Cross-border Transactions: Spotlight on Russia and CIS
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Today’s dynamic transactions market presents a world of opportunity. As corporations and other investors turn their attention to international opportunities, they are looking beyond traditional markets to achieve high growth and competitive advantage. Ernst & Young’s “Cross-Border Transactions” series aims to shed light on the complex, rewarding transaction landscape in selected emerging markets.

“The Spotlight on Russia and CIS,” the second report in our series, provides an overview of opportunity sectors, political context, practical transaction considerations and challenges surrounding deal-making in this fast developing market.

With its burgeoning consumer demand, strong economic growth, strategic location and huge investment opportunities, the Russian deal market has taken off. In 2005, the US$30 billion total deal value to end of September 2005 represented an impressive increase volume over the prior year. Interest from the international community has never been greater.

With Ernst & Young Transaction Advisory Services in more than 70 countries, we are well-positioned to understand the range of issues involved in investing in emerging economies, from target identification to due diligence to post-deal integration.

In Russia and in the CIS, our transaction team has been ranked one of the leading deal advisory groups in 2005 – both in volume of transactions and size of team. Our strength on the ground and close knowledge of industries, markets and technical issues help our clients make the most of abounding opportunities in Russia and in the CIS.

We look forward to hearing from you.
The Russia Enigma

Is there still a ‘Russia discount’ on transactions in what used to be the Soviet Union? In places, yes. But because the region is growing so fast, there is also a ‘Russia premium’. The two largely cancel each other out.

This is the latest version of the Russian enigma that has always puzzled outsiders. But while it is the ‘discount’ side that is uppermost in public perceptions, those on the ground firmly believe that investors concentrating their emerging-market attention solely on China and India may miss a once-for-all opportunity. Russia and the CIS (Commonwealth of Independent States, which means former Soviet Union republics minus Baltics) is increasingly high on the strategic priority list of cross-border acquirers for international expansion. These markets may be more accessible than many investors think.

Although there are undeniably political and/or legal issues in certain sectors and at different stages of the transaction lifecycle, the potential prizes may be large in terms of both strategic positioning and immediate returns. While activity in the oil and gas and minerals and mining sectors – the traditional focus of investor interest – remains strong, the effects of a soaring oil price and continued economic expansion are now generating big opportunities in banking and financial services. Penetration and lending in these sectors are very low by developed economy standards, and in turn are fuelling a consumer boom. Media, real estate and telecoms are also attracting interest. The big magnet is still Russia and its 13 cities with over one million population each, including Moscow and St Petersburg.

Investment level

At the most general level, the ‘Yukos affair’ appears to have had little lasting effect on foreign appetites for Russian assets. While it certainly generated bad publicity and heavy outflow of domestic capital – government estimates of $9 billion for 2004 may be a considerable underestimate – it has been counterbalanced by strong inflows. Capital and stock markets have also continued to develop, making deals an increasingly familiar part of Russia’s economic landscape:

- From a low level, foreign direct investment (FDI) is growing rapidly. The total of nearly $10 billion in 2004 was more than double the 2002 figure;
- Last year Russian companies took out $16 billion in bond issues, including $11 billion via Eurobonds. They also raised $0.8 billion in IPOs in 2004 and almost $2 billion in the first half of 2005 alone, becoming the largest source of international primary offerings in London1 (Figure 1);
- Fuelled with this cash, M&A activity with Russian targets hit $26.5 billion in 2004, while Russian companies made $3.5 billion worth of foreign acquisitions2. The country is now one of the busiest European M&A markets (Figure 2);
- The RTS, the main Russian stock market index, broke the 1,000 barrier for the first time in 2005.

In fact, along with a number of other recent moves, the Khodorkovsky case may actually have served to clarify the rules of the game for foreign investors. After a period of rare openness, Russia is copying most other major oil-producing countries in reasserting state control of its natural resources. In oil and gas, it seems unlikely that there will be other deals like BP’s 2003 50-50 joint venture with TNK. There will also be some key companies with ownership limitations within the metals, minerals, defense and aerospace sectors – though generally there are no restrictions.

However, despite the image problem, in other sectors – particularly consumer industries where politics does not intervene – doing business in Russia has become easier and more predictable than even three or four years ago.

1Ernst &Young research and analysis
2Ernst &Young research and analysis
There are of course still downsides. Reform of the courts and municipal utilities is slow, and changes in administration are more advanced at the federal level than regionally. A recent survey by the Foreign Investment Advisory Council (FIAC) noted that corruption, bureaucracy and selective application of the law were still giving potential investors cause to hesitate (Figure 3).

On the other hand, the legacy of the murkier privatizations of the 1990s has mostly been ironed out, and the tax authorities, the source of the greatest anxiety since the Yukos affair, have to some extent been reined in (although it is true to say that tax is still an issue in almost all Russian transactions). Governance is slowly becoming more transparent, and companies more attuned to the transaction culture. Land and pension legislation is in place, and a government which has made a priority of medium-term growth has made many of the right noises about making the climate more business-friendly.

