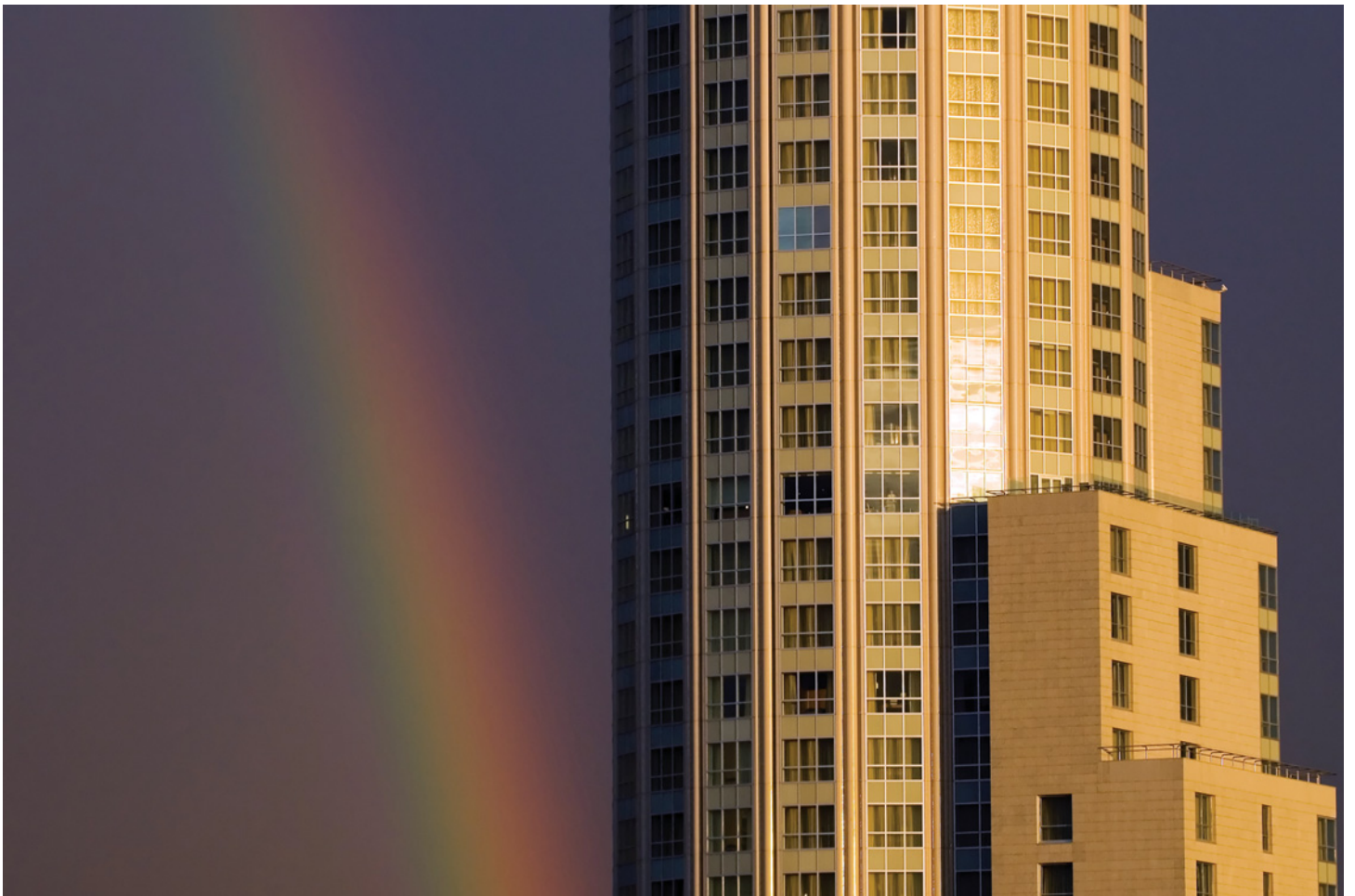


# Shelter from the storm

## Private equity investment in Russia



## Spot check – Russia’s investment credentials

- One of the fastest growing economies in the world (7% GDP growth in 2007<sup>1</sup>)
- Guaranteed and growing investment opportunities – with a population of 142 million and increasing income per capita, the domestic market offers significant growth potential
- Russia offers relatively generous terms for interest deduction, thin capitalisation rules and a maximum interest rate of 15%
- The size of private equity investments is expected to increase in the future amid tougher competition for opportunities and better access to debt financing
- A comparatively low level of foreign direct investment to date, meaning less competition and greater first mover advantage
- WTO entry will ease obstacles to doing business obstacles and benefit foreign investments
- Private equity investors have a wider range of exit strategies open to them than previously
- Doing a deal in Russia requires objective assessments, detailed figures and independent advice
- Underleveraged companies and under-developed debt financing make private equity attractive for Russian companies
- Private equity brings growth and cash flows, competent and efficient management, a sustainable competitive edge over rivals and higher revenue to a company

Increasingly, investors are turning to Russia as a shelter from the global financial storm. With rapid growth, high margins, low competition and numerous attractive target opportunities, the stage is set for an upsurge in private equity activity.

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<sup>1</sup> World Bank

## Opportunity knocks



The credit crunch has slowed the wave of private equity deals around the world and redirected interest to private equity funds that focus on emerging markets, including Russia.

This newfound interest amongst foreign investors is supported by Russia's stable economic

environment (which has yet to feel the effects of the global downturn), ubiquitous growth across most sectors, and a substantial flow of attractive target opportunities. Major international private equity firms have already struck a number of exciting deals and the stage is set for an upsurge in activity.

The Russian market is maturing fast. Last October saw the first 100% leveraged buyout by a foreign private equity major (Lion Capital's acquisition of juice-maker Nidan) and surveys of private investors indicate a bullish outlook where future deal-making is concerned.

