

Emerging From the Crisis?



5th Annual CIS Private Equity and Venture Capital Forum

Event Summary by Squire, Sanders & Dempsey L.L.P.

Spring/Summer 2009



INTRODUCTION

When will private equity and venture capital in Russia and the CIS emerge from the current economic crisis and how different will the industry be when they do? What investment strategies will be successful? What trends are on the horizon?

C5 Group Inc. and global law firm Squire, Sanders & Dempsey L.L.P. are pleased to share the perspectives of leading industry experts on these and other important questions in this overview of C5's 5th Annual CIS Private Equity and Venture Capital Forum held in Moscow on 23-24 April 2009.

We would like to thank all presenters for their thoughtful comments and the Forum delegates for making the discussions productive and profitable.

Squire Sanders' CIS Private Equity Team

Spring/Summer 2009



RUSSIA AND THE CIS: A DIFFERENT KIND OF CRISIS?

Although the private equity market is having a rough ride during the current crisis, some speakers were confident that the path ahead for Russia and the CIS is not entirely bleak. Sounding a general theme, **Henry Potter** of **ALPHA Associates AG** observed that the current situation is very different than the 1998 and 2001 world economic crises when Russia's financial situation was much more precarious. However, there was less consensus as to what the future holds; whether this crisis is an emergency or a golden opportunity has divided the opinions of the speakers.

Generally, there are numerous similarities that link Russia, the CIS and Central Europe in their fight for survival during these uncertain times, including a shortage of liquidity, access to credit and favorable exit strategies. In contrast to Central Europe, Russia and the CIS have been pegged by many outside the market as "losers" in terms of their crisis recovery speed. **Sergei Markov** of **Chiron Capital, LLC** observed that "emerging markets are those markets from which it is hard to emerge in case of an emergency." Whether this is the case remains to be seen.

Several speakers believe that Russia and the CIS remain promising markets for private equity. One such opinion was that of **Alexander Bezugly** of **Alfa Capital Partners**, who stated that despite the burden of a growing budget deficit, high unemployment in industry dependent cities, large outstanding corporate debt, a weak banking sector and high inflation due to unstable currencies, it is important to applaud the differences in the government's crisis management this time around as compared to the 1998 financial crisis. Specifically, Bezugly noted that the Central Bank has so far successfully fended off a banking crisis and stabilized the ruble. **Reinhard Kohleick** of **Quadriga Capital Russia** concurred that the ruble devaluation has been dealt with far better now than in 1998. He also noted that while inflation is high, it is weaker today than it was in the previous crisis and that in 1998 Russia was a foreign debtor, whereas today it is a creditor. Kohleick affirmed that "Russia enters the current crisis in better shape than the earlier crisis and has all the ingredients for long-term growth." However, Kohleick stressed that the world was far more benevolent to Russia in 1998 due to greater stability, which in turn meant that debt and equity markets were more accessible.

Stemming from the lessons learned during the previous crisis, there were many positive remarks concerning the future of private equity in Russia and the CIS.

ALPHA Associates' Potter noted that Russia and the CIS have outperformed all other markets globally in terms of private equity returns over the past three, five and 10 years, including the United States, Western and Eastern Europe, and all other emerging markets. Most notably, Russia and the CIS doubled the comparative returns of Asia and Latin America consistently in both of the last three- and five-year periods. However, he added that there is still room for improvement, as Russia's private equity investments are equivalent to only 0.08 percent of its GDP, well behind the level of many CEE countries. According to Potter, Russia's market is significantly underserved with equity capital, and the gap in terms of private equity investment as a percentage of GDP as compared to Western countries and the other Eastern European countries is large, thus resulting in low deal competition and attractive entry valuations.



