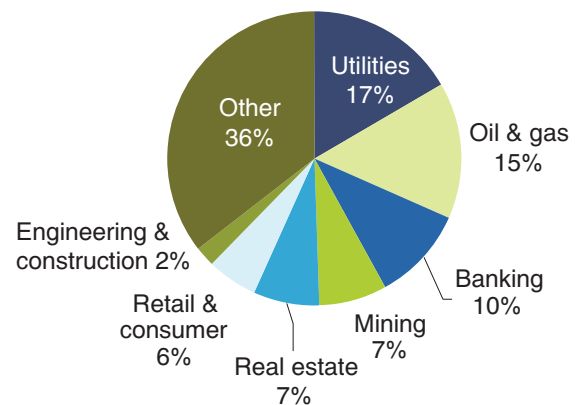
- In the current environment, sellers lack in many instances liquidity and have no choice but have to allow an investor to come in to prevent the company from going bankrupt or to secure that growth opportunities can be seized.
- Many buyers feel that it is the right time to acquire at relatively low prices in order to strengthen their market position. In addition, a number of foreign buyers came to the conclusion that it is the right time to enter the Russian market because of lower prices and less competition for attractive businesses / assets.

Figure 3. Mid-market deal value by sector, 1H 2008



Source: PwC analysis

Figure 4. Mid-market deal value by sector, 1H 2009



Source: PwC analysis

Should the second wave of the crisis occur, Russian entrepreneurs would be more resilient, having already learned from the November '08 events. They would tend to make more balanced decisions with regard to selling their business and a quick sale at any price will no longer be an option.

Shigeru Mukoyama
Executive General Manager,
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Industries

Utilities

Sector statistics for 1H 2009 (1H 2008)

Total transaction value	USD 1,169 million (USD 6,052 million)
Share of total mid-market	17% (26%)
Number of transactions	10 (49)
Average transaction value	USD 117 million (USD 124 million)

Overall sector trends in 2008-1H 2009

The restructuring of RAO UES, the Russian energy giant and distribution conglomerate, generated significant activity in the utilities mid-market in recent years. In 2008, RAO UES related transactions comprised 84% of the total mid-market deal value.

Dynamics of the volume and the value of mid-market sector deals

After consolidation efforts undertaken by large players in the utilities sector in 1H 2008, deal activity in the mid-market has decreased significantly in 1H 2009, showing an 81% decline in value compared to 1H 2008.

The majority of transactions occurred in 1H 2008, with deal flow reaching 49 transactions worth USD 6,052 million.

In 2H 2008, market conditions deteriorated and the market volume dropped drastically to eight deals, worth USD 928 million. However, the market has already begun to demonstrate slow signs of recovery in 1H 2009, with ten transactions worth USD 1,169 million.

The average transaction value in the sector

Overall, in 2H 2008, the average deal value remained comparatively resilient to economic turmoil and decreased by 6% as opposed to 1H 2008 (from USD 124 million to USD 116 million). However, the average deal value – excluding RAO UES related transactions – decreased by 39%.

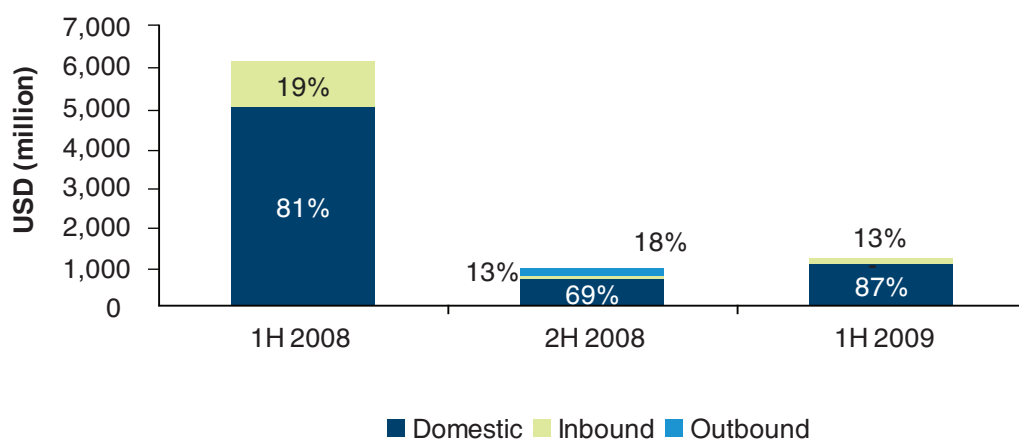
In 1H 2009, the average deal value amounted to USD 117 million.

Description of inbound / outbound / domestic sector deals

Activity in the utilities sector has historically been led by Russian companies. Domestic deals accounted for 81% of the total value of transactions during 2008-1H 2009.

Major inbound transactions in the period 2008-1H 2009 included the acquisition of former RAO UES generation and distribution companies, accounting for 68% of all inbound deals by value.

Figure 5. Deal value in the utilities sector, 2008-1H 2009



Source: PwC analysis

Description of acquired stake in the sector

In view of market uncertainty and the limited ability of acquirers to raise external financing, buyers preferred to acquire minority stakes (as shown in Figure 6).

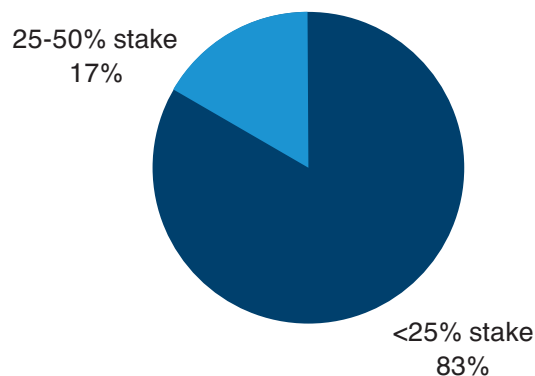
Rationale for transactions within the sector

The restructuring of the Russian electricity industry remains the driving force for activity in the M&A utilities market.

Outlook

As a result of the adverse economic environment, Russian companies may struggle to raise external funds to finance the acquisition of utilities assets. Therefore, in order to carry out the desired transactions, some companies may opt to partner with a foreign investor, which ultimately would lead to a growth of inbound activity.