**Figure 2**
Russia: factors impacting investment decisions

<table>
<thead>
<tr>
<th>Factor</th>
<th>%</th>
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<tbody>
<tr>
<td>The size of the domestic market</td>
<td>88</td>
<td>90</td>
<td>91</td>
<td>91</td>
<td>93</td>
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<td>Sustained growth rates of the domestic economy</td>
<td>77</td>
<td>80</td>
<td>82</td>
<td>83</td>
<td>85</td>
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<tr>
<td>High quality and low cost of human resources</td>
<td>55</td>
<td>57</td>
<td>59</td>
<td>60</td>
<td>62</td>
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<td>Macroeconomic stability</td>
<td>46</td>
<td>48</td>
<td>50</td>
<td>52</td>
<td>54</td>
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<tr>
<td>Overall political stability</td>
<td>40</td>
<td>42</td>
<td>44</td>
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<td>48</td>
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<td>Domestic technological and scientific potential</td>
<td>31</td>
<td>33</td>
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<td>37</td>
<td>39</td>
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<tr>
<td>Cheap energy and raw materials</td>
<td>30</td>
<td>32</td>
<td>34</td>
<td>36</td>
<td>38</td>
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<tr>
<td>Administrative reforms to reduce bureaucracy and corruption</td>
<td>22</td>
<td>24</td>
<td>26</td>
<td>28</td>
<td>30</td>
</tr>
<tr>
<td>Favorable tax regime</td>
<td>17</td>
<td>19</td>
<td>21</td>
<td>23</td>
<td>25</td>
</tr>
</tbody>
</table>

Respondents: 158 international companies, (106 current investors, 49 non-investors) headquartered in Europe and the United States

**Figure 3**

IPO dynamics of the companies conducting business in the CIS

Source: Ernst & Young research and analysis

**Figure 1**

IPO dynamics of the companies conducting business in the CIS

Source: Ernst & Young research and analysis

**What are the top five advantages of Russia?**

- The size of the domestic market: 88%
- Sustained growth rates of the domestic economy: 77%
- High quality and low cost of human resources: 55%
- Macroeconomic stability: 46%
- Overall political stability: 40%
- Domestic technological and scientific potential: 31%
- Cheap energy and raw materials: 30%
- Administrative reforms to reduce bureaucracy and corruption: 22%
- Favorable tax regime: 17%

Respondents: 158 international companies, (106 current investors, 49 non-investors) headquartered in Europe and the United States

**What are the top five barriers restricting foreign investments into Russia?**

- Corruption: 71%
- Administrative barriers: 66%
- Selective interpretation and application of laws: 55%
- Inadequate and inconsistent legislation: 51%
- Conflicts between the state and business: 29%
- Increasing governmental control of the economy: 24%
- Problems with protection of intellectual property: 23%
- Political uncertainty: 22%
- Excessive regulations for visas, work permits: 21%
- Unfair competition by local companies: 19%
- Problems with protection of private property: 19%
- Continuing negative media coverage about Russia: 18%

Respondents: 104 current investors, 50 non-investors

Source: Russia Investment Destination ‘March 2005’ – a survey conducted for the Foreign Investment Advisory Council (FIAC) and the Economy Ministry of Russia
The Russia Enigma continued...

Why invest?

Add in a population of 145 million, GDP growth rates which although slowing are still around 6 per cent, and a well-educated and low-cost workforce eager to compensate for the material hardships of the 1990s, and it is easy to see why hardier investors are not waiting for others to improve the business climate but are getting on with doing it themselves.

Some overseas investors believe that at this juncture the biggest risk is not being in Russia. Two factors are at play here:

• **Competitive push.** Russia/CIS is frontier territory. For any company with pretensions to global presence, given its size and potential it is necessary to be there either as an early entrant to raise barriers to others, or as a follower to prevent rivals getting too far ahead. As one professional put it, ‘you can’t be a world player if you’re not in Russia.’ In some areas, such as energy, the window of opportunity for shaping the sector is already closing. In others, such as financial services and consumer goods, the next three to five years will be crucial.

• **Market pull.** Because of its history, Russia’s economy is structurally different from those of the advanced west. In western economies most sectors, particularly in consumer areas, are so competitive that excess profits are immediately competed away. In Russia as a result of the privileging of heavy industry in the Soviet era, both consumer and small company sectors in general are relatively underdeveloped.

This means that at least temporarily some sectors are effectively oligoplies, with the kind of returns that almost never exist elsewhere. As a strategic option, Russia is thus a very different proposition from China, where intense domestic competition and wafer-thin margins are the rule. Looking further ahead, Russian infrastructure needs are likely to generate great opportunities for financing and construction partnerships with the west.

It is the combination of competitive push and market pull that makes Russia/CIS a compelling draw despite the well documented difficulties. In the FIAC survey of 105 existing investors, 71 per cent said they planned to expand their commitment to Russia in the next three years, while 65 per cent of 48 non-investors were intending to enter the market (Figure 5).

