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The Russian Private Equity sector in the aftermath of the current economic crisis

by

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Executive Summary

How has the modern financial crisis impacted Private Equity sector in Russia? This thesis argues that although the implications of the global economic recession on Russia are significant, in certain ways more so than for the Western economies, nevertheless, the Private Equity industry in Russia might be developing in a way different from other areas of the financial sector.

The thesis looks into the current economic environment in Russia describing the causes and implications of the modern economic crisis and outlining the consequences for different sectors of the economy. It further provides Private Equity definitions and theory and discusses the Modigliani-Miller theorem of irrelevancy of capital structure.

The analysis is based on a series of interviews with Private Equity professionals that provided data to determine what place the Private Equity sector occupies in Russian economy in the aftermath of the crisis and what are the trends forward in the context of a recovery process.

The findings demonstrated that Private Equity sector was not as substantially affected by the modern economic crisis, relative to the many other financial sectors. The thesis concludes that the Private Equity investors in Russia would not be taking a very pro-active role in the short-run coping with the immediate effects of the crisis, such as a scarcity of leverage and lengthened holding period in portfolio companies, as well as with the region-specific challenges. In the longer-run, however, the PE business would benefit from improved financial system regulations and more professionalised business community in the country where the growth potential is anticipated in consumer-oriented industries targeting the emerging Russian middle class.

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Foreword

This thesis is written as part of the International Business Master of Science programme at the Norwegian School of Economics and Business Administration NHH in Bergen.

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Finally, I owe an unstinted thanks to my mother for everything.

Oslo, 2010

Anna Markina

1. Introduction

"*As the global economy works its way to recovery, the roles that we play for our clients become even more important as companies and investors position themselves to emerge stronger following the crisis*"

Goldman Sachs 2009 Annual Report (published 7 April 2010)

This chapter explains the purpose of the thesis and provides an overview of the research scope. It also presents the background behind the choice of geographical area of Russia. Some statistics from the international and Russian private equity markets are included.

After years of growth, private equity firms are experiencing a decline in the value of companies they own as industries are faced with more and more challenges. These difficulties are a result of the credit crisis and the slowdown in the global economy.

Most economies have been hit hard by the recession. This meant lower returns for Private Equity investors as well. Leverage became more and more limited leaving fewer possibilities for closing the deals unless it was for the all-equity transactions.

Worldwide investment activity is certainly slower as the banking systems are being changed, regulations becoming stricter and lenders being extremely careful. However, according to some experts, Private Equity investments are expected to be one of the ways for many industries to get out of the current difficult situation. According to them, certain countries (or better, industries) are already starting to pick up, although not at a fast pace.

Experts see different scenarios on how the private equity sector in different regions will be affected by the global economic downturn. It is clear that the industry activity in Western Europe and the US has been practically frozen since half-a-decade with very few firms and funds reaching a deal or actually getting deal opportunities. These companies used to operate in the times of easy access to debt. Adapting to the changing environment fast enough proved painful and difficult for most of them.

However, some regions were better positioned than others in the hard times. Russia gained advantage via the fact that it was hit by the crisis wave later than some other countries. This left it time and evidence to be more prepared for what was coming. Russian Private Equity firms are benefiting from the region’s adaptability and historic lack of dependence on leverage to make deals happen. That being said, the country certainly did not escape the global crisis and is without a doubt faced with many difficulties in the economic and financial spheres.

Given the peculiarities of the business environment and the crisis development in the region, this paper examines the effects of the global economic distress of 2008 on Private Equity investments in Russia.

Purpose of the thesis

To date, there is an extensive amount of research available on the topic of modern financial crisis and the economic recovery measures and forecasts. A certain amount of research was performed on the role of alternative investments in the current global economic slowdown. It is clear that while some traditional corporate finance practices and instruments will never be the same after the crisis, the situation with the alternative capital is somewhat different. In fact, as Robert Shapiro (2009) outlines in his research, Private Equity investments did not play any role in driving the capital markets into the modern state of crisis, in contrast to the institutions that created the failed investment vehicles and in so doing triggered the deep troubles that the world economy experienced in 2008. There is research that suggests that private equity investments can also have a positive impact in the times of economic downturn and in the early recovery stages (Shapiro, 2009).

The economic crisis hit Russia very hard. Extensive measures were applied by the government to prevent some of the worst of the consequences to occur. While a lot of analysis was performed on the effects of the crisis on various areas of the world economy, as well as on the factors that are likely to influence the recovery process, there seems to be a lack of region-specific analysis on the Private Equity investments in the aftermath of the financial crisis in Russia, apart from the reports published by the investors present on the market.

The purpose of the thesis is to explore the ways in which the Private Equity industry in Russia was impacted by the contemporary financial crisis. The questions to be addressed are:

Is private equity financing a viable option for investors in post-crisis Russia?

What factors must be accounted for by private equity investors in order to achieve successful performance on the Russian market in the aftermath of financial collapse?

To address these questions, relevant Private Equity theory and literature are reviewed in Chapter Two. Private Equity definitions and an overview of investment vehicles are presented in the first of the theory sub-sections whereas the Modigliani-Miller theorem’s assumptions, conclusions and limitations are discussed further.

Chapter Three provides an overview of the financial crisis in Russia: its background, implications, anti-crisis measures implemented by the Russian state and consequences for the various areas of the Russian economy.

Chapter Four includes the sections on the methodology for data collection and discusses the limitations of research.

The description of the empirical analysis focusing on Private Equity investors' experience and forecasts about the Russian market is presented in Chapter Five. The study is based on the field research carried out in the form of interviews conducted in the spring of 2010 with venture capitalists, Private Equity senior fund managers and partners, and financial services professionals. The findings are divided into three relevant parts: current Private Equity environment, strategy for investing in Russia and trends. The Chapter further analyses and discusses the data obtained via the above methods.

Chapter Six summarises the research carried out in the thesis. It includes a conclusion and the recommendations for future research on the topic.

1.1 Research scope

The research is focused on the Private Equity investment activity in Russia after the modern economic crisis. The effect that the crisis had on the Private Equity industry in Russia is examined and a discussion on the consequences for the sector is presented.

The thesis does not aim to compare the Private Equity sector in Russia before and after the crisis although to a certain extent such a comparison is inevitable in the text as a means of emphasising the main focus of the research.

In a similar way, the thesis does not compare the effects of the Russian economic crisis of 1998 to the contemporary global economic distress.

1.2 Why Russia

The decision to focus on the geographic area of Russia was based on the general interest in the country and its development. An analysis of such a financial activity as Private Equity investments that is typically associated with advanced developed economies in an emerging country after the crisis seemed like a fascinating area of research.

Besides, the interest was born by reading articles about the way the crisis affected Russia and the way the crisis also affected the investment decisions of shifting the capital from advanced economies towards the markets that were relatively insulated from the subprime mortgage crisis and the general financial slowdown (Wall, 2008).

As Barbara Wall (2008) suggests, the investment case for Russia is strong and is backed by a number of indicators, among which are the financial sector with no exposure to subprime mortgages, highly lucrative domestic companies with about thirty per cent earnings per annum, growing middle class, low state and corporate debt levels, increasing availability of competent local managers (Wall, 2008). This leads us to believe that there is certainly no lack of investor interest in Russia.

Additionally, as Goldman Sachs, one of the very few investment banks that went through the crisis without substantial losses, states in its letter to the shareholders in 2009 Annual Report, "this will be the century of BRICs and other high growth markets" (Goldman Sachs Annual Report 2009, 2010). According to Lloyd Blankfein, the CEO of the bank, the above markets were driving the world towards economic recovery and are as ever attractive at present (Goldman Sachs Annual Report 2009, 2010). Bearing this in mind, the analysis of the situation with Private Equity investments on the market with high potential and growth proves imperative, particularly in the view of changed financial regulatory conditions.

Despite the optimistic outlook on Russia shared by some, many investors still see numerous warning signs in the market that has historically been characterized by many region-specific challenges. The worrying mood only intensified as the crisis unfolded. Taking into account the differing opinions about the Russian market in these contexts, the latter clearly presents an interesting area for research.

2. Theory and frameworks

2.1 Literature review

The term "private equity" has been a highly popular topic in the world of finance since late 1980s. The widespread of Private Equity was preceded by the Leveraged Buyouts (LBOs) boom in the 1980s whose influence was particularly prominent in the US (EVCA, 2004). The activity saw upsides and slowdowns, striving through the dot-com bubble in 2000s and overcoming the significant challenges in the aftermath of the contemporary financial crisis.
Following the relative lack of business opportunities and ventures in the crisis-ridden advanced economies (i.e. the US and Western Europe), the business community began to seek to explore the emerging markets. The extensive amount of media coverage on the topic only highlights a vivid investor interest in the private equity opportunities in the developing regions.
Private equity investments as a form of FDI are not a new concept for the Russian market. Many big international players such as Delta Capital, Carlyle Group, AIG and others were already present in the region in the 1990s (Euromoney, 2003). However, these companies did not achieve the success they aspired for on the Russian market in those years. This was mainly due to the prominent lack of legal regulation and the non-transparent unlawful practices – some companies were involved in very publicly scrutinised law suits and business disputes scandals at the time. Moreover, Russia was going through a transition period emerging from over a half-a-century restrictive political regime and therefore could not fully satisfy the need for local managers with the required internationally recognised level of education (Euromoney, 2003). The 1998 crisis and the devaluation of the rouble in Russia accelerated the process and by the end of the 90s most foreign PE firms abandoned their investment plans due to high risks and unfavourable business conditions.
In 2001-2003, Russian political and economic environment began to change dramatically under the new President, Vladimir Putin. Improved financial stability and somewhat better securitised legal framework provided by the new government along with the followed steep GDP growth helped Russia regain the investor confidence (Euromoney, 2003). The attractiveness of the market was also fuelled by its ‘undervalued assets’, as described by Mr Bougrov (2003) from Interros, a major Russian private investment company, for Euromoney. While the number of blue chip companies in Russia is relatively low (just above 30), there are

many smaller privately-owned businesses that continuously require financing (Bougrov, 2003).