Figure 6. Deals by acquired stake in the utilities sector, 1H 2009



Source: PwC analysis

Table 3. Top-3 mid-market deals in the utilities sector, 1H 2009

Target	Buyer	Acquired stake (%)	Deal value (USD m)
MOEK	MOEK-Finance	8	237
TGK-1	Gazprom Energoholding	29	221
Moscow Heat Distribution Company (MTK)	Moscow Integrated Power Company (MOEK)	13	132
Total			590

Source: PwC analysis

Real estate

Sector statistics for 1H 2009 (1H 2008)

Total transaction value	USD 508 million (USD 2,421 million)
Share of total mid-market	7% (10%)
Number of transactions	5 (18)
Average transaction value	USD 102 million (USD 135 million)

Overall sector trends in 2008-1H 2009

Real estate probably suffered most among the various sectors in the Russian economy. As consumer purchasing power and confidence among industrial players declined, demand for real estate contracted.

The main parameters have been adjusted accordingly: capitalisation and vacancy rates have increased, while rental rates have come down.

The high dependence on the part of real estate companies on debt during a squeeze in liquidity exacerbated the problem. Companies were faced with the option of either refinancing the debt at much higher rates or freezing projects.

Investors became more selective as to considering real estate in Russia limiting themselves primarily to cash flow producing properties.

Dynamics of the volume and the value of mid-market sector deals

The Russian real estate mid-market shrank in terms of M&A deals to only five transactions with a total value of USD 508 million in 1H 2009, from 18 deals valued at USD 2,421 million in 1H 2008. Its contribution to the M&A mid-market also decreased from 10% to 7% during the same period.

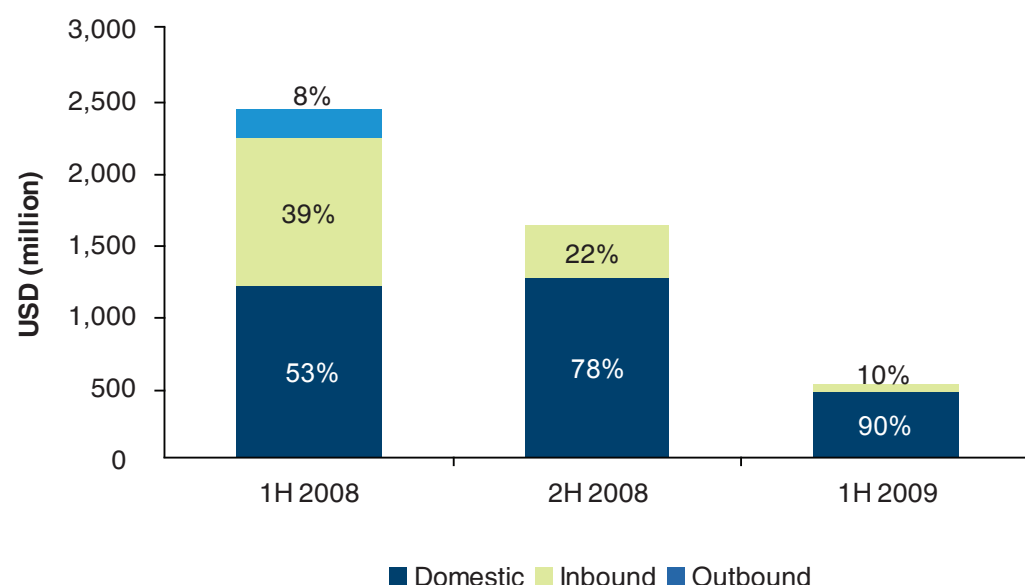
The average transaction value in the sector

The average transaction value decreased by 24% to USD 102 million in 1H 2009, from USD 135 million in 1H 2008, which is illustrative of the compressed valuation of the sector.

Description of inbound / outbound / domestic sector deals

Most transactions were made between Russian sellers and Russian buyers and the proportion of domestic transactions increased over 2008-1H 2009, as foreign investors became more reluctant to invest in the Russian real estate sector.

Figure 7. Deal value in the real estate sector, 2008-1H 2009



Source: PwC analysis

Description of the acquired stake in the sector

Most deals in the mid-market real estate segment were made with caution. The majority of investors secured a blocking stake without taking the lead.

Rationale for transactions within the sector

Most occurred as a result of the financial distress that many companies operating in this sector found themselves confronted with.

In spring 2009, PIK agreed to sell a 25% stake to Nafta Moskva, on the condition that Nafta Vostok would help PIK secure the refinancing of Sberbank loans.

The acquisition of Hotel Budapest in Moscow was also driven by the need to service debt.

However, some deals were driven by strategic considerations. For instance, the Russia Development Fund purchased a 30% stake in Kwartstroy, thus realising its long-term strategic plans.

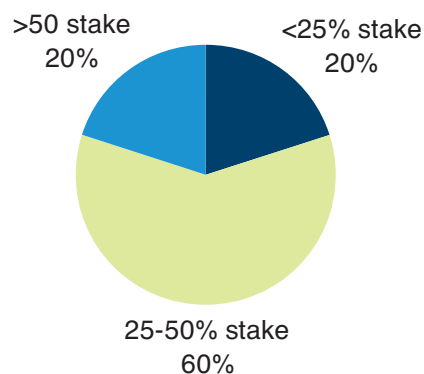
Outlook

The Russian economy is forecast to begin recovering as soon as 2010. Together with the generally low saturation of the real estate market – especially in the residential sector – this should be a strong factor in accelerating the rate of investment into the Russian real estate market.

Financial investors will need to find a balance between leveraging of deals and seizing low-price opportunities that recently appeared on the market. Given the still very limited debt funding available, we will most likely see an increase in acquisitions purely financed by equity.

We also expect to witness a number of distressed sales at high capitalisation rates.