Although favorable circumstances such as those aforementioned may exist, investors will need to adjust to the reality that the era of easy money may be over, according to **David M. Wack** of **Squire, Sanders & Dempsey (Moscow) LLC**. As a result, investors looking at investments will need to add patience to their investment toolkit. Potter of ALPHA Associates observed that holding periods were up anywhere from one-and-a-half to two years for pre-crisis investments before 1998, rounding them out at roughly six years, as compared to the previous maximum period of four-and-a-half years for post-crisis investments after 1998. Regardless, he maintained that “an unleveraged growth market with capital scarcity and low competition presents a ripe opportunity to invest today.” However, private equity firms need to be selective; the current market can be categorized as Darwinian. **Eagle Capital Partners’ Jan Dewijngaert** predicted that because of the downturn in the business cycle, only the best performing businesses will survive, and marginally feasible businesses will disappear.

There may also be opportunities in the CIS beyond Russia. **Horizon Capital Management Team’s Oksana Strashna** stated that even though Ukraine is affected by the global economic slowdown, she sees increasing potential in Ukraine’s market. In the fourth quarter of 2008, the financial markets practically froze in Ukraine, and private equity capital became virtually the only financing option for many companies. While in 2008 it was still difficult to breach the valuation gap, the trend since the beginning of 2009 has evidenced valuation expectations decreasing to somewhat more realistic levels, and many large companies that were not previously open to investment have started showing willingness to come to an understanding with investors on issues such as governance rights and control. Strashna added that while it is important to understand the ramifications of the recession on business overall, the recession will inevitably be followed by a period of growth, so companies and funds must be ready for it.

However, the optimism of the speakers was tempered by a realism based on the gloomy picture painted by the current statistics.

The Ministry for Economic Development provided bleak statistics comparing 2008 and 2009, stating that real GDP growth has dropped from 5.6 percent to -2.1 percent, there has been a fall in industrial production growth from 2.1 percent to -3 percent, the average price of oil per barrel has plummeted from US\$94.6 to US\$45 and gross investment growth has fallen from 10.5 percent to -5 percent. These statistics have undoubtedly affected the market. Most new deals are on hold as fund managers concentrate on their existing investments. **Kirill Vesselov** of **Mint Capital** echoed this sentiment, stating that Mint’s focus right now is on the tight management of its portfolio companies. Vesselov added that the emphasis today is on new cash injections and anti-crisis management.

Nevertheless, Vesselov remarked that there is dry powder still left in the market. An informal poll of the current private equity players showed total commitments of US\$5 billion to US\$6 billion, with approximately US\$2 billion to US\$2.5 billion still available for investment. Though unsurprising, due to the lack of credit, a significant portion of these reserves is being used to stabilise existing portfolio companies and for opportunistic bargain hunting, rather than to pursue the growth strategies that defined the past five years.



A NEW KIND OF DEAL

The crisis has changed the business landscape, providing prospects for those funds that can be flexible enough to change the way they invest in the current climate. An adverse environment calls for new investment strategies.

A predominant topic throughout the Forum was fundraising in the market and whether the source of funds would be foreign or domestic.

The crisis has made raising new private equity funds extremely challenging. Citing the example of the annual commitments of CalPERS, which were reduced roughly 75 percent after 2001, Henry Potter stated that based on the experience of the 2001 crisis, fundraising will only get tougher in the coming months. **Marshall Capital Partners' Sergey Azatyan** agreed, stating that the first quarter of 2009 was the worst for fundraising in the last five years. Observing that Russian funds will not be able to count on the support of pension funds in a comparable way to US-focused funds, he advised investors to carry out road shows in Asia and the Middle East, as the share of Asia-based investors in Russian funds increased by 13 percent in 2008. Azatyan expects some LP's to call off their commitments, but pragmatically advocated that "to raise funds today is to clearly understand what investors want to invest into."

As time pressures mount to raise capital, the use of other instruments of financial engineering is being advocated for expediency.

The shortage in credit seems unlikely to be solved by domestic banks, as **Alexander Abolmasov** of **New Russia Growth** estimated that Russia's banks carry 30 to 40 percent of bad debt that is not reflected on their books, resulting in tighter lending standards. While **Vladimir Gromkovsky** of **Finematika** was optimistic that this crisis is part and parcel of a cyclical process, which will inevitably lead once again to easy access to credit. Abolmasov saw the crisis as an occasion for private equity to provide alternatives to bank debt, including through the use of hybrid financing such as mezzanine capital. Abolmasov warned, however, that while distressed debt is also an option for alternative fund raising, it is frowned upon in Russia because it is associated with corporate raiding.