According to Sarah Lacy in the Business Week (2009), a challenging environment that the modern financial crisis resulted in is not necessarily bad news for venture capitalists. She argues that past experiences and wrong decisions undertaken by the investors might lead to an emergence of stronger industry players (Lacy, 2009). The comeback of the latter can be attained via either innovative new ways to generate returns or by shifting the focus to emerging markets**.**

There are possibilities for private equity, as a method of business financing, to maintain its role in the changing environment nowadays. Sylvia James in Business Information Alert (2008) suggests that while there are areas of private equity that were directly and fully affected by the credit crunch, there are also those that prove resistant to the unfavourable economic conditions and might in fact thrive during these times, irrespective of the location (James, 2008).

LBOs or Leveraged Buyouts are the types of Private Equity investments that will suffer (and so far already have suffered) the most from the current crisis (James, 2008). This is mainly due to their dependence on the collateralised loan obligations CLOs packages created by the investment bankers that were in the heart of the crisis. Once the nature of those neatly 'packaged' loans was unveiled, the LBO type of financing came to an end (James, 2008). James predicts that this trend will continue until another type of loan financing for such deals appears. The two areas of private equity that will survive and in a way benefit from the crisis times are: Management Buyouts MBOs and distressed assets and vulture funds (James, 2008).

2.2 Limitations of Data Collection

The data available on the topic is however limited and some bits of it could be a challenge to obtain. *Private Equity* firms and funds are not legally required to disclose the information about their performance and returns. This means that to a certain extent, the expert estimations are a speculation. Emerging markets is arguably a very challenging area to obtain accurate data on and *Russia* is in no way an exception to this. Although there is a lot of press coverage and studies of the *economic crisis*, it remains a very recent phenomenon and its end as well as its consequences is yet to be experienced in the future. However, the combination of both national and international sources with the knowledge gathered by the independent institutions and academic research provides a basis for realistic estimations and forecasts.

Academic research on the topic of private equity in Russia is relatively limited, compared to the extensive literature available on other, more traditional, investment practices and financial instruments. There is however a substantial amount of publications in the media covering this subject, although still limited with regards to Russian geographic scope. Certain analysis was not conducted in Russia and it is therefore problematic to attain a completely adequate picture based on insufficient statistical information. The reliability of the domestic sources can be questioned due to the public communications regulatory policies in Russia.

The most reliable sources are the publications by the Private Equity institutions and associations, among which are the European Venture Capital Association EVCA, the Norwegian Venture Capital Association, as well as by international institutions with interests and activities in Russia, such as the Organisation for Economic Co-operation and Development OECD, European Bank for Reconstruction and Development, the World Bank and others. These sources were extensively used for the research for this thesis.

2.3 Theoretical framework

2.4.1 Private Equity Definitions

As a means of introduction, let us begin with a brief overview of the industry.

Companies raise finance for their activities from the capital markets by raising debt or issuing equity. The return on a loan depends on the interest rate and the possibility of default. Equity returns depend on the probability and growth of the company. From an investor's perspective much of the discussion about equities focuses on shares quoted on public stock markets. However, a proportion of equity capital is unquoted[1].

The European Venture Capital Association EVCA (2010) provides the following formal definition of Private Equity:

Private Equity is the provision of equity capital by financial investors – over the medium or long term – to non-quoted companies with high growth potential (EVCA, 2010).

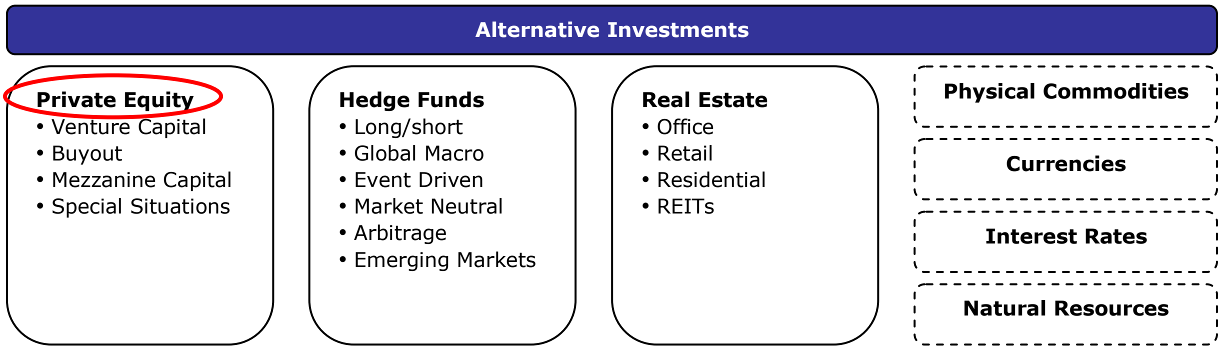
[1] Merill Lynch Investment Managers Limited, 2000. *Private Equity Investing, Overcoming the Information Gap.* 2000 [Brochure] London: Merill Lynch Investment Managers Limited

Private Equity investing may broadly be defined as "investing in securities through a negociated process" (EVCA, 2010). The "negociated process" means that the rapport between investors and the businesses they are working with is narrow. The majority of Private Equity investments are in unquoted companies[2]. Private equity investment is typically a transformational, value-added, active investment strategy.

Private equity is often categorized under the umbrella of "alternative investments", comprising in reality a variety of investment techniques, strategies and asset classes that are complimentary to the stock and bond portfolios traditionally used by the investors (EVCA, 2004).

The chart below shows the components of alternative investments universe and the place that Private Equity occupies in it.

Figure 1. Alternative Investments (Source: EVCA, 2004)



Private Equity can be used with the purpose of developing new products and technologies, to expand working capital, to finance acquisitions, or to strengthen a company's balance sheet. It can also resolve ownership and management issues. A succession in family-owned companies, or the buy-out and buy-in of a business by experienced managers may be achieved using private equity funding[3].

Private Equity investments are typically divided into *several types* based on the ways they drive the reasons that would encourage investors to invest in a company[4]. For the purpose of this paper, six main fund types are identified and described below. These six broad types have their subcategories and own dynamics and differ throughout.

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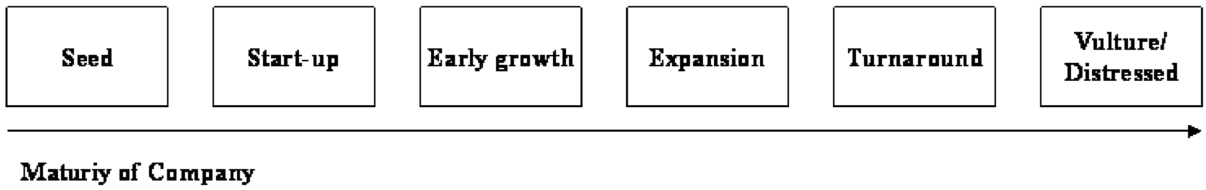
[2] Bance, A., Why and How to Invest in Private Equity. Special paper, an EVCA Investor Relations Committee Paper, 1 March 2004

[3] European Private Equity and Venture Capital Association EVCA. Glossary of Private Equity Terms

[4] Caselli, S., 2008. *Quest for Money: an Overview of Venture Capital and Private Equity.* [Lecture], York University, September 2008

The graphic below demonstrates the distribution of the types relative to the maturity of a portfolio company. The illustration is based on a framework developed by EVCA (2009).

Figure 2: Classification of private equity funds according to the maturity of a company (EVCA, 2009).



The types with certain similar characteristics can be categorized under three broader clusters.
Venture capital ("business of building businesses" – EVCA, 2009) is typically focused on the first three early stages of a firm maturity. The emphasis is therefore placed on the entrepreneurial endeavors and companies that are in the process of developing their products.
In the *Buyouts* category ("buy and build strategy" – EVCA, 2009) the concentration is on the existing companies that often require a restructuring process.
Distressed financing is typically classified under the *Special Situations* category.

Let us briefly describe each fund type.
Seed financing is financing of a research project that is aimed at generating ideas and outputs that can be transformed into products.
The typical target sectors are pharmaceuticals, chemicals, biomedicine and Information Technology. The research area's focus is on producing goods.
Start-up financing is defined by the EVCA (2009) as financing for product development and initial marketing. This includes the companies that are in the process of establishing the business or those that have been in the business for a short period, but have not started selling their products or services in the market and are not yet generating profit (EVCA, 2009).
Early growth financing and *expansion capital* have a number of similarities. In both cases the company is established and is generating output. The difference is in the timing of an investment.
Turnaround financing comprises approximately fifty per cent of the world market of private equity investments and can be divided into two groups: buyouts and acquisitions, where the intervention of private equity is focused on buying a specific company; and corporate

governance deals, where a private equity firm invests in a company that does not in fact need cash.

Vulture/distressed financing is a cluster that is currently experiencing an increase. This type of Private Equity financing is directed towards companies that are still afloat but are encountering difficulties, or towards the firms that failed.

2.4.2 Modigliani-Miller Theorem

The Modigliani-Miller theorem has been linked to the investor choice to allocate to Private Equity. It is therefore interesting to look at its basic assumptions and limitations.

The Modigliani-Miller theorem, otherwise referred to as the Irrelevance Proposition, states that in perfect capital markets the capital structure of the firm is irrelevant (Surhone et al, 2010).

In its original form the theorem developed by Franco Modigliani and Merton Miller in 1958 assumes that in perfect capital markets and in the absence of taxes, the capital structure of the firm (i.e. the debt to equity ratio) does not affect its market value. In their article "Cost of capital, corporate finance and investment theory" (1958) Modigliani and Miller formulated their basic model of corporate financing.

The theorem of Modigliani-Miller is based on the assumption that individual shareholders have access to the same capital market as the firm does. This means that within its portfolio of assets the firm can independently find the right balance between profits and risk, which saves the firm the necessity of decision-making in the financial sector in order to adjust its preferences for different shareholders' requirements. Modigliani-Miller claimed that corporate managers best serve the interests of their shareholders when they simply seek to maximize net income of the company, by resorting to maximize the market (exchange) value of its shares. The company shall not reduce risk through diversification of its shares if the shareholders can do it themselves by their own choice of portfolio investments.

Another theoretical assumption of the theorem is the one that states that the firm and shareholders are rationally organized in perfect markets. The theory further argues that a rational investor's focus when making financial decisions is only on the expected profit of the company. The size and structure of its equity do not matter. Popularly explaining the results derived by the model, Miller cited as an analogy an assertion that the size of the pie can not be changed by using various methods of cutting. We shall discuss further in this chapter the shortcomings of the theorem that explain why this approach cannot be fully applied to the capital structure of a firm operating in the real world that is influenced by a plethora of external factors.