Ernst & Young experience confirms this pattern: once companies have bedded down their first investment, subsequent ones rapidly follow. One client is now up to its seventh in two years. As this suggests, taking advantage of Russia’s rich opportunities may not be initially straightforward, but the effort is well repaid. Yet although rewards are potentially high, Russia is too complex to be approached on a quick in-and-out basis. Success favors those who study the market carefully, harness the best local knowledge, and are prepared to use the unexpected that will undoubtedly occur to rethink tried and tested methods.

Ukraine and Kazakhstan

While Russia continues to be the main focus, other CIS countries are beginning to appear on developed economies’ radar screens. The two most important are Ukraine, traditionally the most ‘European’ of the republics, and Kazakhstan, whose oil and gas reserves are increasingly attractive to China as well as the west. Transactions with Ukrainian targets totalled $2.1 billion in 2004, mostly involving domestic investors and the vast bulk (81 per cent by value) in the metals and mining sector³.

Figure 4

M&A announced deal value

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Note: All deals with domestic targets, excluding outward cross-border acquisitions.

* 9 months 2005 figure for Ukraine does not include $4.8 billion Krivorozhstal auction, as it was announced in October.
However, the boost to foreign confidence provided by political and economic reform in the wake of 2004’s ‘Orange Revolution’ can be measured in two spectacular billion-dollar deals in autumn 2005 — the auction of industrial giant Krivorozhstahl to Mittal Steel for almost $5 billion and the sale of Aval bank to Raiffeisen International for more than $1 billion. Even more activity is likely in the future. Now there is an increased interest from foreign investors, particularly in financial services and consumer products sectors, to gain more insight into the Ukrainian market. Many international players have already entered into due diligence with Ukrainian enterprises as one of their first steps into assessing the opportunities.

Meanwhile, Kazakhstan, the ninth largest country in the world, also aims to capitalize on growing foreign interest. Kazakhstan is advanced in terms of economic reforms. It was the first CIS country to obtain investment grade (Moody’s, 2002). Although most attractive for its energy resources, Kazakhstan is also making strides towards liberalization in banking, transportation and telecoms, with some of the largest state enterprises due to go under the hammer. The country claims to have received FDI of nearly $40 billion over the last decade. We believe that the market has great potential for growth, initially in oil and gas and subsequently in consumer products and other sectors.

Other CIS countries

The other CIS countries are less advanced down the economic reform road than Russia, Ukraine and Kazakhstan, and transactions accordingly less numerous. Several have important deposits of oil and gas and other natural resources — notably Azerbaijan, whose oil and gas reserves in the Caspian Sea basin are attracting increasing foreign interest. Azerbaijan’s economy grew by 10.2 per cent in 2004\(^4\). Georgia’s privatization program and accompanying economic reforms are expected to stimulate increasing foreign investment going forward, for example in transportation and infrastructure. In other countries (such as Turkmenistan, which possesses large gas reserves), transaction levels are likely to remain low in the absence of structural reforms and strong available local companies.

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\(^3\)Ernst & Young research and analysis

\(^4\)World Market Research Center
Toward Transaction Success

Although in Russia the definition of a business opportunity is one where returns are both rapid and high, it takes persistence and energy to unlock them – another aspect of the Russian conundrum. This is because cross-border transactions in Russia/CIS present unfamiliar challenges at each stage of the transaction lifecycle. Lack of public information, administrative barriers, legal complexities, and need for the correct documentation and licenses mean that a deal may take twice or three times as long as in Western Europe or North America. In turn, market entry in whatever form requires serious management effort and commitment, backed up by the best professional advice.

Target identification

Knowledge of the target market is nowhere more essential than in Russia/CIS. Although business is becoming more predictable in certain aspects, the competitive environment is evolving rapidly. Competition for targets is intensifying from both foreign and Russian sources, and more sophisticated entrepreneurs are increasingly aware of their funding options as the capital markets open up. On the other side, given its history Russian business has no culture of disclosure. Requests for information may not be productive, partly because of suspicion and partly because some Russian companies, particularly smaller regional ones, have little concept of what a foreign investor is looking for or even what the strategic options – outright purchase, partnership, joint venture or strategic investment – consist of. Smaller firms may have little or no experience of using professional advisers. Even larger firms may not have a website. Outside the main centers, language is also a barrier.

As a consequence of rapid change and widely varying individual histories, almost every Russian deal is different from every other. Researching the Russian market from abroad is practically impossible, and first-time investors are wise to treat target identification as an education process on both sides.

Investors use several distinct approaches to identify and research partners. Some manufacturers have appointed distributors and used this relationship to prospect the market, in some cases buying the distributor en-route to setting up their own operation. Other companies have seen Russia’s frontier environment as an opportunity to be first on the ground and thus make themselves visible to the most attractive targets via representative offices which allow them to spend up to two years familiarizing themselves with the market before identifying and approaching targets. A representative office has the added advantage of demonstrating commitment to the market. Existing investors too are likely to conduct the front end of the transaction process themselves.

Another group of first-time investors prefer to use professional advisers with first-hand local experience for the initial transaction stages. Advisers may, for instance, document the market and benchmark it internationally to enable a company to decide whether it is worthwhile setting up a representative office. In a number of cases, potential purchasers prefer professional firms to front for them at least until the short-list stage, or even to manage the transaction end-to-end. At a minimum, it is essential for potential investors to take advice on local customs and on what is and is not acceptable business behavior on both their own part and that of partners. Within reason, the more time and effort spent getting to know the particularities of the Russian market on the ground, the less the likelihood of unwelcome surprises later on.

