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FEATURE - EMERGING MARKETS

Love it or hate it: Why Russia is the Marmite of BRICs

Christopher Rose, partner at global legal practice, Squire Sanders, discusses the perception gap between private equity investors inside and outside of the Russian market.

Proponents point to exceptional returns, an enormous, underserved consumer market and an increasingly positive macro-economic outlook. Detractors cite corruption, bureaucracy and political risk. Like Britain's famous Marmite food spread, investors seem to either passionately love, or vehemently hate, the taste of Russian private equity.

Market participants have good reason to be sweet on the asset class -- principally because it has made their investors lots of money. Statistics from the European Bank for Reconstruction and Development, the largest and most active institutional investor in the region, show five-year returns for Russia/CIS investments at 32.3%, versus 20.6% from the Cambridge Emerging Markets PE & VC Index, in each case as of December 2009.

Russia's macro-economic fundamentals are also encouraging. While Russia's GDP fell nearly 8% in 2009, the country's GDP growth rate rebounded in 2010 to 3.7% and is anticipated to reach 4.5% in 2011. Moreover, as compared to other BRICs, Russia has had the lowest levels of indebtedness and the best performing stock market over the past ten years.

Unfortunately for funds seeking to raise money, the "hate it" camp predominantly comprises institutional investors, most of whom have never set foot in Russia. These LPs have ranked Russia as the least attractive emerging market for three years running, according to surveys conducted by the Emerging Markets Private Equity Association. Fundraising statistics further demonstrate this institutional aversion.

Total funds raised by Russian private equity fell from $1.8bn in 2007 to $880m in 2008, before collapsing to just $75m in 2010. China, in contrast, attracted $28.6bn from LPs since 2008, India $15bn and Brazil $5bn.

The disconnect between Russian private equity's stellar returns and its anemic fundraising figures may partly be due to misconceptions about the asset class itself. Western LPs frequently cite government intervention in Yukos and TNK-BP as examples of why not to invest in Russian funds. However, stories like these have little in common with the typical Russian private equity investment.

Strategic sectors like oil and gas, with their inherent political risks, are generally outside the scope of mainstream Russian private equity. Fund managers in Russia instead typically engage in middle-market, expansion capital deals in predominantly consumer-facing industries. These GPs do not rate bureaucracy or corruption as their leading concerns.

What keeps them up at night are questions about the competence of key managers or the credibility of a business plan, just like fund managers in other markets. That's not to say that investing in Russian private equity is always smooth sailing, as global fund, TPG, and Russian bank VTB learned when they invested in the Lenta hypermarket chain.

However, despite a highly-publicised shareholder dispute lasting the better part of a year, the business has performed exceptionally well and Lenta is likely to be a very good investment for TPG and VTB.

The Russian private equity community is taking steps to narrow this perception gap and court institutional investors. In the middle of last year, a group of 16 leading fund managers and service providers launched the Russian Private Equity Initiative (RPEI) as part of an industry-wide effort to promote the asset class domestically and internationally. The government is also sending encouraging signals.

Russian President Dmitry Medvedev earlier this year announced a $10bn private equity fund, partly funded by the government and aimed at co-investing with international firms.

Despite the sluggish fundraising environment, Russian private-equity managers are reportedly seeking more than $4bn in new funds this year. A significant uptick in deal activity in 2011 combined with recent high profile exits, including the tremendously successful IPO of Russian search engine, Yandex, will hopefully aid these efforts.

Nevertheless, until institutional investors truly acquire the taste for Russian private equity, the size of the industry will continue to lag far behind its BRIC peers.

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