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Russian Private Equity Market: Opportunities for Investment

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As the global credit crunch continues to dampen private equity activity in developed markets such as the US and the EU, buy-out firms are looking to emerging markets for opportunities. And thanks to strong economic growth and favourable macroeconomic conditions, Russia is viewed as an attractive destination for investment. It is not always perhaps the simplest place globally to invest, but the potential rewards can more than adequately compensate for the necessary additional effort to properly invest in this dynamic economy.

The Russian economy for the last decade has been a remarkable story of resurrection and transformation. The economy has grown for the last five years at average annual rates exceeding seven percent. During this time, the Russian rouble has also consistently strengthened, as the country's foreign currency reserves have grown from 55 billion USD in 2003 to 581 billion USD as of August 2008. And Russia's foreign currency sovereign bond rating has marched from B to BBB+. In short, Russia has become both a stable and extremely profitable place for business.

This economic renaissance has been the result of prudent government fiscal policy and sound economic reforms, such as the comprehensive tax simplification undertaken in former President Putin's first term. And Russia is benefiting from both public and private investment in infrastructure and construction, making the economy more efficient. Active consolidation and rationalisation of Russian business enterprises are further driving productivity. Rising real wages are driving strong consumer demand. And Russia of course benefits from rising global demand and prices for the many commodities it produces.

Russia presents a particularly favourable environment for private equity. Rapid growth, high margins, and low competition and numerous attractive target opportunities characterise the landscape. Russia offers relatively generous terms for interest deduction and thin capitalisation requirements. Since foreign direct investment to date has been comparatively low and the consolidation process still well under way, there are still many first mover advantages for new entrants. And there are still substantial gains to be made by private equity investors bringing higher quality management and controls to Russian companies.

However, there are substantial challenges as well as compelling opportunities. Proper due diligence is even more important in Russia than in developed markets in order to have a clear picture of a company's finances, operations and competitive position. Also, deal making can be more complex and take longer than in other, more orthodox markets. But none of these challenges are insurmountable, provided that private equity firms know where to look and understand the various market idiosyncrasies.

Retailing and manufacturing are two sectors we believe to be exceptionally attractive now. Russian retailing is experiencing explosive growth as rapidly rising real wages and disposable incomes drive personal consumption. Retailers require financing for both consolidation and for expansion into the regions outside Moscow and St. Petersburg. Manufacturing is another attractive sector as financing is required for both increases in capacity and modernisation and upgrading of facilities. In more developed markets, operational gains often come from cost cutting measures, while in Russia the major challenges are frequently coping with growth and with upgrading technology.

The Russian private equity market has grown rapidly over the last five years, as transactions have grown larger, reaching an average of 60 million USD this year, and as the number of deals has steadily risen as well, with 28 closed through the first eight months of 2008. Private equity in Russia has so far been dominated by local players, who have under management an estimated 10 billion USD, but have at their disposal potentially as much as 40 billion USD. Some, such as Baring Vostok Capital, Renaissance Capital and Troika Dialog, are arms of investment banks. Others, such as Alfa Capital Partners and Renova Capital Advisors are associated with leading financial-industrial groups.

However, many of the largest private equity deals to date have been struck by foreign players. The largest was the April 2008 USD 800 million acquisition by TPG capital (US) of a 50% stake in SIA International, Russia's largest pharmaceutical distributor. Prior to this deal, the largest private equity transaction was also by a foreign player, the October 2007 500 million USD acquisition of Nidan Soki,

Russia's leading juice producer, by Lion Capital (UK). And Lion Capital has since completed the acquisition of Russian Alcohol Group. However, the majority of transactions have been in the $10 million to $50 million range. The most active sector has been consumer products, but activity has been robust also in infrastructure, IT and media, manufacturing, construction and real estate, and financial services. Among other notable deals so far in 2008 are the acquisition of a 40% stake in Investorgbank for $212 million USD by JC Flowers (US) and FPK Capital (UK) and the $150 million acquisition of a 10% stake in dairy giant Unimilk by Capital International (US).

Unlike in more mature markets, leverage is not commonly utilised. One reason is that growth rates are high enough that leverage is not actually a critical element to make a deal profitable. The other side of the coin is that investment in developing markets like Russia is somewhat riskier than in more developed markets, making less leverage desirable. In addition, financing is less readily available, as Russia has not yet developed a high yield bond market or mezzanine finance market. And despite considerable progress, Russian tax legislation and regulation is not sufficiently sophisticated to permit the range of tax-related use of debt that is common in many markets. Eventually, however, as the Russian market matures leveraged deals will probably become more common for the same reasons leverage is a value driver elsewhere.

Operations issues are frequently relatively universal, although even here Russia can exhibit local peculiarities. However, it is in accounting and tax issues that special attention must be devoted to local standards and practices. Russian companies continue to migrate towards International Financial Reporting Standards (IFRS), and IFRS have been mandatory for Russian banks since 2005. However, many companies still report under Russian Accounting Standards (RAS). Unfortunately, RAS is frequently oriented more towards mere bookkeeping and less towards financial reporting. Consequently, RAS statutory accounts are a limited source of realistic performance related information.

In Russia most enterprises have a complicated legal structure, comprised of a number of legal entities. Hence, understanding intercompany transactions and the consolidated group in its entirety are crucial. Among other challenges, investors need to understand the impact of tax optimisation schemes, complex group structures, and must confront a frequent absence of full provisions and accruals as well as a lack of financial projections. These are among the reasons why a local advisor with knowledge and experience managing informational obstacles and careful attention to due diligence are vitally important

Taxation is potentially a particularly difficult subject. Tax considerations have historically been major drivers of the legal structure of Russian companies. To decrease tax obligations, companies sometimes transact business through special-purpose vehicles at non-market prices. Even companies that prefer to operate transparently are sometimes pressed to engage in such practices merely to remain competitive in the marketplace. Such practices can distort the financial condition and performance of the enterprise, making valuation of potential acquisitions more difficult. However, the extent of aggressive tax avoidance schemes began to fall dramatically after 2005. This is particularly important as the statute of limitations for most tax related matters is three years, so as of this year the potential tax exposure for past transgressions is substantially reduced. Another way to minimise exposure to historic tax risks is through careful structuring of the transaction. For example, it is possible to purchase only selected companies or assets, leaving potentially riskier elements of the business outside of the transaction.

Above all, private equity investors should be sensitive to the reality that at present, tax issues can be more difficult in Russia than in more developed jurisdictions, and often need to be resolved in a different manner as well. For example, because binding rulings are not the norm, advance discussions with tax authorities can be unproductive. There are also local differences which require different solutions than usual in other jurisdictions. For example, debt push-down can be used in Russia, but for legal and accounting reasons must be structured differently from how it is traditionally done in western European jurisdictions. Also, Russian companies historically have preferred Cyprus and British Virgin Islands as offshore jurisdictions, rather than Luxembourg or Netherlands, and this may affect deal structure and negotiation. However, despite the potential tax difficulties and numerous differences, with proper advice and guidance private equity firms can and do successfully manage to obtain adequate comfort on tax matters through proper due diligence and intelligent transaction design and execution.

There are plenty of opportunities for private equity to found in today's Russia, as long as investors understand and mitigate the risks. Doing so requires patience, careful study and due diligence, and advisors who know the local marke