

Country Report - Russia

M&A update

Autumn 2012



M&A to increase as companies capitalise on Russia's growth

Russia is now a strategically important market for foreign companies. As the world's sixth largest economy with growth amongst the fastest globally and now accession to the WTO, opportunities across a range of sectors are significant. This should lead to rising levels of M&A.

The key observations from our research:

- The Government is introducing a range of legislative and regulatory reforms to build on its position as the sixth largest economy. These are aimed at attracting foreign companies, increasing economic growth and diversifying the economy away from natural resources.
- The opportunities in Russia are broader than just oil. Over US\$1 trillion is being invested in upgrading infrastructure and US\$24 billion invested in preparation for the 2014 Winter Olympics and 2018 Football World Cup.
- Russian consumers have the highest disposable income and fastest growth in consumer spending of all the BRIC economies. With almost three-quarters of the population living in urban areas, foreign companies have been investing in Russia both through acquisitions and directly to benefit from rising demand for domestic and foreign-branded goods.
- The most successful foreign companies are those who are locating production and distribution in Russia, often using M&A and joint ventures. We believe this strategy will be used by more companies looking to take advantage of Russia's economic growth.



“Many people seem unaware that Russia is the world's sixth largest economy and that unlike some BRIC countries, Russia is an open market in which both large and small foreign corporations have made a lot of money in the last 20 years”

Mark Bond, Managing partner,
NorthStar Corporate Finance

Low debt and healthy trade surpluses supporting financial stability

President Putin encouraging foreign private investment

Over the past ten years the Russian economy has undergone a significant transformation to become the sixth largest economy globally (purchasing power parity basis).

- Real GDP grew by 4.2% in 2011 compared to global and European GDP growth rates of 2.7% and 1.5% respectively. Figure 1 illustrates Russia's rapid move up the GDP rankings.
- Russia has almost no sovereign debt, large foreign exchange reserves, moderating inflation rates (currently 5%-6%), a strong labour market (unemployment is currently around 6%), consumption growth and a positive balance of trade. An increase in the oil price has benefited the balance of trade which has been positive since the early 2000s.

The size of Russia's economy, its geographical scale, high level of GDP and disposable income per capita relative to its largely undeveloped manufacturing and service sectors means there is a focus on

“It is imperative that we increase investment by 2018 to 27% of GDP. By 2020, Russia must be among the top 20 nations with the most comfortable business climate”

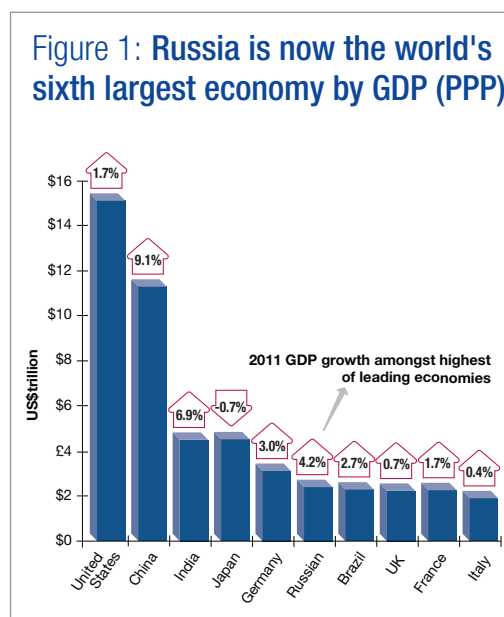
President Vladimir Putin, St. Petersburg International Economic Forum, June 2012

investment-led growth. President Putin has stated publicly that he wants investment in Russia to increase from 20% to 27% of GDP by 2018. The initiatives designed to achieve this goal represent opportunities for foreign companies.

- Four-year privatisation plan which may include strategic sectors of the economy. Large foreign strategic investors will be allowed to participate in these privatisations.
- Raising Russia's ranking from 120th (of 183 countries) to 20th by 2020 in the World Bank's "Ease of Doing Business" index. Roadmaps for three problematic areas – access to power grids, construction regulation and customs procedures – have already been created.