The formal proof of the theorem is based on the consideration of the arbitrage processes (simultaneous purchase and sale of shares bearing identical risk levels with differing prices). The independence of the value of the company from its capital structure is due to the impossibility of existence of the firms identical in the degree of risk and operating profit in an equilibrium situation, but with an uneven market price. The availability of overpriced shares on the market encourages investors, who know that these stocks will not further rise in price, to sell them, investing in shares of undervalued companies – and thus receiving the arbitrage income. These arbitrage transactions would take place and be beneficial to the investor as long as the price of the overvalued stocks does not decrease and the price of the undervalued ones respectively does not increase. In equilibrium (in case of no possibility for arbitrage transactions), the market prices of the two given firms are to become equal regardless of the structure of their capital.

The Modigliani-Miller approach is set for a perfect market and can be regarded as paradoxical for a real economy. Indeed, the size of the pie is not affected by the way it is cut, but the real "corporate pie" does not only consist of stocks and bonds but also includes tax payments. It is in favor of tax payments that the stock share of the pie is cut out. The model unifies the concepts of in-house financial leverage and private leverage. This unification can take place when the possibility of bankruptcy is not accounted for. The personal risk taken on by an investor, who finances a firm using financial leverage, is limited by the deposit size. In case of bankruptcy of the firm the investor has nothing to lose, but his investment (a contribution, share or equity mean a limited liability for an investor). Another situation occurs when the investor personally borrows money, i.e. bearing an unlimited liability, or when firms conduct arbitrage operations. Raising debt capital for firms and individual investors has different costs.

The first publication by Modigliani and Miller was followed by a 1963 article 'Dividend policy and market valuation" (Modigliani et al, 1963). This later version of the theorem assumes that under certain conditions of perfect capital markets, but with the levying of taxation on companies, the capital structure affects the value of the firm: the higher the proportion of debt financing, the higher the value of the firm.

In the 1966's "Some estimates of the cost of capital in the electrical industry" (Modigliani et al, 1966), Modigliani and Miller formulated the two so-called Irrelevance Propositions using the basic model. The first Irrelevance proposition argued, firstly, that the choice between financing the company by attracting equity capital or by bank credit does not affect the market valuation of the firm (expressed in the form of its shares), nor does it affect the average capital costs. Secondly, it demonstrated that the expected profit on the company's shares (and hence the cost of equity) increases linearly with the ratio between the obligations of the company and the relationship between securities and fixed income capital of the company. That relationship was described as a "leverage effect".

The second Irrelevance Proposition argued that under the same assumptions, the dividend policy pursued by the firm does not affect its market valuation (i.e. pricing of its shares on the stock exchange). This provision is formulated by Modigliani and Miller more intuitively rather than basing on a strict calculation of time, although in practice the ratio of dependent variables in the theorem is not as simple as it might seem at the first glance. MM also showed how different types of taxes affect the relationship between the structure of the share capital of the company and its market price, considering the indirect effect of taxes through the formation of equilibrium prices in financial markets.

Modigliani - Miller theorem: conclusions and limitations

The conclusion that can be drawn from the first original version of the theorem is the following: in the absence of taxes, the market valuation of the firm does not depend on the amount of debt (Surhone et al, 2010). The optimal capital structure is not achieved.

The main content of the later developments of the theorem of Modigliani-Miller can be summarized as follows: if there is an optimal equity structure and dividend policy, i.e. if the capital structure and dividend policy affect the market price of the company, it is the result of the impact of taxes and other similar manifestations of market imperfections (Brealy, 2006).

Further we shall discuss the shortcomings of the theorem and its application to transactions taking place in real economy.

First, the approach of Modigliani - Miller does not account for the agency conflict between managers and capital owners. This reflects in managerial reluctance to take on greater responsibility for raising capital under fixed percentage condition. The subject of Corporate Governance has been a raising issue in the Private Equity sector and this link has been researched earlier (Pound, 2000).

Secondly, the theorem does not take into account the direct and indirect costs of bankruptcy because they do not exist in a perfect market. Shareholders with increasing debt are forced to account for financial and bankruptcy risks. In addition, the owners of the debt are the first to receive funds owed to them; in the second round the costs of valuations and judicial procedures incurred in the acquisition of another firm or assets sale are being repaid. In perfect capital markets, bankruptcy costs are null. Assets are sold at their market price which is defined by possible cash flows for the new owners.

The real capital market is imperfect. In the case of bankruptcy, the owners of the capital incur costs. The more rapidly the bankruptcy process unfolds, the greater the direct costs are. Total bankruptcy costs exceed direct costs by an amount of implicit losses that the shareholders are also bound to sense by the speed of the devaluation of the firm's shares (deterioration of firm's reputation, loss of business contacts and potential new investors).

In the case of Venture Capital as well as any other real economy-driven business relations, markets have numerous imperfections. Therefore, due to these imperfect markets, what matters in this industry is the security design. In other words, funding and investment decisions are not independent of each other (Bienz, 2008).

Limitations for the application of theoretical framework

The topic of this thesis is of a high practical application. The theoretical frameworks described in this chapter must be of great consideration and are advised to be reviewed by investors engaged in the Private Equity sector; however, due to the specifics of the industry as well as to the research scope of this thesis, the analysis of the data can be performed rather independently of the theory the application of which proves difficult. Nevertheless the strengths and weaknesses of the theoretical views presented above are a helpful way to gain a more profound understanding of the Private Equity investments.

3. Financial crisis in Russia

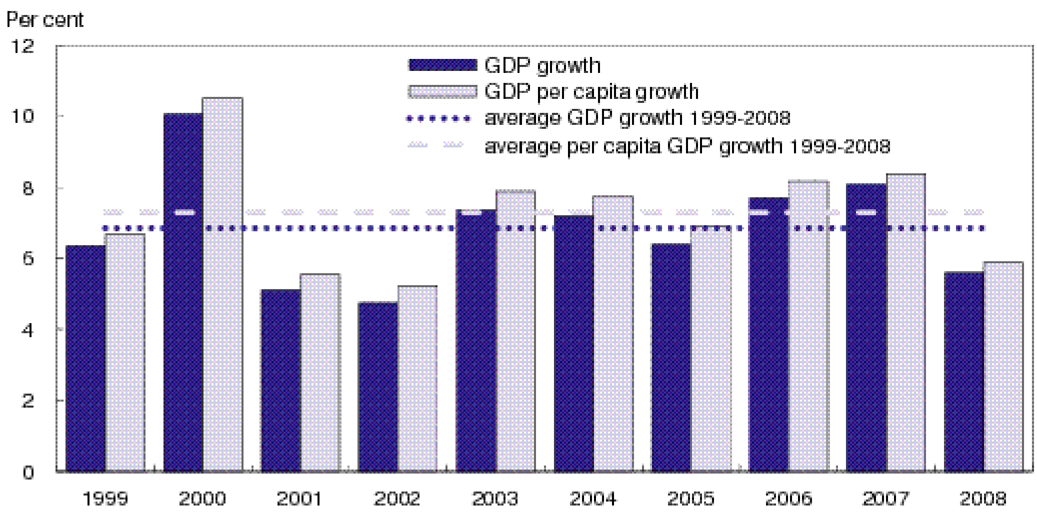
3.1 Background

The unfavorable situation in the U.S. economy affected the rest of the business world, and Russia is no exception. The modern global economic distress hit Russia very hard. Although the country still sustained some growth and adequate position during 2008, the followed decline was severe and led to a state of deep crisis.

Let us briefly look at the development of Russian economy prior to the global economic recession of 2008.

In the period between the Russian economic crisis that hit the country in August 1998 (during which the devaluation of the ruble occurred and the state defaulted on part of its debt) and the global collapse that unfolded in the very early September 2008, Russia demonstrated impressive economic growth with the real GDP figures practically doubling (OECD, 2009). Other socio-economic indicators equally improved during that decade. The Organisation for Economic Co-operation and Development that monitors countries' development and strategies emphasized in the case of Russia a strong growth in total factor productivity, a steep increase of real wages and a sharp decline in unemployment and poverty levels recorded in Russia in the time between the crises (OECD, 2009).

Figure 3. Real GDP growth in Russian Federation (1999-2008) (OECD, 2009)



In the aftermath of the 1998 default, the Russian federal government applied measures that led to a nearly complete refund of the country's public debt. At the same time, foreign capital accounted for up to thirteen per cent of GDP by the end of 2008 (OECD, 2009). OECD in its Economic Survey of the Russian Federation particularly highlights the transformation of the government finances: improved macroeconomic policies and structural reforms, combined with growing international energy prices and low interest rates in developed countries – these actions and external factors contributed to adequate growth figures in the mid-2008 (Policy Brief, OECD, 2009).
So what are then the reasons for Russia's economy becoming so vulnerable to the crisis wave hit? As we shall see below, the economy was most heavily impacted by the impossibility of obtaining cheap foreign loans on the interbank market combined with a decrease in exports.

Amid an outstanding economic performance in the preceding decade, research demonstrates that the factors that contributed to that growth were mostly transitory. This meant that sustaining the same growth levels was no longer possible when in the summer 2008 the world experienced a decline in the oil and gas prices, from US$ 150 down to US$ 40 per barrel. Energy (oil and gas) is of paramount importance for the wealth of Russia, therefore a decline in its prices has greatly reduced income from its exports. The effect that this sharp decline had on the Russian economy was aggravated by other events as well. Similar steep declines in the prices of other export commodities, discontinued access of developing countries to the international capital markets and the world trade crisis (that shook Russia's exports of metals and natural gas) were among the external factors.
Internally, currency fluctuations and insecurities about domestic banks exacerbated the effect that a decrease in international energy prices had on the Russian economy (OECD, 2009). The stock market had an immediate and harsh reaction to the events that took place over the year as well. Not only did the growth of stock indices, RTS and MICEX, stop in May 2008, but they also set to decline. Overall, to date the indices fell by 70%. According to many publications, disagreements on some policy views between Russian and the West are to blame. The Georgian-Ossetian conflict that unfolded in August 2008 gave rise to confrontations between Russia and Western countries and caused the outflow of foreign capital from the country. Some Western economists, however, tend to see the reason for this is not so much in the hostilities, but in an earlier scandal involving an energy company OAO TNK-BP and a coal producer OAO Mechel (Goble, 2008). There, Western and Russian managers also had differing views on governance. Although most of these conflicts have been

resolved, the attitude of the West to Russia changed in many ways which caused the stock market to suffer numerous losses.

