Better than Her Reputation? A Closer Look at Russia's Private Equity Landscape

Understanding Russia has consistently proved elusive for international private equity investors. This atypical BRIC has been plagued with more bust than boom cycles of late, leading investors that had flocked there in 2007 to rush for the exit at the height of the global financial crisis. Today, the fundraising environment continues to be challenging for most Russia-focused GPs, but a recent upturn in investment may signal the beginning of a return to the pre-crisis mentality.

Institutional investor interest in the country is low—according to the annual *EMPEA/Coller Capital Emerging Markets Private Equity Survey*, Russia has ranked at the bottom of all emerging markets in terms of investment attractiveness for the past three years. However, market participants assert that global impressions of Russia are not aligned with reality. This article aims to address this perception gap by taking a closer look at Russia's private equity environment in the context of its macroeconomic fundamentals. We in turn examine the primary sources of capital most likely to contribute to the growth of the asset class in the near-term.

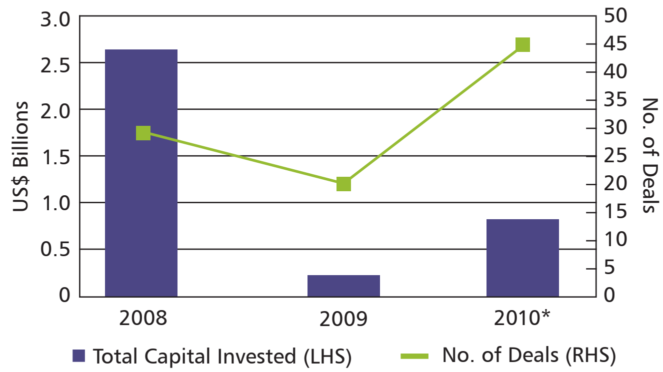
The Macro Story

It's a commonly held opinion that Russia has not kept pace with its BRIC counterparts. Russia's GDP fell nearly 8% in 2009 compared to flat growth in Brazil and stellar growth in China (9.2%) and India (5.7%). The country's reliance on income from oil and other natural resources has been a cause of concern for investors, as has the disappearance of short-term financing. According to UNCTAD, foreign direct investment fell by greater than 40% between 2008 and 2009 to just under US$40 billion, where it remained through 2010.

The Russian government has been forceful in its response to the crisis, replacing lost foreign capital with its own. The global surge in oil prices also helped, and as a result, the country's GDP growth rate rebounded in 2010 to 3.7% and is anticipated to reach 4.5% in 2011. The near-term outlook for Russia is brighter than it has been for a while—Bank of America Merrill Lynch declared in December 2010 that Russia's equity market would be a top performer in 2011, while UNCTAD placed Russia in the top five priority host economies for foreign direct investment through 2012. Furthermore, Russia's long-anticipated accession to the World Trade Organization (WTO), if successful, will open up a number of opportunities via greater access to global markets.

A bigger picture view of Russia's economy is in fact fundamentally positive. According to Michael Calvey, Founder and Senior Partner at Baring Vostok Capital Partners (BVCP), "All

Exhibit 1: Russia Deal Value & Volume by Year, 2008–2010



*Data as of 31 December 2010.
Source: Emerging Markets Private Equity Association.

emerging markets have good and bad aspects to their investment story. We are clearly in a cycle in Russia where investors are focusing on the negatives and ignoring many positives. For example, in relation to the other BRICs, Russia had the fastest growing economy in dollar terms over the last 10 years, was the best performing stock market, and is the least indebted. While investment cycles can result in asset prices moving above or below their fair value, the thing that really drives long-term investment returns is portfolio company revenue and profit growth, and this has been consistently strong over most of our 17 years in Russia."

Doing Business in Russia

Russia has not been able to shake the image of a business environment fraught with challenges, including corruption, bureaucracy, weak rule of law and poor infrastructure. Transparency International's most recent Corruption Index placed Russia in 154th place out of 178 countries. On issues such as starting a business, paying taxes and obtaining permits, the World Bank's Doing Business 2011 report ranked Russia in 123rd place out of 183 economies. From a private equity perspective, the Global Venture Capital and Private Equity Index, sponsored by IESE Business School and Ernst and Young, gave Russia an attractiveness score of 51.1 (out of 100), placing it 41 out of 80 surveyed countries, in its 2011 edition.

