

Russian Private Equity

An Opportunity for which the Time Has Not Yet Come

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Private Equity in Developed Markets

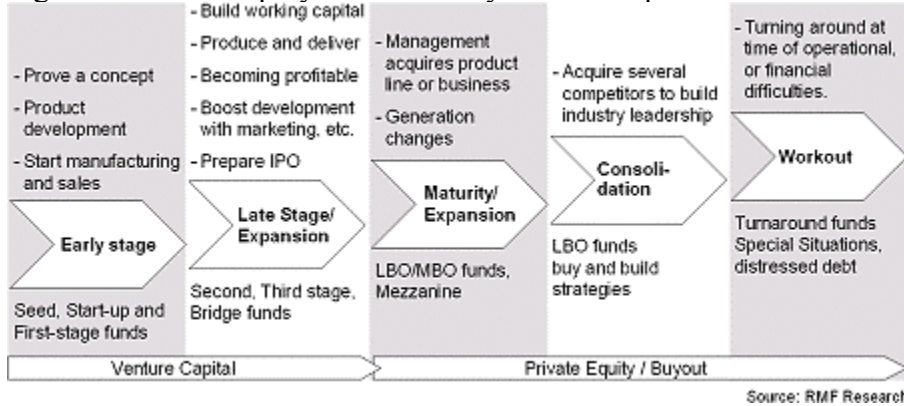
Private equity is a relatively common investment discipline in many Western countries and is an asset class that, over the years, has become an important component of many institutional portfolios. It refers to investments in private companies in the form of venture capital or leveraged buyouts (LBOs). Venture capital is risk capital for starting, expanding, or acquiring private companies and is important for the growth of any economy. LBOs refer to the purchase of generally established and cash flow–positive companies using only a small amount of equity and paying for the rest of the acquisition with debt financing. In addition to venture and buyouts, private equity encompasses privately issued defaulted debt, mezzanine (junior debt), funds-of-funds, and secondary purchases. In this memorandum, the term private equity will be used primarily to refer to venture capital and debt financing. Buyouts and other categories of private equity are rare in Russia and are not the focus of this analysis.

In developed economies such as that of the United States, private equity plays a central role throughout the life cycle of a company, including 1) early-stage development, 2) late-stage development, 3) expansion and maturation, 4) consolidation, and 5) turnarounds. This life cycle is illustrated in Figure 1 below. The key point to remember is that private equity, at each phase in the life cycle of a company or business, can play a pivotal role in generating and enhancing value to customers, management, shareholders, and the larger economy. Private equity functions as risk capital that finances new technology, new ideas, and new management teams. It facilitates the growth of companies that are being spun off by family owners or privatized by government. It assists in creating more efficient, consolidated businesses where markets are fragmented. And, in the case of failing or failed companies, private equity can provide the impetus for restructuring and turnarounds in situations where the dismantling and quick liquidation of assets could mean value destruction. Many private equity–backed entities—especially in venture capital—fail; however, the few that succeed do generate significant returns to investors, value to consumers, and growth for the economy. In the United States,

* The views presented in this memorandum are those of the author alone and do not in any way represent the author’s employer, AIG Global Investment Corporation.

examples of companies representing hundreds of billions of dollars in market value that were once backed by venture capital include Apple Computer, Federal Express, Minute Maid Orange Juice, Digital Equipment, Amgen, Genentech, eBay, and America Online.

Figure 1: Private Equity in the Life Cycle of Companies



Private equity in the United States was a cottage industry for many years, limited in distribution to high-net-worth individuals, families, and merchant banks. By the 1970s, successful investments in technological innovation (e.g., the personal computer) and regulatory and tax changes (e.g., a 1977 decision by the U.S. Department of Labor to overhaul the regulation of pension funds to allow them to invest in private equity) greatly facilitated U.S. private equity capital formation. In the late 1990s to 2000, the birth of the Internet, investment exits via a super-hot IPO (initial public offering) market, and fantastic returns further popularized private equity. The asset class became so attractive that, at the height of the market in 2000, hundreds of billions of dollars poured into the asset class in the United States and Europe. In the aftermath of hyped valuations and other market excesses of the late 1990s through 2000, private equity is suffering a downturn. In the developed markets, however, it remains an institutionalized asset class that is a key source of capital for businesses, a generator of jobs, and an important source of economic growth.

Russian Private Equity: A Brief and Uneven History

Unlike in the United States, Russian private equity is a more recent, less institutionalized, and relatively unproven investment discipline. It began only after the dismantling of communism and as a result of post-communist privatization, and has, at most, a decade of history in Russia. Private equity does not constitute a major source of capital for Russian businesses and is not a major contributor to Russian economic growth.