While Chiron Capital's Sergei Markov perceived syndication as an alternative to traditional means of financing to be a relatively novel concept in Russia's market, **Andrei Tikhomirov** of **Aton Capital Partners** applauded "club-deals" with like-minded co-investors and "buy and build" transactions. Observing that debt financing can be complicated and time consuming, Tikhomirov added that private equity investors make their decisions more quickly and efficiently than banks and are therefore more suited for the current climate. Vesselov of Mint Capital supported a syndication strategy, but warned that it may now be more difficult to convince LPs to co-invest as they are limited to their own public/private ratio investments.

While some presenters were skeptical about the appetite of banks to provide financing in the current environment, **Vadim Serebrennikov** of **Gazprombank** advised not to be too hasty in dismissing the financing opportunities still available with banks, as access to capital still exists. Many banks are interested in working with companies where a strategic investor is already present. However, the criteria for state-owned and large banks providing credit has drastically changed. Serebrennikov



stated that Gazprombank may be interested in stepping in as a sole creditor. Depending on the mutually agreed terms, the range of financing can extend anywhere from US\$10 million to US\$50 million, and even up to US\$100 million is a possibility for bigger companies.

Although fundraising was at the top of the agenda, an equally significant question was which exit options are available in the current market.

Exits have also been dramatically impacted by the crisis. **Renaissance Investment Management, Inc.’s Leila Alieva** posited that IPOs are not a viable exit strategy for Russia’s market, nor have they ever been a frequent exit for Russia-based companies. As public markets are now essentially shut for new issuances, Alieva noted that the time for IPOs to be a promising exit strategy will not come soon. Conversely, surer bets can be placed on the return of strategic investors and hedge funds to the market. Thus, three realistic exit options remain: trade sales, management buyouts and write-offs, the last clearly being a final resort. The availability of trade sales will depend heavily on interest from strategic investors. Alieva concluded that in the past 25-percent returns were both expected and realistic, whereas now investors would be happy to get back their original investment.

TRENDS ON THE HORIZON

A crystal ball would probably be the best investment right now, as very few investors can predict what the future holds. Throughout the Forum, the speakers did, however, offer views on what trends to watch for in Russia and the CIS based on personal experiences and predictions.

Such words of wisdom were shared about the retail, consumer products and services, TMT and agriculture sectors. There were also calls to branch out of the epicenter of capital cities into surrounding regions.

Regarding areas to embrace and avoid, **Albina Nikkonen** of the **Russian Venture Capital Association (RVCA)** championed the biotechnology and pharmaceutical industries to be the most prosperous for venture capital investment. **Patricia Cloherty** of **Delta Private Equity Partners** noted that there is still plenty of bandwidth in consumer products, financial services, technology and media. **Reinhard Kohleick** of **Quadriga Capital Russia**, on the other hand, believed the automotive and construction materials sectors to be bad bets for the short term.

Hans Christian Dall Nygård of **CapMan Russia** believed another untapped area for private equity investment to be regional businesses. Nygård observed the large imbalance between investments into Moscow and into Russia’s regions and stated that the regions provide attractive investment possibilities because of low rent, salaries and local tax incentives as opposed to the over-utilized infrastructure found in Moscow. He saw strong consumption growth in the regions, which will eventually catch up with Moscow, but in a less competitive environment. With diminished equity valuations resulting from a lack of regional debt financing and a lack of competition from other private equity players, the multipliers for regional business are becoming increasingly attractive to private equity investors. Nygård emphatically affirmed that selected regions can have higher growth than Moscow for several years, even during the crisis, thus making it an “ideal time” to invest in these regions.



One sector that solicited the most fervent disparity in viewpoints was agriculture. Capman's Nygård thought that agriculture may be a viable investment sector with sound future prospects for private equity. While Bezugly of Alfa Capital Partners disagreed. He reminded the audience that in 2002 purported agriculture investments were really just land speculation plays. Strashna of Horizon Capital Management Team was also skeptical about investing in primary agriculture, observing that there are too many risks outside of investor control in the sector. **Da Vinci Capital Management's Evgeny Fetisov** shared examples of success in the industry, remarking that agriculture is an area where Russia has perspective for growth and can compete in the global market.