Regulatory treatment of the asset class is murky—private equity is lumped in with other financial products such as mutual funds and venture capital. However, Dr. Reinhard Kohleick, Managing Partner at Quadriga Capital Russia, argues that, although perhaps cumbersome or incomplete, legislative frameworks for administration and structuring of private equity instruments do exist in Russia, unlike in some emerging markets. Further, Dr. Kohleick points to the equitable treatment of offshore funds, something not common in all markets. "Offshore funds don't have to contend with any investment caps or restrictions—they get comparable treatment to that of a typical Russian investor, with the exception of investments related to areas deemed to be of national strategic importance—and these restrictions apply to all types of investors. As such, private equity firms are in no better or worse position than anyone else doing business in Russia."

Efforts underway to introduce greater legislative transparency include a number of important laws in the area of capital markets that are aimed at investor protections and greater alignment with international legislative practices. Other initiatives include an insider trading law that came into effect in January 2011 and amendments to the Russian Securities Market Law that permit the flotation of foreign securities on Russian exchanges.

Many market participants argue that the drawbacks associated with investing in Russia, far from unique, are faced by investors in all emerging markets. Chris Rose, Partner at global law firm Squire, Sanders & Dempsey, notes, "The funds we work with in our day-to-day practice don't view corruption, property rights and political intervention as their leading concerns—they are thinking about the trustworthiness of a counterparty or the credibility of a business plan, which are typical questions for all GPs regardless of where they invest." Rose observes that the issues depicted in the press are not top of mind for many funds active in Russia, as they know how to manage these risks. "The greater issue is one of perception for investors outside the market who can't get their head around these challenges," he notes.

A Post-Crisis Revival

Home to US$2.6 billion in investments in 2008, Russia saw private equity investment activity take a nosedive in 2009, with only 20 deals valued at US$217 million (see Exhibit 1). Only a handful of new fund managers, unhindered by issues with existing portfolio companies, executed any deals during this time period. However, 2010 showed signs of recovery via an upturn in deal value and volume with 45 deals totaling US$816 million (see Exhibit 2).

What are the factors contributing to the recent resurgence in investment activity? Squire Sanders' Chris Rose points to a stabilizing economy, aided in part by government policies, that led to greater confidence that "a second shoe was not going to drop. While valuations didn't come down as low as people had hoped, they did reach levels that people felt were more realistic. Private equity funds that were sitting on a lot of dry powder were eager to get back into the game."

At the height of the crisis in 2009 and 2010, most fund managers sat out the market, waiting for valuations to fall. Squire Sanders' David Wack, Partner, reflects on this quiet period: "The pool of potential portfolio companies in Russia was quite limited. Most investible businesses were asking for excessively high valuations that just weren't warranted given the general economic climate. There was also a prevailing sense that a good, solidly-run company would be in a position to manage its cash flow and not need a white knight investor to come to the rescue. Today, with commodity prices rising and growth stabilizing, the economy has found its footing, and as a result, valuations are coming back in line with expectations."

Exhibit 2: Sampling of Recent Investments in Russia

Fund Manager, Co-investors	Company	Sector	Trans. Value (US$m)	Trans. Date	Equity (%)
Almaz Capital Partners	Alawar Entertainment	IT	3	Feb-10	23
Baring Vostok Capital Partners	ER-Telecom	Telecom	80	Oct-10	10
General Atlantic	Kaspersky Lab	Computer Software	200	Jan-11	20
Macquarie Bank / Renaissance Capital	Brunswick Rail Limited	Railways	125	Dec-10	16
Russia Partners	Skolkovo Innovation City (Inograd)	Telecom & Internet Infra	250	May-10	N/A
TPG Capital	VTB Group	Banking	100	Feb-11	N/A
UFG Private Equity	Russian Towers	Telecom & Internet Infra	30	Feb-10	N/A
Venture Investments & Yield Management (VIYM)	Agro-Alliance	Agribusiness	N/A	Jul-10	N/A
VTB Capital	Brunswick Rail Limited	Railways	30	Dec-10	7

Source: Emerging Markets Private Equity Association.