3.2 Implications

In this sub-chapter, let us describe what implications the crisis had on certain specific areas of the Russian economy and society. Some of the effects of the financial crisis can be already observed today, while others Russia has yet to encounter.

<u>Devaluation of the ruble</u>

Today, in addition to a decline of the stock market, one can see the depreciation of the ruble in relation to major world currencies - the US dollar and euro. The devaluation of the ruble is a reality, although it is not as severe as it was in 1998. In general, there are expectations of an overall decline in incomes amid rising prices for goods and services.

<u>Industry and employment</u>

The impact of financial crisis in Russia itself was felt by nearly all enterprises, in particular those whose activities are export-oriented. Even the largest of the companies have introduced numerous investment programs with the goal to in all possible ways reduce their budget spending. The latter could if not properly addressed in turn entail mass layoffs and job cuts.

<u>Banking system and consumer deposits</u>

With regards to the banking system, banks have introduced stricter requirements to potential borrowers by raising interest rates on new loans and by liquidating many mortgages and consumer programs (e.g. unsecured and interest-free loans).

As Sergey Mironov (2010) states in an article for “Banking Review”, the state nowadays strongly supports the banking services sector, realising its great significance for the country (Mironov, 2010). Nevertheless, some small regional banks were not able to avoid collapse. As Roman Dusenko (2010) – the president of a regional KubanBank point out, he main forces of the government are concentrated in maintaining the largest and most important financial institutions, that are primarily state-owned (Dusenko, 2010). The most significant event that took place in the aftermath of the crisis is the consolidation of the banking sector in Russia. The Central Bank of Russia introduced the new (elevated) minimum capital requirement

(MCR) for new and established banks in order to achieve this consolidation and reduce the number of small and regional players (Dusenko, 2010).
As Alexander Murichev (2010) from the Russian Union of Entrepreneurs and Industrial Workerst states for the “Banking Review”, it is evident that the most delicate question for many Russians today is the safety of their savings (Murichev, 2010). However, for most of the citizens there should not be any particular reasons of concern on this account, because if the bank is part of a deposit insurance system (and this is the case in most institutions), then all savings of up to seven hundred thousand rubles are guaranteed to be secured.

Real Estate

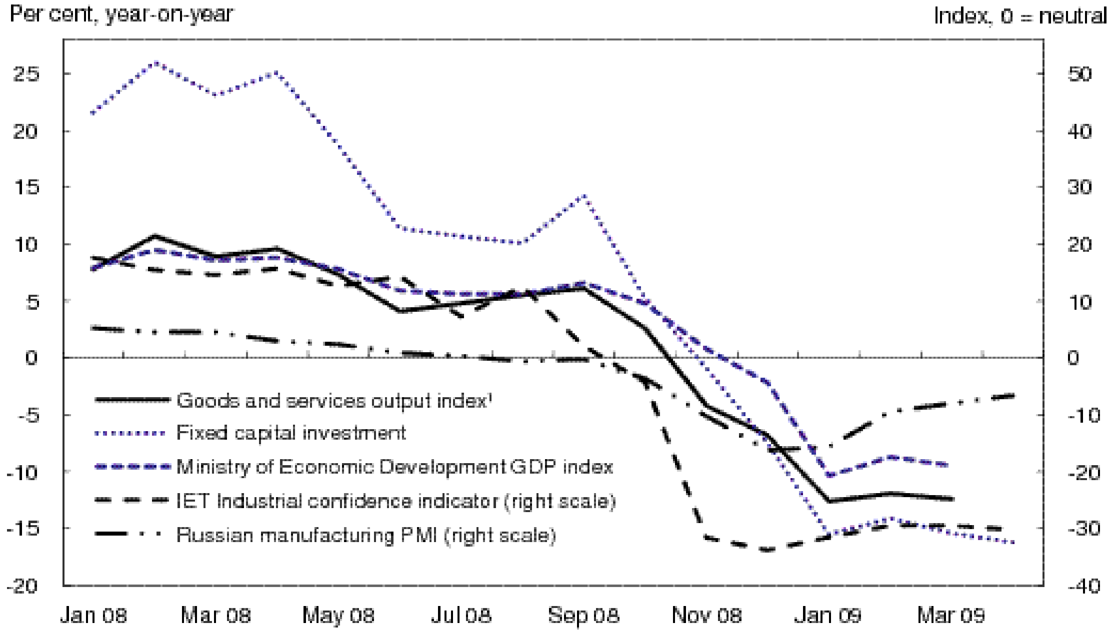
Prices for land and real estate have also changed in the direction of a decrease. But soon enough the financial crisis in Russia played a positive role in this segment by protecting the real estate market from collapse by artificially inflating the value of properties and its continuous growth.

Positive effects of financial crisis

Amid a clear tendency towards unfavorable effects, the crisis also brought in some positive moments.
In the industrial markets, it was the so-called "natural selection". Only the most viable companies with strong policy management remained afloat. Similar firms that were unable to survive the competition were forced to leave the market. In the context of survival in the competitive environment, a reduction in the prices for certain goods and services occurred, which certainly is another positive development. The examples are: petrol, land, real estate. The crisis led to a natural market pricing. Additionally, as a general rule, access to the forefront of domestic producers is regained in the economies that struggle to fight recession.

The graph below provides a general overview of what areas saw a decline and how rapidly they were influenced by the economic collapse in Russian Federation.

Figure 4. The consequences of the economic crisis in Russia (OECD, 2009)



3.3 Consequences for Russia

The Russian state's response to offset the effects of the crisis was rapid and involved an extensive use of the significant resources that the government achieved access to following the ongoing fiscal and balance of payments surpluses: the country's banking sector received injections of cash and capital while deposit insurance limits were lifted (OECD, 2009).

There is an extensive amount of publications, both in Russia and abroad, discussing the projections of how the situation is going to develop into the future. Having studied some of it, the conclusion is that building a uniform prediction as to how long and how severe the crisis will be is difficult. Opinions and forecasts differ greatly. Some experts, such as Flexography (2009) predict extremely serious consequences of the crisis for Russia. Others, however, believe in a relatively speedy recovery of the Russian economy. Despite the undertakings by the Russian government to offset the recession, most of the analysis and sources are now consistent in the view that the crisis takes a tougher toll on Russia and that its effects were initially underestimated by many. It is now univocal that the modern downturn is going to be severe and long-term. Also, there seems to be some uniformity in the view that the situation should gradually improve after the start of 2010. Accurate forecasts at this point appear difficult, because as according to research by Troika Dialog (2009), the outcome will depend on many factors, and on actions by all countries, but also on how well Russia develops cooperation with the European Union and other states (Troika Dialog, 2009).

3.4 Post-crisis environment and regulations

The time after the crisis resulted in increased government controls in nearly all investment-related areas in Russia. The changes concerned regulations for both inward and outward investment policies, corporate social responsibility in conglomerates and other big enterprises, as well as the product market regulations. All of these are bound to affect foreign investors. Due to the complex legal structure of private equity investments, improved regulations in the investment sphere will have an impact on their further development in Russia in the times during and after the crisis.

The Russian government introduced a set of new laws that ensure state controls over the country's economic performance. The OECD (2008) sees the new regulations as affecting the system and as being relevant for Private Equity investors going into Russia (for a complete list of regulations see Appendix 2).

In addition to the newly regulated financial system and the banking sector, there is a number of developments to be seen in the nearest future as Russian economy emerges from the crisis. Russian GDP growth is expected to rebound in 2010. Despite a reduction in wage growth, consumer demand is expected to remain strong. Import substitution which occurred after the 1998 crisis is expected to favour lower priced domestically produced goods in 2010 and subsequent years.

4. Data

4.1 Methodology for data collection

Since the research is based on gathering and understanding the information regarding funds' strategy for investments in Russia, a qualitative approach has been used. The companies for the interviews were selected based on their Private Equity investment activity in Russia. The EVCA member directory was used to obtain a list of Private Equity companies and other financial services companies that allocate to Private Equity with investment activity in Russia. Several companies were added to the list based on earlier knowledge of their active business in Russia. The research sample contains the biggest players that have Private Equity investment experience in Russia before and after the modern economic crisis, both foreign and domestically founded. Interviews have been conducted with each company's senior representative, since we believe that these persons are determining the strategies and directly influencing the decision process for the operations of their firms in Russia. Since the main focus of the research is on the consequences of the crisis and market trends forward and not on specific fund's performance, the research sample companies were selected irrespective of whether the fund makes direct investments or acts as a fund of funds manager and such.

Nine organisations were contacted by phone or email. The challenge was to get hold of the people who are directly working with the Russian Private Equity sector and are a position that allows then to determine the strategy for the firm. The number of companies is limited as the goal was to interview the biggest players on the market. Another limitation to adding a wider range of firms (particularly domestically founded) is that there is no possibility of finding out their contact data as they are not members of or the contacts are not disclosed by the Russian Venture Capital Association and other sources. Furthermore it should be noted that the total number of companies investing in private equity in Russia is lower compared to Europe or the US.

Further data analysis is based on the responses received from five companies that returned the questionnaire. Towards the end of the research process two more respondents returned the questionnaire the results of which were not included due to time constraints. The response rate above fifty per cent provides enough material to make comparative and analytical research and draw the conclusions.

The respondents were asked to fill out a questionnaire composed of three parts: current PE environment, strategy for investing in Russia and trends forward. The interviews were semi-structured, meaning that in the process of the dialogue/correspondence, the questions could be altered depending on the respondents' input. The interviewees were allowed to speak freely, even though the main questioning line had to be followed in a chronological order. The interviews were conducted in the period between April-June 2010. The companies interviewed asked to treat the information gathered confidentially. This requirement is therefore fully accounted for in this thesis. Disclosing the confidential information would not have altered the findings or conclusions in a significant manner. For a complete questionnaire, please refer to Appendix 1.