Figure 8. Deals by acquired stake in the real estate sector, 1H 2009



Source: PwC analysis

Table 4. Top-3 mid-market deals in the real estate sector, 1H 2009

Target	Buyer	Acquired stake (%)	Deal value (USD m)
PIK	Nafta Moskva (Lacero Trading Ltd)	25	162
Kwartstroy Company	Russia Development Fund	30	150
Hotel Moskva	Moscow City Government	26	85
Total			397

Source: PwC analysis

Retail and consumer

Sector statistics for 1H 2009 (1H 2008)

Total transaction value	USD 390 million (USD 2,016 million)
Share of total mid-market	6% (9%)
Number of transactions	5 (20)
Average transaction value	USD 78 million (USD 101 million)

Overall sector trends in 2008-1H 2009

Retail and consumer, traditionally one of the hottest sectors, did not make it into the top 5 by value or by volume in the M&A mid-market rating in 1H 2009.

Dynamics of the volume and the value of mid-market sector deals

Mid-market retail deals dropped sharply in 1H 2009 to USD 390 million compared to USD 2,016 million in terms of value and to 5 from 20 in terms of volume in 1H 2008. This decline was driven by the need to quickly get the operating activities under control given increased costs (due to the high dependency on imports) and a marked drop in consumer confidence.

Average transaction value in the sector

The average transaction value declined by roughly 23% to USD 78 million in 1H 2009 from USD 101 million in 1H 2008. Investors, acting with a higher degree of caution, largely sought out smaller businesses or minority stakes trying to avoid larger-scale acquisitions.

Description of inbound / outbound / domestic sector deals

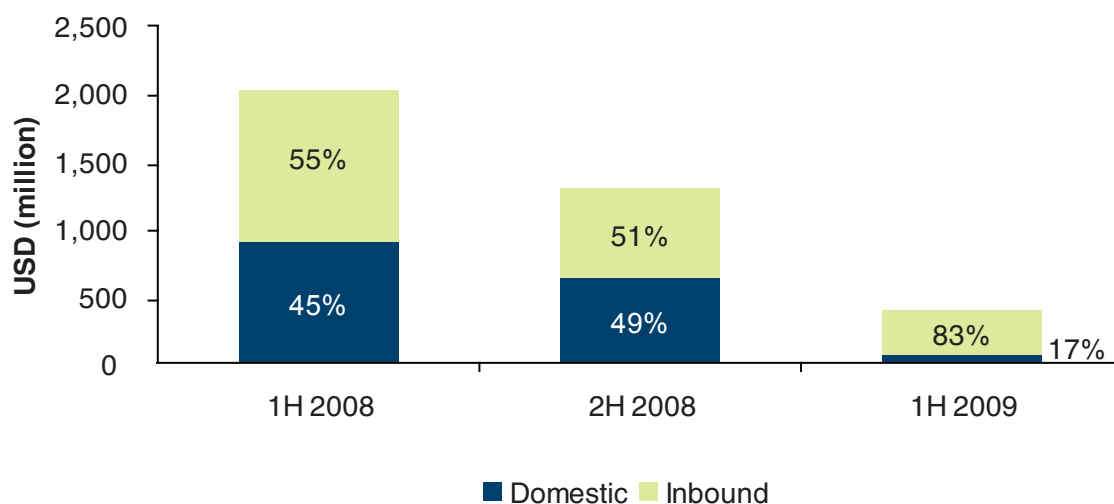
During the last couple of years, the sector was appealing to foreign investors looking for high returns in a quickly developing and growing market. Inbound deals prevailed over both periods. Russian investors remained active in 2008, but were mostly on the sidelines in 1H 2009.

Inbound transactions comprised 83% (USD 323 million) of total deal value in 1H 2009 compared to 55% (USD 897 million) in 1H 2008. This reflects the continued interest of foreign strategic investors in Russia.

One of the problems in the coffee and tea mid-market is the lack of quality acquisition targets with strong brands.

*Daniel Brooks
Tetley Tea*

Figure 9. Deal value in the retail and consumer sector, 2008-1H 2009



Source: PwC analysis

Description of acquired stake in the sector

There were only five deals in the retail and consumer sector during 1H 2009: three involved the sale of a 100% stake, one deal was for the sale of a 75% stake and one transaction pertained to a minority stake of 15%.

Rationale for transactions within the sector

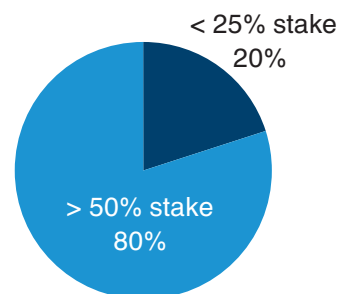
Until mid-2008, the retail and consumer sector was still one of the most attractive sectors to invest in due to constantly growing personal income and consumption behavior. However, the situation reversed in late 2008 when consumer confidence declined and many retail companies were faced with liquidity issues. Most investors suspended their plans for Russia. On the other hand, many Russian entrepreneurs were threatened by the rapidly changing conditions and started to seriously consider selling their businesses, in part or in whole.

Some retailers experienced defaults given their comparatively high debt levels, and some were forced to close unprofitable business units. During 1H 2009, deals were mostly driven by cash-rich foreign investors that were expanding into the Russian market. For instance, Unilever acquired the condiments business of Baltimor Holding and a large Japanese instant-food producer Nissin purchased a minority stake in Mareven. Some of the major ongoing deals were delayed in autumn 2008 and major deal terms were often renegotiated.

Outlook

We anticipate an increase in M&A activity in the retail and consumer sector over the next few months. Most deals that are currently being negotiated are expected to close and foreign investors are expected to renew their confidence when a recovery of world economic conditions becomes evident. This coupled with the high growth potential of the Russian retail and consumer sector will inevitably lead to a further sector consolidation.

Figure 10. Deals by acquired stake in the retail and consumer sector, 1H 2009



Source: PwC analysis

It is now difficult to recover account payables for companies working in the FMCG sector and many wholesalers, retailers and supermarkets often delay payments as they themselves face a difficult financial situation. In general, the P&L remains fairly strong, but Cash Flows, which are the basis for valuation, are weak.