But is it all plain sailing? Russia is still a 'known unknown' for many foreign investors, and some major private equity houses have had their fingers burnt in the past. Moreover, many Russian companies and

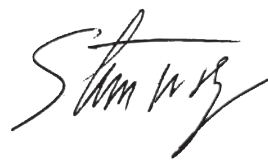
entrepreneurs have only a vague idea of how private equity actually works.

Foreign private equity firms should be prepared for a number of challenges. It can still be hard to obtain a clear picture of a company's operations and due diligence can unveil a number of potentially off-putting issues. Deal-making can take longer and prove more complex than in other, more orthodox markets. And taxation requires careful handling and close monitoring.

Russian companies positioning themselves as target opportunities need to project a compelling 'can-do' attitude. And they need to focus on documenting past performance, as well as providing credible evidence of future cashflows.

But none of these challenges are insurmountable, provided that private equity firms know where to look for targets and understand the various market idiosyncrasies.

This overview looks at the current state of the private equity sector in Russia, examining the two key issues of due diligence and tax structuring of deals, as well as highlighting how private equity investors and Russian targets can ensure smooth and mutually profitable transactions.



**Steven Berger**  
Partner  
Transactions leader  
Central & Eastern Europe

## Doing deals in Russia

Measured by dollar volume, M&A activity in 2007 in Russia rose another 61% on 2006, registering an estimated \$179 billion. This is over three times the \$53 billion in deal value created in 2005. The number of deals year-on-year actually fell 22%, from 1210 to 941. However, the estimated average size of deals in 2007 jumped 106%, from \$92 million to \$190 million.

But despite these impressive statistics, the challenges of investing in Russia persist. Objective assessments, detailed due diligence and independent advice all play a crucial role in successful deal-making. Financial due diligence, in particular, can often present foreign investors with difficulties, due mainly to a lack of reliable financial information and the impact of tax minimisation schemes.

### Dealing with financial information

Despite a move towards IFRS in recent years, statutory financial statements must be drawn up in accordance with Russian Accounting Standards (which are more a basis for tax accounting than a source of true and fair performance-related information). Additionally,

most Russian companies use finance software packages that, while well suited to small and mid-sized businesses, do not give foreign investors the level of information they require.