In addition to the interviews, the research relies on the statistical sector-specific data obtained via ThomsonOne database. The database was recommended by a number of investment banking professionals. The focus of the data collection lies in gathering the statistics on the Private Equity transactions in Russia in order to combine this data with the interviewees input on specific funds. A wider data range allows for clearer view on developments and forward trends in the sector.

4.2 Data sources

The following companies were interviewed for the research for this thesis:

CapMan Russia Fund, Moscow, Russia

CapMan is one of the leading alternative asset management companies in the Nordic region and Russia. It has approximately $3.5 billion of capital under management via its funds. The company was founded in 1989 and is organised into six investment areas, among which is CapMan Russia fund that targets mid-sized companies operating in Russia.

EBRD Equity Funds, London, UK

The European Bank for Reconstruction and Development is an international financial organisation that provides support to projects in the countries ranging from Central Europe to Central Asia. It is a single largest investor in the region. EBRD Equity Funds target investments such as business start-ups, expansion capital and acquisitions. The Bank's activities are primarily aimed at promoting entrepreneurship and encouraging a transition towards adequate market economies in the region.

Troika Capital Partners, Moscow, Russia

Troika Capital Partners is an alternative investments branch of Troika Dialog – a Russian investment company founded in 1991. It has a leading position on the Russian financial services market. Its activities include operations on the capital markets, asset management, private banking, commercial banking and Troika Capital Partners – an alternative investment division that comprises direct investments and venture capital businesses.

Aurora Russia Fund, London, UK

Aurora Russia Limited is an investment fund that specialises in investments in the rapidly growing sectors of Russian economy. The fund targets small and medium-sized businesses in the financial and consumer-oriented sectors.

Storebrand Private Equity, Oslo, Norway

The Storebrand Group is a leading Nordic financial institution that provides services in the spheres of pensions, life and health insurance, banking and asset management. As part of its investment portfolio, Storebrand asset management allocates to Private Equity.

EastCapital, Stockholm, Sweden

EastCapital was founded in 1997 and is an independent asset manager based in Stockholm with focus on the Eastern European financial markets. Its Russian Property Fund within the Private Equity division specialises in investments in the real estate sector in Russia.

Baring Vostok Capital Partners, Moscow, Russia

Baring Vostok Capital Partners is one of the pioneers on the Russian market of Private Equity. It has been specialising on investments in Russia and the CIS region since 1994. Through its funds, the company currently has $ 2 billion in assets under management.

4.3 Credibility of the research findings

Data collected via interviews represents the respondents' view on the market. All of the interviewed companies conduct extensive market analysis, some to a much greater extent than the others. The data gathered through interviews is more credible in cases where the respondents presented the views shared by a group of colleagues, often those directly responsible for the market analysis. It is less credible where the answers were given based purely on one individual's evaluation of the market and forward trends making the responses more speculative. It is however nearly impossible to make a clear distinction between the two approaches to answers as this is based only on individual's choice.

The overall level of data credibility is high due to the fact that all of the interviewees are directly and actively involved in the Russian PE operations of their firm and therefore have the most unmediated views on the market there are. This is particularly important for the sector of Private Equity and the regional focus on Russia, due to the overall limited data availability in these areas (as discussed earlier).

ThomsonOne is a reliable source of information on the transactions that take place within the set sector and country.

4.4 Limitations of data collection

The data obtained through questionnaires needed to be limited to the non-disclosure conditions that the funds apply to the potentially sensitive information communicated externally. Therefore in many cases the results could not be quoted in a straightforward fashion, were required to be aggregated without being identifiable or specifically quoted. This does not represent a significant constraint for the research but does somewhat limit the discussion.

Another limitation is that a small number of funds that were approached with the questionnaire did not revert.

ThomsonOne is a trustworthy information source for the US and Western European markets where one can be certain to obtain reliable information on the researched criteria. The availability of the data for the Russian market can be a challenge for some research criteria as the primary sources are less reliable than in the former regions.

5. Findings and analysis

5.1 Overview of the findings

Earlier chapters discussed the background, Private Equity theory, theoretical framework and methodology. This section is focused on providing the overview of the data obtained via interviews. The data collected is captured as follows:

5.1.1 Current Private Equity environment

Reasons for investing in Russia

For the majority of the respondents the main reasons for investing in Russia are higher returns and unexploited opportunities provided by the Russian market. The absence or lack of professionalized Private Equity community as opposed to Western economies was indicated by two respondents as one of the reasons for turning to Russia. Successful prior experience, lower tax rates and few high-leveraged transactions were listed as motivators by one respondent.

Such investor reasoning demonstrates that the initial motivation to invest in Russia is typically triggered by the factors that are in abundance in Russia but are either fully absent or somewhat lacking in the developed economies. The capital flows are incentivised by the opportunities that fundamentally stem from emerging economies.

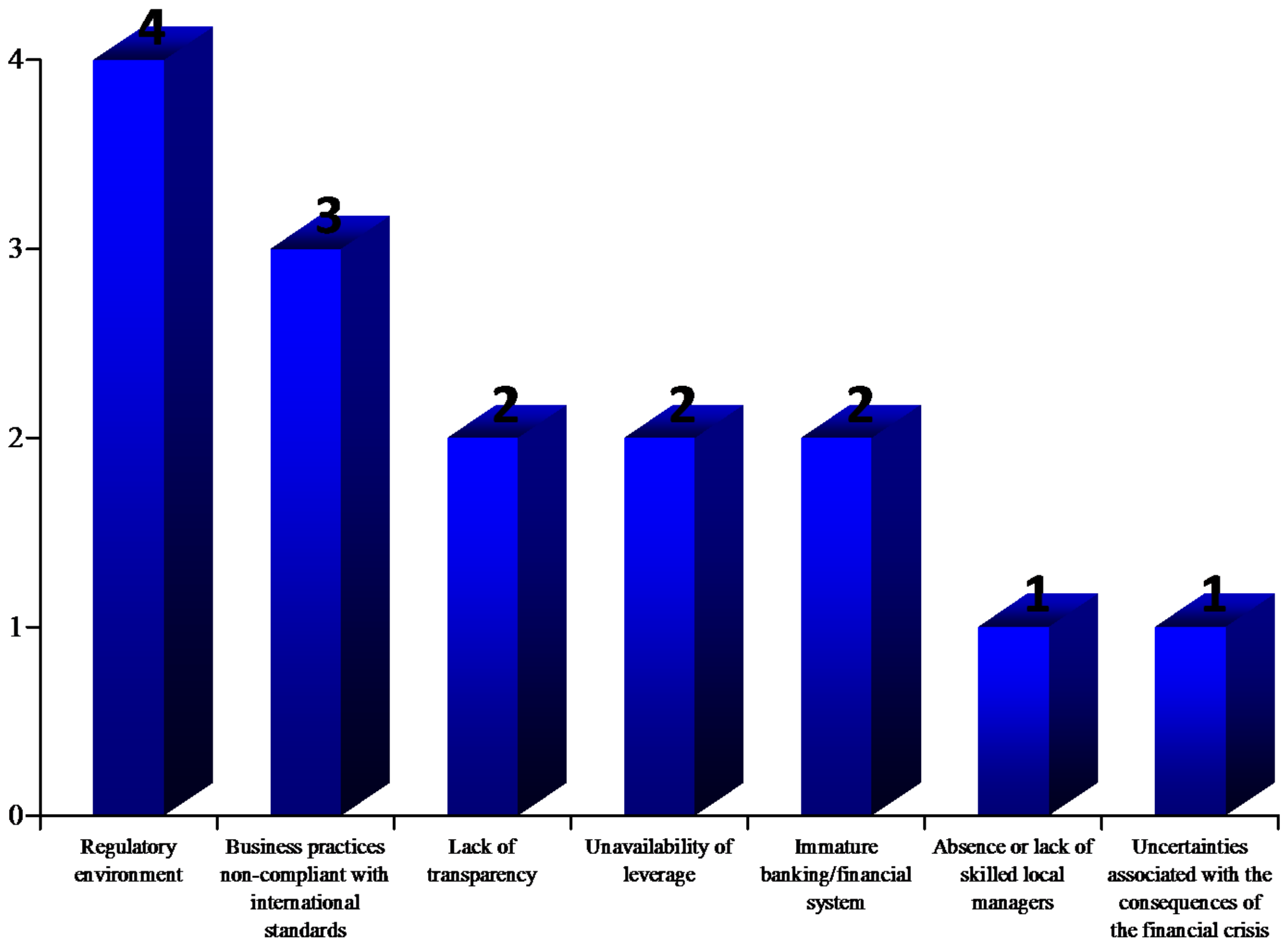
These reasons are important in order to understand the motivation for initial decision towards investments in Russia. Since all of the interviewed companies invested in Russia prior to the crisis, these reasons demonstrate what motivated investors to enter the region before the recent economic distress when the Russian economy was growing having recovered from the earlier Russian economic crisis of 1998. The listed reasons are not applicable to the organisations with a specific country mandate as their activities are specifically focused on Russia and CIS following the nature of business.

Reasons to remain on the Russian market during and after the crisis

The two reasons that make investors remain on the Russia market are the buying opportunities created by the global economic crisis and the network needed to gain deal access. The absolute majority of the respondents listed these two reasons. Another reason quoted was that the investor would like to further remain on the Russian market in order to take a more active role in assisting locally-focused private equity funds and in order to become more proactive in its Russian business.

Major obstacles for Private Equity investors in Russia currently

Figure 5: Major obstacles for investing in Russia. (Author's construct)



From the chart above one can see that the majority of respondents quoted the regulatory environment and business practices non-compliant with international standards as the main obstacles for investing in Russia today. Lack of transparency, unavailability of leverage and immature banking and financial systems follow suit as other negatively impacting factors. Uncertainties associated with the consequences of the modern financial crisis and absence or lack of skilled local managers were quoted as a reason by one respondent each.

From the above data one can observe the independence of the investors' decisions to go into Russia from the effects brought in by the economic crisis. The major constraints as quoted by investors are not caused by the financial crisis but are representative of the economic environment in Russia overall.

Other obstacles that were quoted by the respondents are the following: the role that the Russian government plays, the interests it pursues in the financial sphere and the necessity to implement a high risk strategy. It is important to note that these factors were not brought by the financial crisis but represent a typically quoted view on the market from the foreign investors' standpoint.