Although the real estate sector may finally be welcome to private equity investment, it does not discount the fact that funds themselves are in short supply of liquidity and hesitant to embark upon new investments.

While the real estate market has been hit particularly hard, depending on one's perspective and ability to survey the market holistically, the speakers declared that there still may be some opportunity in the market. **Maksim Kunin of Investment Management Group (IMG)** reminded the audience of a recent article in *Vedomosti* stating that 60 to 70 percent of real estate developers are likely to go bust in the coming six to 12 months. As in many other sectors, leverage is critical in the real estate sector. The mortgage market today is almost non-existent, and real estate investors have turned to federal budgets that allocate funds for social housing. At the beginning of 2008, only 20 to 25 percent of apartment purchases were financed by mortgages, and 75 percent were purchased with cash. Historically, Russia's real estate market was funded by pre-sales, and most businesses were not interested in private equity financing; since the crisis, this attitude has changed, and the market welcomes potential private equity investment. Kunin warned that the double taxation treaty between Russia and Cyprus will have important consequences on the market; investors may not be able to structure real estate transactions as share purchases and will need to purchase underlying real estate assets, making paying all taxes unavoidable. While investment in residential real estate may still have a promising future, supply will be extremely restricted. In 2008, 60 million square meters were available for sale, whereas Kunin estimated that in 2009 less than five million square meters will be available. Furthermore, no new construction is anticipated in 2009, which may equate to less competition in the future.

Sherzod Yusupov of UniCredit Group espoused an optimistic view of the future. He remarked that these times offer a ripe occasion for buyers to be active in the market. Yusupov recommended concentrating on Moscow and St. Petersburg, being the most liquid markets, and then moving on to regions that have diverse economies and are less commodity dependent. In addition, Yusupov observed that there is less development risk with retail, whereas Class A offices are more risky. While prices are down three to four times and rent rates have been cut in half, lending in the real estate market will resume only within six to 12 months, but will depend on broader micro- and macro-economic factors. Kunin upheld this view, cautioning that seasoned investors will capitalize on the current possibilities derived in this market, but it will be difficult for newcomers to identify, find and structure opportunities, as real estate as an asset class has become very institutional.



THE FUTURE LEGAL PANORAMA

The legislative bodies of Russia and other CIS countries are responding to the financial crisis by introducing new, and amending old, legislation in an effort to provide solutions. While this does not necessarily mean that the new legislation is any easier to navigate, it does offer some comfort that a need for change has been identified and addressed.

A panel of lawyers from **Squire, Sanders & Dempsey L.L.P.** discussed several changes in the laws in Russia and Ukraine that impact struggling companies and their investors and creditors, particularly amendments to laws on foreclosures and bankruptcy. The Squire Sanders team pointed out that recent amendments related to foreclosures may reduce the time and expense associated with foreclosures on various types of collateral. Moreover, bankruptcy was unanimously agreed to be an option of last resort in both Russia and Ukraine and a very unattractive option if one hopes to restructure debt and maintain a going concern. **Patrick J. Brooks** of **Squire Sanders** recommended that in evaluating any distressed situation one should identify the weaknesses in the company, determine if it is a viable business going forward and conduct a liquidation analysis because that will drive stakeholder conduct in any workout process. **Squire Sanders' Sergey A. Treshchev** noted that the current bankruptcy law sets forth unrealistic terms. Financial rehabilitation must happen within 18 months, as opposed to what can be several years in other countries. Further, the bankruptcy law does not provide for administrative consolidation of cases; instead, each company must file in the districts where it is registered, which makes restructuring a group of affiliated entities extremely difficult. In addition, there is no unified register for recording bankruptcies in Russia; notice is provided only in *Kommersant* (earlier such notices were published by *Rossiskaya Gazeta*). As creditors are not notified personally of their debtor's bankruptcy, if they do not file their claims within six months of constructive notification by one of the publications they lose any right to claim.

