Market Intelligence

PRIVATE EQUITY 2020

Global interview panel led by Simpson Thacher & Bartlett

LEXOLOGY®
Getting The Deal Through

LEXOLOGY
Getting The Deal Through

Publisher
Edward Costelloe
edward.costelloe@lbresearch.com

Subscriptions
Claire Bagnall
claire.bagnall@lbresearch.com

Senior business development manager
Adam Sargent
adam.sargent@gettingthedealthrough.com

Business development manager
Dan Brennan
dan.brennan@gettingthedealthrough.com

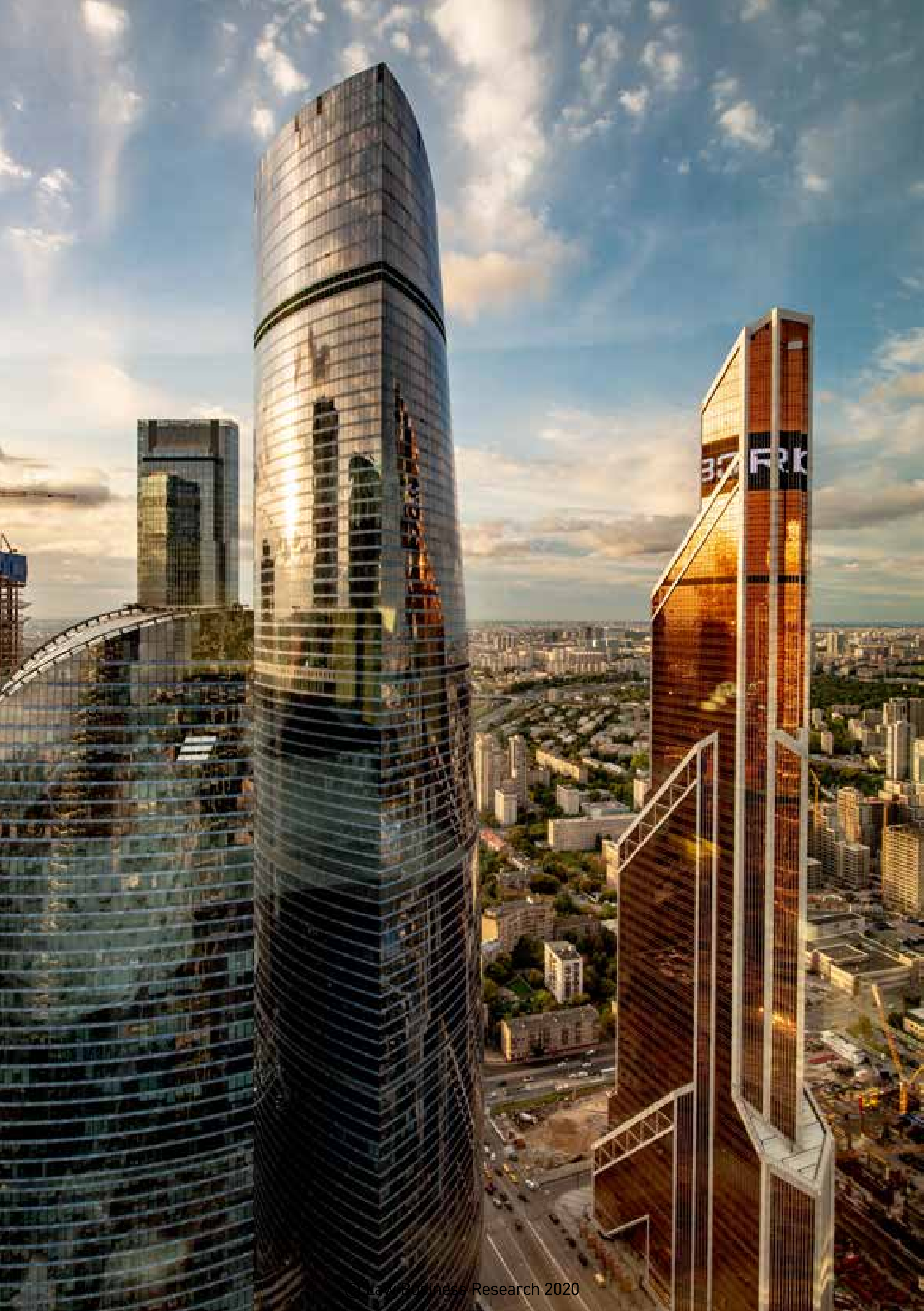
Published by
Law Business Research Ltd
Meridian House, 34-35 Farringdon Street
London, EC4A 4HL, UK

Cover photo: Songquan Deng/shutterstock.com

ISBN: 978-1-83862-420-0

Printed and distributed by Encompass Print Solutions

Private Equity 2020



Russia

Alexei Roudiak is a Russian corporate lawyer and the managing partner of the Europe, the Middle East and Africa offices of Herbert Smith Freehills. He advises Russian and international clients on all aspects of M&A projects, private equity deals and corporate restructurings. He is highly skilled in dealing with complex joint venture issues (both formation and break-up), defending against hostile take-overs (both structuring and litigation strategies) and advising on investments that involve state participants and offshore structuring issues. Alexei has developed a particular expertise in the energy and natural resources and real estate sectors.

Stefan Kecman is a senior associate. He advises on a broad range of corporate transactions, including international and domestic public and private M&A (including private equity transactions), joint ventures, initial public offerings and other equity capital markets transactions and corporate advisory work.