US\$1 trillion infrastructure investment by 2020

Figure 1: Russia is now the world's sixth largest economy by GDP (PPP)



Source: World Bank

- US\$1 trillion investment in infrastructure until 2020. Public and private partnerships (PPP) are regarded as one of the most efficient instruments prospectively in funding projects. The government is actively looking to bring foreign investment to Russian infrastructure to develop roads, rail, airports and utilities.
- Full membership of the WTO (ratified in August 2012) which will dismantle foreign trade barriers and reduce tariffs. This will help attract more foreign capital to Russia, boost trade and investment, promote industrial reform and accelerate the formation of a transparent and open market environment (see page 4).

Distinguishing opportunities from myths

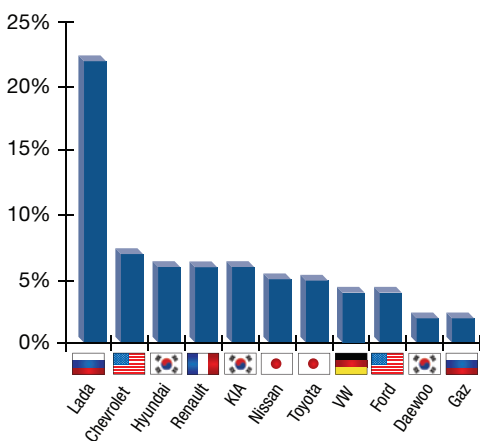
There are several myths associated with doing business in Russia which we examine below.

Myth 1: The opportunities in Russia rest on oil

As the world's largest oil producer, much attention has been focused on the opportunities for foreign companies to gain access to Russia's exploration and production supply chain. However, there are many other sectors which are developing quickly and have attractive growth opportunities.

- Russia's automotive market is the second largest in Europe after Germany with over 2.6 million new cars sold in 2011. With light vehicle density at just 250 cars per 1,000 people compared to 643 in the US, the potential for growth is significant. As shown in Figure 2, a range of foreign manufacturers have meaningful market share. In 2011, locally-produced foreign brands including Ford, Renault and VW dominated car sales (40%).

Figure 2: Foreign brands accounted for 72% of passenger car sales in 2011



Source: Ernst & Young, AEB, Otkritie Capital Research

- Upgrading infrastructure is a top priority and Russia is actively encouraging involvement from foreign companies. For example, Bombardier Transportation has signed co-operation agreements with Russian rail manufacturer Uralvagonzavod to jointly develop and sell metros and trams, establish local production facilities and transfer Bombardier technology.

Russia is hosting the 2014 Winter Olympics and 2018 Football World Cup. Some US\$24 billion is being invested in infrastructure including the construction of new motorways, railways and tourist facilities, and the construction and reconstruction of football stadia in 13 Russian cities.

- Three-quarters of aircraft in Russia are currently foreign-made. While Russia is building its own fleet of aircraft, strong air passenger growth (13% 2010-2011) means that partnerships with leading foreign companies continue to be vital. Boeing for example, has a production joint venture with Russian Technologies, Ural Boeing Manufacturing, through which it procures titanium parts for the 787 Dreamliner.

Myth 2: Foreign companies can't make money in Russia

The performance record of foreign companies in Russia is evidence that success is achievable and meaningful. For example, E.ON Russia, the electricity producing arm of the German utility provider, reported 2011 profits of US\$495 million.

German companies have been particularly successful (see figure 3). They view Russia as a strategic market and have invested progressively over a number of years. Companies typically invest in phases, building on proven demand for their products and then combining plant investment with strong commitments to training staff and developing sophisticated logistics systems to support component imports and local distribution.

Russia set to become Europe's largest auto market in 2012

German companies very successful in Russia

Figure 3: German companies are making a significant commitment to Russia

Sector	Company	Approach
Automobiles	Volkswagen	Locally-based manufacturing in Kaluga. Significant investment training mechanical and auto-mechanical engineers partly by apprenticeships at its Kaluga plant. Currently 4% market share in Russia.
Consumer goods	BSH Bosch and Siemens household appliances	Locally-based manufacturing capability for washing machines, freezers, refrigerators near St. Petersburg. Established logistics center. Acquired 25% stake in Power Machines in 2006.
Industrials	HeidelbergCement	€600 million investment in a state-of-the art cement factory in Tula region, TulaCement. The company will be the only local cement producer supplying high-strength cement types to the local Moscow regional market, which represents 85% of TulaCement sales. TulaCement will benefit from the upcoming expansion of greater Moscow.
Industrials	Schott	Two manufacturing sites based near Nizhny Novgorod, a centre for the pharmaceutical industry in Russia, producing 590 million ampules and bottles annually for the country's pharmaceutical industry.