Leveraged transactions in Russia post-crisis (in comparison to prior periods)

The majority of respondents replied that the number of highly leveraged transactions in the Private Equity sector in Russia decreased after the crisis compared to prior periods. This view is not shared by one respondent who replied that no significant changes occurred to leverage situation after the crisis. This goes in line with another respondent’s quoting that Russia has not really seen any leveraged deals at all.

Number of investments before and during/after the crisis

Table 1. Number of investments before and during/after the crisis (Data obtained via interviews)

Company	Number of investments before the crisis	Number of investments during and after the crisis	Number of exits during and after the crisis	Current number of portfolio companies	Historical IRR for investments (per annum)
I	24	4	0	8	25 %
II	6	1	2	5	N/A
III	5	0	0	5	80 %
IV	7	0	0	7	N/A

Impact on the holding period

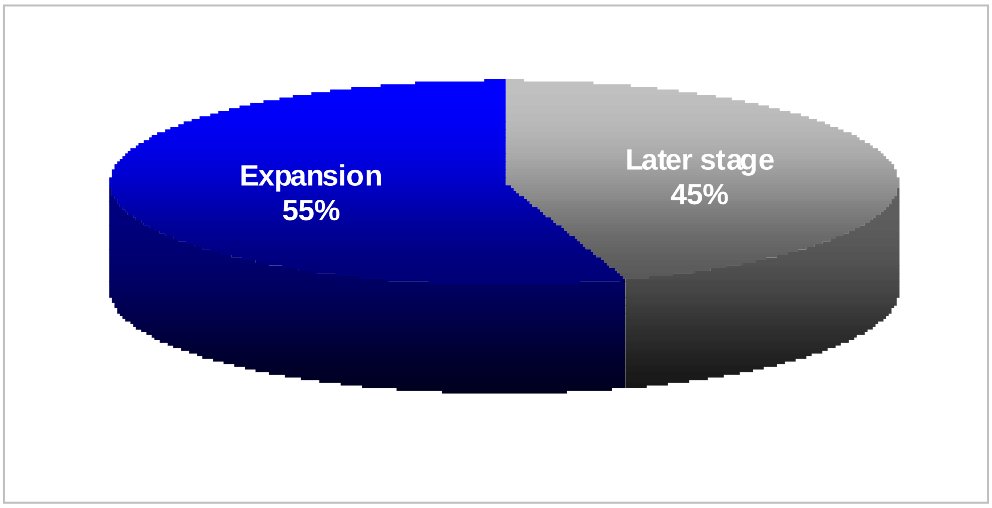
All of the respondents agree that the crisis significantly lengthened the holding period in their portfolio companies.

5.1.2 Strategy for investing in Russia

Investments in Russia by stage

The chart below shows the breakdown of private equity investments by stage. One can see that the market is dominated by expansion and later stage capital.

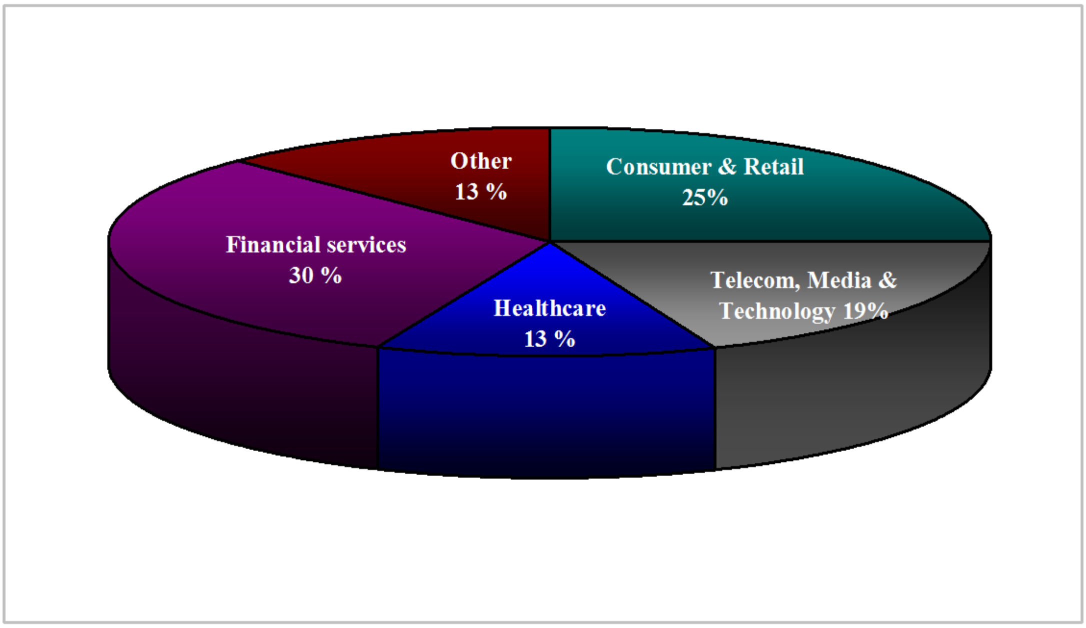
Figure 6: Investments in Russia by stage (Source: Thomson One, accessed 19 April, 2010)



Targeted sectors

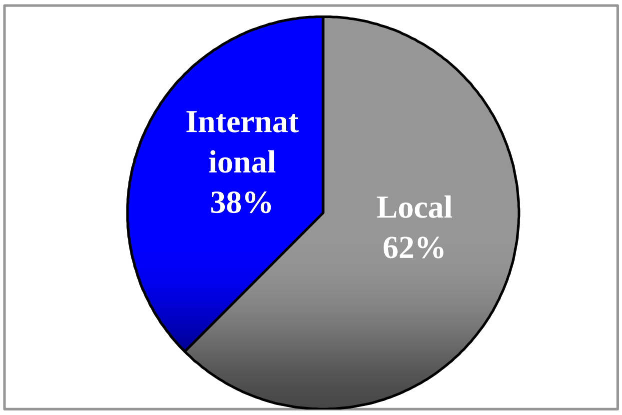
The chart below shows the distribution of sector focus for investors in Private Equity in Russia. The “Other” category comprises the Manufacturing sector and Business & Consumer services sector as quoted by two respondents respectively. It is worth noting that none of the companies focus on the Oil & Gas industry that is undoubtedly one of the strongest economic drivers in Russia. This observation will be further discussed in the analysis section.

Figure 7: Sectors targeted by companies investing in PE in Russia (Author's construct)



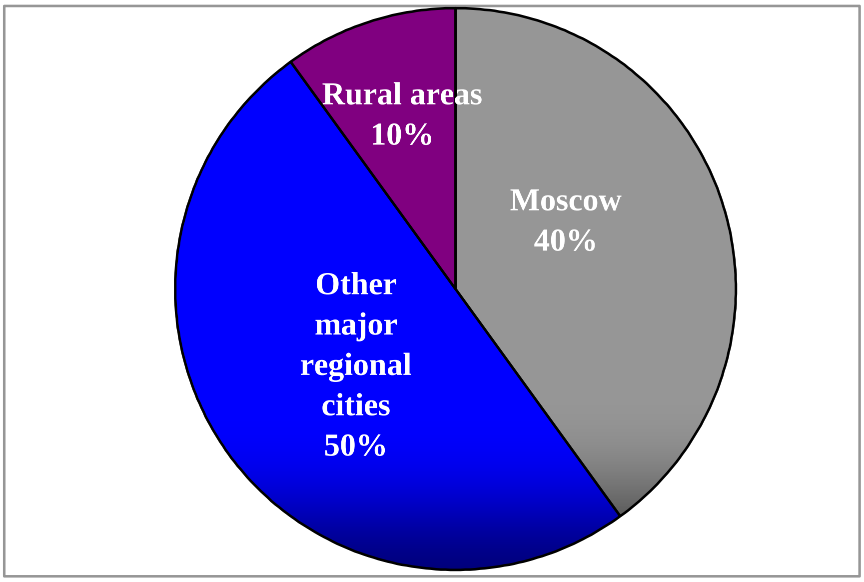
Growth potential (geographically) and focus for new investments

Figure 8: Sought growth potential in portfolio companies (Author's construct)



One of respondents commented on the growth potential geography saying that the company is looking for growth in general and does not have a specific requirement as to the local or international scope.

Figure 9: Sought growth potential in portfolio companies, internal (Author's construct)



Number of local managers in the team

All of the companies have over fifty per cent of the team consisting of employees of Russian or CIS origin.

Core competences that the company is looking for in a managerial pool

The top three important competences required by the companies are financial and operational ones and relevant network. Strategic skills and country-specific knowledge are somewhat less game changing with one to two respondents quoting those. Good track record is another quoted requirement from managers.

Factors contributing to the returns of the fund (in order of priority)

Investors see the following factors as the main contributors to the returns:

1. Terms of exit via a sale or a stock exchange listing
2. Company management competence
3. Improvement in margins of an investment target
4. Growth of investment target
5. Optimisation of the capital structure

The above factors represent the top half of the returns contribution influence. The following factors are of a insignificant importance to the returns on investment:

- brought-in management team;
- level of leverage;
- total committed capital at vintage year.

Investor involvement in a portfolio company

Figure 10. Level of team involvement (Author's construct)

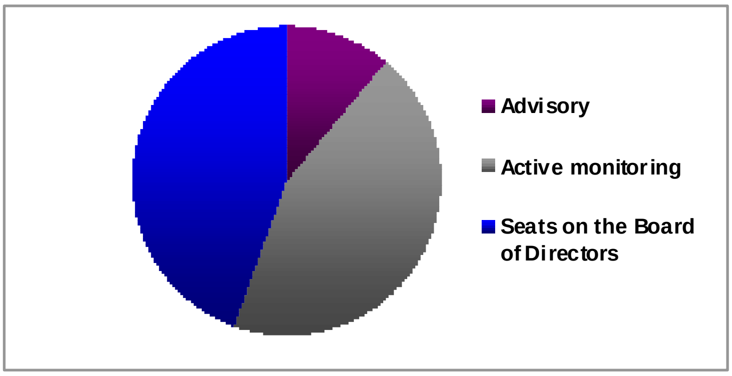
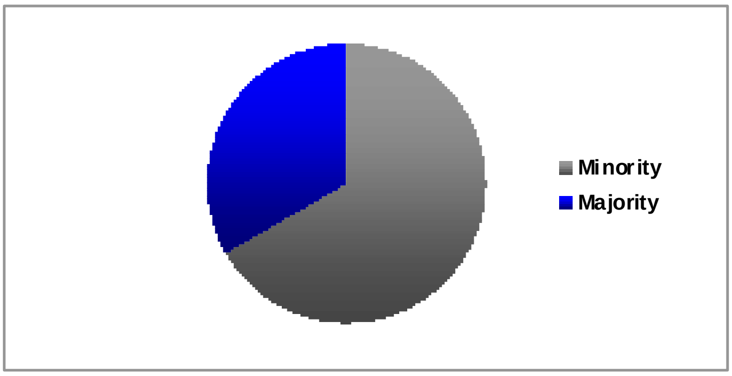


Figure 11. Stake requirement (Author's construct)



The most attractive exit routes for portfolio companies in Russia nowadays

According to the respondents, the most attractive exit route for the portfolio companies is a trade sale to a foreign or Russian strategic buyer.