Sergei Eremin, is a Russian-qualified senior associate specialising in national and cross-border corporate and individual taxation, investigations and sanctions.

Graeme McIntyre is a corporate associate who advises on public and private M&A (including private equity transactions) and joint ventures in relation to transactions and projects primarily in Russia, the Commonwealth of Independent States and Europe.

1 What trends are you seeing in overall activity levels for private equity buyouts and investments in your jurisdiction during the past year or so?

Market conditions in Russia had been improving in 2018 and 2019, with commentators reporting an overall increase in the number of private equity deals, and this trend had been expected to continue in 2020. However, in line with other major economies, the Russian economy sharply contracted in the first half of 2020, driven largely by the impact of the global covid-19 pandemic, and this has led to a decline in private equity activity in 2020.

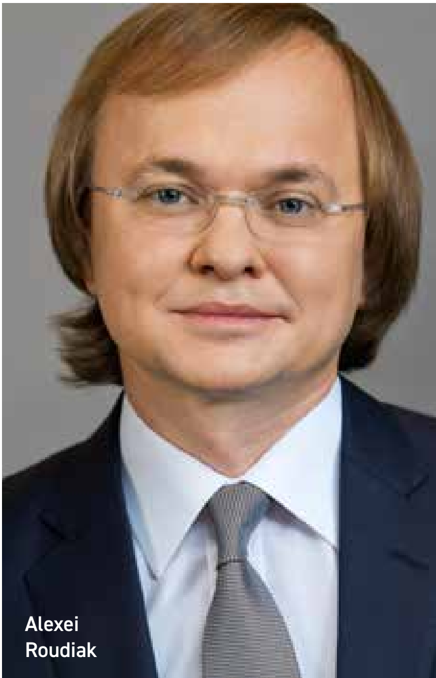
After growing 1.6 per cent in the first quarter of 2020, according to preliminary data released by the Federal Statistics Service in August 2020, the Russian economy suffered an annual 8.5 per cent reduction in the second quarter of 2020 (a 9 per cent drop was predicted in a *Reuters* poll of analysts in late June 2020). Only Russia's agriculture sector grew in the second quarter, with commodity, retail, transport and the services sectors being the hardest hit. According to a World Bank report published in July 2020, Russia's 2020 GDP growth is projected to contract by 6 per cent, an 11-year low, with a moderate recovery projected in 2021 to 2022.

In addition to the impact of the global covid-19 pandemic, the Russian economy has also been challenged in 2020 by the sharp decline in oil prices (which has had a substantial impact on Russia as a leading global energy exporter) and the depreciation of the Russian rouble against other major currencies in the first half of 2020. Furthermore, the risk of US and EU sanctions (while not escalating recently) remains. Finally, the President announced in early 2020 the renegotiation of double tax treaties with what Russia considers to be transit jurisdictions to dramatically increase withholding tax on dividends and interest sourced from Russia.

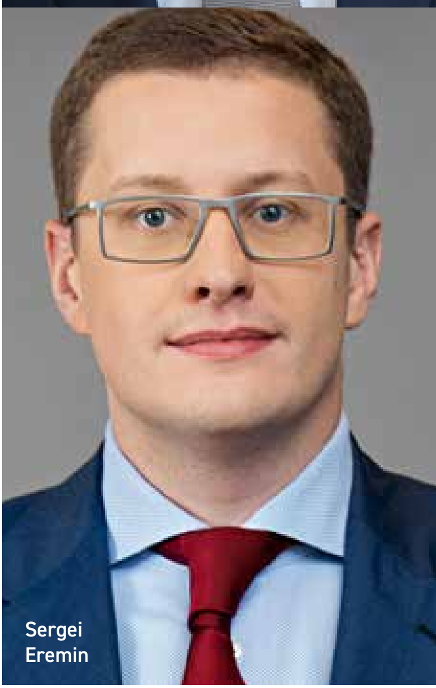
These negative trends, and the associated uncertainty for the Russian economy, are likely to depress private equity activity in Russia and, in particular, investors are likely to adopt a 'wait and see' approach to major transactions during 2020, deferring these decisions into the first quarter of 2021.

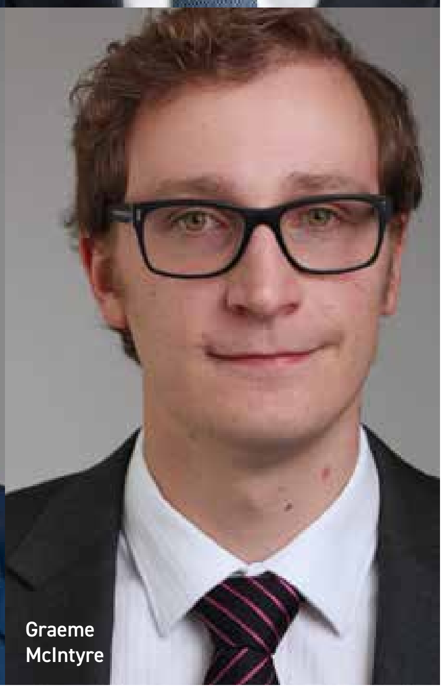
At the same time, the current situation has also presented new opportunities in stressed and distressed private equity transactions, and certain sellers have also been exploring the acceleration of anticipated disposals of non-core or underperforming businesses to raise cash.