*Shigeru Mukoyama
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Table 5. Top-3 mid-market deals in the retail sector, 1H 2009

Target	Buyer	Acquired stake (%)	Deal value (USD m)
Mareven (formerly Angleside)	NISSIN FOODS HOLDINGS CO LTD	15	103
Sokia	Kia Motors Corporation	100	100
Santa Khaus	Hammar Invest AB	75	70
Total			273

Source: PwC analysis

Banking

Sector statistics for 1H 2009 (1H 2008)

Total transaction value	USD 712 million (USD 1,550 million)
Share of total mid-market	10% (7%)
Number of transactions	6 (13)
Average transaction value	USD 119 million (USD 119 million)

Overall sector trends in 2008-1H 2009

In 2008, foreign banks continued to tap into the Russian market through acquisitions. In addition, large domestic players continued to acquire assets in a still highly fragmented banking industry. However, activity decreased significantly in 1H 2009 given the global financial crisis.

Dynamics of the volume and the value of mid-market sector deals

The mid-market banking sector witnessed a two-fold decrease in the number of deals, seeing only six deals

in 1H 2009 compared to 13 in the same period in 2008. The value declined accordingly from USD 1,550 million to USD 712 million. However, from a deal activity point of view, the banking sector remained relatively attractive during the downturn, increasing its market share to 10% from 7% in 1H 2008.

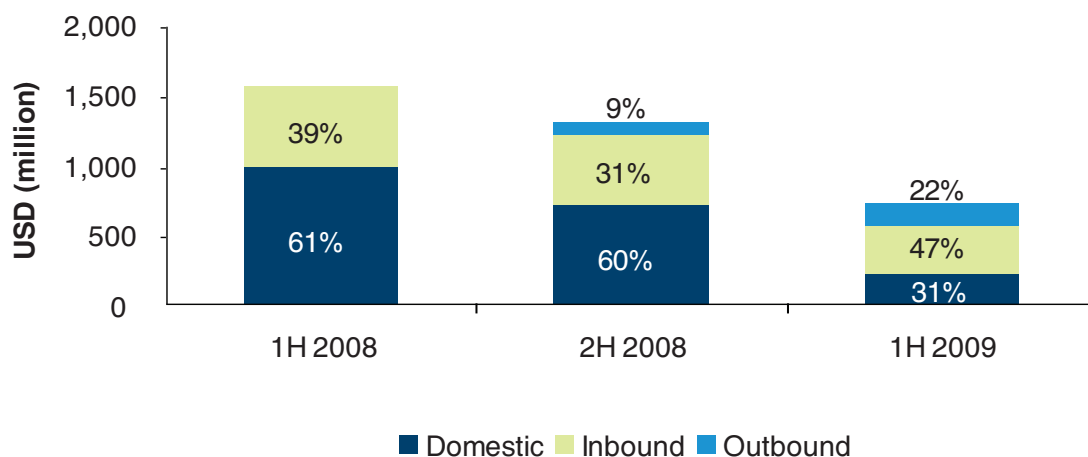
The average transaction value in the sector

At the same time, the average transaction value remained at USD 119 million.

Description of inbound / outbound / domestic sector deals

There is continued evidence of the importance of inbound deals in the quickly developing Russian financial sector. In 1H 2009, 47% of deal value was attributable to foreigners.

Figure 11. Deal value in the banking sector, 2008-1H 2009



Source: PwC analysis

Description of acquired stake in the sector

At the beginning of 1H 2009, the financial sector was at high risk globally: as a result, investors took a prudent approach opting often for minority stakes only (the share of deals in which a minority stake was acquired comprised 67% of all deals).

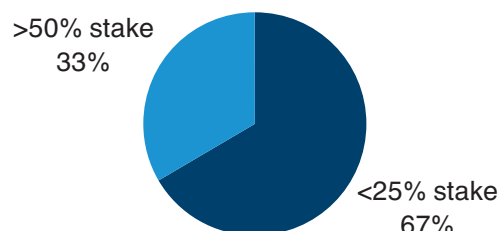
Rationale for transactions within the sector

Deals were primarily driven by increasing stakes in already existing investments as well as by bailing out troubled banks.

Outlook

The banking and capital markets sector is still relatively underdeveloped and saturation is low. Therefore, prospects remain attractive. Although global financial markets continue to be faced with uncertainty, in the mid-term, we expect a further gradual sector consolidation of the sector, driven by well positioned large local as well as foreign players. However, we would expect that deals will be conducted at fairly low multiples for quite some time.

Figure 12. Deals by acquired stake in the banking sector, 1H 2009



Source: PwC analysis

Valuations will not decline significantly any more, but it will take about two years for valuations to come back to the 2008 levels.

Daniel Brooks
Tetley Tea

Table 6. Top-3 mid-market deals in the banking sector, 1H 2009

Target	Buyer	Acquired stake (%)	Deal value (USD m)
Rosbank	Société Générale	7	182
Prominvestbank	Vneshekonombank	75	158
Bank of Moscow	Andrei Borodin	5	148
Total			488

Source: PwC analysis

Oil & gas

Sector statistics for 1H 2009 (1H 2008)

Total transaction value	USD 1,047 million (USD 792 million)
Share of total mid-market	15% (3%)
Number of transactions	8 (8)
Average transaction value	USD 131 million (USD 99 million)

Overall sector trends in 2008-1H 2009

In 2009, oil prices reeled from the impact of the crisis, which unfolded in full in the second half of 2008, resulting in a 300% drop in the price of oil from its July 2008 peak. The price of Urals grade oil declined from USD 140 per barrel to only USD 30 per barrel in December 2008, partly rebounding to USD 68 in July 2009.

Russian majors began with actively consolidating the industry, taking advantage of low valuations to acquire mid-sized oilfield services firms.

Dynamics of the volume and the value of mid-market sector deals

The Russian oil & gas mid-market sector saw ten transactions in the first half of 2009, with a total value of USD 1,047 million. The market share of the sector increased significantly from 3% in 1H 2008 to 15% in 1H 2009.