The interviewed companies have not done any IPOs. However, it was mentioned that the type of company was determinant to the selection of a specific stock exchange, as well as the terms applied at the different stock exchanges.

Strategies and success factors that the Private Equity firms rely upon in Russia

Interviewed companies rely on the following strategies in their Russian activities and emphasize the importance of the following success factors (quotes by respondents):

"Finding companies that fall under the small and medium enterprise sector definition with outstanding management with good track record, with transparent shareholders, working in a sector with good growth prospects"

"For our equity funds: management teams with solid investment strategy, looking for experience that would back up the investment, i.e. a pipeline that supports the investment strategy"

"First-to-market strategy with focus on underserved sectors and based on transparent growth platforms"

5.1.3 Trends

Trends in the Russian Private Equity market mid- to long-term

As to the trends that are likely to occur on the Russian Private Equity market medium- to long-term, the respondents foresee the following to happen further:

- Private Equity backed mergers and acquisitions deals will increase from today's low levels;
- smaller unsuccessful teams will disappear;
- teams with good track-record will increase funds under management;
- development from today's growth capital focus to more buy-outs, MBOs, LBOs, mezzanine and sector-focused funds;
- increased amount of exits through IPOs.

With regards to the Private Equity business, the respondents predict that the sector will be highly demanded in Russia in the future. It is therefore expected to see an increase in the number of transactions throughout all industries with Private Equity funds participation.

As to the effects of the modern economic crisis, the respondents foresee several consequences. Firstly, the crisis made bank financing currently unavailable. Furthermore, the crisis negatively affected the real sector company financials. One of the observations is that the EBITDA of those that did not go bankrupt fell sharply. As a result, professionals forecast that in the short-term on the one hand, Private Equity funds will have limited ability to invest while on the other hand potential portfolio companies that are fundamentally strong will not be ready to accept a sale at low valuations.

Developments in the FDI inflow to Russia in the aftermath of the crisis

The development of the FDI investments has seen major adjustments for many regions in the aftermath of the financial crisis. The interviewed companies foresee the following trends in the FDI development in Russia post-crisis.

One shared view is that the FDI inflow will be depressed for a long period, excluding the oil and gas sector.

As to the viability of such investments, one interviewee noted that a lot of good companies are currently in need of new money, but as almost no bank financing is currently available they are looking for it from other sources. The respondent continued that in anticipation of economic recovery, direct investments made now may generate high returns in the future – the only question is whether low valuations will be acceptable for the real sector.

5.2 Data discussion and analysis

The analysis of the Russian Private Equity market demonstrated that the Private Equity investments in Russia are currently largely unleveraged and were unleveraged before the financial crisis unfolded in 2008. The takeaway from the conducted interviews is that the scarce capital that has been characteristic of Russian private equity market earlier has intensified since the start of the financial crisis. The market is characterised by a nearly complete absence of leveraged buy-outs.

The motivation for investing in Russia in the first place and for remaining on the market is typically triggered by the factors that are abundant in Russia but are scarce or have become scarce in the developed economies. The investors are taking advantage of the growth potential provided by on the one hand, an emerging market and by on the other hand, the current economic environment that created many opportunities. Once the companies have an established presence on the Russian market, they gain access to a valuable and mandatory business network and are therefore presented with a wider range of opportunities. A business network in Russia should not be underestimated in the way it facilitates access to the Russian market.

Although all of the interviewed companies already have a presence in Russia, the obstacles that they see on the market for new entrants and for their own operations still have to be dealt with. However, despite the difficulties that the economic recession brought to Russia, Private Equity investors do not see any of the obstacles stemming from the recent changes in the economy. The Private Equity sector is relatively unaffected by the consequences of the crisis as Private Equity was not involved in any of the factors that caused the crisis. The sector seems to be operating in a market of its own in Russia, both before and after the crisis. The current economic crisis is not seen as a reason for leaving the country. As one of the respondents stated, investors have to deal with the consequences of the crisis in Russia but it would not be different from anywhere else.

The focus area for the Russian PE market players is expansion capital for mid-sized companies operating in consumer-oriented sectors and addressing the growing demand of the Russian middle class. The companies follow a common value creation plan by selecting a well-positioned company is a growth sector of the Russian economy and acquiring it at distressed price level. Investors then proceed to improving the transparency of the company's reporting and operations and by applying their methodology in order to grow the business by working together with the management team. Companies do not necessarily require full control over the company but are very pro-actively monitoring the development and would typically request a minority stake at the time of entry.

The number of investments that was done before and during and after the crisis differs to a large extent. The number of investments during or after the crisis has fallen dramatically from earlier levels. Some companies did not invest at all, neither have they exited any of their existing investments. It is clear that the crisis impacted the operations of the Private Equity companies by lengthening their holding period, creating constraints to enter new investments and by increasing investor risk-aversion. It appears that many firms chose the strategy of focusing on their existing portfolios in the times of the crisis without looking to add new companies to the list. However, some of the interviewees stated that they do not fully quit monitoring the market for new opportunities, but their approach has become more selective in the crisis time with stricter requirements to the company and the management.

One of the most commonly recognised investment principles among a number of investors is avoiding sectors and assets deemed strategic by the Russian government. Russian economy has long been and still continues to be to a large extent commodity-oriented. Although many professionals recognised in the course of interviews that the natural resources sector (oil and gas, in particular) is eminently attractive both in terms of growth and unexplored opportunities, the common strategy is to remain "out of the radar screen" of the highest Russian instances that seem to prefer to dictate their rules in this sphere and do not tolerate external criticism and active participation in crucial decision-making processes. Many investors quoted recent events that took place on the Russian financial scene, i.e. the case of the Hermitage Asset Management firm and its involvement in the politics followed by the most dramatic outcomes. Although such investment behaviour does not necessarily characterise the Russian economic and political environment from the positive side, this however demonstrates that the number of long-term players on the market is growing and these players are making strategically correct decisions taking into account the specifics of the market. By avoiding earlier mistakes investors would avoid the costly and highly negative consequences that were seen in earlier times.

The sectors that the companies have most of their focus on are consumer-oriented areas targeting the emerging Russian middle class. There is a substantial lack of the good quality services in some areas on the Russian market. The financial services sector, various consulting and retail services can often lack quality in Russia as opposed to developed countries. Investors are targeting these sectors and in so doing are not only making a strategically correct choice for their own commercial sake but are also contributing to the development of the consumer-oriented sector of the Russian economy. This sector has many times fallen out of the attention of the Russian government due to the its primary focus on developing the commodities sector and associated industries.

In terms of growth, investors seem to focus on growth potential in general without necessarily targeting a specific geography or region. With a slight tendency towards domestic growth, it can be suggested that Russian small and medium sized companies in the consumer-oriented sector are not yet ready to expand internationally. Some of the growth is nevertheless anticipated into the CIS countries and other neighbouring states due to historically close links to Russia.

The investors are rightfully including local managers on the teams (up to over fifty per cent), confirming that local expertise is crucial in Russia. It can prove difficult for foreign investors to fully understand the processes that take place on the Russian market and in particular to see the causes of certain actions both by the real sector and the government. It is therefore essential to consult Russians familiar with the systems prior to and in the process of investing in Russia. This is also linked to obtaining the necessary network to start the business on the market and to expand the operations.

The interviews demonstrated that the current economic crisis did not lead to investors' leaving Russia completely, as it was seen during the 1998 crisis in Russia. This means that the investor confidence in the market is improved and that companies are willing to take risks associated with the Russian market even in the challenging times for the global market. It also suggests that investors analyse the market and find that the crisis might be unfolding in a different way in Russia, than it is in the other parts of the world.

From the data obtained from ThomsonOne on Private Equity market performance for the past year, one can conclude that the global financial crisis puts some institutional and private investors under pressure to prematurely sell their Private Equity investments, although well-performing, with the goal of generating liquidity or restructuring their balance sheets, as well as to reduce their liability to fund unfunded capital commitments – even to top-tier managers with excellent track records and strong high quality deal flow.

Among the comments on this point, it was noted that the impression is that although capital is needed in regions, many companies find investing there less attractive than in major cosmopolitan areas. Regional presence does on the one hand expand the scope of the business, on the other hand however, it does not provide the same advantages, both financially and logistically, as established presence in the Russian capital does, which makes such expansion less interesting for the majority of companies.

Finally, although Russia still falls under the category of high risk strategy regions, it is a wider accepted conclusion that it is necessary and possible to select transparent businesses in the country. The presence of international companies on the market forces many businesses in search of financing to review their reporting and operating principles in order to comply with the standard internationally accepted practices. This is of utmost importance in the aftermath of the financial crisis when regulations are becoming stricter. Compliance with the new norms is obligatory in order to continue working in Russia and to potentially expand to international markets.

The following chapter summarises the analysis and present the conclusions on the development of Private Equity sector in Russia after the crisis.

6. Conclusions and implications

6. 1 Implications for Private Equity investors in Russia post-crisis

The view shared by most of the respondents to the questionnaire demonstrated that it is worth taking a risk in order to invest in Russia. After several erroneous attempts to enter and remain on the Russian market, it seems that the bankers nowadays manage to find ways to overcome the challenges still present on the Russian market. Established market presence is seen as a major competitive advantage on the global scale for most of the Private Equity investors.

The crisis has without a doubt hit Russia harder than many other countries, but the Private Equity sector was not affected by its consequences to the same extent as other sectors were.