In the early 1990s, a burst of Russian private equity activity came about in response to privatization and the availability of cheap assets on the market. Roughly \$3 billion has been raised since 1993, with an estimated two-thirds of this invested as of 2002. A significant portion of early private equity capital in Russia came from public or quasi-public sources, many of them Western in origin. Private sponsors, mainly of Western origin, also launched other funds.

Early capital raised for Russian private equity targeted a broad swathe of the Russian business landscape, including food processing, natural resources, communications, media, pulp and paper, technology, real estate, consumer goods, pharmaceuticals, transport and distribution, and financial services. General partners who managed private equity funds tended to be generalist in orientation, given the nascent state of the Russian market economy, vast unmet needs in all types of sectors, and value found in many business areas in the early days of Russian market formation. However, a few funds, such as the Agribusiness Partners, did take a specialist approach, but these were a minority.

How have early private equity funds fared in Russia? It is difficult to verify the performance of Russian private equity to date, but some funds are reported to have spectacular annualized IRR's (Internal Rate of Return) of 70 percent to 340 percent on a significant number of companies in their portfolios. These returns are credible for investments made in the earlier phase of the Russian market, but are highly unlikely to be the norm going forward. One private-equity-fund manager interviewed for this memo remarked that "1993–1997 was the brief golden age" of Russian private equity; in the period following, many funds lost money and never recovered. In the future, the best-managed funds and the most connected private-equity-fund managers will likely have some outstanding returns on their investments, but average returns for Russian private equity will veer toward more normal historical standards for around 20 percent globally. This proposition remains unproven, of course, until more data are collected on the performance of funds from 1998 onward.

Currently, a number of Western and Russian groups are showing renewed interest in Russian private equity. This interest is being driven by economic reforms and the relative political stability under Putin, economic growth in Russia over almost four years, stable fiscal policy, improvements in the Tax Code and in corporate governance, and the publicized sale of government stakes in major companies. In the past year and a half several groups have closed new Russian private equity funds, have been fundraising, or have announced plans to launch funds. These include: Baring Vostok Capital Partners (which closed a \$205-million fund in early 2002), Finartis Group of Switzerland, AIG (American International Group), the EBRD (European Bank for Reconstruction and Development), Troika Dialog Asset Management, Delta Capital (which now manages The U.S.-Russia Investment Fund), Agribusiness Partners, ESN Group (which is spearheaded by a Russian entrepreneur), Alfa Bank, and Vostok Nafta Investment (which recently launched the Russian Resources Fund, with a \$20-million first close).

Feedback from fund principals indicates that fundraising for Russian private equity has been slow and challenging. One fund has been on the road fundraising for a year and one-half with little success. It remains to be seen if investors will take the risk in Russian private equity. It would be particularly interesting to see if the interest in private equity expressed by cash-rich Russian companies, banks, and financial groups translates into something concrete. For now, most investors remain skeptical. Undoubtedly, the difficult global economic environment and recent dismal returns on private equity in the developed markets are partially driving the lack of investor enthusiasm for Russian private equity. However, lack of investor enthusiasm is also due to concerns that regulatory, legal, financial, and tax risks, along with police corruption and the absence of

more competitive dynamics in making deals, may prevent them from making high returns in any Russian private equity investments.

Challenges in the Russian Private Equity Market

Multiple challenges in the Russian context presently impede the development of the private equity industry and will continue to do so until effective changes take place. The most important of these challenges are summarized below.

Narrow Deal Pipeline

Private equity begins with a deal pipeline from which investors can pick and choose situations in which they would like to invest. In Russia, it is difficult to find deals that simultaneously include solid management; transparent and credible financials; clean provenance; large and growing markets; a solid business plan; binding contracts with vendors, suppliers, and distributors; and clear potential exit strategies. When these deals do occasionally appear, private-equity-fund managers can find themselves in frustrating situations where their money is not wanted. The companies in question may not be interested in growth beyond a certain size or they end up being the subject of deeply discounted acquisitions conducted in relative secrecy. Many deals are also too small in size (\$500,000-\$1,000,000) and, given the intensity and costs of hands-on, private equity investing, deals this size simply do not make economic sense for many private equity funds.