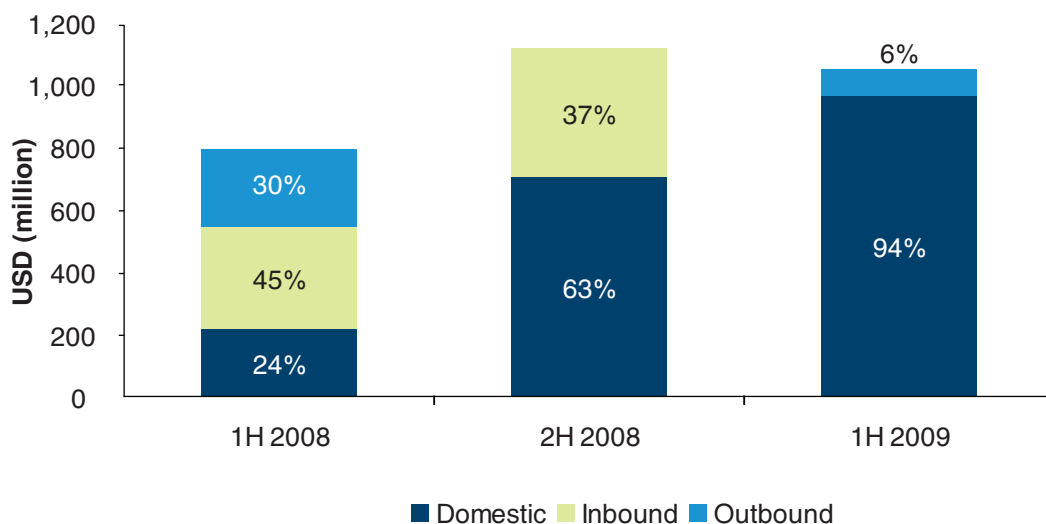
The average transaction value in the sector

The average transaction value increased 33% to USD 131 million, compared to USD 99 million in 1H 2008.

Description of inbound / outbound / domestic sector deals

In terms of deal type, the overall trend in 2009 is characterized by domestic deals (92% of the deal value). No inbound deals took place during this period.

Figure 13. Deal value in the oil & gas sector, 2008-1H 2009



Source: PwC analysis

Description of acquired stake in the sector

Buyers preferred to acquire non-controlling stakes, with 57% of deals taking place in the 25–50% stake segment.

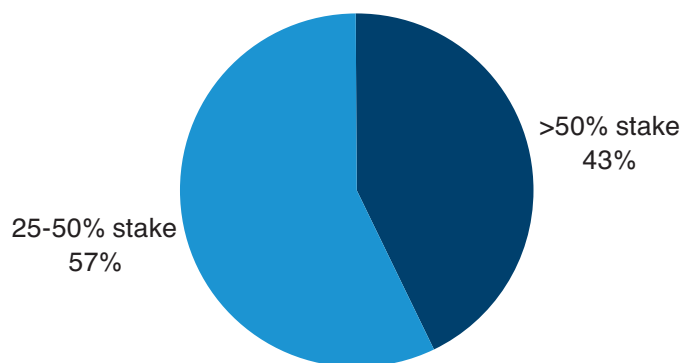
Rationale for transactions within the sector

Given the uncertainties for the industry, buyers shifted their attention to service or downstream operations (e.g. petrol stations or transportation) instead of making large investments into exploring and developing new oil fields and building infrastructure.

Outlook

While domestic consolidation will continue, we also anticipate that the number of outbound deals will grow as Russian majors look for diversification.

Figure 14. Deals by acquired stake in the oil & gas sector, 1H 2009



Source: PwC analysis

Foreign investors should more actively consider investment targets in the Russian regions.

Daniel Brooks
Tetley Tea

Table 7. Top-3 mid-market deals in the oil & gas sector, 1H 2009

Target	Buyer	Acquired stake (%)	Deal value (USD m)
Moscow-based petrol stations services holdings	LUKOIL	100	238
STBP Holdings Ltd	TNK-BP	25	230
Dulisma	Sberbank	99	197
Total			665

Source: PwC analysis

Mining

Sector statistics for 1H 2009 (1H 2008)

Total transaction value	USD 516 million (USD 1,187 million)
Share of total mid-market	7% (5%)
Number of transactions	5 (11)
Average transaction value	USD 103 million (USD 108 million)

Overall sector trends in 2008-1H 2009

2008 was certainly noteworthy for being a year of extremes in the mining industry. Commodity prices soared to record highs only to subsequently fall sharply as the financial crisis intensified and economic conditions deteriorated. As a result, most investors preferred to exercise caution by putting their expansion plans on hold.

Dynamics of the volume and the value of mid-market sector deals

The M&A mid-market slowed in 2008 with total deal value contracting nearly twofold from USD 1,187 million in 1H 2008 to USD 657 million in 2H 2008. The slowdown primarily reflected worsening global economic conditions, volatile commodity markets and expensive credit markets.

The downward trend continued in 1H 2009 with a total deal value that further dropped to USD 516 million, thereby registering a 22% decrease as compared to 2H 2008.

The number of transactions was down from eleven deals completed in 1H 2008 to seven deals in 2H 2008 to only five deals in 1H 2009.

Average transaction value in the sector

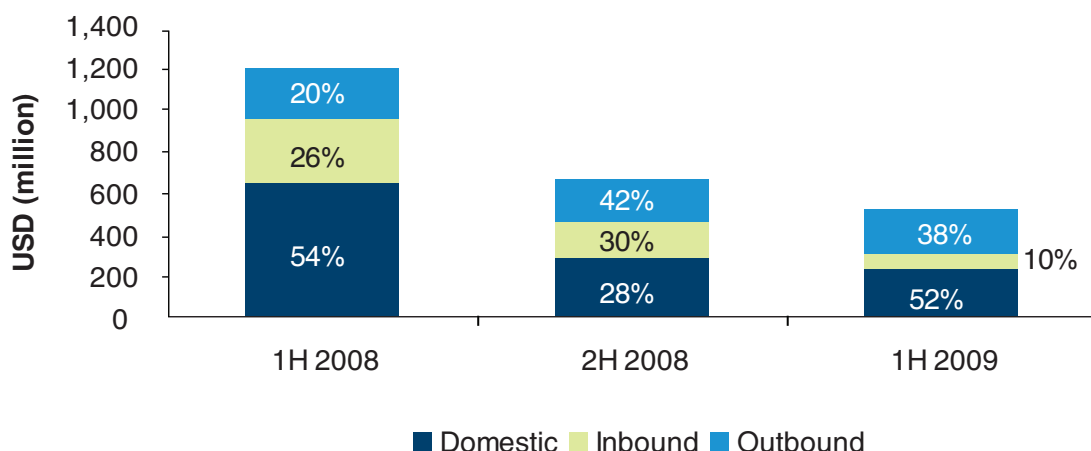
In 2008, the average deal value declined by 13%, from USD 108 million in 1H 2008 to USD 94 million in 2H 2008. In 1H 2009, the average deal value reached USD 103 million.