Opportunity assessment

Due diligence

Due diligence is the most critical phase in the transaction lifecycle in Russia. In the stable business environment of developed economies, investors assess targets mainly on present risk. In Russia, companies have lived through a decade of fundamental change, during which some practices that were common at the beginning of the decade have become unacceptable, while others have changed out of recognition.
The chief risks therefore may lie in the past. This adds another dimension – and potentially much time – to due diligence, since it is hard to anticipate at the outset what the eventual scope of the process will need to be. As a rule of thumb, while in developed economies due diligence may turn up hidden surprises in one case in every 10, in Russia only one case in 10 does not. From experience, issues fall under a number of headings:

- **Ownership/legal questions.** Does the company own the assets it says it does and is planning to sell? Does it have the licenses to develop them? Is ownership transparent? To answer these questions, the incorporation and privatization documentation needs to be scrutinized in detail. Although fundamental problems are becoming rarer with distance from the initial privatizations, there are frequently documentation and registration issues with subsequent acquisitions which need to be thoroughly checked.

- **Governance.** Although improving among companies seeking access to the markets, corporate governance is often opaque and nowhere near required western regulatory standards.

- **Accounting.** Although the country is moving towards international standards, Russian accounting principles differ substantially from US GAAP and IFRS, and practice tends to favor form (laid down in detail) over substance. The function of accounts departments is largely to provide data for tax purposes, and companies often keep two sets of books, one cash-based. Off-balance-sheet transactions are common and sometimes have large economic implications, and companies do not always strictly observe debt covenants and funding requirements. Management accounting may be rudimentary or non-existent, providing little guidance as to how the firm actually operates and sometimes camouflaging management issues such as kickbacks or stock obsolescence. It is often poorly related to statutory financials and difficult to reconcile with history. In addition, Russian companies are relatively unsophisticated at budgeting and forecasting, rarely looking more than 12 months ahead. Interpreting the figures, and even being sure which are the correct ones, is therefore a critical part of the exercise.

- **Tax.** Tax issues are still a factor in most cross-border deals. There are a huge number of variables, depending on industry, public or private status of the parties, history, etc. Although Yukos was on a different scale, because of the overbearing tax regime, most companies had aggressive tax-optimization schemes in place until a few years ago, often involving offshore elements. Unscrambling or ring-fencing these in a new structure is therefore a priority in many Russian transactions. Transfer pricing and trades between related businesses may also be an issue.

- **Hidden liabilities.** Under the Soviet system, large industrial complexes located in the interior to take advantage of natural resources were the anchor for entire towns. As a result, some Russian industrial firms have a legacy of obligations for the upkeep of social and economic infrastructure – schools, hospitals and leisure facilities as well as community housing and heating, for example. It is also the case that such companies probably employ 10 times as many people as would be customary in developed economies. Apart from the legal issues, taking a line on social and employment obligations is a fine balance. Although labor efficiency seems poor by developed economy standards, labor and utilities are cheap, keeping unit costs low. Conversely, abandoning traditional obligations may be politically impossible, at least in the short term.

The nature of the hazards, varying information formats and accounting standards, lack of pre-existing information and unfamiliarity of many companies with transaction needs make due diligence in Russia a labor-intensive affair – an exercise in triangulation of a number of data points in addition to the financial due diligence review. For these purposes, traditional ‘data-room’ approaches are not practical. Typically the process involves a sizeable team of professional advisers working on site with the management and chief accountant to build up and interpret the necessary information.
Valuation

Because of all the foregoing, valuation too is not always straightforward in Russia/CIS.

As noted earlier, the ‘Russia discount’ has been steadily shrinking. One factor is the country’s improving credit rating in general: its debt is now classified investment grade. At the same time, Russia’s growth rate and size are becoming increasingly attractive to potential buyers in slow-growing developed countries, and investor perceptions of political stability and commitment to continuing reform are favorable. A third factor is increasing awareness among Russian managers and entrepreneurs of the strategic value of their assets. As a result, there are fewer bargains than there used to be among the larger Russian companies.

Competitive pressures mean that in some sectors, prices for second-line, less transparent targets are creeping up as well. In the regions away from the main population centers, valuations are unsurprisingly lower, reflecting poorer transparency, limited infrastructure and weaker market prospects.

Because the economy is evolving so fast, timing may also be a part of the valuation equation. Sustained growth rates mean that in some cases companies that look fully valued or even expensive at the time will seem cheap three years later, marginal ‘overpayments’ fading into insignificance. By then, a top-line strategic partner may no longer be available whatever the price.

Fast-changing conditions and the presence of so many variables (tax position, contingent liabilities) mean that even last month’s price may not be a useful valuation guide today. Balancing all these factors makes judgments about valuation in Russia/CIS a fine art, requiring both skill and experience.