It was also noted Russia's legislation currently prohibits debt to equity swaps, which therefore can occur only at the offshore level. With offshore debt to equity swaps, one must ask how many ordinary shares should be issued in exchange for the debt, so valuation is critical. Furthermore, if the debt is onshore, one must decide how the debt can be moved offshore, which raises nettlesome accounting and tax questions. If the lender is willing to move the debt offshore, it should assess whether it would in fact be better to preserve its creditor status at the Russian level and have more rights or take the risk of subordinating its position in the companies' capital structure for possibly greater future returns. A recent draft law proposes to eliminate prohibitions on debt to equity swaps at the onshore level. Nevertheless, numerous Russian laws need to be further amended in order to make this a workable solution, and even if such amendments are enacted they will be of little immediate use. However, any expansion of restructuring tools will be welcomed. According to **Peter Z. Teluk** of **Squire Sanders**, there is no blanket prohibition against debt to equity swaps in Ukraine, but there are a number of administrative and practical obstacles that would need to be overcome.

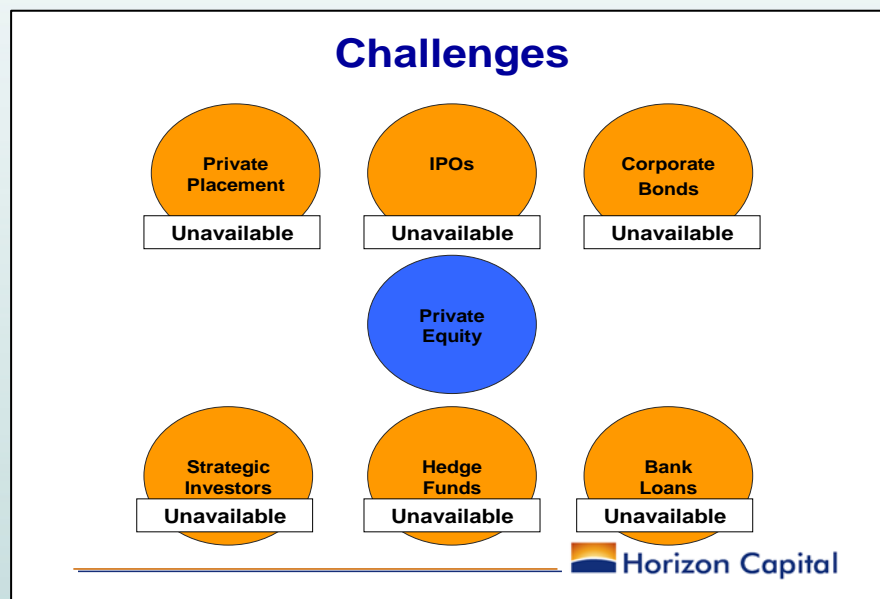
While offshore structures applying English law are still predominantly used for structuring Russian deals, recent amendments to Russia's LLC law provide for the use of shareholders' agreements. The law also adds a new provision that allows participants to carve out automatic exits from LLCs that have previously been shown to significantly hamper investment structures. While the amendments provide more effective controls over share transfer and registration, LLC agreements are yet to be seen in practice and require further statutory expansion. **Lovells' Maria Baeva** believes that in Russia,



because of the issues surrounding the strictness of the imperative regulation, offshore structures with English shareholders' agreements will continue to be employed well into the future. Baeva also discussed the new law on strategic investments, which restricts investment by foreign investors and sets forth a long list of strategic sectors that either prohibit investment or call for special clearance or notification. These sectors include public telecommunications services, television broadcasting, mining exploration, exploitation of subsoil areas granted federal status and services provided at transport terminals, ports and airports.

WHAT THE NUMBERS SAY

Below is a sampling of the statistics that were shared by the speakers in their presentations. Thank you to **Oksana Strashna** of **Horizon Capital Management Team**, **Reinhard Kohleick** of **Quadriga Capital Russia**, **Henry Potter** of **ALPHA Associates AG**, **Jan Dewijngaert** of **Eagle Capital Partners**, **Hans Christian Dall Nygård** of **CapMan Russia** and **Alexander Bezugly** of **Alfa Capital Partners** for permitting us to include these in our event summary.