Along with a convergence in price expectations between buyers and sellers, a less competitive environment is making it easier for PE investors to get deals done. "Pre-financial crisis, the biggest competitor to private equity in Russia was the local capital market—there were a lot of high net-worth individuals with risk appetites," remarks Henry Potter, a Partner at fund of funds manager and advisor Alpha Associates. "Many of these providers of capital were, in the end, cyclical investors and many have since disappeared. In contrast, private equity funds are unleveraged and can invest throughout the cycle—as long as the GPs have the stomach to do so."

A Fundraising Drought

Despite signs of a more fertile investment environment in Russia, fundraising remains sluggish. In 2007, fundraising surged to US$1.8 billion with participation by many first-time funds.[1] In the slowdown that followed, total funds raised fell from US$880 million in 2008 to only US$75 million in 2010 (see Exhibit 3).

A resurgence in fundraising is not expected anytime soon, as most GPs remained focused on managing their current portfolios. Quadriga Capital's Dr. Kohleick notes, "There has been little movement by market participants in terms of substantial fundraising in Russia over the last 18 to 24 months. It's not uncommon for Russian private equity managers to have at least one problem child in their portfolio, and the main focus of the industry right now is dealing with these portfolio company issues."

[1] EMPEA fundraising statistics for Russia do not include amounts allocated to Russia by global or regionally-focused CEE/CIS funds.

Although 2010 saw little capital raised by Russia-dedicated funds, a handful of GPs will be in the market looking to raise money in the coming year. Alpha Associates' Henry Potter points out, "In many ways, the Russian market is underserved by private equity, so there is plenty of room to launch new franchises. However, given the state of mind of investors today, it seems unlikely that a new wave of Russia-focused funds will be launched in the short-term."

Where are the LPs?

According to the annual *EMPEA/Coller Capital Emerging Markets Private Equity Survey*, international institutional investors have ranked Russia and the CIS region as the least attractive emerging market for GP investment for three years running. In 2011, only 20% of surveyed LPs indicated a desire to begin or expand investing in Russia over the next 1–2 years, versus 45% in China, 41% in India and 48% in Brazil (see Exhibit 4). The major hurdles deterring investors from Russia were cited as political risk (63%), challenging regulatory and tax issues (30%) and a limited number of established GPs (25%). For the near-term, money may be scarce for new Russia funds aside from a few distinct sources of funding, namely international financial institutions, local investors and the Russian government. Below is a closer look at each of these investor groups.

The Cornerstone Investor

In tough economic times, private equity fund managers often look to the international financial institutions (IFIs) to step up to the plate and help fill the fundraising gap, and IFIs are expected to remain the industry's cornerstone investor throughout 2011. However, the list of IFIs from which Russia-focused fund managers can choose isn't terribly long.

Exhibit 3: Sampling of Firms Investing in Russia

Fund Manager	Fund Name
Alfa Capital Partners	Alfa Private Equity Partners LP (2006, US$200m)
Alpha Associates	Alpha Russia & CIS Secondary Fund (Raising)*
Baring Vostok Capital Partners	Baring Vostok Private Equity Fund IV (2007, US$1.1B)
East Capital	Special Opportunities Fund II (Raising, US$130m)
Marshall Capital Partners	MarCap II (2008, US$176m)
Mint Capital Advisors	Mint Capital II (2005, US$130m)
New Russia Growth (NRG) Private Equity Advisors	Volga River Growth Fund (Raising, US$250m)
Quadriga Capital Partners	Quadriga Capital Russia PE Fund II (2006, US$136m)
Runa Capital	Runa Capital Seed Fund (Raising, US$72m)
Russia Partners	Russia Partners III (2008, US$626m)
UFG Private Equity	UFG Private Equity Fund II (2009, US$225m)
United Capital Partners	UCP PE Fund II (Raising, US$250m)
Venture Investments & Yield Management (VIYM)	VIY Growth I LLP (Raising, US$100m)
VTB Capital	VTB Capital Growth Fund I

*Fund of funds, excluded from EMPEA fundraising statistics.
Source: Emerging Markets Private Equity Association.

