Russian Federation

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MARKET AND INCENTIVES

1. Please describe briefly the private equity market in your jurisdiction, in particular:

- **The sources from which funds established to invest in private equity transactions (private equity funds) obtain their funding, such as institutional investors (for example, pension funds, insurance companies and banks), companies, individuals and government agencies.**
- **Market trends (for example, the role of hedge funds in private equity).**

Sources of funding

Russian private equity funds obtain their funding from a variety of sources, including pension funds, endowments, family offices and high net worth individuals. Development finance institutions, including the European Bank for Reconstruction and Development (EBRD), the International Finance Corporation (IFC) and the US Overseas Private Investment Corporation (OPIC), have also been major capital providers over the past ten years. Geographically, significant inflows of capital in recent years have come from Western Europe, Scandinavia, Asia and North America, as well as from within Russia.

Market trends

Private equity opportunities in Russia have changed dramatically over the past 15 years. Between 1994 and 1997, private equity investments focused primarily on mass privatisations of large, stated-owned enterprises. During the period between the 1998 financial crisis and 2003, the focus moved to media, telecommunications, oil and gas, and some consumer-related businesses. Since 2004, the emphasis has shifted heavily to consumer and applied technology-related businesses, financial services and real estate.

The international financial crisis is not expected to impact the Russian private equity landscape as dramatically as in other markets. The view of some private equity firms in the region is that investment activity may actually increase. This may be due, at least in part, to the fact that unlike transactions in the US and Europe, most private equity deals in Russia do not use leverage and therefore are not dependent on bank financing. In addition, as a result of the turmoil in the stock markets and tighter bank lending standards, private equity is becoming one of the few sources of capital available to growing Russian businesses. These market conditions have enabled private equity investors to negotiate more favourable valuations and deal terms, with the use of convertible loans, preferred shares and other downside protections becoming increasingly common.

2. Please summarise the level of activity in recent years in relation to:

- **Fundraising by private equity funds and hedge funds.**
- **Private equity investment in established, early stage and start-up businesses.**
- **Private equity financed transactions (for example, management buyouts (MBOs), management buy-ins (MBIs) and public to private transactions).**
- **Exits from private equity funds (that is, the realisations of the investments).**

Fundraising

According to the Russian Private Equity and Venture Capital Association (RVCA) (*see box, Private equity/venture capital association*), the total value of assets under management on 31 December 2006 was about US$1.3 trillion (about EUR0.91 trillion) which is about 100 times more than it was 15 years ago. By the end of 2005, the total capitalisation of all private equity and venture funds in Russia rose 25.6% as compared to 2005 and totalled US$6.28 billion (about EUR4.39 billion), with US$1.45 billion (EUR1.01 billion) raised in 2006. From this amount, US$980 million (about EUR686 million) was used to establish 22 new funds in 2006. The ratio of foreign capital to Russian sources was 3:1, as it was in 2005; however, the proportion of governmental participation in Russian sources dropped three times as compared to 2005.

Investment

According to the RVCA, the total amount of private equity investment in Russian companies was US$653 million (about EUR457 million) in 2006, which was 2.5 times greater than the 2005 figure of US$247 million (about EUR173 million). 75% of these deals were in the expansion stage and 6% were in the early stage; 13% were in the later or buyout stage and 6% were at the seed-level stage. Expansion stage deals doubled in number and tripled in value when compared with 2005. The majority of private

equity investments are in the middle market, with a focus on expansion-stage or early-stage transactions with an average deal size of between US$5 million and US$10 million (about EUR3.5 million and EUR7 million).

In terms of industry investments, the telecommunications and IT sector dropped one place from its ranking in 2005, accounting for US$143 million (about EUR100 million) of private equity fund investment in 2006, or 22% of the total investments. The consumer goods and services market was the largest sector in terms of total investment, with US$173 million (about EUR121 million), or 27% of the total investments in 2006.

Transactions

Russia has seen an increase in the number and size of private equity transactions in recent years, although these figures are still below Western levels. According to the RVCA, private equity funds closed 65 deals in 2006 as compared to 33 deals in 2005, 28 in 2004 and 16 in 2003. The average transaction size in 2006 was about US$10 million (about EUR7 million).

Exits

The exit market for Russian private equity backed companies has continued to improve in recent years, with most activity in strategic sales. However, it is yet to be seen what impact the international financial crisis will have on exits. In particular, IPOs will be difficult for most companies for some time.