Due Diligence

Private equity involves intensive due diligence on technology, management, markets, contracts, current and future financials, ownership structure, and other matters. In Russia, market culture and infrastructure have sufficiently matured in the past decade to allow private equity investors to carry out a significant amount of due diligence. There are challenges, of course, but the most vexing problems tend not to be those fact-finding problems, but judgment on risk taking at the end of a long and intensive due-diligence process. What risks is an investor willing to take? If she uncovers facts related to nonpayment of taxes, should she assume that this was a one-time lapse that is unlikely to recur? Can she ascertain that certain payments made were legitimate, or were they illegal bribes? Can she accept mistakes in a deed, records of transfer payments between companies, and other risks common in the Russian deal marketplace?

Difficult and Unreliable Legal Environment

In the United States, the most common form of private equity securities is preferred stock, which grant certain privileges and protections unavailable to holders of common stock. In Russia, private equity deals largely entail the purchase of common stock, giving minority shareholders inadequate protection. In fact, most laws that have been developed to protect minority shareholders have to do with large enterprises, instead of small and medium-size enterprises that are the domain of private equity. There are also no legally binding shareholders' agreements, which are the norm in developed markets private equity. Other problems on the legal front have to do with the difficulty of rights enforcement in local courts, corrupt judges, opaque bankruptcy laws, poor corporate

governance, and cumbersome regulations. One example of the last of these problems is the requirement that the Anti-Monopoly Ministry register and approve every security issuance, including those by small private companies. This imposes an unnecessary burden on private equity investors and increases their transaction costs.

Limited Entrepreneurial Culture and Inadequate Financing Options

Russia's entrepreneurial culture has improved in the last decade. However, the concepts and practice of innovation and growth remain inadequately developed, thus hampering the advancement of private equity. Many investors, for example, thought that Russia might have a comparative advantage in high technology but discovered that it was extremely difficult to convince Russian technical and creative talent to change traditional approaches in order to meet the needs of a potentially larger Western market. There is also, in some corners, a meager desire for growth. For example, one private equity fund was interested in putting growth equity into a cooking oil and margarine company that had over \$200 million in sales in 2001, but the company in question was not interested in further growth. On the financing front, the problems of Russian banking need not be elaborated here. Suffice it to say that the absence or, at least, grave scarcity of debt financing, equipment financing, lines of credit or other types of short-term and medium-term financing make the burden of nurturing and growing companies too huge for alone.

Few Exit Opportunities

Finally, a critical challenge for Russian private equity is the limited availability of exits. To date, no private equity investments in Russia have exited through an IPO. The small size of the Russian public stock market (total market cap of just over \$100 billion as of October 21, 2002) and its illiquid nature (10–20 stocks dominate trading) make it highly unlikely that IPOs will soon become a common exit for private equity investments. Exits to date have been carried out primarily through strategic sales. For example, in February 2002, a private-equity-backed Russian beer company (Bravo Beer) was sold to Heineken for \$400 million. Strategic sales are good, but represent only one exit option. Other potential exits (e.g. IPO market, management buyouts) have to emerge for private equity to gain further traction in Russia.

Conclusion and Recommendations

Private equity in Russia can be an exciting and lucrative investment discipline. However, the space for making Russian private equity deals remains narrow and fraught with risk. Some of those who invested early made spectacular returns, but the advantage of cheap assets and deals in the early days of Russian marketization has been largely exhausted. Going forward, private equity investors must proceed with great caution and cultivate an attitude that will allow them to ride the relative unpredictability, illiquidity, and occasional turbulence of the Russian market.

Two policy recommendations for the U.S. government develop from the preceding analysis. One is that it may be advisable for the U.S. government to limit its direct role in Russian private equity. It is clear that Russia needs huge capital infusions, but government money is not the best source of such infusions. Instead, private capital

(especially Russian) that is more accountable to its sources is what needs to be harnessed for the Russian private equity market at this stage of its evolution. U.S. governmental and quasi-governmental moneys that poured into Russian private equity in the early 1990s may have been useful in starting the industry and creating the initial legal, accounting, and other infrastructure and culture around it, but is not going to be its main driver going forward. If the experience of developed markets is any guide, it is the participation of pensions, endowments, and other institutional funds that truly unleashed the potential of private equity. Second, the U.S. government would do well to focus more of its political and financial capital into facilitating and expediting banking reform in Russia. Some of this is already being done, but the results are still meager to date. Without a functioning banking system, there can be no sustained sources of funding for the small and medium enterprises that are needed for sustained Russian economic prosperity and growth. Private equity can propel some small and medium businesses forward, but it is woefully inadequate as the basis for a dynamic and diversified Russian economic base.

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