Unlike in other jurisdictions, an initial public offering (IPO) is not a common exit strategy for private equity in Russia and therefore there is not a particularly strong correlation between changing stock market valuations and private equity activity. The only notable IPO in 2019 and the first half of 2020 was the listing of HeadHunter (a leading Russian online job search portal) on the NASDAQ


Alexei
Roudiak


Stefan
Kecman


Sergei
Eremin


Graeme
McIntyre

exchange and while there were numerous negotiated private equity exits during this period, it remains a challenging market to successfully exit from a private equity investment.

Overall, the Russian private equity market faces a tough period and we are unlikely to see a major uptick in transaction activity or new fundraisings in the next 12 months.

Photo by Viacheslav Lopatin on Shutterstock

2 Looking at types of investments and transactions, are private equity firms primarily pursuing straight buyouts, or are other opportunities, such as minority-stake investments, partnerships or add-on acquisitions, also being explored?

Buyouts (whether by management or otherwise) and public-to-private transactions tend to be relatively uncommon in Russia. It is more common for investors to take minority stake investments. Where control is acquired, these investments tend to be carried out by way of a consortium deal. One of the main drivers for this is financing. As with any jurisdiction, investors can access larger deals by clubbing together, but this increased financial resource is particularly relevant in Russia where deals tend either to involve limited debt financing or none at all.

Finance is just one reason why foreign investors often seek out local investors with whom to partner. Russia has a reputation as a jurisdiction in which it is desirable to have a strong local partner to achieve a successful business operation. A domestic partner brings local knowledge and connections that can be indispensable for foreign investors who are unfamiliar with the Russian regulatory system or who lack relations with the Russian authorities. Partnering with a local private equity house may make obtaining investment committee consent easier, as comfort is taken from the experience, expertise and influence of the local partner. For the Russian investor, involving an international partner may provide access to funding from banks based in the same overseas jurisdiction as the foreign investor and carries with it a certain cachet that can be of particular leverage when marketing a business for sale or further investment or trying to negotiate an exit. In addition to funding, international investors can bring a greater depth of deal experience and sector knowledge to what is still a developing private equity market.

3 | What were the recent keynote deals? And what made them stand out?

The key deals in 2019 and the first half of 2020 have centred around three broad themes:

- the 'pivot east', evidenced by the relatively high levels of inbound investment from Asian and Middle Eastern sovereign funds to Russia;
- the diversification of private equity investments across a broader range of sectors (outside the traditional extractive industries), with particularly strong performance in the innovation and technology sector; and
- the increase in the number of private equity investments by major Russian state-backed players (such as Sberbank, VTB and the Russian Direct Investment Fund (RDIF)).

Throughout 2019 and the first half of 2020, a number of significant inbound investments were executed by Asian and Middle Eastern funds. These included:

- a consortium of RDIF, the Russian-Chinese Investment Fund (RCIF) and several Middle Eastern funds acquiring a 28 per cent stake in Alium (a top 10 pharmaceutical company in Russia);
- a consortium of investors, including RDIF, RCIF, Mubadala Investment Company (an Abu Dhabi sovereign fund), among others, acquiring a stake in ivi.ru (the leading online video streaming service in Russia);

- a consortium of RDIF, along with partners from France and the Middle East acquiring a stake in Elementaree (a market leader in the delivery of ready-to-cook meal kits); and
- a consortium of RDIF, Baring Vostok and leading funds from the Middle East acquiring a stake in Carprice (one of the largest car sales services in Russia).

Another standout deal involving a Middle Eastern player in this period was the investment by Mubadala Investment Company of US$637 million in the Galeria Mall in St Petersburg.

According to public reports, RDIF is actively negotiating further deals with Asian and Middle Eastern sovereign funds. We expect the trend of significant inbound investment by Asian and Middle Eastern sovereign funds to continue as these investors become increasingly comfortable with the Russian market and, as highlighted in question 6, RDIF continues to stimulate interest among them.

The second key trend of 2019 and the first half of 2020 was the diversification of private equity investments across a broader range of sectors (outside the traditional extractive industries), including banking and insurance, innovations and technology, consumer markets, communications and media, and healthcare. The diversification of private equity investments reflected the strong levels of consumer confidence before the effects of the covid-19 pandemic were felt and the then-availability of quality private equity targets in consumer-facing sectors, which had, in part, been driven by lower domestic production costs from the relatively weak rouble and the shift in consumption towards domestically produced goods. This trend had also been supported by the Russian government's focus on diversifying the domestic economy and export base, which has traditionally been dominated by extractive industries; a policy priority that looks set to remain a key Russian government focus in the coming years.

The innovation and technology sector was a standout performer in 2019 and 2020, and we expect this trend to continue. The activity in this sector is supported by the trends of digitisation of the economy (which has been in part accelerated by the covid-19 pandemic) and the building of 'ecosystems' of digital brands under the auspices of established Russian businesses. Notable deals included:

- the acquisition by Rostelecom of a majority stake in Tele2 Russia Telecom (a Russia-based company engaged in mobile telecommunications services) from VTB and other shareholders for US$2 billion;
- the acquisition by DXC Technology of 100 per cent of Luxoft (a Russia-based IT company) from existing shareholders for US$2 billion; and
- a share buy-back by MegaFon of 20.4 per cent of its share capital for US$1.27 billion.

> "The innovation and technology sector was a standout performer in 2019 and 2020."