Automobiles, manufactured goods and telecoms to benefit from WTO membership

Myth 3: The Russian economy is too volatile

The government has established two funds to reduce the impact of volatile oil and gas export earnings on the economy. The US\$60.5 billion Reserve Fund, built on oil and natural gas revenues, ensures the financing of federal budget expenses in the case that oil and gas budget revenues decline. The US\$85.6 billion National Welfare Fund, used to support the pension system, has the ability to lend money to Russian banks and can be used to absorb excessive liquidity.

Membership of the WTO should help to create a diversified economy. This binds Russia to a series of trade rules and commitments which should create a more transparent and predictable environment for business. Sectors that will benefit from WTO membership include:

- **Automobiles.** WTO membership will halve car import duties to 15% by 2019. Import duties for trucks will fall from

25% to 5% by 2018. This will increase demand for foreign cars which the government will attempt to control via recycling fees and by supporting the localisation of production for foreign brands and the creation of joint ventures with foreign producers. For example, the Russian automotive group Sollers' partnerships with Ford, Mazda and SsangYong.

- **Manufactured goods.** A general reduction in tariffs with the average falling from 10% to 7.8%. Russia has committed to join the information technology agreement which provides for duty free treatment of relevant goods (e.g. computers) within three years.
- **Telecoms.** Increased market access to the telecoms sector with a current foreign equity ownership limitation of 49% being phased out over four years from accession. Russia has agreed to abide by the WTO's basic telecommunications agreement aimed at promoting fairness and competition.

The rise of the Russian consumer

Substantially increased earnings and low income tax have boosted spending power in Russia's underpenetrated consumer market. Russian consumers have the highest disposable income and fastest spending growth of all BRIC markets (see figure 4).

- Unbranded goods dominate total consumption at low levels of household income and for essential goods and services. However, as income starts to rise, the preference for branded goods increases and at affluent levels, premium brands attract greater market share (see figure 5).
- Foreign brands and companies including BMW, Nivea, Adidas, and Sony are taking advantage of the growth potential for international brands in the discretionary space.

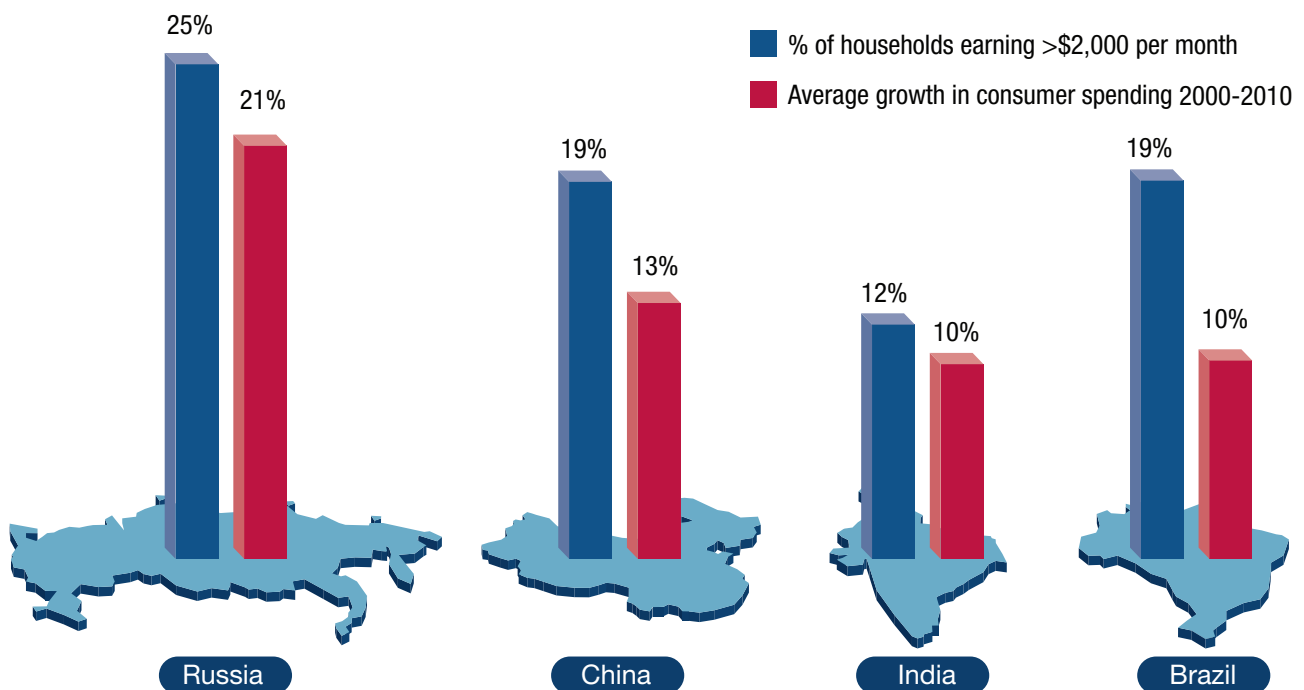
“We believe in Russia’s huge long-term potential, that’s why we continue with Nestlé investments into the development of local production facilities.”