Clearly, therefore, investors must be ready to deal with a number of information challenges, including:

- Impact of tax optimisation schemes
- Highly formal auditing standards
- Complex group networks
- More reliable but often incomplete management accounts
- Lack of full provisions and accruals
- Absence of projected financial information

Simple patience and perseverance will ease the deal-making process. All the above challenges will be manageable if sufficient time is allowed to complete the due diligence process and build buy-in from target management. In put from experienced local advisors is invaluable here, as is the need for both parties to manage their expectations.



“It is essential that the due diligence process obtains an understanding of the cash flows and economic and ownership relationships between the company and its related party entities, and as well as with its third-party customers and suppliers.”

**Jonathan Thornton**, Partner, Transaction services

## Dealing with taxation

Tax schemes are still commonly used by Russian legal entities. These often involve operating through special-purpose vehicles at artificial prices, issuing false invoices and using the cash profits to make under-the-table salary payments and/or deploying opaque legal ownership structures to avoid paying VAT, profit and payroll taxes. And, crucially, while the use of these schemes is becoming less wide spread, investors should be prepared for their having been used in the past.

Historic tax risks affect the purchase price (by giving rise to potential penalties yet to be imposed by the Russian tax authorities), as well as distorting the target's financial performance as shown in the statutory accounts.

In addition, cessation of tax optimisation schemes may make the company uncompetitive against less honest rivals. This means that careful analysis of the competitive environment and extensive due diligence are both priority procedures for foreign buyers.

## Dealing with practicalities

Most buyers correctly focus on financial and tax due diligence. But this, on its own, will fail to answer the three key questions for any investor assessing a target company: Is the market attractive? Is the company a winner in terms of its capabilities and competitive position? Are the projections achievable considering the risks, sensitivities and potential upsides?

To answer these questions and make an informed decision based on hard data and thorough research, a buyer must be equipped to challenge the target management's business plan and corporate strategy. And, crucially, if the buyer does not do so, the banks certainly will. For this reason commercial and operational due diligence is vital for private equity buyers (it will also, of course, help to identify post-deal opportunities for performance improvement and structural optimisation).

## What are the hot tickets?

Historically, retail and real estate have accounted for the bulk of the country's private equity deals. In this section we look at the sectors offering the richest pickings for private equity.

### Retail and consumer goods

The Russian retail and consumer goods industries have experienced enormous growth in recent years.

According to PricewaterhouseCoopers' Shopping for the future – Russian Retail Market Survey over the last five years, its real growth has significantly surpassed the real growth of the GDP. In 2006 the total retail trade turnover was estimated at \$317 bn by the Russian State Statistics Committee.

The Russian consumer market is very dynamic, driven by growing earnings and the rapid development of the domestic retail sector. Compared to other European emerging markets, Russia demonstrated the highest cumulative growth rate for consumer spending in 2002-2006.

#### Recent deal

November 2006: Russian Retail Growth Fund, managed by Renova Capital, purchased a stake in the Holiday group for \$50 m. Holiday manages a network

of supermarkets under the Holiday Classic brand and Sibriada, a convenience store chain, in Siberia.

### Real estate

Among the fastest growing segments of the financial sector, Russia's real estate boom covers all property types and all regions. Today supply cannot keep up with demand and the number of development projects has rocketed. Developers and investors get significantly higher returns from Russian projects than anywhere in Europe.

#### Recent deal

March 2007: British fund, Raven Russia, cooperating with Turkish developer and logistical operator, EGL Holdings, signed a deal to construct a logistical complex near Moscow's Sheremetevo Airport. The complex will cover nearly 55,000 m<sup>2</sup>. In another deal, Raven Russia, cooperating with RDI Group, plans to construct a 100,000 m<sup>2</sup> warehouse complex on the outskirts

### Financial services

According to market analysts, many of Russia's top-20 privately owned banks are now actively on the look-out for buyers.



“Look for a company with a respectable position, committed management, good indicators, margins and cash flows. Russia has the recipe for successful private equity investments—growing companies in growing markets.”

**Martijn Peeters**, Director, Transaction services strategy

The Russian financial services sector has a number of attractions. The domestic marketplace is huge and undersupplied with banks. The industry is still fragmented. And, compared with most western markets, the banking culture remains underdeveloped. There are, consequently, some exciting opportunities for new entrants to establish a strong foothold relatively quickly.