The exit of capital from the market for direct and venture investment in 2006 comprised about US$173 million (about EUR121 million), which by many times exceeds the amount in 2005 of US$10 million (about EUR7 million). According to the RVCA, there were 16 exits through sales to strategic investors in 2006, which represents 88% of all exits, up from 59% in 2005. There was one MBO and one IPO. In 2005, there were seven exits, four through MBOs and no IPOs.

3. What tax incentive schemes exist to encourage investment in unlisted companies? At whom are the schemes directed? What conditions must be met?

Russia does not have any tax incentive schemes to encourage investment in unlisted companies.

FUND FORMATION

4. What legal structure(s) (domestic or foreign) are most commonly used as a vehicle for private equity funds in your jurisdiction?

Private equity funds formed under Russian law are typically organised as closed investment funds (PIFs) and are regulated by the Federal Commission for the Securities Market (FSCM) in accordance with the Law on Investment Funds (*No 156-FZ, 29 November 2001*). However, as virtually all of the major private equity funds operating in Russia are established under foreign law, the focus of this article is on offshore fund structures.

The most common offshore structure is a limited partnership formed in a reputable, tax-advantaged jurisdiction like Bermuda, British Virgin Islands, Cayman Islands, Isle of Man, Guernsey or Jersey. Often, the general partner and possibly a manager are incorporated in the same jurisdiction as the fund. In addition, a Russian company or a foreign company with a branch office located in Russia acts as a local investment adviser.

Russian source income received by a foreign entity other than through a permanent establishment in Russia may be subject to Russian withholding tax. Accordingly, fund investments are typically made through Cyprus, Luxembourg or Dutch holding companies, thereby taking advantage of the favourable double taxation treaties these jurisdictions have with Russia.

5. For each structure identified in *Question 4*, identify whether it is taxed, tax exempt or fiscally transparent (that is, tax is levied on the individual investors rather than the fund itself):

- **So far as domestic investors are concerned.**
- **So far as foreign investors are concerned.**

The offshore limited partnership vehicles described in *Question 4* are fiscally transparent for foreign investors. However, the special purpose vehicles through which these limited partnerships typically invest in portfolio companies are subject to withholding taxes on dividends, interest and capital gains in accordance with the applicable tax treaty between Russia and the SPV's jurisdiction.

In respect of Russian investors, due to the Russian tax authorities' relative lack of experience with fiscally transparent structures (flow through vehicles are generally not recognised under Russian law), there is the possibility that capital gains derived from investments in foreign limited partnerships by Russian tax residents could be characterised as ordinary income and therefore be taxed at a higher rate. Accordingly, Russian investors investing in fiscally transparent fund structures tend to hold their interests through a tax exempt or low tax offshore company.

6. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as not being tax transparent (in so far as they invest in companies in your jurisdiction)? What parallel domestic structures are typically used in these circumstances?

The concept of partnerships is underdeveloped in Russian legislation. Particularly, under Russian law, partnerships are treated as legal entities and their profits are subject to corporate profits tax at the level of the partnership itself rather than at the level of the partners. The Russian profits-tax legislation does not provide for any equivalent to the US check-the-box rules. Accordingly, tax transparent structures (that is, limited partnerships) commonly used by private equity funds in other jurisdictions are generally

not used for direct investment into Russian companies. Funds typically employ companies formed in Cyprus, Luxembourg or The Netherlands when investing in Russian portfolio companies, which enable the fund to reduce withholding taxes payable by such holding company through double taxation treaties.

7. Are a private equity fund's promoter, principals and manager required to be licensed?

The management company, custodian and register holder of private equity funds incorporated under Russian law must be licensed. However, all of the significant private equity funds operating in Russia are established under foreign law and there are no licensing requirements for these foreign funds.

8. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

Private equity funds formed under Russian law are regulated as investment funds. These regulations do not apply to foreign funds and, therefore, do not have any practical effect on how most private equity funds are marketed and advertised in Russia.

9. Are there any restrictions (for example, nationality, age and number) on investors in private equity funds?

There are no restrictions under Russian law on investors in foreign private equity funds. However, there may be restrictions under the laws of the jurisdiction in which a foreign private equity fund was formed.