Stefan De Loecker, Chief executive officer of Nestlé Rossiya.

Source: “Nestlé to Create a Greenfield Factory in Vladimir Region,” Nestle press release, 15 June, 2010, www.nestle.com

Global consumer companies using M&A to tap growth in consumer spending

Figure 4: Russia has the highest proportion of high income households and fastest rate of consumer spending in the BRICs

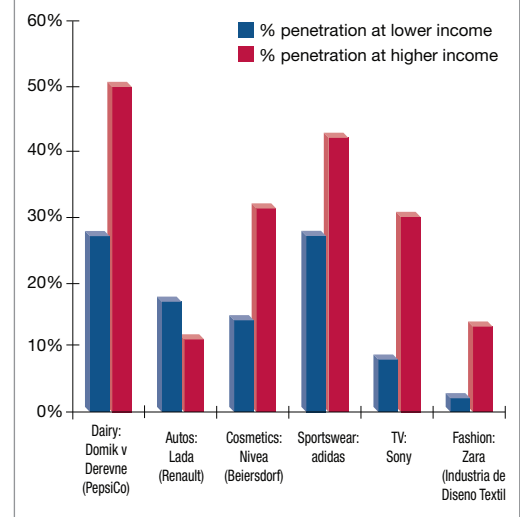


Foreign companies attracted to well-positioned local brands

- Stable demand for locally-branded essential goods and services across the income curve is driving acquisition activity by foreign companies. PepsiCo's 2010 acquisition of Wimm-Bill-Dann gave the company ownership of two leading dairy brands. PepsiCo's products are now sold in 98% of retail outlets across Russia. Nestle has been linked to the potential acquisition of Russian baby-food and juice producer Progress, having already made acquisitions in Russia (for example, Ruzskaya Confectionary Factory).
- Foreign companies are looking for local brands with a strong market position, growth potential and positioned to take advantage of the shift from unbranded to branded products. For example, Russia accounts for about 40 per cent of Carlsberg's sales. The brewer is close to finishing a US\$1.2 billion purchase of minority stakes in its local subsidiary, Baltika,

with total investment in the country adding up to more than US\$12 billion in the past two decades.

Figure 5: Brand market penetration according to income group



Source: Credit Suisse Emerging Consumer Survey 2012

Sporting success for Adidas

Adidas, the world's second largest sporting goods manufacturer, expects the Russia/CIS region to become its third largest market globally behind the United States and China with annual sales of over US\$1.3 billion by 2013. Sales are expected to increase by a double-digit average growth rate annually to 2015.

Adidas is the market leader for sporting goods in Russia/CIS with over 700

corporately owned stores and 13,000 employees (Nike currently has around 100 stores in Russia). The company has its head office and distribution center in Moscow, and regional offices in seven Russian cities. Adidas brands Reebok and Rockport also have their own chain of stores in Ukraine and Kazakhstan. Adidas aims to have 1,200 stores by 2015.

