

Proceeding With Caution



6th Annual CIS Private Equity Forum

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

Spring/Summer 2010



INTRODUCTION

As Russia emerges from the worldwide financial crisis, continued uncertainty in the global financial markets could again cause the economy to lose its footing. Nevertheless, many of the leading private equity players are cautiously optimistic about the prospects for growth in 2010 and beyond and feel that 2010-2011 could turn out to be vintage years for the industry, much like the years following the 1998 crisis.

C5 and global law firm Squire, Sanders & Dempsey L.L.P. are pleased to bring you an overview of the perspectives and insights of leading industry experts from the 6th Annual C5 CIS Private Equity and Venture Capital Forum, held in Moscow on 23-24 March 2010.

We would like to thank all the presenters for their thoughtful comments on the state of the private equity market and the Forum delegates for their contributions to the discussions.

Squire Sanders' CIS Private Equity Team

Spring/Summer 2010



C5 PRIVATE EQUITY AND VENTURE CAPITAL FORUM: GENERATING ALPHA IN A MARKET RETURNING TO GROWTH

David M. Wack of **Squire, Sanders & Dempsey L.L.P.**, chairman of the Forum, set the tone, stating that most fund managers regarded 2009 as a “rebuilding year,” tending to focus on managing their portfolio companies through the crisis. A few highlights from the Forum include:

- 2009 witnessed the end of the era of readily available credit, forcing funds to focus on managing expenses and enhancing value.
- Most private equity fund managers spent 2009 tending to their existing investments, rather than making new ones. Exits were relatively rare.
- A trend which began to gain traction in 2009 and will likely continue through the remainder of 2010 is an increased level of regulatory involvement by both US and EU regulators. Forthcoming legislation in Europe may soon require private equity funds based outside the European Union to register with regulators in each EU Member State. These proposed regulations will affect private equity funds based in Russia that are seeking to raise money from investors in Europe.
- The mismatch in value expectations was perhaps the single biggest impediment to deal flow and the reason there was no wave of “distressed” acquisitions that many anticipated. Well-managed companies with relatively healthy balance sheets were not interested in selling at the nadir of a down market (or at least not at distressed valuations), and weaker companies were not interesting to funds looking to preserve capital and select the best value propositions for growth.
- Industry leaders are looking to the consumer-driven, banking and pharmaceuticals sectors as key growth areas.
- Forum presenters were cautiously optimistic about the prospects for private equity in Russia in 2010, with one expecting activity to pick up in the third quarter.

WHAT THE EXPERTS SAID

2009 in Review

Looking back, it has become somewhat of a cliché to say that 2009 was a challenging year. **Richard Sobel**, CEO of **Alfa Capital Partners**, observed, “The economic downturn was worse than anticipated, with adverse consequences for portfolio companies and the private equity industry generally.” However, in the second half of 2009, economic decline slowed and visibility improved, mostly due to a recovery in commodity prices and a strengthening ruble.

“The crisis divided companies into those that merely survived and those that succeeded,” remarked **Alexander Abolmasov** of **NRG Advisors**. Certain industry sectors fared better than others. According to Sobel, the losers included “consumer, transport and real estate-related industries,” while

“The crisis divided companies into those that merely survived and those that succeeded.”

– Alexander Abolmasov



the winners tended to be “resource producers, food retailers, domestic manufacturers and multinationals.” **Oleg Jelezko** of **Da Vinci Capital Management** cited the pharmaceutical sector as one of the few sectors that actually grew in 2009.

Gleb Davidyuk of **Mint Capital** described 2009 as “a year of battling with costs.” He explained that most companies were caught off guard by the crisis and, as a result, had to alter prior strategies. “Almost all companies had their business plans prepared in 2008-9, and as a result, those budget projections had to be adjusted accordingly,” he said.

Needless to say, deal activity tapered off dramatically in 2009. **Giedrius Pukas** of **Quadro Capital Partners** estimated that the number of deals fell to almost one-third of 2007’s highs. He also observed that deals tended to be smaller in size. Abolmasov pointed to the considerable uncertainty in the market throughout last year, commenting that “vendors waited for the crisis to end and for the market to return to the way it was 6-12 months earlier. Meanwhile, investors took a conservative approach because there were a lot of companies with negative value.”