10. How is the relationship between the investor and the fund governed? What protections do investors typically seek?

For the majority of foreign private equity funds operating in Russia which employ a limited partnership structure, the relationship between the fund and its investors (the limited partners) is governed by the terms of the limited partnership agreement. Such funds are managed by the general partner, which have unlimited liability. Investors typically seek to negotiate:

- Restrictions on the types of investments that may be made by the fund.
- Activities of the fund managers.
- Management fees.
- Carried interest.
- Expenses reimbursable by the fund.

11. Are there any statutory or other limits on maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

For investment funds formed under Russian law, the effective term should not exceed 15 years. Russian law imposes no such limits on offshore private equity funds. However, there may be restrictions under the laws of the jurisdiction in which the foreign private equity fund was formed.

INVESTMENTS

12. What are the most common investment objectives of private equity funds?

The most common objective of private equity funds operating in Russia is capital appreciation.

The average life of a fund is 8.5 years.

The average internal rate of return sought is 35%.

13. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? What are the relative advantages and disadvantages of each? Are there any restrictions on the issue or transfer of shares by law?

Private equity funds generally take equity interests in portfolio companies, although convertible loans are becoming increasingly common.

When investments are made directly (that is, without using an intermediate offshore holding company), private equity funds will purchase ordinary shares (in respect of Russian joint stock companies) or participation interests (in respect of Russian limited liability companies). Downside protections are typically negotiated in the shareholders' agreement, usually in the form of equity ratchets and puts.

Private equity fund investments tend to be structured through offshore special purpose vehicles. Often these vehicles pre-date the investment, having been formed by the portfolio company's founders. Alternatively, they are formed by the fund for the purposes of the investment. While the use of these holding companies is primarily motivated by tax efficiency, governance issues also play a significant role. Russian corporate and contract law tend to be inflexible, rendering certain aspects of typical investment structures (that is, shareholders' agreements) unenforceable. Accordingly, foreign law (typically English) is used to improve the enforceability of these investor protections.

Russian law imposes certain restrictions on the issue or transfer of shares. For instance, a shareholder of a joint stock company has a statutory pre-emptive right in relation to new issuances and a right of first refusal in respect of sales of shares by other shareholders. In contrast, a participant in a limited liability company may leave at any time and receive from the company a portion of

the company's assets, proportionate to such participant's participation interest. These provisions can be waived or modified in the company's charter or foundation documents.

BUYOUTS

14. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

Buyouts of private companies by auction do occur in Russia but such tenders are not yet commonplace. When they do occur, they typically involve auctions of shares at the offshore holding company level. In such cases, Russian law is not implicated. In the event that the auction involves a Russian company, general legislation and rules relating to auctions or tenders apply (*Russian Civil Code No 51-FZ, dated 30 November 1994*).

15. Are buyouts of listed companies common (public to private transactions)? If so, which legislation and rules apply?

Buyouts of listed companies are uncommon in Russia. When they do occur, such buyouts:

- Must comply with the anti-takeover rules promulgated under the Joint Stock Company Law (*No. 208-FZ, dated 26 December 1995*).
- May require governmental consent under the Foreign Strategic Investments Law (*No. 57-FZ, dated 29 April 2008*).
- May require the consent of the Federal Antimonopoly Service (FAS).

Anti-takeover rules

Anti-takeover rules provide that:

- Any person intending to acquire more than 30% of an open joint stock company's voting shares (including, for these purposes, the shares already owned by the person and its affiliates) can make a public tender offer to other holders of such shares or securities convertible into the shares (voluntary offer).
- Within 35 days after acquisition by any means of more than 30%, 50% or 75% of such shares the acquirer must make a public offer to purchase the remaining shares from the shareholders (compulsory offer).
- If as a result of such voluntary or compulsory offer the acquirer purchases more than 95% of the voting shares, it must:
  - notify all remaining shareholders (within 35 days after acquisition of shares above such threshold) of their right to sell their shares and other securities convertible into such shares; and
  - purchase such shares on the request of each minority shareholder.
- Alternatively, in lieu of giving such notice, the acquirer can deliver a buyout demand, binding on the minority shareholders, that they sell their shares.
- An offer of the kind described in any of the preceding three paragraphs must be accompanied by a bank guarantee of payment. In addition, prior notice of the offers must be filed with the Federal Financial Markets Service (FFMS). The FFMS may require revisions to be made to the terms of the offer (including the price) in order to bring them into compliance with the rules.