One area that requires particular attention is intellectual property – and intangible assets in general. One of Russia’s major advantages is its highly educated workforce – in some sectors, such as IT, it may be the most valuable asset. Historically, such values have rarely been recognized or taken into account. As part of due diligence and subsequent valuation, it is important that potential buyers properly identify patents, know-how and other IP, and ensure that both sides know what is included.
In general, because firms do not always employ professional advisers, investors should expect to spend much time and effort explaining the deal and making that target managers understand what it entails. This means that valuation can often seem to take a frustratingly long time.

**Restructuring/post-merger integration**

Deals in Russia tend to be complex:

- There is often an offshore element and some degree of restructuring to contain future tax problems;
- A large Russian company will have a number of separate legal entities: can you simplify the existing structure or integrate it with others to make it more tax efficient?
- From the buyer’s point of view it is critical to structure the transaction not just for entry but also for possible exit – an aspect that is often overlooked;
- It is sometimes hard to interpret what the seller wants. Nonetheless, although the preliminaries can be long-drawn-out, it is important to act fast when the time comes. A few investors have missed out when targets have lost patience with what they saw as investor delay at the critical moment.

Partly because the deal itself takes longer and absorbs more resources than investors are used to, they often fall down by failing to devote adequate attention to post-deal aspects – how they will actually integrate and run the target. In fact, integration is likely to be at least as much of a management challenge as the acquisition. People issues are particularly important.

Companies from developed economies are often tempted to replace existing management, but it is unwise for the deal team to withdraw leaving an entirely new and untried team to cope with all the unexpected operational issues that will undoubtedly arise. On the other hand, the investor will want to have a say in, or control over, the appointment of the CEO and chief accountant, the Russian equivalent of the CFO.

Involving existing managers in pre-transaction planning enables learning on both sides and can help circumvent common problem areas such as software incompatibilities and widely differing management cultures. Companies should not make the mistake of failing to line up competent expatriate managers for posts in the new company where appropriate. This sounds elementary, but several deals have been delayed or the benefits diminished because of failure to put the right expatriate managers in place.

In addition to people and operational integration issues, companies also need to focus on corporate governance. It is hard to tell whether the need for Chief Executive Officers to sign off on internal controls under Sarbanes-Oxley has had an effect in deterring US companies from making acquisitions in Russia/CIS – there is anecdotal evidence both ways. Nevertheless, acquiring companies must reckon with the fact that their new acquisition is unlikely to meet international governance standards as it stands. Hard work on internal processes right through the company will be required to bring them into line.

Many companies are overstaffed by developed country standards even if overall costs are low, and some retain significant social obligations. In other cases, critical know-how is locked up in the heads of key employees; the value of a deal painstakingly researched and negotiated over years can evaporate in the first six months if they quit.
Oil and gas
Oil and gas has traditionally commanded the lion’s share of cross-border transactions in the CIS region.

In Russia, activity continues to be strong, at least in terms of overall deal value. The total number of deals, however, is now more evenly shared with other sectors such as metals and mining, financial services, retail and consumer goods (Figure 8). Over the last 12 months, however, attention has shifted dramatically to internal deals which have centralized government control over the oil and gas industry and reshaped the transaction environment in the sector.

With the $9 billion purchase of the major Yukos production arm Yuganskneftegas by oil giant Rosneft and the $13 billion acquisition of Sibneft by the natural-gas monopoly Gazprom, the state now controls almost 30 per cent of Russia’s total oil output. At the same time the government proposed a draft of a subsoil law which would bar companies with majority foreign ownership from bidding for licenses for some of Russia’s oil and natural gas deposits and minerals.

The government plans to list ‘strategic’ fields where foreign investment will be limited, and has already identified five protected deposits – three oil and gas fields in Siberia and Timan-Pechora, the Udokan copper deposit and Sukhoi Log goldfield. Strategic status is planned to be granted to untapped fields and will not apply to deposits already in production. At the same time, as of November 2005, this draft law was still under discussion. It is expected that it could come into force in the second half of 2006 if approved by parliament.

While minority foreign shareholdings in Rosneft and Gazprom will be permitted after the abandoning of merger plans between the two state-owned giants, it seems unlikely that cross-border transactions like that which created the BP-TNK venture, the world’s 10th largest oil company, will be allowed in the future. Conoco-Philips acquisition of 10 per cent of Lukoil, another oil major, is a more likely pattern.
That said, the region will continue to be a compelling draw for the world's oil corporations for the foreseeable future. Russia/CIS is the last frontier for oil and gas exploration. No global player can afford not to be present, whatever the form of the participation. In particular, eastern Siberia is sitting on vast untapped reserves that are currently inaccessible because of hostile terrain and lack of infrastructure to ship oil or gas out.

New pipeline construction is under discussion, however, and the higher the oil price, the more rapidly outlying fields become viable. Russia is well aware of the stakes here.

We expect that consolidation and restructuring will continue in the oil and gas industry, with substantial foreign involvement as the majors jockey for position around the region’s reserves. While Siberia and the far east of Russia will be important in the long term, more immediate investor attention may center on another CIS country – Kazakhstan.

