Russia's day of reckoning?

The turmoil of recent months has hit Russia particularly hard, with last autumn's stock market crash, falling oil prices and a devaluing rouble. Patrick McCurry reports

For private equity players the name of the game is helping portfolio companies through the storm and, for those with cash to spend, looking to pick up bargains when the dust has settled. A year ago the Russian market was proving to be a magnet for many PE investors, with its high economic growth, buoyant revenues from natural resources and rapidly developing consumer market. But then last September trading was suspended on the Russian stock markets as shares nosedived in the wake of the collapse of Lehman Brothers and plunging stocks on Wall Street, which saw foreign capital hastily withdrawn from the country.

The hostilities between Russia and Georgia last August didn't help investor sentiment and since then the country has found itself painted as the aggressor in other international incidents, notably the stand-off with Ukraine over gas supplies.

So, from an increasingly attractive investment destination a year ago, Russia experienced rapid capital outflows in the autumn, much of which was from local oligarchs protecting their assets as the economy looked ready to tank.

But despite the problems, there are also likely to be opportunities going forwards for those PE houses still in the game and willing to invest. Vladimir Andrienko, a managing director at Russia Partners, says: "One of the positives that will come out of this crisis is that valuations will be much lower and less frothy and we'll be able to see which management teams can perform as there's nowhere to hide in the current market."

It is important to understand the make-up of the Russian PE market, when attempting to forecast activity. There is an important distinction between established institutional players, such as Baring Vostok, and then the "non institutional" players, which refers to the funds owned by Russian oligarchs or entrepreneurs. Most of these oligarchs were highly leveraged and therefore when the credit crunch hit Russia and the rouble began to sink they faced major problems because much of their debt was dollar or euro denominated.

"The oligarch-driven, non-institutional Russian private equity has its money outside the country. They are borrowing from the state to carry their Russian investments and are not making any new investments at the moment," says Peter O'Driscoll, a partner with wide Russia experience at law firm Orrick in London: "They are waiting for the rouble to hit bottom, perhaps 40 to the dollar, before re-entering the market and snapping up bargains."

Russia Partners' Andrienko says he does not expect to see much PE activity in Russia until the second half of the year and that those houses that do make acquisitions from then will be focused on more longer terms, five years rather than two or three. The difficulty at the moment, he says, is a lack of cash among PE houses.

Andrienko says: "There are very few players that don't have to go back to their boards to invest in Russia right now. There is little Russian money around, whereas before the crisis that made up a sizable proportion of the market. That won't change for at least six months." He says many of the international houses that set up shop in Russia in recent years have redirected resources, including staff, away from the country.

One of the main concerns is anticipation that the economic situation will get much worse in the coming months and that the government, deprived of high oil revenues, will struggle to address the challenges. "Russia doesn't have the resources of the US or the UK and, while the government is trying to gradually talk down the euro there's no guarantee that we won't see a sudden collapse in the currency," says O'Driscoll.

A key issue is likely to be the refinancing challenges faced by a lot of Russian companies, which took out dollar-denominated debt and can't access Western capital markets. It is possible bondholders will agree to restructure companies' debt and wait for recovery, particularly if the alternative is letting companies go to the wall and creditors getting very little back. But confidence in Russian business practices is likely to take a hit among foreign investors, thanks to oligarchs moving assets out of failing companies in order to set up new companies with the same assets.

On the positive side, Evgeny Fetisov, managing director at Da Vinci Capital, says there has generally not been much leverage in Russian PE deals. "Apart from the occasional LBO by a larger buyout house, the Russian story has been about mid-market transactions and growth capital," he says.

Shortage of debt, in itself, has not impacted dramatically on the Russian market, but the wider financial turmoil clearly has. Fetisov says: "Since October/November people have been digesting the implications of the stock market crash and economic slowdown on portfolio companies, looking at where the economy is heading and what the valuations benchmark is."

Given the devaluing of Russia's blue chips, owners of private companies need to adjust their price expectations substantially. He argues: "If sellers adjust to new pricing levels we will see deals in 2009. We're already seeing some distressed sales in sectors such as real estate but at huge discounts."