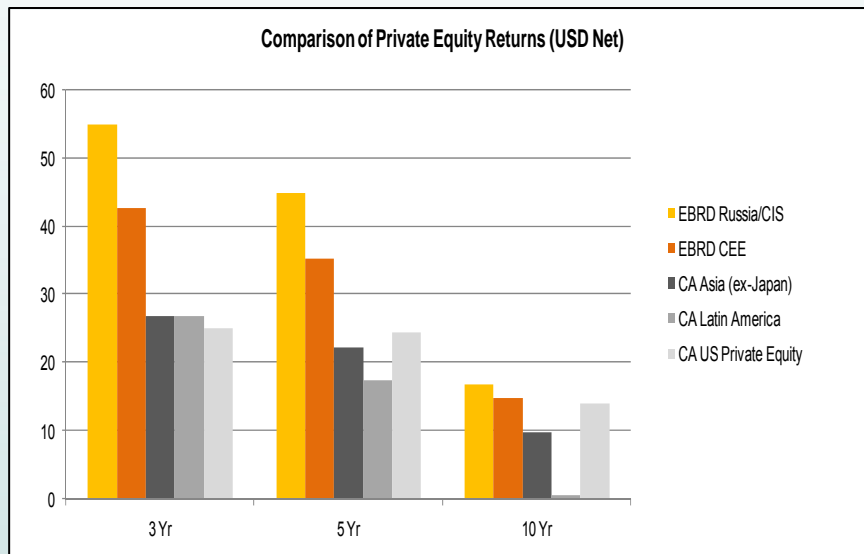
Comparing 1998/99 and 2008/2009

Company Level

	1998/1999	2008/2009	Comment
Rouble Devaluation	✓	✓	... but far less than in '98
Liquidity Problems	✓	✓	similar in extent
Credit Problems	✓	✓	... but today much more leverage
Banking Relations	✓	✓	... today foreign banks reduce exposure
Import Substitution	✓	(✓)	... today there is less to substitute
Personnel Reductions	✓	(✓)	... today qualification counts more
Down-Market Move	(✓)	✓	... today less room to do that
Sector: Banking	✓	✓	... but today legal framework stronger
Sector: Construction	-	✓	... nonexistent in '98
Sector: Retail	-	✓	... nonexistent in '98
Sector: Energy	✓	✓	... low prices then & now

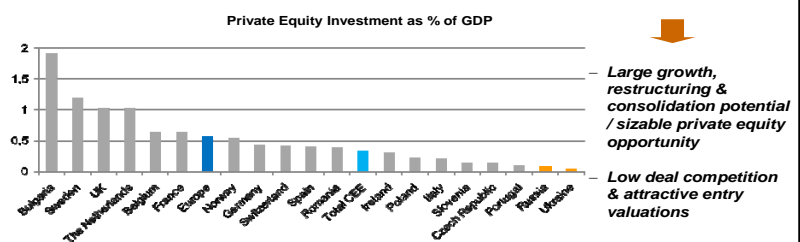
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Private Equity in Russia & CIS Capital Scarcity and Low Competition

- The Russian market is **significantly underserved with equity capital**, and the gap in terms of private equity investment as percentage of GDP vis-à-vis Western countries as well as the countries of Eastern Europe is large – low deal competition
- Russia's private equity investments are equivalent to only about 0.08% of its GDP**, well behind the level in CEE; private equity penetration is even lower in Ukraine, Kazakhstan and Turkey



Sources: EVCA; EBRD; Troika Dialog

alpha associates

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Private Equity in Russia

- Historically, PE returns in Russia have been very high
- The period directly following the '98 crisis has proven to be fantastic from a PE perspective

Net returns as at 31 Dec 2006	Three years	Five years	Ten years	Since inception
Russia/CIS (*)	57,5%	21,7%	13,4%	12,9%
Central & South-eastern Europe (*)	36,2%	14,9%	9,6%	9,6%
EVCA all private equity	13,0%	5,4%	11,0%	10,8%

(*) Net returns for EBRD's portfolio of funds

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Type of exits: Russia vs. CEE