Sberbank (a major Russian state-backed bank), which was mandated by the government to build a world-class digital ecosystem, has been especially active in the innovation and technology sector. In 2019 and the first half of 2020, Sberbank acquired stakes in MF Technologies (a major shareholder in Mail.ru Group) and 2GIS LLC (a company which provides local search and city navigation services). Sberbank also established a joint venture with Mail.ru Group for food-tech and mobility services (combining Delivery Club, YouDrive, DC Daily, Performance Group and Foodplex) which was valued at US$1.5 billion, among numerous other deals. According to recent media reports, Sberbank is set to continue its acquisition spree and is in talks to buy up to 30 per cent of Ozon (a leading Russian online retailer, which has also attracted investment interest from US e-commerce and technology giant Amazon).

Other standout deals in the technology and communications space were:

- the acquisition by South African company Naspers of a 29.1 per cent stake in Avito (a leading e-commerce platform) for US$1.2 billion;
- the acquisition by Ivan Eremin of Business News Media (the publisher of leading Russian business daily newspaper, Vedemosti) from Demyan Kudryavtsev; and

- the acquisition by Goldman Sachs and Baring Vostok of a majority stake in Tinkoff Digital Limited (a Russia-based comparison website for insurance, loans and mortgages) from Oleg Tinkov.

The third key trend of 2019 and the first half of 2020 has been the increase in the number of private equity investments by major Russian state-backed players (such as Sberbank, VTB and RDIF). As described, both RDIF and Sberbank have been particularly active. VTB, a major Russian state-backed bank, has also made several large investments in this period. For example, VTB acquired control of Rustranscom (the leader in rail transportation of grain in Russia and Kazakhstan and of timber and mineral fertilisers in Russia), a 33 per cent stake in the European Legal Service (a leader in the Russian market for distance legal services) and a controlling stake in Domyland (a provider of real estate management systems). This trend looks set to continue in 2021 and beyond as Russian state-backed players continue to grow in confidence and experience, and have capital available to deploy on private equity investments.

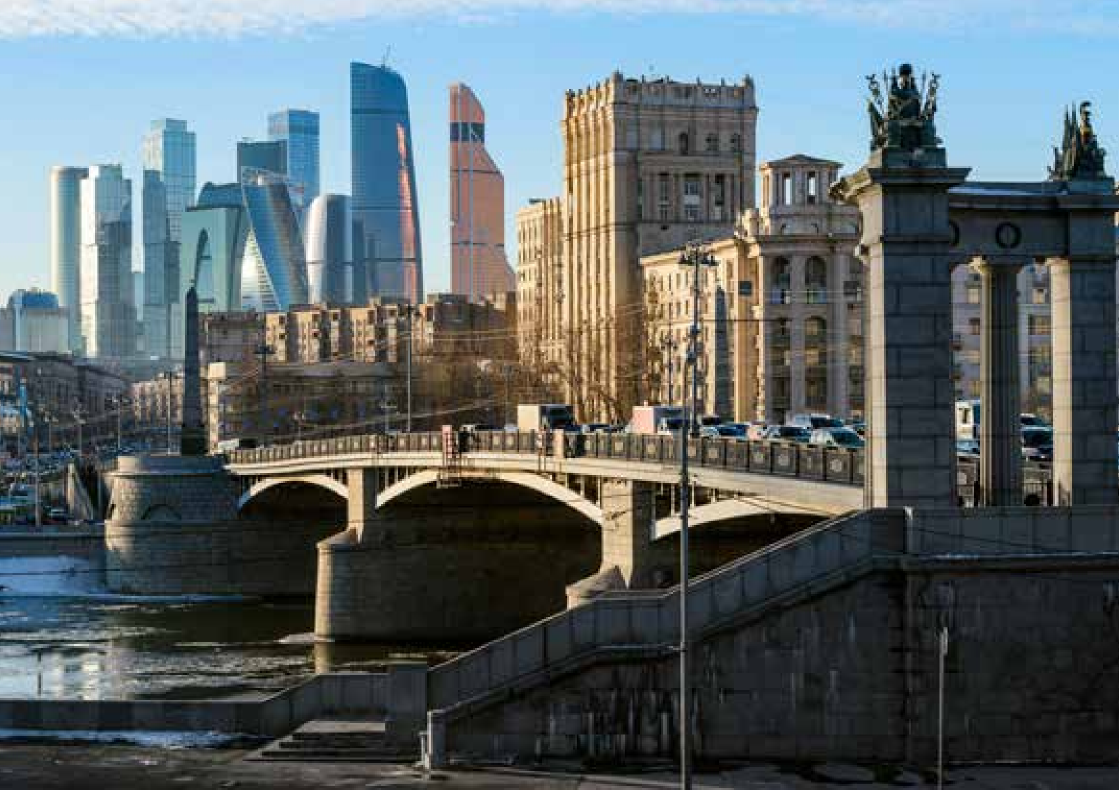
Finally, many ‘classic’ private equity deals continue in the market. For example:

- the acquisition by Baring Vostok of a minority stake in Synergetic (a fast-growing Russian manufacturer of environmentally friendly cleaning products and cosmetics);
- the acquisition by Vostok New Ventures and Baring Vostok of a minority stake in Monopoliya (a leading Russian transport and logistics operator); and
- the acquisition by Elbrus Capital of a significant minority stake in YCLIENTS (a leading software-as-a-service business management platform in Russia and the Commonwealth of Independent States (CIS)).

Another noteworthy deal in the period was DKBR and Krasnoe i Beloe entering into a joint venture to create a combined Russian retailer valued at US$2.6 billion.

4 Does private equity M&A tend to be cross-border? What are some of the typical challenges legal advisers in your jurisdiction face in a multi-jurisdictional deal? How are those challenges evolving?