Source: "Adidas Group sales in Russia/CIS to exceed €1 billion by 2013 and grow double-digit yearly till 2015," Adidas press release, 10 October, 2011, www.adidas-group.com

Our perspective on M&A trends in Russia

NorthStar is Merger Alliance's Russian partner. Mark Bond, NorthStar's Chairman and Managing Partner, and Nick van den Brul, Partner, have over 50 years' combined experience working in Russia. They discuss M&A trends and share their insights about how foreign companies should approach Russia.

Q How would you describe the M&A market in Russia?



Nick van den Brul: There has been a significant increase in inbound and outbound M&A enquiries this year. As Russian businesses mature we are seeing a shift away from new greenfield investments to acquisitions of fully-fledged businesses, such as PepsiCo's purchase of the Wimm-Bill-Dann food producers and Unilever's acquisition of Concern Kalina.



Mark Bond: Interest in Russia's large consumer market is driving a lot of the activity. We expect continued interest in acquiring businesses serving Russian consumers and general add-on acquisitions by companies which already have a local presence. It is surprising that there is not more interest in the mining sector given the recent positive changes in legislation regarding the bidding for licences.

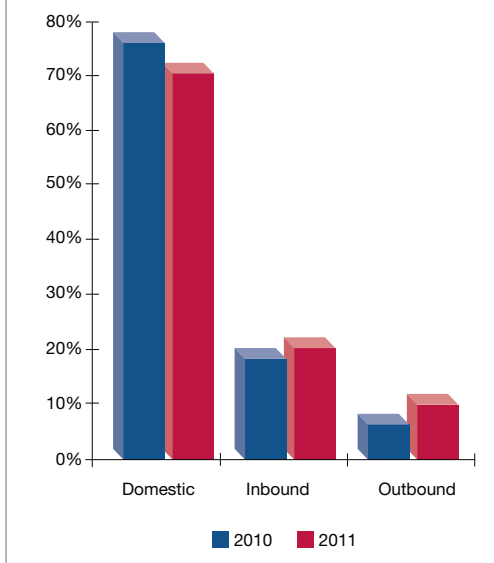
Q How should foreign companies approach Russia?

Nick van den Brul: Working with a good partner is vital. High profile corporate activity such as TNK-BP, an example of a 2003 joint venture that has resulted in widely reported shareholder conflict, can put off foreign companies who do not yet have a foothold in Russia.

A suitable partner will ensure the investor retains control of investment and operating decisions. The many German companies investing in Russia are good at this as they take a long view, even if they are eventually surprised by the size and quickness of the returns. The recent Carlsberg bid for the minority stakes in its Baltika beer business, which has a 38% market share in Russia and accounts for 40% of Carlsberg's global sales, shows how this can pay off. All successful investments have been structured this way whether by purchase of the operating company or by acquisition of the assets.

Interest in Russia's large consumer market is driving activity

Figure 6: Domestic activity currently dominates M&A but inbound and outbound activity is increasing



Working with a suitable partner is vital

Source: Mergers Alliance

Rigorous due diligence is critical

Q What should companies be aware of when transacting a deal with a Russian company?

Nick van den Brul: Rigorous due diligence to check whether a potential partner has a disreputable background is vital. Fundamental due diligence on critical areas such as asset title, potential tax exposure or outstanding or potential litigation should also be conducted. The absence of GAAP or IFRS accounting standards (apart from in the financial sector) means that a proper view of the operating situation can only be achieved through a detailed review of the management accounts. This can mean longer transaction timetables. It is helpful that Russian sellers are open to the use of English law in M&A transactions and to the use of offshore acquisition vehicles.

Mark Bond: Strong personal relationships are important. As with other emerging economies, it's important to build relationships with local administrative

officials and politicians. Also, the increasing number of Russians who go to European and American business schools means that many managers are now willing to look at Western corporate incentive arrangements, including share option schemes.

Q What are the typical market entry strategies used by companies?

Nick van den Brul: The auto market is a good example of how companies can work successfully in Russia – imports initially, then component manufacture followed by the development of sophisticated logistical systems. German companies have been present in this sector and logistics companies such as DHL and Rhenus have followed them. The infrastructure for successful business operations is getting better every year.