International Finance Corporation (IFC), one of the largest investors in emerging market private equity funds, has shifted its geographic strategy over the last six years. While Russia represented IFC's single greatest country exposure as of the end of 2004, a greater focus on Asia and Africa resulted in investment in Russia falling to fourth place by June 2010. Similarly, Russia accounted for 6.6% of the funds portfolio of U.S. development finance institution Overseas Private Investment Corporation (OPIC) through fiscal year 2009, down from 15.3% historically. Furthermore, the fact that Russia does not participate in the European Investment Bank (EIB) means managers are not eligible for that funding program.

Currently, the European Bank for Reconstruction and Development (EBRD) stands out as the largest and most active institutional investor in the region, with cumulative private equity commitments to CEE and CIS funds topping US$3.2 billion across 125 funds over the last 15+ years. Throughout the global financial crisis, EBRD continued to actively evaluate new fund managers in Russia. In fact, while EBRD has made a few recent commitments to the region, including their cornerstone commitment to Alpha Associates' Alpha Russia & CIS Secondary fund, much of the Bank's time today is spent working with first-time funds to shape their investment teams and strategy before an official fundraising launch.

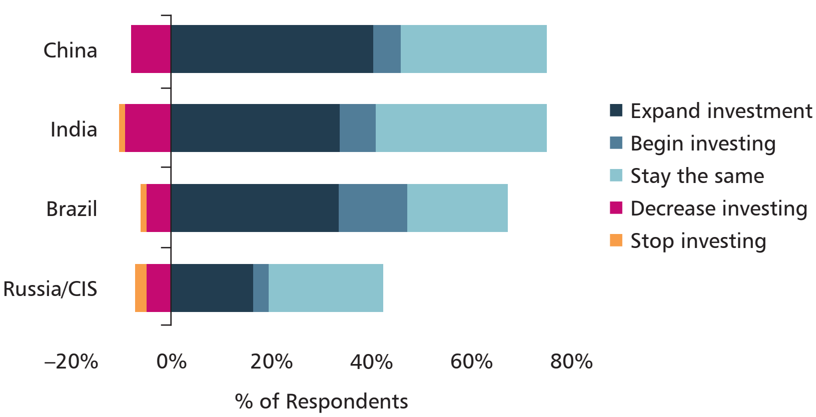
Funding from Within

The remarkable accumulation of local wealth in recent years may translate to a substantial source of funding for Russia's private equity industry over the next decade. Some of Russia's remaining oligarchs and high net-worth investors are already active in private equity, but further growth of a domestic funding base is predicated upon a greater understanding of the asset class among the broader investor community, as well as changes to current regulatory hurdles that hinder local institutions and individuals from investing in private equity. In particular, legal restrictions prohibit most Russian investors from investing in offshore vehicles—a serious impediment given that so many funds have offshore structures.

Russia's pension funds have historically focused on liquid securities—none invest in private equity today. Many pension fund programs are newly-created, so the amount of total capital available to invest remains small—in fact, too small relative to the average minimum ticket size for a private equity fund. Russian pension funds are also required by law to publish annual performance results. Andrey Nikitchenko, President of one of the leading non-governmental pension funds Stalfond, notes, "We have chosen not to build up our expertise in private equity just yet, as the pressure to report strong annual returns limits our ability to invest in such a long-term asset class. If pension funds were able to collectively move away from this short-term focus on returns, our fund would likely invest up to 3% of our assets in private equity."

Separately, the country's asset management companies and financial institutions have begun to invest in the asset class, but face similar roadblocks as pension funds. According to Managing Partner of New Russia Growth (NRG) Alexander Abolmasov, "While raising capital for our Volga River Growth Fund, we received a great deal of interest from domestic commercial banks. However, regulations imposed by the Central Bank and the Federal Financial Markets Service currently make [it] complicated for Russian banks to invest in offshore vehicles, thus creating a major impediment for private equity investors. So you have to use derivatives to structure the investment, [which] results in additional costs and time."