Most private equity deals relate to Russian targets and, despite some investment activity by international funds (particularly based in Asia and the Middle East), foreign investors are still in the minority. Outbound investment by Russian private equity sponsors in overseas investment opportunities is rare, although LetterOne has proved comparatively active in this respect, acquiring Holland & Barrett, Europe’s largest health and wellness retail chain, for £1.7 billion in 2017, and



completing a business merger with BASF in 2019 to create Wintershall Dea, the largest independent oil and gas exploration and production company in Europe. On the other hand, VTB Capital completed a major overseas divestment in 2019, selling its entire stake in Bulgaria's leading telecoms operator, Vivacom, to United Group, in a deal reportedly worth up to US$1.3 billion. The bulk of private equity transactions nevertheless involve the acquisition of Russian assets by Russian bidders. However, these deals have traditionally had a strong cross-border element since, as a result of various tax, regulatory and legal considerations, the deals still tend to be structured using offshore acquisition vehicles. Although these structures may face increasing challenges in the future, they continue to dominate market practice.

Typical challenges to be dealt with by legal advisers working on cross-border transactions in Russia include:

- the complex regulatory landscape and marrying the applicable requirements of the Russian legal system with those of the chosen governing law of the transaction;
- the complexity of sanctions issues;
- the rapidly evolving taxation regime;

Photo by EvgenySHCH on Shutterstock

> "Russia is a market that is continuing to develop and we see increasing interaction between differing legal frameworks."

- the lack of established market practice and relatively few precedent deals against which to benchmark transactions;
- the related lack of experience of private equity dealmaking among the business community; and
- managing relations with the Russian regulators and government, particularly where the transaction involves entities operating in 'strategic' sectors such as significant mass media, subsoil industries and aviation.

Russia is a market that is continuing to develop and, as its own laws are revised to include concepts that are commonly used in other markets, we see increasing interaction between differing legal frameworks. It is critical to ensure that advisers have a full understanding both of what international investors expect from their transactions in Russia and how the unique features of the Russian market might impact on them.

5 What are some of the current issues and trends in financing for private equity transactions? Have there been any notable developments in the availability or the terms of debt financing for buyers over the past year or so?

The use of acquisition finance to leverage private equity acquisitions is not a prevalent feature of private equity investment in Russia. The significant majority of deals are equity-only and the restraints on access to international financial markets, resulting from international sanctions, make the ability to 'self-fund' more important than ever. That said, there are examples of state banks providing debt financing for acquisitions – for example, in 2020, Sberbank reportedly provided up to US$1.8 billion to finance a share buy-back of En+ shares from VTB. Likewise, in 2019, VTB reportedly provided debt financing to Marathon Group for the acquisition of an 11.82 per cent stake in Magnit for approximately US$1 billion. Domestic financial institutions and funds such as VTB Capital, Sberbank CIB and RDIF can, at times, offer the ability to refinance post-investment, which gives them a competitive advantage over other private equity sponsors.

6 How has the legal, regulatory and policy landscape changed during the past few years in your jurisdiction?

Recent years have been marked by the desire on the part of the government to make Russia more attractive to foreign investors and to support the growth of a local private equity market, although efforts have been made more challenging by the imposition of EU and US sanctions. That said, the ongoing corporate dispute over control of Vostochny Bank (described in question 7) has negatively impacted foreign investor confidence and is being closely followed by foreign investors.

The emergence of government-backed sponsors and financial institutions over the past several years has transformed the Russian private equity market. In particular, Rusnano, a US$10 billion private equity fund established in 2007 to invest in the nanotechnology sector and RDIF, a US$10 billion fund established in 2011 to make equity co-investments with major Russian and international players, have significantly impacted the market. Today, RDIF is one of the most active players in the Russian private equity market. RDIF has established investment funds with international partners from a range of countries, although with a focus on Asia (including China, Korea, Japan, Vietnam and India) and the Middle East (including Abu Dhabi, Saudi Arabia, Bahrain, Kuwait, Turkey and Qatar). This trend continued in 2019 and 2020, with several new funds being established; for example, the Russia-China Technology Investment Fund with a target capital of US$1 billion and the Russia-Mongolia Investment Cooperation Fund. These funds have generally committed to investing a substantial percentage of their capital into Russia and RDIF and various other sovereign wealth funds have made significant investments across various sectors of the Russian economy.

As mentioned, private equity transactions (even with only Russian participants) have in a significant number of cases been structured through non-Russian acquisition and joint venture vehicles. Russian policymakers' efforts to try and stem the high level of capital flight from Russia have been twofold.

First, the government has sought to stimulate private equity houses to move their assets onshore through the 'de-offshorisation ' initiative. The de-offshorisation campaign included the introduction of controlled foreign companies (CFC) legislation (discussed further in question 13), a tax and capital amnesty between 2015 and 2020, a new redomiciliation mechanism available since 2019 and, most recently, proposed changes to the withholding tax rate on dividends and interest paid from Russia to offshore entities (discussed further in question 13).

Court practice regarding the application of double tax treaty relief is rapidly developing and has, so far, been largely detrimental to taxpayers. The Common Reporting Standard, launched in Russia at the end of 2017 (the first exchange of information occurred in 2018), is expected to significantly contribute to the ability of Russian tax authorities to trace evasion schemes. We expect a further hardening of tax and regulatory requirements in the coming years. The government's impetus for greater transparency around the involvement of offshore structures in Russia-focused transactions is also seen in the foreign investment laws that were introduced on 30 July 2017, which apply greater scrutiny to transactions where a foreign partner acquires an asset in Russia or a Russian investor acquires an asset in Russia through a foreign vehicle, especially if the asset is regarded as 'strategic' in Russia.