Description of inbound / outbound / domestic sector deals

As a result of the high degree of concentration in the Russian mining market, Russian companies have become more focused on expanding their operations abroad. This resulted in a decreased number of domestic deals and a growth of outbound transactions during 2008 and 1H 2009. While domestic deals decreased in value by over 60% in 1H 2009 compared to 1H 2008, outbound transactions remained relatively resilient to the adverse economic conditions showing a modest 7% decline during the same period. Russian companies primarily invested in companies controlling deposits or in processing companies. Primary outward destinations included Western Europe, the CIS and Australia.

Inbound transactions fell by 45% in 2H 2008 compared to 1H 2008 (from USD 314 million to USD 173 million) and further declined in 1H 2009 to USD 59 million.

Figure 15. Deal value in the mining sector, 2008-1H 2009



Source: PwC analysis

Description of acquired stake in the sector

During 1H 2009, two deals represented an acquisition of a 100% stake, one deal involved a purchase of a 50% stake, and the two remaining transactions concerned the acquisition of stakes of 20% and 25%.

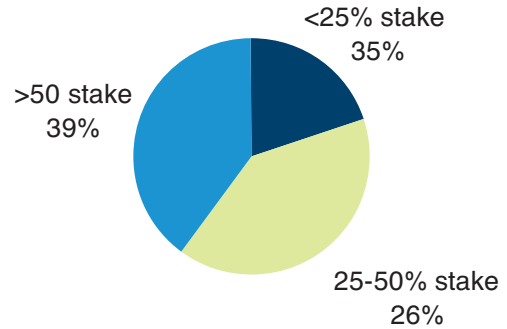
Rationale for transactions within the sector

While continuing with the process of consolidating assets in the local market, Russian mining companies such as Evraz Group and Severstal showed an interest in foreign companies. This has been driving outbound deal flow and we may witness a further increase in the number of cross-border transactions.

Outlook

Looking forward, smaller transactions are likely to provide the bulk of mining M&A activity until acquirers gain more certainty over the direction of the economy and credit markets and improvements in commodity prices, which will provide acquirers with a greater willingness to engage in larger transactions.

Figure 16. Deals by acquired stake in the mining sector, 1H 2009



Source: PwC analysis

Buyers should think more strategically into the mid- and long-term future and not simply look at the current financial position of the company, which often only mirrors the overall worsened economic conditions whereas future prospects are rather bright.

*Shigeru Mukoyama
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Russian Business Department
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Table 8. Top-3 mid-market deals in the mining sector, 1H 2009

Target	Buyer	Acquired stake (%)	Deal value (USD m)
Karatau	Atomredmetzoloto	50	150
Apatit	Federal Agency of Federal Property Management	20	131
Zolotorudnaya Kompaniya Maiskoye	Polymetal	100	105
Total			386

Source: PwC analysis

Other sectors

General statistics for other sectors are shown in Table 9 below, which reveals the same trends as observed for the top 5 sectors, i.e. an overall decline in M&A activity in 1H 2009.

Entertainment & media

Distressed situations for traditional, advertising-dependent media, a shortage of debt financing and significant price expectation discrepancies between buyers and sellers resulted in a more than twofold decrease in deal value in 1H 2009 compared to 1H 2008

Metals

After a high level of activity witnessed in recent years, metals industry deal-making contracted sharply in 2009, as demand fell and – accordingly – prices for metals plummeted in 2H 2008. As a result of uncertainty in the market, major players such as Evraz Group and Severstal suspended their expansion plans. Given this, the metals mid-market showed a more than three-fold drop in value in 1H 2009 compared to 1H 2008.

Transportation & logistics

As with other industry sectors, the Russian transportation and logistics M&A mid-market was adversely affected by tight credit terms and the high risk aversion. Since the transportation and logistics mid-market has historically been comprised of minority stake purchases, we expect that minority stake acquisitions will continue to make up the bulk of market activity during the remainder of the year.

The Russian M&A mid-market is positioned for further growth since in many sectors business is still underdeveloped and has high growth potential. This will attract investors.

*Daniel Brooks
Tetley Tea*

Table 9. Mid-market deal activity in other sectors

	Transaction value, USD m		Market share, %		Number of transactions		Average deal value, USD m	
	1H 2008	1H 2009	1H 2008	1H 2009	1H 2008	1H 2009	1H 2008	1H 2009
Entertainment & media	671	321	3%	5%	6	2	112	161
Metals	981	287	4%	4%	7	3	140	96
Transportation & logistics	1,262	275	5%	4%	8	4	158	69
Aerospace & defence	92	250	0%	4%	1	1	92	250
Chemicals	500	240	2%	3%	5	1	100	240
Communications	853	224	4%	3%	9	3	95	75
Industrial manufacturing	1,471	222	6%	3%	14	2	105	111
Investment management	589	204	2%	3%	5	2	118	102
Automotive	510	200	2%	3%	4	1	127	200
Engineering & construction	1,640	150	7%	2%	13	1	126	150
Pharmaceuticals	496	140	2%	2%	4	2	124	70
Forestry, pulp & paper	138	63	1%	1%	2	1	69	63
Technology	237	50	1%	1%	3	1	79	50

Source: PwC analysis

Domestic and cross-border activities

As compared to 1H 2008, M&A mid-market activity in Russia shrank in 1H 2009: domestic deals decreased in value by 69%, inbound deals by 77%, and outbound deals by 62%.