According to a recent survey by PricewaterhouseCoopers and mergermarket, 'Mergers & Acquisitions in the Financial Sector in Russia', almost three-quarters of respondents believe private equity investment in Russian financial services will increase.

**Recent deal**

June 2007: Renaissance Investment Management's RenFin fund bought a 20% stake in Hlynov, a regional bank in Kirov. The deal was valued at approximately \$3–5 m.

**IT, entertainment & media**

The Russian IT market is growing by 25% a year. This rapid expansion is underpinned by demand for new IT systems amongst Russia's corporate majors. The market is currently extremely fragmented, giving ample scope for acquisitions. However, consolidation is inevitable, so this window of opportunity is temporary.

PricewaterhouseCoopers' Global Entertainment and Media Outlook: 2007–2011 estimated the turnover of Russia's entertainment and media (E&M) market in 2006 at \$19.9 bn, but in 2007, the market is around \$21.1 bn. The industry's growth rate hit 7.1%, while the projected annual mean growth rate for 2007 to 2011 is 6.9%.

**Recent deal**

March 2007: Sweden's Mint Capital and Britain's RP Explorer Fund invested \$40 m in Russian IT company Vervysell, using a combination of direct equity and a convertible loan.

## Tax risks and structuring

Russia's tax system has yet to reach maturity and lacks the sophistication seen in developed economies. For private equity transactions, this means that authorities are unfamiliar with the complex structures of leveraged buyouts, there is an absence of binding rulings, ambiguous treatment of VAT and transaction costs and a lack of standard debt push-down techniques.

However, Russia has also made attempts to make transactions easier, such as a recent exemption for dividends on strategic investments. There are also plans to introduce tax grouping of subsidiary companies which will significantly ease debt servicing for private equity funds.

### Tax baggage

Many attractive target opportunities in Russia will have historic tax risks, and they need to be dealt with openly, either through deal structuring or by paying up for previous misdemeanours (e.g. grey salaries). But historic tax risks need not necessarily mean cash outflows. And even if they do, the penalties for tax arrears now stand at about 20% of the overdue amount, much less painful than earlier levels of 100%, while late payment interest is calculated at about 10%.

Structuring the transaction to reduce exposure to historic tax risks takes time, but many use this opportunity to dispose of undesirable assets or companies and make the target leaner before acquisition. Buyers and sellers should be prepared for an initial reduction in net profits due to the resulting increase in the tax burden.

### Debt push-down

Traditional debt push-down does not generally work, often for accounting and legal reasons. For example, the classic merger debt push-down almost inevitably results in technical insolvency. Transaction costs are difficult to deduct at the level of the Russian operating company and VAT and withholding tax leaked needs to be managed. Even though Russian law provides for a relatively generous interest deduction cap of 15%, these costs require complex solutions, often involving group restructuring at acquisition, which will impact the timing of a transaction.

Debt push-down is restricted to 'economically justified' expenses, mostly to do with the acquisition of assets or shares. But Russia offers relatively generous terms for interest deduction, thin capitalisation rules and a maximum interest rate of 15%. Unlike in many mature



**“In the private equity sector none of the historic risks of the targets private equity clients were looking at have been so great that you couldn't structure around it.”**  
**Galina Naumenko, Partner, Tax M&A services**

markets, Russia allows the use of tax losses upon a change of ownership or restructuring.

Foreign buyers can take advantage of Russia's wide network of double-tax treaties with liberal rates. For major jurisdictions, it is often possible to attain 5% withholding tax on dividends, and 0% on interest and royalties.

This advantage is qualified by the care needed for legal and accounting compliance. Vague wording of the law and the lack of court rulings means the authorities can adopt ambivalent positions about particular transactions.

Most acquisition structures involve either assets or shares, or a combination of both.