In parallel, the government has continued its efforts in creating a more favourable legal and business climate onshore, as evidenced by Russia's ascent in the World Bank Ease of Doing Business Index from rank 124 in 2010 to 28 in 2020 (with substantial improvements in the ease of starting a business, registering property and enforcing contracts, among others). Russian civil and corporate law has been subject to numerous amendments in recent years with the aim of adapting the legal instruments commonly used in Western jurisdictions for use in Russia (such as warranties, indemnities and option agreements) and enabling investors to implement typical Western-style corporate governance and shareholder agreement arrangements at the onshore Russian company level. While market participants have generally remained cautious in implementing the new legislative instruments, we have seen a number of clients get comfortable executing deals onshore. Overall,

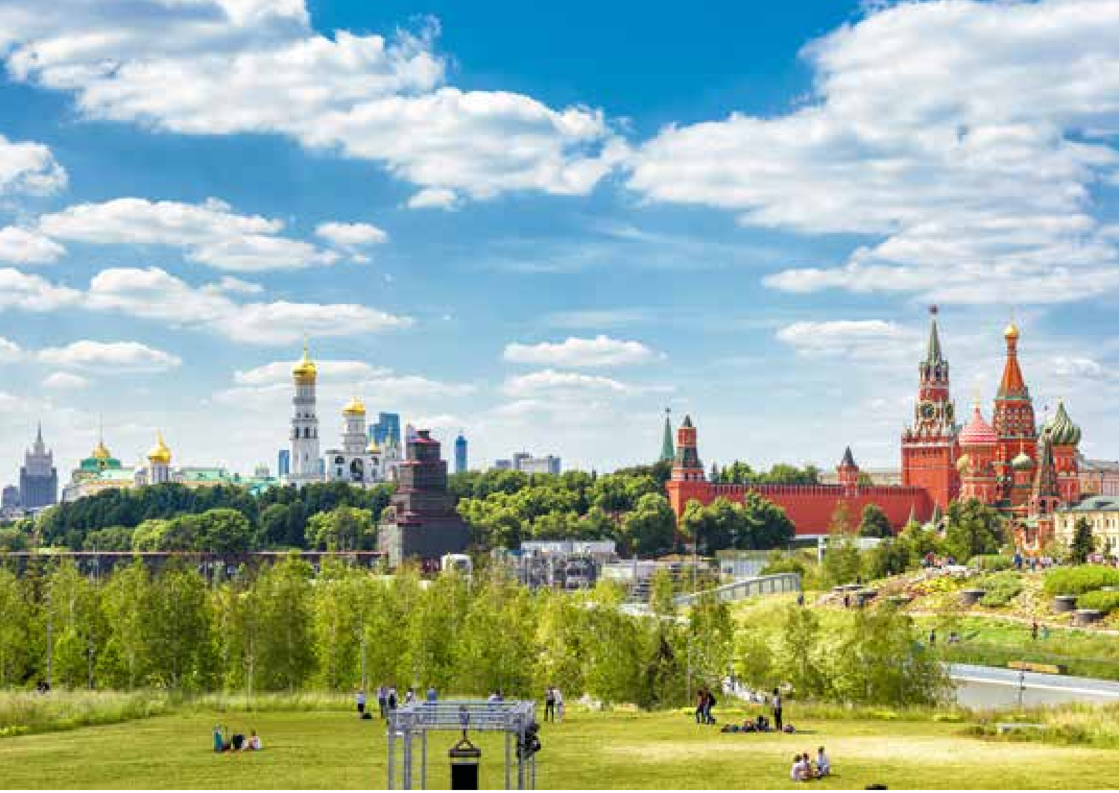


Photo by Viacheslav Lopatin on Shutterstock

there are positive signs that momentum is building for Russian law to play a bigger role in private equity transactions going forward.

Additionally, there is some possibility that the government will seek to create more domestic investment opportunities through a privatisation programme. In January 2020, the government published a draft privatisation programme for 2020 to 2022, which indicated plans to sell stakes in major enterprises such as Makhachkala Commercial Sea Port, Novorossiysk Commercial Sea Port, Almazyuvelireksport, VTB Bank, Rosspirtprom, Modern Commercial Fleet and Kizlyar cognac factory. Further, in July 2020, the Russian Ministry of Finance published plans to reduce by half the number of companies with state participation in the period 2020 to 2025. However, it remains to be seen whether these plans will be implemented in the context of the weak global economic climate and relatively strong Russian government finances.

Another area the government has addressed in recent years is investor concern about the legal robustness of dispute resolution forums relating to Russian investments. Over the years, for a number of reasons, participants in Russia's private equity market have shied away from investment structures that lead to significant corporate disputes being adjudicated in the Russian courts. At the same time, there

> "There has been a spike in political and public scrutiny of the private equity industry in Russia recently."

has been significant uncertainty as to whether such disputes could instead be referred to arbitration. In an effort to address this issue, Russian law now expressly allows corporate disputes concerning Russian entities to be handled by arbitration institutions, provided that they have registered with Russian regulators and, in most cases, provided that the place of arbitration is in Russia. At the time of writing, the Hong Kong International Arbitration Centre and the Vienna International Arbitral Centre have each obtained a licence to administer Russian corporate disputes.