Foreign Strategic Investments Law

Under the Foreign Strategic Investments Law, foreign investment in 42 sectors deemed to be strategic is subject to government approval in certain cases. The 42 strategic sectors include:

- Areas such as oil and gas, and other natural resources.
- Defence.
- Nuclear energy.
- Certain transportation activities (including airports, seaports, rail and pipelines). Certain telecommunications and media companies (excluding internet-related).
- Certain electric power and heat transmission businesses.
- Aviation and aerospace.
- Fishing.
- Specialty metals processing.

Specifically, approval is required for:

- Foreign acquisition of a controlling interest in a strategic sector company or more than 10% if the company is in the mineral resources sector.
- Acquisition by a foreign state, international organisation or organisation under their control of more than a 25% interest in a strategic sector company or more than 5% if the company is in the mineral resources sector.

Approval by the FAS

Under Russian anti-monopoly legislation, which was significantly amended in July 2006, prior FAS approval must be granted for an acquisition of voting interests in a Russian company over certain thresholds (25%, 50% or 75% for joint stock companies or 33.33%, 50% or 66.66% for limited liability companies) through purchase, creation of a joint venture company, statutory merger or consolidation or the acquisition of more than 20% of the assets of a Russian company where any of the following are met:

- The combined asset value of the target's group and the acquiring group, calculated in accordance with Russian accounting standards, exceeds RUB3 billion (about US$117 million) and the target's group has at least RUB150 million (about US$5.9 million) of assets.

- The combined revenues of the target's group and the acquiring group, calculated in accordance with Russian accounting standards, exceeds RUB6 billion (about US$234 million) and the target's group has at least RUB150 million (about US$5.9 million) of assets.
- A company in the target's group or the acquiring group has more than a 35% market share for its goods or services and is included on the FAS register of monopolists.

In addition, the acquisition of voting interests in a foreign company may be subject to FAS consent if, as a result of the acquisition, control over Russian companies or assets changes and the change of control could affect competition in the Russian market.

16. What are the principal documents produced in a buyout?

Control over Russian joint stock companies is generally understood as ownership of 75%, plus one share, which gives the acquirer control over all major decisions (subject to minority protection rights). The principal documents involved in a buyout of a joint stock company are the share purchase agreement and the share transfer order.

If the target company is a limited liability company, the principal documents produced are the purchase agreement, the notice of participation interest transfer and the registration of amendments to the company's foundation documents.

Buyouts structured as direct asset purchases are not widely used in Russia. Typically, if a straightforward share acquisition is not desirable, the parties establish a newly-formed company (NewCo), usually in the form of a limited liability company, to which assets of interest to the purchaser are transferred as in-kind contributions to the charter capital of NewCo and the shares of NewCo are subsequently sold to the purchaser by means of the documents described above.

17. What forms of contractual buyer protection are commonly requested by private equity funds from sellers and/or management?

Private equity funds commonly request customary representations, warranties and indemnities. Depending on the size of the investment, private equity funds also frequently negotiate:

- Equity ratchets for:
  - down rounds;
  - the failure of management to meet financial targets (common when the investment is made on the basis of projected targets); and
  - failure to achieve exit by a particular date.
- Puts.

Purchase price retentions to ensure payment for warranties or specific liabilities are uncommon except in pure buyouts.

18. What non-contractual duties (for example, of confidentiality and employment) do the portfolio company managers owe and to whom (for example, when approaching possible investors in relation to an MBO)?

The Joint Stock Company Law has a number of general provisions regarding director and officer duties and liability. In particular, it requires board members and officers to act in good faith and in the best interests of the company, and makes them personally liable for losses incurred by the company that result out of actions that they took knowingly against the best interests of the company. An additional duty of care and confidentiality may also arise based on the contractual terms of the manager's employment contract.

19. What terms of employment are typically imposed on management by the private equity investor in an MBO?

Management employment agreements typically include severance, non-compete and confidentiality provisions, along with financial incentives such as cash bonuses and stock options.

20. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company (for example, representation at board level)? Are such protections more likely to be given in the shareholders' agreement or company bye-laws?

Private equity funds generally require one or more seats on the supervisory board of the holding company through which the investment is made and veto rights/special quorum requirements in respect of certain major decisions, including the approval of:

- Business plans.
- Debt/equity financing rounds.
- Corporate changes.
- Major acquisitions
- Dividends.
- Appointment of key officers.

These protections are usually found in the shareholders' agreement but certain provisions (that is, veto rights) are often repeated in the holding company's articles.