As a result of economic reforms and a strategic position within reach of both Europe and China, Kazakhstan is enjoying an oil and gas boom. It aims to triple oil production by 2015. So far foreign investment has mainly consisted of greenfield projects, US and European groups being heavily involved in the republic’s three major known deposits. However, cross-border deals, largely oil and gas based, are growing fast in value: China National Petroleum Corporation’s $4 billion purchase of Toronto-quoted PetroKazakhstan in October 2005 more than quadruples the 2004 figure and is likely to trigger an upsurge of new interest on the part of Western companies.
Metals and mining

The region’s vast resources make metals and mining the second most important focus for investor interest after oil and gas.

In a busy Russian M&A market, major domestic steel producers have continued to acquire upstream companies to secure their resource base, and last year saw the sale of the last remaining independent iron ore and mining complexes at Mikhailovskiy, Stoilenskiy and Kachkanarsky. But cross-border activity has also increased, with Alcoa’s $257m acquisition last year of a controlling stake in two aluminum fabricating facilities providing an important stimulus for foreign strategic investment. There are also a number of international players on the Russian gold mining scene (e.g. Peter Hambro Mining, Barrick Gold).

As noted in the previous section, government plans to include the country’s largest untapped goldfield, Sukhoi Log, and huge Udokan copper deposits on its ‘strategic list’ will bar foreign investors from participating in auctions for these most lucrative assets. On the other hand, foreign interests will be able to tender for many other projects except the largest ones.

It seems likely that M&A activity in the sector will remain strong as consolidation and formation of alliances continue and cross-border players seek to enter.

However, over the last year Russian developments have been put in the shade by events in Ukraine. Metals and mining are as important to Ukraine as are oil and gas to Russia, accounting for 81 per cent of M&A transactions with Ukrainian targets in 2004 (almost all privatizations).

Dwarfing the total of $2.1 billion for all these deals in 2004, the October 2005 auction of the country’s flagship steel mill, Kryvorizhstal, netted a stunning $4.8 billion, more than double the original estimate, as strong competition between the eventual buyer Mittal Steel, a consortium headed by Arcelor and the Russian-owned Smart Group pushed the price up. Mittal has said that it would also like to buy an uncompleted iron ore mine and dressing mill near Kryvorizhstal. The transparent and inclusive nature of the auction will go some way towards reassuring foreign investors who have been hesitant to commit (FDI) to Ukraine after being held at arm’s length by the previous regime. At the same time, President Viktor Yushchenko has indicated that pricing and process disputes will be settled by negotiation rather than resale in the future.

In the short term, activity in Ukrainian mining and metals will be determined by China’s demand for steel. Even if that wanes, however, the political events of 2004 and accompanying land and tax reforms, the avowed desire to attract FDI and an economy growing at double-digit speed are likely to underpin a continued increase in foreign investment, in the form of both M&A and greenfield projects.

Kazakhstan too has a significant mining sector – the country is rich in copper, zinc, coal and other mineral resources, and transaction activity is increasing. In 2005 the main events have been public placements rather than M&A. Thus, in October, Kazakhmys, the largest copper producer in the CIS, generated $1.2 billion from its IPO on London’s main stock market, and several more natural resources companies have announced their plans to go public.
Banking and financial services

Although oil and gas, according to World Bank estimates, still accounts for an overwhelming 25 per cent of Russian GDP, every city center testifies to the trickle-down effect that is now beginning to occur in the consumer and banking sectors. Retail trade grew last year at almost 10 per cent, substantially exceeding the overall growth rate of economy. This was fuelled in part by rising living standards, but also by the appearance for the first time in Russia of consumer credit.

As a result, the last two years have seen a wave of banking consolidation, reflected in the rapid rise in the value of M&A activity in the sector (around $1.3 billion in 2004) and increasing deal size. So far consolidation has affected mainly the myriad of smaller banks, some banks in name only, which do not have the capital to support growth. However, the larger Moscow banks are now increasingly looking to regional organizations for expansion.

International banks are increasing their activity on the Russian market. In 2005, Société Générale Group strengthened its position in mortgage and consumer loans by acquiring DeltaCredit in Moscow and Promek-Bank in Samara, while Italy’s Banca Intesa paid $90 million for a controlling stake in KMB bank, which focuses on small business lending. Noteworthy in 2004 were: the sale of mid-sized retail DeltaBank to GE Consumer Finance for $100 million, the price reflecting high expectations for the development of the Russian loans market; and the purchase by EBRD of blocking stakes in several well-placed regional banks – Sibacadembank in Novosibirsk, Uraltransbank in Ekaterinburg and Tsentr-Invest in Rostov-on-Don.

In light of rising household income, continuing reforms and growing competition from foreign banks, we expect further banking consolidation to drive increasing levels of M&A activity in the sector in the next few years, with regional and retail expansion leading the charge. Foreign investors will certainly participate in this wave, partly for reasons of strategic timing and also to avoid the stipulation that new banking enterprises must wait for three years before entering the retail sector.

The same broad economic trends, including rising living standards and shrinking government benefits, are also beginning to stimulate demand for private insurance, provoking growing investor interest in the sector. Larger Russian insurers are already beginning to mop up smaller domestic outfits.