Case study: GRUMA's acquisition of Solntse Mexico

In July 2011, NorthStar advised Solntse Mexico, Russia's leading tortilla manufacturer, on its sale to Mexican tortilla producer GRUMA. Founded in 1949, GRUMA is one of the world's leading tortilla and corn flour producers and owner of the brand Mission Foods. The company has operations in the US, Mexico, Venezuela, Central America, Europe, Asia and Australia and exports to 105 countries. GRUMA has approximately 20,000 employees and 96 plants.

Reason for acquisition

Over two thirds of GRUMA's sales come from its non-Mexican operations. Solntse Mexico introduced tortillas and corn chips to the Russian market and grew to become the market leader with net sales in 2010 of

US\$9 million. The acquisition gave GRUMA entry into Russia. GRUMA had a presence only through exports prior to the acquisition.

How the deal was transacted

The deal involved multiple jurisdictions, cultural and time differences. The Mexican management of GRUMA dealt through their American subsidiary based in Texas, USA, the legal jurisdiction was the law of England and Wales with the legal firm based in London, while Solntse had its holding structure in the British Virgin Islands and on-the-ground operations in Russia.



Q What types of companies are Russian investors acquiring?

Mark Bond: There is a strong interest in buying companies in natural resources and manufacturing. This is being driven by the desire to increase market access and gain operating synergies, acquire trading operations, and to acquire new technologies. For example, the Russian group Digital Sky Technologies acquired stakes in a number of high-profile US technology companies (Facebook, Zynga). TNK-BP made a hinterland acquisition buying Vik Oil in Ukraine and has made other acquisitions internationally. Sberbank acquired Troika Dialog in Russia and has also acquired a bank in Turkey, Deniz Bank.

Q How is private equity approaching Russia?

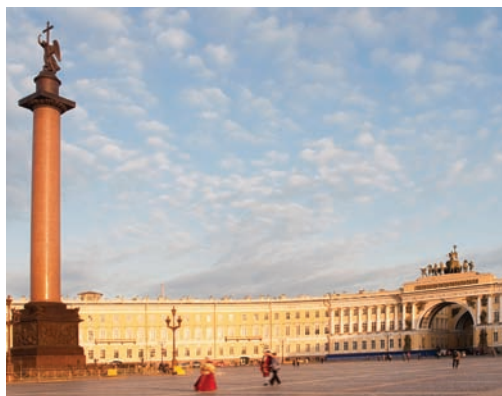
Mark Bond: Private equity firms operating in Russia add a useful dimension since, like the Russian partners and entrepreneurs, they are interested at the outset in a clear route to potential exit. Many Russian companies lack financial sophistication and this means that constructing exit strategies in order to avoid a potentially costly dispute is a key part of any investment.

There is now around US\$5 billion of foreign private equity funds dedicated to investment in Russia, as well as the large amount of investment by Russian-owned funds. For large deals involving a foreign investor where the investment is greater than US\$100 million, the Russian Direct Investment Fund (RDIF), established by the Government in 2011, is a very helpful development. We have already seen a joint venture announced between the RDIF, BlackRock, Goldman Sachs and Templeton to invest in leading Russian companies preparing for IPOs in Moscow.



“80% of our business growth is going to come from high-growth areas identified as BRICs. Our footprint will correlate with the ring of growth in various places around the world, providing they have good open markets.”

Lloyd Blankfein, Goldman Sachs chief executive
St. Petersburg International Economic Forum, June 2012