21. What percentage of the finance will typically be provided by debt and what form does that debt financing usually take (for example, term loans, working capital facilities, convertible loans and bonds)?

Private equity investments are typically comprised entirely of equity, although with bank debt becoming increasingly available in

the Russian market many observers believe that the emergence of true leveraged buyout transactions is on the horizon. Debt, primarily in the form of credit linked notes (CLNs), is frequently used by large, mature Russian companies with predicable cash flow to finance modernisation, expansion or strategic acquisitions.

22. What forms of protection do debt providers typically use to protect their investments, in particular through what types of:

- **Security?**
- **Contractual and structural mechanisms such as subordination?**

Debt providers typically protect their investments through the use of:

- Pledges over assets and/or shares.
- Third-party guarantees.
- Bank guarantees or sureties.

23. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this impact on the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

Russian law does not have any special rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company. However, many of the jurisdictions through which investments in Russia are commonly made (for example, Cyprus and The Netherlands) do have financial assistance rules, which frequently raise issues in connection with the making of warranties and covenants by the company and grants of equity ratchets.

24. What is the order of priority on insolvent liquidation? Are debt providers given priority over equity holders by law or is priority purely a matter of contract and company constitution?

The Russian Civil Code gives creditors the following order of priority during liquidation:

- **First priority.** Individuals owed compensation for injuries or deaths, or moral damages.
- **Second priority.** Employees and copyright claims.
- **Third priority.** Federal and local governmental authorities claiming taxes and similar payments to the budgetary and non-budgetary funds (for example, pension funds and social insurance fund).
- **Fourth priority.** Other creditors in accordance with Russian legislation.

PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATIONS

Russian Private Equity and Venture Capital Association (RVCA)

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Status. The RVCA is a non-governmental organisation.

Membership. The RVCA has 33 full members and 32 associate members.

Principal activities. The RVCA promotes and develops the private equity and venture capital industry in Russia and abroad.

Published guidelines. None.

Information sources. The RVCA publishes an annual *Yearbook* available to its members.

Claims of creditors in obligations secured by a pledge of the company's property are satisfied from the sale proceeds of the pledged property prior to claims of any other creditors, save for the creditors of the first and second orders of priority, provided that claims of such creditors arose before the respective pledges have been entered into. Any residual claims of secured creditors that remain unsatisfied after the sale of the pledged property rank *pari passu* with claims of the fourth-priority creditors.

The remaining assets of the company are distributed among shareholders in the following order of priority:

- Payments to repurchase shares from shareholders having the right to demand repurchase.
- Payments of declared but unpaid dividends on preferred shares and the liquidation value of the preferred shares, if any.
- Payments to holders of ordinary and preferred shares on a pro rata basis.

25. Is it possible for a debt holder to achieve equity appreciation through conversion features such as rights, warrants or options?

Such conversion features are possible under Russian law but they typically implemented at the offshore holding company level.

PORTFOLIO COMPANY MANAGEMENT

26. What management incentives are most commonly used (for example, shares, options and ratchets) to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

Deferred or stock-based compensation, including stock option programmes, is increasingly being used to incentivise portfolio company management. In addition, equity ratchets tied to the company's performance and/or a successful exit by a pre-agreed date are also frequently employed.

27. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

Russian law does not provide tax reliefs or incentives to portfolio company managers investing in their company.

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EXIT

28. What forms of exit are typically used to realise a private equity fund's investment in a successful company (for example, trade sale, initial public offering (IPO) and secondary buyout)? What are the relative advantages and disadvantages of each?

Trade sales, management buyouts and management buy-ins are the forms of exit most frequently used to realise private equity fund investments in Russia. While IPOs of Russian private equity-backed companies became increasingly common in 2005 and 2006, public offerings have since experienced a decline due to unfavourable conditions in the capital markets.

29. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

Unsuccessful investments are normally exited by means of a trade sale. Alternatively, the company is liquidated.

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Private Equity in the CIS and CEE

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We have extensive experience structuring and organizing private investment funds, advising on the acquisition and financing of public and private businesses, and designing and implementing exit strategies. Our private equity practice extends across the CIS and CEE, staffed from offices and associate offices in Bratislava, Bucharest, Budapest, Kyiv, Moscow, Prague and Warsaw and supported by tax, corporate and securities lawyers from Squire Sanders offices in Frankfurt, London and Washington DC.

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