Although cross-border mergers and acquisitions were a constant feature of the Russian M&A mid-market in the last few years, most deals were happening domestically. During the period from 1 January 2008 until mid-2009, purely Russian deals amounted to USD 27 billion out of all mid-market M&A transactions, totalling USD 43.5 billion or 62%.

Over one third of overall domestic deal value was accounted for by two sectors: utilities (24%) and real estate (11%) over the period 2008-1H 2009.

In cross-border deals, foreign companies were more acquisitive, buying into Russian companies with USD 12 billion in overall deal value, as compared to USD 4.5 billion spent by Russian companies on acquisitions over the last 18 months.

In terms of the number of deals, 234 deals were done domestically, 103 inbound and 45 outbound in 2008-1H 2009.

The average size of domestic transactions stood at USD 115 million. Cross-border deals were of similar value, with the average size of inbound deals amounting to USD 117 million and the average size of outbound deals to USD 99 million in 2008-1H 2009.

Inbound transactions mostly involved buyers from Western Europe, Eastern Europe and the CIS.

The most popular sectors among foreign buyers in terms of deal value were retail and consumer (17%), real estate (12%), utilities (12%) and banking and capital markets (12%).

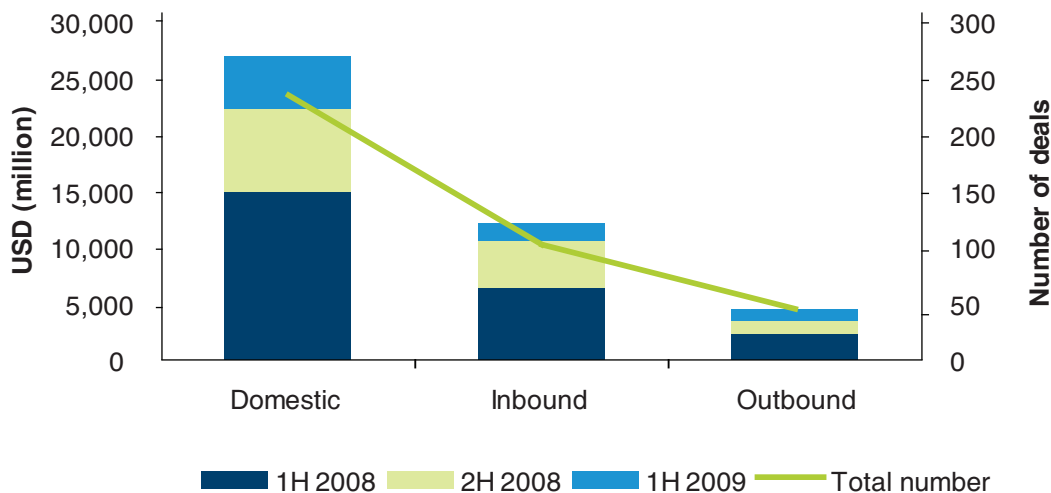
Foreign investors have established or expanded their presence on the Russian market. For example, in January 2009, Nissin Foods acquired a minority stake in Mareven (formerly Angleside).

Russian companies were mostly interested in making acquisitions in Western Europe, Eastern Europe, and the CIS countries.

We will probably see more share deals due to the lack of high quality investment targets.

*Daniel Brooks
Tetley Tea*

Figure 17. Domestic, inbound and outbound deals



Source: PwC analysis

Contrary to inbound transactions, where the consumer-related sector dominated, the majority of outbound deal is attributable to extractive industries and production companies in mining (15%), metals (15%) and the manufacturing (11%) sectors in 2008–1H 2009.

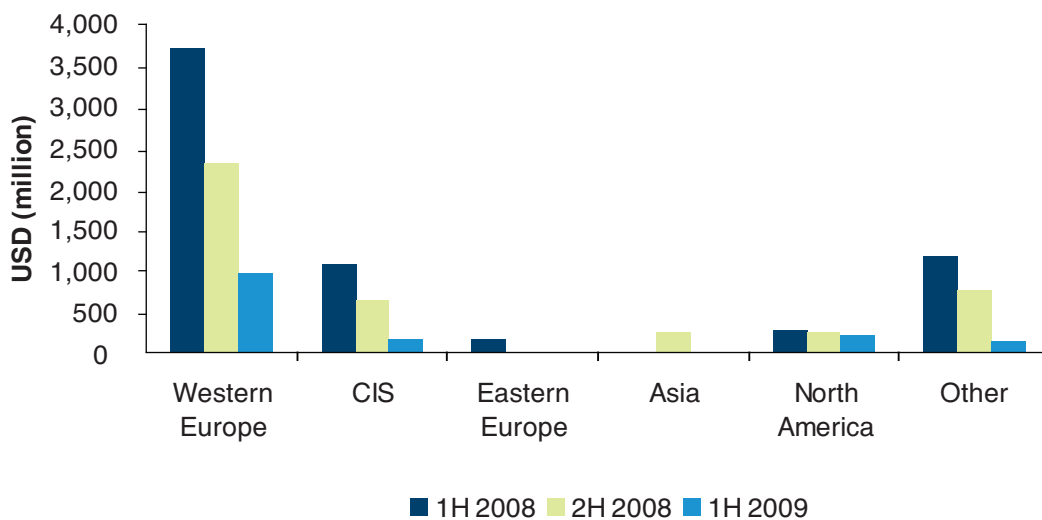
Russian companies boosted M&A activity, targeting CIS countries in 2H 2008 when overall M&A activity was on hold. For example, Avtovaz acquired Asia Avto, a Kazakh entity, realising its strategic plans to expand in Kazakhstan.

As to CIS countries, apart from Kazakhstan, Russian companies were making acquisitions in Ukraine, Armenia and Moldova in 2H 2008 and 1H 2009.

There is a big difference between the business culture in Russia and in the West. That is a clear obstacle for cross-border deals. Therefore, it is vital for future partners to be able to jointly break this wall.