Fundraising in the current climate is very difficult. Delta Private Equity Partners has put its fundraising on hold (see profile) and Da Vinci Capital also has been affected. The firm is raising a second fund, with a reported target of around US$300m. Fetisov says: "We contacted potential investors last October and a number did not seem interested. But we have identified a group of overseas investors who have been keen to invest in Russia but were put off in the past because it seemed expensive and so, with valuations falling, we hope they will be investing in our new fund." He says he hopes for a first close in Q2 this year.

Evgeny Fetisov, Da Vinci Capital

Thomas Dix, KPMG

What will be important for those PE houses still in the game will be assessing when is the best time to re-enter the market. Russia Partners' Andrienko says: "What is unclear is the timing and sequence of when the different sectors of economy will hit bottom and start to recover."

The firm is analysing different economic sectors to try and predict which ones will rebound first. This builds on the firm's top down approach, in which first an attractive sector is identified and then particular companies within that sector.

"The main thing we'll be thinking when we look at target companies this year will be what they could look like in three years," says Andrienko: "Those funds investing this year will be longer term than the kind of investments made in recent years."

But, ahead of new investments, most PE houses will be concerned with looking after their portfolio. Fetisov says: "Our investments have focused on the services sector and the only concern we have is around our financial services companies. In the other services sectors we feel we can predict, to an extent, the decline in revenues going forward but in finance it's harder right now." The positive element, he adds, is that because the firm specialises in all-equity transactions, few of its portfolio companies carry much debt. "Also, the value of our portfolio companies is still way above their book value," he says.

Thomas Dix, a partner at KPMG in Moscow, says the structural problems in the Russian economy combined with the global financial crisis and fall in the oil price mean the short term outlook for the country is extremely negative. "A lot of companies are under stress and, while this may seem like an opportunity for PE houses, at the moment the assets that can be acquired are generally not attractive because they're in the wrong sector or, in some cases, have been run down too much."

Growth in consumer demand of recent years will also be hit hard, he says: "With the devaluation of the rouble, which is clearly linked to the fall in the oil price, imports will cost more but wages are not keeping pace and in some cases are falling."

Dix says one problem is that, while the PE model relying on high leverage is being rethought across the world, in Russia the PE model relying on high growth rates is also questioned. "It will take time for changes to the PE model in Russia to take shape," he says: "At the moment most PE houses are more concerned with fixing their portfolio companies than new investments."

Stefan Dierks, another KPMG partner, says Russia has depended for too long on a high price for oil and raw materials. While those prices were high the economy boomed. He says: "But when times were good the authorities didn't tackle the longer-term challenges faced by the economy, such as the need for new infrastructure, better corporate governance and a more diversified economy and creation of intellectual assets.

"However, as the economy has established tight connections to the world economy, Russia will be one of the first to benefit from any economic recovery, be it in Europe, the US or Asia."

Whether the current crisis will provide the stimulus for these structural changes remains to be seen. The danger is a worsening economy and lower consumer incomes will lead to more political instability.

But according to Peter O'Driscoll, one positive to come out of the crisis will be that the over valuation of Russian assets will end: "Hopefully people will begin to price Russian risk more carefully and to take corporate governance issues more seriously. As was the case in 1998, the current crisis has brought governance issues to the fore. There have been some fairly outrageous examples of bad behaviour, particularly in relation to the manipulation of Russian courts."

But in the longer term, he says, Russia is an attractive country for private equity: "If you can structure your deals to mitigate risks and get the pricing and corporate governance right, there are some very good opportunities. Even if the economy hits the buffers in the short term, over the long term the consumer sector will continue to grow."

For Evgeny Fetisov, there are still a number of key variables that will influence the medium-term environment in Russia. One of these is the oil price: "If we have an oil price of around US$40 for the rest of the year that will require an adjustment in government spending and the economy will be impacted by that. But at least businesses will know where they stand and be able to plan. The problem is that the Russian economy is still not as flexible as it should be and too dependent on oil."