In the short- to medium-term, Private Equity companies are going to hold on to the investments they already have and the buying activity should not be expected to pick up at a rapid pace. Although the crisis created more buying opportunities, it is unclear whether the real sector companies are going to accept the lower valuations and be available for sale.

In longer-term, the market activity is expected to increase and the economic improvements are anticipated to be significant. Stronger players would emerge leaving behind small unsuccessful teams. In the future, Russia is going to see more buy-outs, both MBOs and LBOs type – which is not the case nowadays.

6.2 Directions for future research

Further research into the problems analysed in the thesis should be directed toward the analysis of the development of the effects of the global economic crisis in Russia. As mentioned in earlier chapters, parts of the analysis are limited to the information that is presently available whilst other data is an attempt at forecasting the future. Many experts agree that the crisis would have deeper effects on Russian economy than many can foresee nowadays what would require more profound analysis of its causes and consequences. As the economic recovery unfolds, it would be interesting to analyse the place of Private Equity companies in a more economically favourable environment.

Another interesting area of investigation is the role that Private Equity investments play in promoting the economic recovery. As mentioned earlier in this paper, this aspect was not taken into review but as the Russian SME sector is growing and the middle class emerges, it could be an interesting topic for further research.

Additionally, since there are a number of changes happening in Russia in the economic sphere, the investment conditions and regulatory environment might be further changing with time as well what would bring other implications for the investors. The research might extend to more legal areas as the regulatory aspect is becoming increasingly important in the post-crisis time. Given the practical application of the thesis, it might be beneficial to collaborate with Private Equity companies investing in Russia to work on a specific case study in this area.

Additionally, one might research the question of whether the development of Private Equity industry can be the nudging factor for catching up on the overall economic growth for the emerging countries (or specifically, for Russia). Often in the media and political circles, the increase in private equity activity becomes highly correlated with the technological innovation in the country. Specifically, the availability and accessibility of venture capital has been linked to the technological advancements in the US since mid-90s by the many researchers of the issue. It is claimed that easy access to venture financing encouraged innovative entrepreneurial activity in the country and promoted the rapid growth of start-up firms. That was, in its turn, followed by an increase in high tech innovation and practice[5]. The growth theory suggests that, as outlined by Karl Aiginger, ‘the medium-term growth rate of an advanced economy depends in R&D, human capital and the speed of diffusion of new

[5] Lerner, J. (Harvard University), 2010. Innovation, Entrepreneurship and financial market cycles. OECD Directorate for science, technology and industry. STI working paper 2010/3, 13 March 2010

technologies' (Aiginger et al, 2005). It is therefore interesting to investigate the development and impact of private equity on the socio-economic growth of the countries.

Finally, one may want to consider a comparison of the cases of a developed and emerging country recovering from the current economic crisis and how the respective Private Equity sectors develop in the two environments.

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Appendix 1

Anti-crisis measures to support the banking system (Source: OECD, 2009)

• Reduction of reserve requirements 18 September and 18 October, boosting bank liquidity by approximately RUB 400 billion.

• Auction of government deposits to banks. Originally RUB 1.1 trillion, later expanded 30 to RUB 1.5 trillion.

• Increased CBR repo transactions, beginning in September 2008. Average amounts increased roughly five-fold after early September, peaking in late-January 2009.

• Permission for CBR to extend uncollateralised credit to banks with designated credit ratings. Amount extended rose to RUB 1.9 trillion in February 2009.

• Amendment to 2008-10 Budget to allow government to deposit money from National Welfare Fund with VneshEconomBank (VEB), which is to buy back shares of enterprises controlled but not wholly-owned by the state, up to RUB 75 billion in 2008 and RUB 175 billion in 2009.

• Set-aside of USD50 billion to help companies (via VEB) refinance foreign loans falling due. USD12 billion used by end-2008.

• Permission for CBR to compensate banks for losses on interbank loans through end-2009.

• VEB authorised to provide subordinated loans of RUB 450 billion to banks other than Sberbank, with CBR authorised to provide up to RUB 500 billion to Sberbank.

• Acquisition (via VEB and state-owned enterprises) of failing private banks (Globex, Kit, Sobinbank, Svyaz).

• Raising of deposit insurance limits to RUB 200 000 from RUB 100 000, and at 90% up to RUB 700 000 from RUB 400 000.

• Raising of interest rates paid to banks by CBR on deposits.

• Restarting of CBR 90-day repos, after earlier being discontinued for lack of demand.

• Amendment of 2008 Budget to provide for capital injections of RUB 200 billion to the Deposit Insurance Agency (in order to allow it to restructure or liquidate failed banks) and RUB 60 billion to the State Mortgage Agency.

• Guarantee by State Mortgage Agency of mortgage bonds and lending, up to RUB 500 billion.

• Recapitalisation of RosSelkhozbank (agriculture bank) and RosAgroLeasing.

• Government guarantee of bank loans to corporates, up to 70% of loans; amount available RUB 300 billion.

• Announcement of further possible injections of capital into banks, up to RUB 1.4 trillion.

Appendix 2

Questionnaire

Norwegian School of Economics and Business Administration
Bergen, Norway

Master of International Business

Questionnaire for MSc Thesis
by
Anna Markina

Contact: +47 94 28 67 23
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Supervisor: Dr Stig Tenold

Title:
Russian Private Equity sector in the aftermath of the contemporary economic crisis

Kindly complete the questionnaire. The research is intended for academic use only.

All the information obtained via the questionnaire will be treated confidentially.
You can choose to remain anonymous.

<u>Questionnaire on PE investments in Russia before and after the modern economic distress</u>

Name: ____

Position: ____

Fund: ____

Vintage: ______

Year the Fund entered Russian market: ______

NB: the questions below make reference to your firm's investment activities in Russia, unless otherwise stated.

1. Current PE environment (please tick one or several boxes for each of the questions below)

<u>What were the reasons for your firm to first invest in Russia:</u>

☐ Higher returns

☐ Successful prior experience

☐ Unexploited opportunities

☐ Absence or lack of professionalised PE community as opposed to Western economies

☐ Lower tax rates

☐ Few high-leveraged transactions

☐ Other, please specify: ____

What are the reasons for your firm to remain on the Russian market today (during and after the crisis):

☐ Shift from commodity-driven economy to domestic industries and restructurings (and investment opportunities created in these sectors)

☐ Stabilised political environment (compared to earlier decades)

☐ Historically few high-leveraged transactions

☐ Buying opportunities created by the global economic crisis

☐ Russia's relative insulation from subprime market

☐ Network needed to have deal access

☐ Other, please specify: ____

What do you see as major obstacles for PE investors in Russia today?

☐ Regulatory environment

☐ Political instability

☐ Absence or lack of skilled local managers

☐ Business practices non-compliant with international standards

☐ Lack of transparency

☐ Uncertainties associated with the consequences of the financial crisis

☐ Commodity-driven economy

☐ Unavailability of leverage

☐ Immature financial/banking system

☐ Lack of or no access to network to enter the market

☐ Other, please specify: ____

From your experience, how have leveraged PE transactions developed in Russia after the crisis (compared to prior periods)?

☐ The number of highly leveraged deals increased

☐ The number of highly leveraged deals decreased

☐ Remained the same, no significant changes

☐ Other, please specify: ____

How many companies did you invest in before the crisis?

____

How many companies did you invest in during and after the crisis?

____

Have you exited any investments during or post the crisis? If yes, how many?

________exits

Has the crisis impacted your holding period?

☐ Yes, significantly

☐ No

2. Strategy for investing in Russia (please tick one or more boxes for the questions below)

What is the total committed capital of the fund?

€____________

What is total invested capital of the fund?

€____________

What is the historical IRR for the investments?

_____% per annum

How many portfolio companies do you have?

____

What sectors does the fund target?

☐ Consumer & Retail (goods & services)

☐ Agriculture

☐ Oil & Gas

☐ Infrastructure

☐ Telecom, Media & Technology

☐ Healthcare

☐ Financial services

☐ Real Estate

☐ Consulting services

☐ Other, please specify:____

Geographically, what growth potential does the fund look for in a target firm?

☐ Local

☐ International

Where are the portfolio companies located?

☐ Moscow

☐ Other major regional cities

☐ Rural areas

How many Russians are there on your team?

______ out of ______ total number of employees

What are the core competences that the fund is looking for in a managerial pool?

☐ Financial

☐ Operational

☐ Strategic

☐ Country-specific

☐ Relevant network

☐ Other, please specify: ____

What factors contribute to the returns of the fund? (please rank in order of importance, 10 being the most important)

☐ Vintage

☐ Total committed capital at vintage year

☐ Terms of exit via sale/stock exchange listing

☐ Company management competence

☐ Level of leverage

☐ Improvement in margins of investment target

☐ Growth of investment target

☐ Working capital improvements

☐ Brought-in management team

☐ Other, please specify: ____

What level of team involvement does the fund practice in its Russian portfolio companies?

☐ Majority stake

☐ Minority stake

☐ Active monitoring/advisory

☐ Seats on the Board of Directors

☐ Other, please specify: ____

On what stock exchanges are portfolio companies typically listed?

☐ Moscow Stock Exchange

☐ London Stock Exchange

☐ New York Stock Exchange

☐ Hong Kong Stock Exchange

☐ Other, please specify: ____

What are the realised/expected exit routes for your portfolio companies in Russia?

☐ IPO

☐ Trade sale

☐ Sale to another PE firm

☐ Management buy-out

☐ Other, please specify: ____

Other *strategies* and *success factors* that your firm relies upon in Russia, please define liberally below:

____

____

____

____

3. Trends

What trends do you foresee in the Russian PE market mid- to long-term?

What developments do you foresee in FDI inflow to Russia post-crisis?

Thank you for taking time to complete this questionnaire. You input is highly appreciated.

Abbreviations

CBR	Central Bank of Russia
EBITDA	Earnings before Interest, Tax, Depreciation and Amortisation
EVCA	European Venture Capital Association
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IPO	Initial Public Offering
LBO	Leveraged Buy-out
MBO	Management Buy-out
MCR	Minimum Capital Requirement
MM	Modigliani-Miller theorem
OECD	Organisation for Economic Co-operation and Development
PE	Private Equity
REIT	Real Estate Investment Fund
RVCA	Russian Venture Capital Association
SME	Small and Medium Enterprise