As for cross-border transactions, Germany’s Allianz last year established a life- and casualty-insurance venture with Moscow-based Rosno, Russia’s third-largest insurer by gross premiums. As a global financial services provider Allianz, Europe’s largest insurer, considers Russia, along with India and China, a strategic growth market. Allianz’s move may well trigger competitive reaction from other global groups. Other examples include the acquisition of Standard-Reserve by TBHI and the setting up of local offices by AVIVA and ACE.

As resource development feeds through into the broader economy, western companies are starting to prospect for banking and financial services opportunities in other areas of the CIS, particularly in Ukraine. The attractions of Ukraine, already the most ‘European’ of the republics and with a relatively homogeneous population of 47 million, have been much amplified by recent political and economic reforms. Just days before Kryvorizhstal’s auction in October 2005, Raiffeisen International, the eastern European arm of the Austrian banking group, acquired Ukraine’s second largest bank, Aval, for more than $1 billion. More deals will follow: other European banks were currently in merger discussions with targets that included Ukrsoptsbank and Ukrsibbank, respectively Ukraine’s third and fourth largest banking groups.

5Ernst & Young research and analysis
Consumer products/food and beverages

Food and beverages companies accounted for 5 per cent of 2004’s Russian deal volume by value, with average deal size jumping to $50 million. For the first half of 2005 the share of the sector in total M&A value increased to 15 per cent. This reflects continuing high investor interest in a sector that raises few political complications and directly benefits from rising disposable income and consumption levels. Double-digit retail growth in Russia contrasts sharply with fierce competition and stagnant growth at home.

With a few exceptions, concentration in these markets is relatively low compared with other industries. Since most companies are quite small by developed economy standards, increasing competition, pressure on margins from retailers and the need for capital to grow market presence is likely to drive industry consolidation. Companies with established brands increasingly attracting competition from both domestic and foreign sources. Greenfield investment – with the advantage of tax and other transparency – also has its attractions as producers seek to increase capacity in line with market growth.

Beer and soft drinks are a good example of current trends. Brewing has long been favored by foreign investors, and many of the obvious opportunities have now been snapped up. In recent acquisitions, Heineken and InBev (formerly Interbrew) have added to their Russian assets both in Moscow and the regions, while SABMiller is substantially expanding its Kaluga Brewery.

In 2005, much interest has centered on soft drinks, consumption of which – particularly juices and bottled water – is predicted to grow strongly. In 2005, Coca-Cola spent $501 million buying Russia’s second largest juice producer, Multon, and expects to commit a further $100-$150 million a year to growing its Russian business, central to its global growth strategy. Arch-rival PepsiCo, another heavy spender, plans to build a new line at its just-opened St Petersburg plant at a cost of $30 million.

Other significant multinational investors in consumer and related areas include Mars, Unilever, Philip Morris and BAT. Many Russian companies are also seeking foreign investment and partnership to expand both inside the country as well as to other CIS markets. We also see more foreign strategic investors taking a closer look at Ukrainian and Kazakh consumer products sectors.

Infrastructure

For Russian GDP to double in the next decade as President Putin has estimated, a huge effort will be needed to upgrade the country’s infrastructure to today’s standards. Some 75-80 per cent is in need of renewal, according to estimates. The requirements are enormous in energy ($9 billion a year for power stations alone), transport – road, rail, bridges and airports – schools and hospitals, and municipal works, especially water, sewage, and waste treatment. Even with a soaring oil price, this is far beyond the capacity of the federal budget to finance, always assuming the money were properly spent.

This puts a premium on developing long-term public-private partnerships (PPPs) or other innovative credit concepts for the public sector. So far these have been the exception rather than the rule. One reason is the lack of a legal and contractual framework for such arrangements. This is changing with the enactment in 2005 of a ‘concession law’, although it remains to be seen how it will work in practice. Another barrier is attitudes. At the municipal, and to a certain extent, the government levels, a combination of national pride and suspicion of private sector motives has meant that motivation for partnership, particularly with foreign interests, remains weak.

On the supply side, the rapid growth of developed economy banks lending to Russian corporates shows that under the right conditions there is plenty of appetite for large scale projects. If the few pilot projects now under way are successful and the government is persuaded to outsource the infrastructure effort in earnest, this could become an increasingly attractive opportunity over the next few years. A lead may come from Ukraine, where for instance 40 per cent annual growth in air travel has made the infrastructure a priority for the new administration. Watch this space.

6Ernst & Young research and analysis
Private equity

There is no vibrant venture capital culture in the CIS region. The capitalist model is relatively new here, so there are only a limited number of mid-cap companies of a size to attract the big global funds. However, the availability of private equity is improving if from a low level and the size of potential deals likewise increasing. For instance:

- In February 2005, Baring Vostok raised $400 million for its third fund to invest in Russia, Ukraine and other former Soviet Union countries;
- Delta has already invested about $300 million in Russian fast-growing companies through its US-Russia fund and successfully exited from a number of its shareholdings (e.g. the sale of DeltaBank and DeltaCredit). This year Delta raised $120 million for a new fund to focus on investments in Russia and Ukraine;
- Russia Partners II, a follower of the Russia Partners fund, is expected to raise up to $350 million;
- Western NIS Enterprise Fund which invests in Ukraine and Moldova, plans to raise a second private equity fund this year.