“Almost all companies had their business plans prepared in 2008-9, and as a result, those budget projections had to be adjusted accordingly.”
– Gleb Davidyuk

Lessons Learned From the “Krizis”

Several presenters advocated a return to basics, observing that the enthusiasm of the years leading up to the crisis may have lead some investors to rush into deals they would have been better off walking away from.

Sean Glodek of **Darby Private Equity** reminded delegates that “cyclical industries are exactly that – cyclical.” He stressed the importance of having a cash cushion and the need to proactively identify and manage conflicts of interest. Mint Capital’s Davidyuk believes that a critical lesson from the crisis is not to economize or compromise on the quality of due diligence. “Fast does not necessarily translate into good,” he observed. Davidyuk urged investors to “take things slowly” before making investments, including sitting in on target company board meetings. “It is more prudent to analyze what is happening in the company you are investing in at an earlier stage than to confront problems in the future,” he added. In contrast, distressed acquisitions require a different approach. **Vladimir Lupenko** of **Financial Consulting Group** advised “acting fast but clever” when conducting due diligence in distressed transactions, focusing on the company’s prospects rather than going too deeply into its past.

“Instead of leverage, private equity returns must be realized by traditional means: low entry price, top-line and bottom-line growth and a successful exit.”
– Dr. Reinhard Kohleick

Dr. Reinhard Kohleick of **Quadriga Capital Russia** observed that debt, as an acquisition tool, is unavailable, stating that “instead of leverage, private equity returns must be realized by traditional means: low entry price, top-line and bottom-line growth and a successful exit.” Quadro’s Pukas also cited a lack of available leverage. “Private equity’s ability to raise debt for acquisitions has decreased. The main focus now is to create value,” he added.

Da Vinci Capital Management’s Jelezko predicted that the key factor for success in the post-crisis era will be industry focus. “If you know the industry sector well, you can build teams of people who can speak the same language as the owners of the business and help them take a company to a new



level.” Jelezko believes the main reasons why some funds fared poorly during the crisis were “over justification and lack of depth of understanding of real issues and resources.” **Franz Hoerhager** of **Mezzanine Management GmbH** emphasized the importance of local knowledge and presence. “You

“You need to be on the ground. You need a stable and multifaceted team who speaks the local language and has a good network of relationships.”

– Franz Hoerhager

need to be on the ground. You need a stable and multifaceted team who speaks the local language and has a good network of relationships,” he advised.

In the wake of the global financial crisis, certain presenters called for legislative reform to facilitate the growth of the private equity and venture capital industries. **Alexander Kondrashov** of **RUSNANO** pointed out the need for a Russian legal entity similar to the limited partnerships used in other jurisdictions around the world. **Ilya Ponomarev** of the **Russian State Duma** elaborated on this issue, confirming that a new law introducing an organizational legal form analogous to the LLP (limited liability partnership) is expected to be read in the State Duma this year. Ponomarev also advocated introducing other legal remedies which are standard for investors abroad, including amending the Civil Code to include protection of intellectual property rights, updating the corporate and bankruptcy laws and revising the tax system to promote favourable tax schemes for the innovation sectors. He also indicated that the introduction of a law on the transfer of technologies (similar to the United States’ Bayh-Dole Act) is currently under consideration.

Market Trends

Several presenters gave their predictions on which sectors to watch.

Tim Demchenko of **VTB Capital** commented that while his organization is looking at various sectors, “growth has been in the consumer-driven segments.” **Marina Chekurova** of **Renaissance Investment Management** is optimistic about Russia’s banking sector. “Setting aside the largest banks, Sberbank, VTB and Gazprombank, there are very few large players in the market,” she observed. Da Vinci Capital Management’s Jelezko predicts further growth for the pharmaceuticals industry, estimating 15 to 20 percent over the next 10 years.

“Growth has been in the consumer-driven segments.”