### Share deal

#### Pros

- Can be made offshore (preferred by many local sellers)
- No input VAT suffered on asset purchase
- Tax losses can be utilised

- Licenses, permits and registrations do not generally need renewal (difficult and time consuming in Russia)

#### Cons

- Historic tax issues in legacy entities
- No step up to fair value of acquired assets in tax books
- Risk of cash trap (especially in real estate) – debt pushdown may not work

### Asset deal

#### Pros

- Step up to fair value in tax books
- (Relatively) flexible purchase price allocation
- Debt can be injected into purchase vehicle
- No historic tax issues inherited (except for, in some cases, customs issues)

#### Cons

- Offshore deal structure not possible
- Tax losses of legacy entities lost
- Licenses, permits and registrations require renewal

## Tips on striking deals

An understanding of cultural differences is very important for successful negotiations in Russia. Many targets are unfamiliar with the due diligence process and are often surprised at the detailed list of documents they have to provide. Inexperienced vendors will leave it up to the private equity firm to arrange advice on the transaction structure and on how to deal with historic tax risks.

### Private equity benefits

So what can a private equity investor offer a potential seller? Private equity can bring competent and efficient management and a sustainable competitive edge to a company that needs to enter another league and strengthen its market position. There is also the possibility of ownership incentives for management.

But to obtain these benefits, targets need to meet a few basic criteria to attract serious attention. Specifically, there must be a capable management team that an investor can work with, as well as a clear and detailed business strategy. A few years of audited financial statements will be an added bonus.

Spontaneous solicitation of private equity firms tends to fail due to a lack of preparation. To position itself properly as an attractive opportunity, a company should prepare a convincing business case and approach potential investors through the correct channels. This

helps to minimise differences of expectations and any cultural misunderstandings between the two parties.

### Setting your sights and closing in

Foreign private equity funds also have to take major issues on board before committing any money.

- Russian companies will be upbeat and optimistic and won't see the need to give documentary evidence of their viability
- Russian owners should fully understand the fund's exit strategy and its implications
- It's better to set up shop in Russia and appoint experienced Russians to manage investments directly
- In terms of deal structuring, Russian companies are more familiar with Cyprus or Cyprus-BVI as holding company locations
- In a market that is growing so rapidly, there is little focus on market share. Russian companies may talk about growing by 30%, but the market has actually been growing by 35-40%.

According to market sources, most Russian companies are still unaware of the ways in which they could be benefiting from the professionalism of private equity investors. Provided these benefits are properly communicated, access to targets – and opportunities for closing deals – should improve substantially.



**“When, eventually, growth cools off a little, companies that have inherited operational excellence expertise from a private equity shareholder will have an edge on competitors.”**

**Michael Knoll, Head of M&A lead advisory**

## Outlook

Prospects for the Russian economy in the next three to five years are very promising, and risk is seen as manageable.

Foreign direct investment into Russia totalled US\$55 billion in 2007<sup>1</sup> – double 2006 levels (US\$26 billion)<sup>2</sup>. With western markets currently undergoing a slump, Russia's growth potential marks it out as an opportunity for investment.

We expect to see the existing volume of private equity investments in Russian companies more than double over the next three years. Russian private equity houses will also become more active.

However, foreign strategic investors will be formidable competitors for the choicest targets – particularly

so because they are more willing than private equity funds to accept higher entry valuations.

The high oil price, a recent pick-up in industrial production, increasing fixed investment and burgeoning consumption will keep the economy buoyant. All that topped by an average GDP growth forecast of 6%<sup>3</sup> for the period 2007–2012. In short, the Russian economy is in rude health.

The implications for private equity investment in Russia are clear. More foreign money, bigger deals, better access to debt funding and more IPO exit possibilities. The time is now.

Russia is no longer the economic basket-case it appeared to be in 1998. After 10 years, it has emphatically gone from bust to boom.