Exhibit 4: LPs' Planned Changes to EM PE Investment Strategy Over the Next Two Years



Source: 2011 EMPEA/Coller Capital *EM PE Survey.*

Government Support

With twin goals of cultivating a domestic technology industry and drawing greater foreign investment, the Russian government has become one of the most promising sources of funding for Russia-focused GPs. One platform created to support these goals, the state-owned Russian Venture Company (RVK), was launched in 2007 as a venture capital fund of funds with authorized capital of US$983 million. To date, RVK has backed 12 funds.

More recently, the government announced that it was establishing a US$10 billion fund to invest alongside foreign private equity players. In reaction to the initiative, BVCP's Michael Calvey comments, "It is an encouraging sign that the Russian government recognizes private equity as an attractive investment class. In comparison to foreign portfolio investment, private equity is stickier and can bring more to a country than just pure capital. This positive attitude contrasts sharply with the anti-private equity regulatory mood currently found in North America and Europe." However, he cautions, "Of course, this initiative will be complicated and difficult to implement on actual deals, so it isn't clear how successful it ultimately will be."

Other industry programs aimed at encouraging domestic private equity and venture capital include state-backed RUSNANO, which is focused on commercializing development in nanotechnology; and Skolkovo, a high-tech research hub located outside of Moscow, established to encourage greater collaboration between the government, private sector and academia in fostering innovation.

Making the Case

Available performance data suggests there is a case for Russian private equity investors' ability to deliver returns that outweigh the risks. EBRD's portfolio shows five-year returns for Russia/CIS investments at 32.3%, versus 20.6% from the Cambridge Emerging Markets PE & VC Index, both as of December 2009 (see Exhibit 5).

Andreas Boesenberg, Deputy Head of Private Equity and Special Situations at VTB Capital, remarks, "When you look at the return data from EBRD and Cambridge Associates, Russia always comes up on top of these lists vis-à-vis Eastern Europe or other BRIC countries. So this begs the question—why aren't more people flocking to Russia and putting money into the country? One key reason is visibility. LPs are not seeing these exits as the data over the past four years in Russia has been very thin. I believe the industry will produce some great exits in 2011, which will lead to a resurgent interest in Russian private equity."

A continuously improving economic outlook, a wider pool of mature fund managers and greater availability of exit information will certainly resonate with investors over time, helped along by concerted efforts from the local industry. Groups such as the Russian Private Equity Initiative (RPEI) are lobbying for necessary regulatory changes at the government-level and promoting greater standards of professional conduct at the fund manager-level (see Exhibit 6 for more details). With luck and hard work, leadership from the local industry combined with positive fundamentals will narrow the persistent gap between perceptions and the reality of the opportunities awaiting investors in Russia.

Exhibit 6: The Russian Private Equity Initiative (RPEI)

The Russian Private Equity Initiative (RPEI) is a group comprised of 16 private equity fund managers and service providers formed in mid-2010 to promote the asset class both domestically and abroad. Currently in the process of being registered, RPEI aims to be the voice of the industry. The primary goals of the Initiative are to:

- Raise awareness of private equity among Russian institutional investors;
- Create a more favorable legal environment for raising capital, investment and management of private equity domiciled both in Russia and other jurisdictions;
- Promote Russian PE in the global LP/GP community and enhance its market position among other emerging economies; and
- Set standards of professional conduct in corporate governance, reporting and SRI, improving industry-specific business education and professional qualifications.

Exhibit 5: EBRD Net Horizon Returns (as of 31 December 2009) (USD)

	One Year	Three Years	Five Years	Ten Years	Since Inception
EBRD Private Equity Portfolio (All Funds)*	6.4%	5.2%	25.0%	16.9%	12.3%
Cambridge Emerging Markets VC & PE Index**	8.3%	3.5%	20.6%	15.0%	N/A
EBRD Portfolio Breakdown:					
Central and Southeast Europe	1.5%	8.6%	20.5%	14.6%	11.0%
Russia/CIS	16.7%	0.6%	32.3%	20.1%	13.7%

Source: European Bank for Reconstruction and Development.
* EBRD tracked portfolio pooled end-to-end return, net of fees, expenses, donor grants and carried interest. Excludes property funds, and includes liquidated partnerships.
** Pooled end-to-end return, net of fees, expenses, and carried interest. The "Since Inception" figure represents the net pooled IRR since inception for funds formed between 1980 and 2009.