REPRINT | FINANCIER WORLDWIDE MAGAZINE

FINANCIER WORLDWIDE corporatefinanceintelligence

REPRINTED FROM:
SEPTEMBER ISSUE 2011

Follow The Smart Money: Private Equity In Russia

BY CHRISTOPHER ROSE

Many people are surprised to learn just how successful Russian private equity has been in recent years. At its IPO earlier this year, Russian search engine Yandex was valued at a whopping 500 times more than the price paid by leading fund manager Baring Vostok Capital Partners in 2000. The European Bank for Reconstruction and Development (EBRD) has also seen remarkable returns from its portfolio of Russia/CIS funds. The largest and most active institutional investor in the region, EBRD's returns between 2004 and 2009 were 32.3 percent. By way of comparison, the Cambridge Associates Emerging Markets PE & VC Index, which covers a broader range of emerging economies, showed returns of 20.6 percent over the same period.

Baring Vostok, EBRD and other veteran investors have demonstrated that there is real money to be made in Russian private equity. This is not meant to suggest, however, that success in Russia comes easy. Identifying and executing deals which produce superior returns requires a tailored investment strategy and meticulous structuring. Below is a list of commercial and legal tips compiled from the experiences of Russia's most successful investors.

Focus on consumer-facing industries. Most fund managers in Russia avoid sectors of national strategic importance, like oil and gas. They instead engage in middle-market, expansion capital deals in predominantly consumer-facing industries. By following this strategy, you can avoid getting caught up in Kremlin politics, where a perceived lack of transparency is often cited by international players as a reason not to invest Russia. This consumer focus also sets the stage for potential exits. With Russia predicted to become the largest consumer market in Europe within 10 years, global players cannot afford to ignore the region – creating a fertile environment for potential trade sales as these companies seek to acquire local market leaders.

Conduct thorough due diligence. A rigorous due diligence process is critical to identifying successful investment opportunities and discovering potential issues that can be either remedied or avoided. In addition to assessing the legal and financial risks associated with the target business, be sure to conduct thorough tax due diligence. During the course of the due diligence process, ensure that the target company has no outstanding tax liabilities which will cause problems for the business going forward and, if any such liabilities are outstanding, rectify them prior to investment or insist on appropriate indemnity protection in the deal documentation.

Invest through an offshore holding company. Structuring your investment through an offshore holding company increases the likelihood that your negotiated rights will be enforceable. Because of their beneficial tax treaties with Russia, Cyprus, Luxembourg and the Netherlands are frequent choices. These jurisdictions have robust bodies of corporate law and flexible forms of companies.

Restructure the target group (if necessary). Investing through an offshore company will provide you with a basis for enforcing your rights. However, for tax reasons and otherwise, Russian holding structures frequently resemble an inverted family tree, comprising a series of sister companies and affiliates owned directly or indirectly by the founders. To ensure that your governance and economic rights reach all parts of the target group, it is often necessary to restructure the business to provide for a vertical holding structure whereby each subsidiary is wholly-owned, directly or indirectly, by the top-level holding company in which you are a shareholder.

Govern your agreements by English law. Used in combination with an appropriate offshore company, governing your agreements by English law can dramatically increase the chances that your rights will be enforceable. Be sure, however, that your counsel works with an adviser from the applicable offshore jurisdiction to make sure that the English law agreements do not conflict with any mandatory provisions of local law.

Conform the organisational documents to the shareholders agreement. Incorporate the provisions of your shareholders agreement, to the extent possible, into the organisational documents of the offshore holding company and the Russian subsidiaries. The benefit of including these features in the articles and charters is that, while a violation of the shareholders agreement is a breach of contract, subject to the remedies available under the governing law of the agreement (i.e., damages), a violation of a company's constitutional documents can be grounds for invalidation of the action itself. Moreover, it is critical to push down corporate governance rights to the operating companies of the group.

Maintain control over your investment proceeds. Require that a person you appoint, typically in the role of CFO or financial controller of the company, has signature authority over disbursements above a pre-agreed threshold. This control may overlap with your veto rights over the approval of the business plan and other major decisions.

Use investment tranches or ratchets. For greater downside protection, inject capital in stages, with each tranche subject to achieving

FINANCIER WORLDWIDE corporatefinanceintelligence

REPRINTED FROM:
SEPTEMBER ISSUE 2011

certain targets. Alternatively, use ratchets to reallocate shareholdings if certain milestones are not met. Traditionally, this requires the company to issue additional shares but note in certain offshore jurisdictions this may run afoul of 'financial assistance' rules.

Negotiate the ability to replace senior management. Lastly, push for the ability to replace the CEO and other senior management if certain KPIs are not met. While difficult to negotiate, this can be the most effective way to right the course of an underperforming company.

Christopher Rose is a partner at Squire Sanders.
He can be contacted on +44 (0)20 7655 1000 or by email: christopher.rose@ssd.com