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<sup>1</sup> Economist Intelligence Unit

<sup>2</sup> Central Bank of the Russian Federation

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<sup>3</sup> Economist Intelligence Unit

## Private equity deals in Russia in 2007–1Q2008

Acquirer	Target	Sector	Date	Stake	Deal value (USDm)
TPG Inc.	SIA international ZAO	Pharmaceuticals & Biotech	July 2008	50%	800
EBRD	Territorialnaya Generiruyushchaya Kompaniya 9 OAO	Utilities	March 2008	8%	209
AIG Private Equity AG	Kholdingovaya kompaniya Geotek	Oil & Gas	March 2008	20%	100
Baring Vostok Capital Partners	Upravlyayushchaya kompaniya-Stroitelnyi kholding Etalon-LenspetsSMU ZAO	Technology	March 2008	15%	n/a
Capital International Inc.	Unimilk OAO	Food & Beverage	March 2008	10%	175
Brysam Global Partners LLC	Vozrozhdeniye Bank OAO	Banks	February 2008	9.9%	154
Troika Capital Partners	Laventa OOO	Retail	February 2008	25% + 1	n/a
Deutsche Bank AG London	Neftekamskii Zavod OAO	Automobiles & Parts	February 2008	5.04%	n/a
EBRD, Moore Capital Management LCC	Transkonteiner OAO	Industrial Goods & Services	January 2008	15%	318
EBRD, Baring Vostok Capital Partners	Enforta BV	Telecommunicatios	January 2008	Minority	40
Quadriga Capital Russia GmbH & Co KG, Norum private equity advisors LTD	Tascom ZAO	Telecommunications	January 2008	Minority	n/a
Columbia Capital	GTS Central European Holdings Ltd	Telecommunications	December 2007	Institutional buy-out 100%	n/a

Acquirer	Target	Sector	Date	Stake	Deal value (USDm)
Deutsche Bank AG London	Orelenargo OAO	Utilities	December 2007	Stake increased from 3.12% to 7.06%	3
EBRD	Teploenergeticheskoye Predpriyatiye Teplovykh Setei Teploenergo OAO	Utilities	December 2007	25% + 1	5
Troika Capital Partners	URSA Bank OAO	Banks	December 2007	7.94%	n/a
Alfa Capital Partners	Elki-Palki	Consumer (Retail)	December 2007	90%	27
Eagle Venture Partners Ltd	Bask ZAO	Personal & Household Goods	November 2007	Minority	n/a
Lion Capital LLP	Nidan Soki OAO	Food & Beverage	October 2007	75.001%	500
Troika Capital Partners	Gameland ID	Media	September 2007	Minority	12
VCP Capital Partners Unternehmensberatungs AG	BC Unibank SA	Banks	September 2007	100%	21
Mint Capital	UCMS Group EMEA Ltd	Human resources services	September 2007	Minority	n/a
Mint Capital	Naturalnye Produkty ZAO	Food & Beverage	September 2007	Minority	9
East Capital Explorer Financial Institutions Fund AB	Kolyma Bank OAO	Banks	August 2007	Stake increased from 4.21% to 19.95%	n/a
Marshall Capital Partners OOO	Nikita Mobile OOO	Telecommunications	August 2007	Institutional buy-out unknown stake %	n/a
EBRD	KMB Bank ZAO	Banks	July 2007	40.158%	51
EBRD	Servisnaya Kompaniya Vyso	Technology	July 2007	25% + 1	12
Great Circle Capital LLC	STS Logistics OOO	Industrial Goods & Services	July 2007	Minority	21

## PricewaterhouseCoopers Russia transactions experience – selected deals

2007

Buy-side advisor  
to **Lion Capital**  
on the acquisition  
of **Nidan Soki OOO**  
(a large Russian juice  
and beverage producer)

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2008

Buy-side advisor  
to **TPG Capital**  
on the acquisition  
of a 50% stake  
in **SIA International**  
(a leading Russian  
pharmaceutical distributor)

*Deal size – USD 800 m*

PRICEWATERHOUSECOOPERS   
Transaction Services

2008

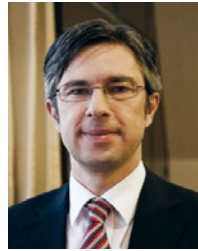
Buy-side advisor  
to **Lion Capital**  
and **Central European  
Distribution Corporation**  
on the acquisition  
of **Russian Alcohol Group**  
(a large producer of vodka  
and ready-to-drink alcoholic  
beverages in Russia)

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Transaction Services

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