So far, foreign PE funds have trodden cautiously in terms of both size and type of deal. It will be some time before they begin to compete for the best deals with corporate buyers, as in the west. However, it is becoming clear that in an environment where ambitious companies can grow at 30 or 40 per cent or more a year, there are substantial returns to be made by taking a minority stake that can be sold to a strategic investor in two or three years’ time. Private equity involvement, both foreign and domestic, is likely to grow as the information and other constraints suffered by all outside investors are removed.
In Summary

After the false starts and genuine hardships of the immediate post-Soviet reforms, Russia and the CIS region are at last in sight of fulfilling their huge economic potential. Progress is of course not even. Political and ethnic tensions complicate the issue in some areas, and while in some countries structural and other liberalization is well advanced, in others it has barely begun. But there is growing awareness among administrators that foreign investment and know-how will need to play a key role not only in exploiting their petrochemical and mineral riches but also in meeting their citizens’ appetite for the goods and services taken for granted in the west.

Russian entrepreneurs are smart and becoming increasingly sensitive to investor needs. Foreign investors are keen to respond, as demonstrated in the growing share of sectors such as consumer goods and financial services in today’s deal totals. We expect this trend to strengthen as economic activity in the region continues to broaden and deepen. While the macroeconomic framework is encouraging, none of this is to imply that doing deals in Russia/CIS is anything but challenging.

The complicated legacy of the past is still present in a continuing lack of transparency and weaknesses in accounting and legal processes. Tax continues to be a concern, as do court procedures and the pace of administrative change. Treading a path through the transaction lifecycle is a delicate and time-consuming process that demands patience and the best possible professional advice. However, while there is still a way to go, the direction of change is unmistakable. Each new deal reinforces it; indeed, shaping the future of one of the most exciting emerging markets in the world is part of the attraction of what is on offer in the territory today. Both geographically and temperamentally, Russia/CIS is a stepping stone between Europe and the Far East. We believe that ambitious companies will want to study the market carefully to take advantage of the unique opportunities that it offers, and we stand ready to help them do so.
Leader in Transactions in Russia and CIS

The establishment of our practice in Moscow in 1989, meant that Ernst & Young was the first international professional services firm to establish operations in Russia and the Commonwealth of Independent States (CIS). Today, with more than 100 transaction advisory services professionals, Ernst & Young is the market leader – both by number of advisers and by value and volume of deals advised among the ‘Big Four.’ Ernst & Young also holds the overall number one financial adviser position, ranked by number of deals in the region (Figure 9).

Our team provides integrated advisory services through the entire transaction lifecycle, including lead advisory, due diligence, valuation, project finance, restructuring and transaction integration.

Complementing our transaction professionals, there are a broader team of 2,000 people in Ernst & Young CIS in 13 offices across seven CIS countries. Across our major services – assurance and advisory business services, tax and transaction advisory, we service a large number of the biggest names in Russia and the CIS along with leading multinational corporations.

A key adviser to the Russian government, Ernst & Young is the leading provider of project finance advice on public-private partnership (PPP) projects. Our industry expertise in oil and gas, utilities, mining, industrial products, consumer goods, financial services, telecommunications, technology and media, real estate and infrastructure is resident in our team, adding valuable sector know-how to our technical and transaction experience. This ensures clients receive practical and timely advice.

Global reach and international experience enables the Ernst & Young team to provide advisory services for complex cross-border deals and staff multinational engagements. With a team of 5,100 Transaction Advisory Services people in 70 countries, our relentless focus on quality and our strong track record have made Ernst & Young a chosen adviser in thousands of transactions involving clients in every industry and every market. And as part of the broader Ernst & Young professional services organization there are 106,000 people in practices over 140 countries whose expertise can be leveraged.

Figure 9
Financial Advisers Ranking – Russia, 9M 2005 (completed deals)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company</th>
<th>Number of deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Ernst &amp; Young</td>
<td>9</td>
</tr>
<tr>
<td>2</td>
<td>UFG-Deutsche</td>
<td>8</td>
</tr>
<tr>
<td>3</td>
<td>Troika-Dialog</td>
<td>8</td>
</tr>
<tr>
<td>4</td>
<td>Citigroup</td>
<td>3</td>
</tr>
<tr>
<td>5</td>
<td>Morgan Stanley</td>
<td>3</td>
</tr>
<tr>
<td>6</td>
<td>Renaissance Capital</td>
<td>3</td>
</tr>
<tr>
<td>7</td>
<td>IB “Trust”</td>
<td>3</td>
</tr>
<tr>
<td>8</td>
<td>Dresdner Kleinwort Wasserstein</td>
<td>2</td>
</tr>
<tr>
<td>9</td>
<td>Merrill Lynch</td>
<td>1</td>
</tr>
<tr>
<td>10</td>
<td>ING-Bank</td>
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</tr>
</tbody>
</table>

Source: Mergers & Acquisitions magazine, November, 2005
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