– Tim Demchenko

Innovation was repeatedly cited as a significant trend in Russian venture capital and private equity investments. **Maxim Shekhvotsov**, managing director of venture capital funds at **Allianz ROSNO Asset Management**, commented that “computer technology and online media investments are at the forefront,” while **RUSNANO**’s **Kondrashov** pointed to media and Internet projects. The Russian State Duma’s **Ponomarev** further elaborated on this theme, stating that an “innovative economy is the main priority of development” for Russia’s government. He added that among the priorities for development are energy efficiency and conservation, space technologies, telecommunications, nuclear technologies, information technologies, supercomputers, pharmaceuticals and biotechnology. **Konstantin Torgov** of **The European Bank for Reconstruction and Development (EBRD)** commented that his institution is also supporting innovation deals.

Experts also shared their thoughts on which investment strategies will be successful post-crisis.

Richard Sobel of **Alfa Capital Partners** advocated working with portfolio companies to pursue industry consolidation and acquisition opportunities, noting that “it is cheaper to buy weaker competitors than it



is to start a new and developing business.” **Jan Dewijngaert** of **Eagle Venture Partners** shares this view, believing that the best performing companies will find “great expansion opportunities via organic growth and M&A,” while at the same time benefitting from less competition from oligarch-controlled vehicles, global private equity houses and hedge funds.

Mint Capital’s Davidyuk believes that control acquisitions will prevail in the new economic reality, as compared to the minority investments that typified the market over the last several years. “While a majority stake acquisition poses a number of additional risks, they are worth it,” he added. Davidyuk also predicted that less available capital in the market will result in smaller deals in the short to medium term: “In the next two to three years, deals averaging US\$15-20 million will prevail and deals in the range of US\$100-300 million will be unheard of.”

“It is cheaper to buy weaker competitors than it is to start a new and developing business.”

– Richard Sobel

Prospects for 2010 and Beyond

The Forum presenters were cautiously optimistic about the prospects for Russian private equity. Richard Sobel commented that “as we look into 2010 and beyond, the economy appears to be turning around and returning to a period of growth. The outlook is better than expected, even though the economic downturn was worse than expected.” **Kamal El Tayara** of **KCP Capital** agreed. He believes that Russian private equity activity will “pick up during the third quarter of 2010,” with the assistance of domestic private equity firms, state-backed Russian banks and overseas funds with strong local knowledge being tempted back into the market. Reputable industry reports appear to support these viewpoints. **Igor Checkoun** of **Private Equity Russia & CIS Journal (PERCIS)** suggested investors have “adapted to the new market realities” and deal volume will resume to higher levels in 2010.

Despite increasing confidence levels, “today most funds are trading lightly,” according to Renaissance Investment Management’s Chekurova, who compared the current investor climate to the period immediately following the 1998 crisis. **Albina Nikkonen** of the **Russian Private Equity & Venture Capital Association** acknowledged that many investors continue to have a wait-and-see attitude, stating, “Today we have favourable conditions for investment, but the market is still waiting to see what will happen with the Russian economy and how investors will react.” Quadro Capital’s Pukas suggested liquidity issues may also be hampering investment activity. “Not all investors are ready for draw downs, even on existing commitments,” he commented.

“Today we have favourable conditions for investment, but the market is still waiting to see what will happen with the Russian economy and how investors will react.”

– Albina Nikkonen

VTB Capital’s Demchenko observed the relative lack of competition for deals in Russia’s market: “What we are experiencing today is essentially a white space.” Mezzanine Management’s Hoerhager concurred, stating that “the market is not yet saturated, nor will it be saturated for the next 5-10 years.” He added that those that have money “are in a very good position because there are many opportunities, lower valuations, and quite often, private equity is the only source of capital.” To ensure long-term growth, KCP’s El Tayara maintained that Russia will need to “modernize its economy by promoting hi-tech industries and services, reducing dependence on the energy sector and switching to a knowledge-based, innovative economy.”



Alexander Vlasov of **CapMan Russia** expects significant growth outside of Moscow. He noted that throughout the crisis, the divide between Moscow and the regions significantly increased. “This divide was evident in the disparity of salaries along with lease rates and overall business value,” he maintained. According to Vlasov, in five to seven years, “the growth rate in the regions may surpass that of Moscow.” However, he believes that currently there are few funds that are prepared to spend several hours to commute to the regions.