On the other hand, in June 2020, the Russian government enacted a new law granting Russian state courts exclusive jurisdiction over certain disputes involving Russian sanctioned individuals and entities, as well as foreign entities controlled by them. Generally, the new law does not prevent parties from referring disputes to international arbitration or to foreign state courts. However, if the jurisdiction of a foreign court or arbitral tribunal is agreed, sanctioned persons will be able to disregard the dispute resolution provisions if they cannot be enforced due to sanctions that 'impede access to justice'. While it remains to be seen how Russian courts will determine whether dispute resolution clauses involving sanctioned persons are unenforceable and, equally, how widely the courts will interpret the provision on impediments to access to justice, this law may further complicate the already complex arbitration regime and lead to a deterioration of the investment climate in Russia. Accordingly, this is an area for private equity investors to monitor closely.

7 What are the current attitudes towards private equity among policymakers and the public? Does shareholder activism play a significant role in your jurisdiction?

Historically, the private equity industry has been widely supported and championed by Russian policymakers and there have been no signs of the political or public scrutiny of the private equity industry experienced in other major jurisdictions. This may have been, in part, because of the novelty and relatively low prominence of the private equity industry in Russia, as well as the political and economic headwinds it is facing in the present environment, which have discouraged some foreign players without prior experience of deal-making in Russia and, conversely, created opportunities for local private equity investors.

While these conditions generally remain true, there has been a spike in political and public scrutiny of the private equity industry in Russia recently because of the widely publicised battle between Baring Vostok Capital Partners (a leading Russian private equity firm) (BVCP) and Russian businessman Mr Artyom Avetisyan over control of Vostochny Bank. Vostochny Bank is reportedly one of the 30 largest Russian banks by asset value. The battle involves litigation in the Russian courts, the London Court of International Arbitration and various offshore jurisdictions.

This corporate dispute attracted widespread international news coverage when Mr Michael Calvey (CEO of BVCP) and other senior employees of BVCP were arrested and charged in early 2019 with criminal fraud in relation to their dealings with Mr Avetisyan. At the time of writing, Mr Calvey and other BVCP employees have been under house arrest for more than a year. Commentators have contended that these criminal charges were unlawfully instigated by Mr Avetisyan to pressure BVCP into handing over control of Vostochny Bank. These events have caused serious concern within the investment community and are being closely monitored by foreign investors.

Another notable incident was the arrest in June 2020 of Mr Alexander Povalko, the chief executive officer of Russian Venture Company (RVC). RVC is a state fund of funds and a development institution in the Russian venture capital market. Mr Povalko is suspected of misusing RVC's funds. While the investigation remains ongoing, several prominent investors have already publicly expressed their concerns about the arrest and the impact it may have on the Russian venture capital sphere.

Finally, in June 2020, it was announced that Yandex has agreed to terminate its joint venture with Sberbank, bringing an end to a decade-long partnership that had

recently soured over Sberbank's plans to expand further into the technology sector. Under the deal, Yandex will buy out Sberbank's stake in Yandex.Market (a leading e-commerce platform) and sell its stake in Yandex.Money (a leading payments platform) to Sberbank. It will be interesting to see what impact this split will have on private equity activity as both Sberbank and Yandex have proactively pursued M&A opportunities in the technology sector in recent years.

The prevalence of low free floats and controlling shareholders means that it is unlikely that the levels of activist and turnaround investment experienced in the United States and the United Kingdom will become a regular feature in Russia.

Photo by Viacheslav Lopatin on Shutterstock

8 | What levels of exit activity have you been seeing? Which exit route is the most common? Which exits have caught your eye recently, and why?

The only notable IPO in the period covering 2019 and the first half of 2020 was the listing of HeadHunter (a leading Russian online job search portal) on the NASDAQ exchange (the first listing of a Russian company on the NASDAQ exchange since

2013). There were also several secondary offerings, such as the US$158 million and US$249 million secondary placements by Detsky Mir (a leading Russian children's goods retailer) on the Moscow Exchange in November 2019 and June 2020, and the US$200 million secondary placement by Evraz Group (a leading Russian steel making and mining company) on the London Stock Exchange in June 2019.

At the same time, several companies that had previously been touting potential IPOs in 2020 or 2021, such as Yandex.taxi (the largest Russian online taxi booking service), Ozon, Delimobil (the second largest Russian car sharing company) and VkusVill (a major Russian food retailer), among others, have shelved or delayed these plans in light of ongoing economic uncertainty, and share market volatility, resulting from the covid-19 pandemic. Accordingly, we do not expect much IPO activity in the next 12 months.

A number of negotiated exits by private equity funds have been reported, such as:

- the sale by Elbrus Capital Fund of its majority stake in OSG Records Management (the leading player in the document storage and information management market in Russia and the CIS);
- the partial sale by Goldman Sachs and Baring Vostok of their stakes in Familia (Russia's leading off-price retailer); and
- the sale by Baring Vostok of its stake in European Medical Centre (the largest private operator of hospitals and clinics in Moscow) to Pharmstandart.

Another notable exit announced in April 2020 was the sale by VTB of a 50 per cent stake in its consolidated grain business to Agronova and Marathon Group for an undisclosed sum estimated to be in the region of US$1 billion.

The secondary market for private equity exits in Russia remains relatively small and there are a limited number of sponsors willing to take on IPO mandates. Given that the strategic market predominantly relies on foreign investors who offer the most attractive terms and that the current geopolitical climate is not conducive to foreign investors entering the market at present, it remains a challenging environment for exits by private equity sponsors in what remains an investment market.