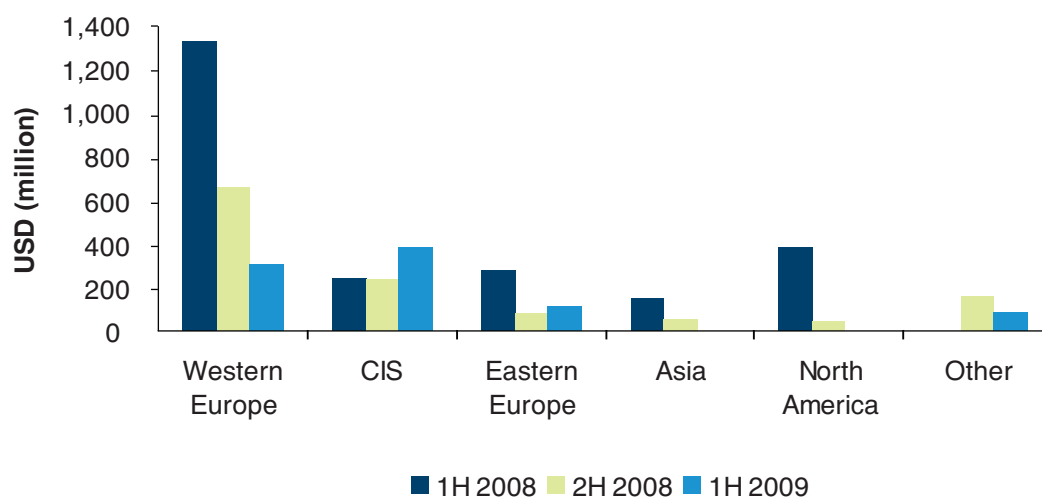
*Shigeru Mukoyama
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Figure 18. Inbound deals by country of buyer



Source: PwC analysis

Figure 19. Outbound deals by country of target



Source: PwC analysis

Deal drivers

In the mid-market, many sellers are self-made Russian entrepreneurs who, having reached a certain level, understand the need for bringing in a strategic partner which can help elevating the business to the next level.

In addition, many Russian entrepreneurs face more intense competition, as mature and experienced “heavy” players expand in Russia or arrive in Russia.

Apart from the above, certain other themes that help drive mid-market deal flow have recently emerged.

Attractive prices

Many investors, both Russian and international, sought and seek to seize the opportunity given that valuations have come down significantly.

Moreover, while it became difficult to allocate cash for acquisitions, some companies still found a way to conduct deals on a pure equity swap basis or a mix of cash and equity.

Distressed M&A

The global and local economic crisis resulted in a number of medium-sized businesses seeking partners in order to survive. As a result, distressed M&A played a more significant role in the mid-market last year.

Collapse of the IPO market

Prior to 2008, companies had a choice of raising funds via a listing on the stock markets, raising debt or bringing in an equity investor. At the beginning of 2008, when stock markets collapsed and debt became close to unavailable, raising capital via M&A became more popular for Russian companies / entrepreneurs.

I think that the M&A market should come back as investors' confidence grows. As the market recovers, speculations in the commodity markets should be replaced by thorough investment analysis.

*Daniel Brooks
Tetley Tea*

Challenges

The Russian M&A mid-market naturally displays the characteristics of an immature market which has an impact on all participants involved in the M&A process. For small- and medium-sized enterprises, there are two main problem areas that investors encounter when considering an acquisition in Russia: the impact of tax minimisation schemes and the lack of reliable financial information.

In addition, mid-market deals are generally more demanding since sellers are less familiar with process requirements and given the fact that most deals require a restructuring of the business before the transaction can be closed, which leads to a longer deal process than in mature markets.

A set of additional challenges with regard to the M&A mid-market has evolved from the financial difficulties that Russia was faced with in 2008–1H 2009.

Increased risk

The financial difficulties that Russia and the rest of the world were recently faced with explain the majority of developments which were observed in regards to the Russian M&A mid-market activity. Since Russia is generally seen by foreign investors as an alternative investment market, during tumultuous times the capital flow to the country is fading. In addition less capital became available to Russian companies which could be spent on expansion abroad. .

Scarcity of debt financing

Banks became more cautious in their domestic lending activities. As a result, debt financing was less readily

available than was previously the case and terms are less favourable for potential borrowers.

M&A activity in recent years (until 2008) was also partly driven by the private equity industry. However, given that private equity firms can hardly leverage their deals in the current environment, private equity activity has almost stopped.

Tremendous valuation gap

Most owners, having enjoyed high valuation levels in the past, can still not accept lower prices and therefore rather wait until prices start to recover.

A wide gap in price expectations has become one of the major deal breakers in the last eighteen months. Often, deals that have been work-in-progress for several months fall apart as buyers wish to renegotiate price.

Legal barriers for foreign investors

In certain sectors, buying into Russian companies became more difficult for foreign investors in 2008. The terms and conditions for foreign investments into Russia are now regulated by the Law “On Strategic Industries”, which came into force on 7 May 2008, and the Law “On Foreign Investments”, which was amended with the adoption of the law on strategic industries.

As a result, certain Russian companies are now deemed to be of strategic importance for Russia’s national defence and security.

If you are a foreign investor and you want to go to Russia, you need to make a strategic decision to go first and then deal with the issues as they arise. Theoretically, you cannot clear all barriers. Practically, it is impossible.

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Trends

Difficult economic environment

The economic environment in Russia is expected to remain difficult for the remainder of 2009. This is to a large extent driven by low commodity prices and weak customer confidence.

Accelerated consolidation

The most vulnerable industries, such as real estate, banking and retail will experience further consolidation.

Moreover, distressed M&A situations will play a bigger role in the M&A mid-market than in the past.

Domination of inbound deals

Given that Western countries appear to come out of the recession earlier, many Western companies see the current environment in Russia as an attractive one to either enter the market or make bolt-on acquisitions. As a result, we would expect to see more activity by foreign strategic buyers.

More private equity deals

Despite the limited availability of debt, private equity will, in an attempt to benefit from low prices, most likely increase their buy out activity in the Russian market. In addition, high demand for high-growth industries has built up (food, retail and pharmaceuticals).

Small and mid-sized companies normally suffer from poorly developed accounting systems. If Russian companies want to be more global, they should intensify their focus on financial reporting. A clean and transparent financial report demonstrates an attitude of respect towards money.

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