WHAT THE NUMBERS SAY

Below is a sample of slides that were shared by some of the speakers in their presentations. Thank you to Jan Dewijngaert of Eagle Venture Partners, Konstantin Torgov of The European Bank for Reconstruction and Development, Kamal El Tayara of KCP Capital and Dr. Reinhard Kohleick of Quadriga Capital Russia for permitting us to include these in our event summary.



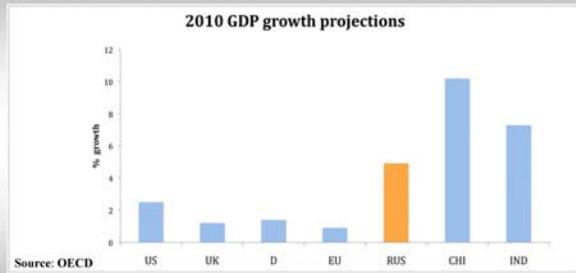
Investment by Country (2001-2009), US\$m

| Country | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|--------------|-------|------|-------|-------|-------|-------|-------|-------|-------|
| Brazil | 281 | 261 | 321 | 120 | 474 | 1,342 | 5,285 | 3,020 | 989 |
| China | 1,575 | 126 | 1,667 | 1,389 | 2,991 | 8,200 | 9,458 | 8,994 | 6,288 |
| India | 320 | 40 | 456 | 1,272 | 1,377 | 5,687 | 9,905 | 7,598 | 4,001 |
| Russia | 77 | 127 | 113 | 240 | 240 | 653 | 1,018 | 1,479 | 217 |
| South Africa | 202 | 407 | 651 | 1,154 | 711 | 850 | 3,362 | 1,183 | 748 |

Source: Emerging Markets Private Equity Associations



In 2010 Russia is growing again (1)



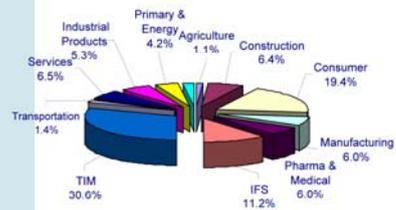
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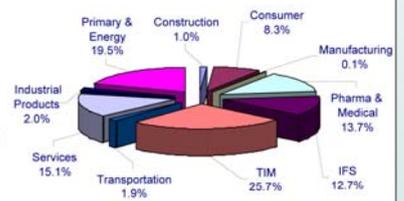
Investments by Sector

Since inception to end 2008



2009 Investments only

Total 42 investments, of which 16 "follow on"



Note: EBRD-tracked funds only, by investment cost, in EUR, CSE and CIS, based on preliminary 2009 data



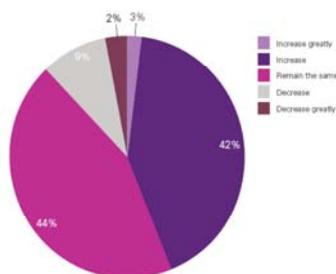
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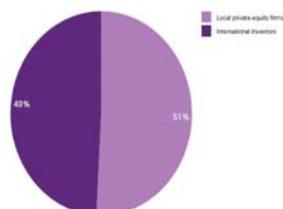
Mergermarket Feb 10 Survey: A Snapshot

What do you expect to happen to the level of private equity buyouts in Russia over 2010?



Respondents are split on whether foreign or local private equity firms will dominate the M&A landscape in 2010

Do you expect the majority of private equity activity in Russia over the next 12 months to be conducted by local private equity firms or international investors



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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 Europe 2010* and *PLC Which Lawyer?* have 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.

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“With his fluent Russian and long experience on the region’s private equity deals, David Wack is ‘one of the US lawyers most adapted to the local environment – he knows how to deal with local clients,’ say sources. Christopher Rose is a private equity lawyer who ‘certainly knows what he is talking about,’ peers confirm.”

– *Chambers Europe 2010*



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