Russian companies looking overseas to acquire new technology

US\$5 billion of foreign private equity funds are invested in Russia

Figure 7: Selected recent M&A transactions

Date	Target Company	Country	Target Activities	Acquirer	Country	Deal Value (US\$m)	Deal Type
Jun-12	Stream LLC	Russia	Digital content delivery services	Sistema JSFC	Russia	15	Domestic
May-12	Denizbank Anonim Sirketi	Turkey	Turkish bank owned by Franca-Belgian Dexia	Sberbank	Russia	3,542	Outbound
Apr-12	OOO BAW-Rus Motor Corporation	Russia	Manufactures SUVs, minivans	Beijing Automobile Works	China	ND	Inbound
Mar-12	Open Joint-Stock Company Enel O GK-5	Russia	Engages in the generation and wholesale of electric power and heat	Rusenergo Fund/ Russian Direct Investment Fund	Russia	750	Financial Acquisition
Mar-12	Natur Produkt International, JSC	Russia	Over-the-counter drugs, generics, and food supplements	Valent Pharmaceuticals	Canada	185	Inbound
Feb-12	JSC Tascom	Russia	Wireless broadband service	Moscow City Telephone Network	Russia	55	Domestic
Jan-12	Facebook, Twitter, Zynga	USA	Various US based leading online companies	Digital Sky Technologies	Russia	N/A	Outbound
Dec-11	Concern Kalina	Russia	Russia's largest personal care company	Unilever	UK/ Netherlands	694	Inbound
Nov-11	RTS	Russia	Merger of two Russian stock exchanges	Micex	Russia	N/A	Domestic
Oct-11	Plastic Logic	UK	Develops and commercialises plastic electronics	RUSNANO	Russia	150	Outbound
Aug-11	Lenta	Russia	Chain of supermarkets	TPG Capital	USA	1,100	Financial Acquisition
Mar-11	Novatek	Russia	12% stake in Russia's second-biggest natural-gas producer	Total SA	France	4,000	Inbound
Feb-11	Wimm-Bill-Dann Foods OJSC.	Russia	Produces dairy products, juices, mineral water and baby food	PepsiCo Inc	USA	1,356	Inbound
Oct-10	SevenTV	Russia	General entertainment television channel	Walt Disney Co.	USA	300	Inbound
Jan-10	Vik Oil	Ukraine	Fuel stations and oil depots in the Ukraine	TNK-BP	Russia/UK	302	Outbound

Source: Mergers Alliance

Prospects for M&A

Given the long-term drivers discussed above, we expect to see a rise in M&A over the next 18 months.

- While the State retains overall control of strategic sectors including oil and gas (above a certain size), the defence industry and certain areas in infrastructure such as railways, there are many opportunities to invest in consumer industries, manufacturing, infrastructure and many areas of natural resources, such as coal, gold and other metals.
- Given the strong outlook for local brands in essential goods and services, foreign companies will acquire local brands.

- Legislative reform such as the Third Anti-Monopoly Package and general changes to civil legislation should all improve deal making conditions and encourage inbound M&A.
- WTO membership will prompt domestic consolidation in certain sectors, especially in telecommunications, insurance and other financial services, while legislative and regulatory initiatives should encourage inbound M&A.
- Further investment and acquisition activity by private equity, especially by those companies already active in Russia.

Positive outlook
for M&A

Find out more

If you would like to discuss this report in more detail, please contact us.

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Mark is the Chairman and Managing Partner of NorthStar. He has over 20 years of experience of M&A gained in London, New York and Moscow. Mark is the longest serving foreign finance professional in Russia, having been based in Moscow since 1990. He set up Deloitte & Touche in the former Soviet Union, was a vice president for Bear Stearns responsible for Eastern Europe and was CEO of one of the first private equity funds for Russia. He has been at NorthStar since 2004.

Languages spoken: English, Russian, German, French and Italian

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Nick is a Partner and member of the Board of NorthStar. He was part of the S.G. Warburg "Troika" team of advisers to emerging market Governments and State Enterprises in Asia and Latin America on debt funding and project finance. Nick was subsequently a corporate finance executive of the S.G. Warburg Group in Australia and Europe and also the Head of Transport and Logistics equity research at BNP-Paribas for over 10 years. He has extensive experience of debt restructuring and of valuing companies for market investment as well as in preparation for IPOs and capital raising. He became a Partner of NorthStar in 2009.

Languages spoken: English, Russian, French, German and Spanish

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In particular, we offer:

- Acquisition search assignments and checks on individuals in the Russian Federation
- Advice on structuring and completing deals in Russia, with guidance through complex transaction issues in order to identify and avoid potential risks
- Information on sector trends and valuations in the Russian market
- Access to corporate and governmental decision-makers at all levels

Our unique understanding of Russia, its economy, industries and political structures enable us consistently to deliver high quality, effective and confidential service and advice to our clients.

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