	Russia	CEE
IPO	6%	3%
Trade sale	88%	56%
Buyback	-	6%
Secondaries	6%	24%
Other	-	11%

Source: RVCA (2006), EVCA (2007)

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Example of statistics showing regional potential

Office space in regions' capitals, square meters per 1000 inhabitants - 2007

Region	Office space (sq meters per 1000 inhabitants)
Moscow	~650
Ekaterinburg	~200
Novosibirsk	~150
Samara	~100
Rostov-on-Don	~80
Kazan	~70
Perm	~60
Nizhny Novgorod	~50
Chelyabinsk	~40
Ufa	~30
Qnsk	~20

Source: Knight Frank Research 2008

10 Regional Investment Opportunities 07 May 2009 STRICTLY CONFIDENTIAL CapMan



Private Equity Deals During Downturn confidential

2002-2008

➔

2009-2011

- ❑ Growth, multiple expansion
 - ❑ Regional expansion
 - ❑ Organic growth, development
 - ❑ Pre-IPO
 - ❑ Growing leverage
 - ❑ Minority stakes
 - ❑ Top line growth
- ❑ Deep value
 - ❑ Focus on central Russia, Moscow & St. Petersburg
 - ❑ Consolidation plays
 - ❑ Distressed sellers
 - ❑ De-leveraging, refinancing
 - ❑ Control investments
 - ❑ Cost cutting, focus on cash and liquidity

Alfa Capital Partners page 8

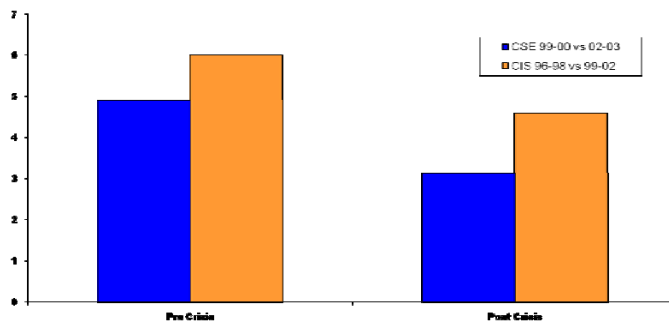
What is “a region” in Russia?

- The locals say:
 - Россия не одна Москва. (Russia is not only Moscow)
- Private equity deals (according to RAVI):
 - 74% of PE deals (based on size) are in Central Federal Okrug, despite 26% of the population
- Facts: (PE investments in the 7 FAO according to RAVI, 2005):

FAO	Population	PE investments	PE inv/Capita
Central	37m	\$180m	\$4.9
NorthWest	14m	\$33m	\$2.4
Urals	13m	\$13	\$1.0
Far East	7m	\$3m	\$0.43
Siberia	21m	\$8m	\$0.38
Volga	31m	\$7	\$0.23
South	23m	\$4	\$0.17

Lessons from 1998 and 2001 Patience was a Virtue

■ Holding periods up 1.5 to 2 years



Source: EBRD

About Squire Sanders

Founded in 1890, Squire, Sanders & Dempsey L.L.P. has lawyers in 32 offices and 15 countries around the world.

On the ground in Moscow and Kyiv, and leveraging the global resources and expertise of our Emerging Markets Private Equity Group, Squire Sanders is widely recognised as having one of the leading private equity practices in Russia and the CIS. *Chambers Global 2009*, *Chambers Europe 2008*, *Legal 500 EMEA* and the *PLC Which Lawyer? Yearbook 2009* have all recommended our lawyers for their private equity experience in Russia.

We advise on all types of private equity investments and exits and have a deep understanding of the issues peculiar to key industry sectors including chemicals, communications, energy, food and beverage, financial services, hospitality and leisure, logistics and infrastructure, media, natural resources, real estate and technology.

For more information, please contact our CIS Private Equity Team:

Christopher A. Rose

Moscow +7.495.258.2853 | London +44.20.7189.8113 | crose@ssd.com

David M. Wack

Moscow +7.495.258.5280 | dwick@ssd.com

Peter Z. Teluk

Kyiv +380.44.220.1400 | pteluk@ssd.com



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