9 Looking at funds and fundraising, does the market currently favour investors or sponsors? What are fundraising levels like now relative to the past few years?

The Russian private equity funds market is in its relative infancy. As such, there is not sufficient volume to determine which side of the investment relationship the market favours. The general sentiment is one of trying to support and grow the industry as a whole, rather than favour one constituency over another.

Russian-focused private equity fundraising levels are low at present. Geopolitical risk, sanctions and low levels of economic growth in Russia, among other factors, have challenged fund closings in recent years. Further, given the impact of the covid-19 pandemic on the global economy and financial markets, we are unlikely to see a major uptick in Russian-focused fund closings in the next 12 months. Symptomatic of the challenging environment, in November 2019, Baring Vostok announced plans to scrap the launch of its sixth fund which had been expected to raise in excess of US$1.3 billion. Elbrus Capital, another leading Russian private equity fund, had been aiming to raise US$600 million for its third fund by early 2020, but there have been no public reports indicating that the fund raising was successfully closed.

On the other hand, state-backed players – which, as explained above, have been increasingly active in the Russian private equity market – have arguably been more successful in fund formation than private investors. For example, in 2018, RVC and investment fund Da Vinci Capital formed the Da Vinci Pre-IPO Tech Fund (with up to 6 billion roubles under management) to invest in established start-ups that are seeking stock exchange listings. Also in 2018, RVC partnered with private investors to establish the Terra Fund II to invest in advanced technology businesses (with up to 6 billion roubles under management). RDIF has also been active in the past couple of years in establishing new investment funds in partnership with international state-backed funds (see question 6 for further details).

10 | Talk us through a typical fundraising. What are the timelines, structures and the key contractual points? What are the most significant legal issues specific to your jurisdiction?

Russian fundraising has tended to follow the patterns and structures used in other markets, with fund vehicles established in onshore markets such as Luxembourg or typical offshore centres such as the Cayman Islands or the Channel Islands. Luxembourg has the benefit of being an established, regulated environment and, since January 2014, has had an amended double taxation treaty with Russia (although, as discussed in question 13, the Russian government is seeking to amend the double taxation treaty to increase the withholding tax rate).

Cyprus has been a key jurisdiction for investments into Russia (given the favourable terms of its double tax treaty – although, as discussed in question 13, the Russian government is seeking to amend the double taxation treaty to increase the withholding tax rate), but it was rarely used as a fund domicile, except in club or friends-and-family deals. Following the European debt crisis, Cyprus is being used even less in Russian fundraising deals as investors look instead to more traditional markets and structures.

> "Private equity sponsors operating in Russia are not subject to additional regulation over and above what applies to other businesses operating in the jurisdiction."

Where investors are taking on greater portfolio risks than in more mature markets, they want to minimise risks from using non-traditional fund vehicles. Due diligence remains key with investors that spend a great deal of time on understanding the team, its governance structures and its approach to investments. This will lengthen the fundraising periods. Fund documentation will also reflect the enhanced portfolio risks in terms of the fund governance arrangements and, of course, the target returns and performance fee triggers.

11 How closely are private equity sponsors supervised in your jurisdiction? Does this supervision impact the day-to-day business?

Private equity sponsors operating in Russia are not subject to additional regulation over and above what applies to other businesses operating in the jurisdiction. In particular, there is no body, whether self-regulated or otherwise, charged with overseeing the private equity industry. However, there are still key regulatory issues of which any entity operating in Russia needs to be aware. For example, in relation to anti-monopoly regulation that falls within the remit of the Federal Antimonopoly Service or regulatory approvals in relation to 'strategic' companies.

12 | What effect has the AIFMD had on fundraising in your jurisdiction?

As Russia is outside the European Economic Area (EEA), the AIFMD does not apply to Russian managers raising and marketing funds within Russia or anywhere else outside the EEA. To the extent that Russian managers are marketing or managing EU Alternative Investment Funds (AIFs) or marketing a non-EU AIF to EU investors, the AIFMD will be relevant because of the directive's extraterritorial effect. As mentioned in question 10, many onshore funds are based in Luxembourg, which offers some flexible solutions to the AIFMD, including its securitisation vehicles.

13 | What are the major tax issues that private equity faces in your jurisdiction? How is carried interest taxed? Do you see the current treatment potentially changing in the near future?

Russian legislation dealing with CFC, which came into force in 2015, continues to develop. Russian CFC rules are broadly consistent with the approach of the Organisation for Economic Co-operation and Development and the European Union. While court consideration has so far been limited, tax authorities have started gaining experience in applying these rules. Nevertheless, Russian CFC rules have already started heavily influencing the choice of traditional private equity investment structures.

The Russian CFC legislation sets out rules in four areas of tax structuring. First, it addresses the taxation of profits received by the controlled foreign companies of Russian residents but not yet received by the residents themselves. Second, it requires Russian residents holding shares in, or controlling, foreign companies or non-corporate entities to notify the Russian tax authorities of such shareholding or control. Third, it lays down the test for determining the tax residency of legal entities. Lastly, it introduces the concept of beneficial ownership of income for the purposes of double tax treaties.

It is clear that the government's aim is to restrict the availability of double tax treaty benefits for recipients of Russian-sourced passive income where offshore structures are deliberately established to obtain tax treaty benefits for the ultimate beneficial owners of such income. This focus of the government's recent reforms is of key importance to the private equity sector.

In May 2020, the President announced that a withholding tax rate of 15 per cent (being the Russian domestic tax rate in respect of dividends paid out of Russia)

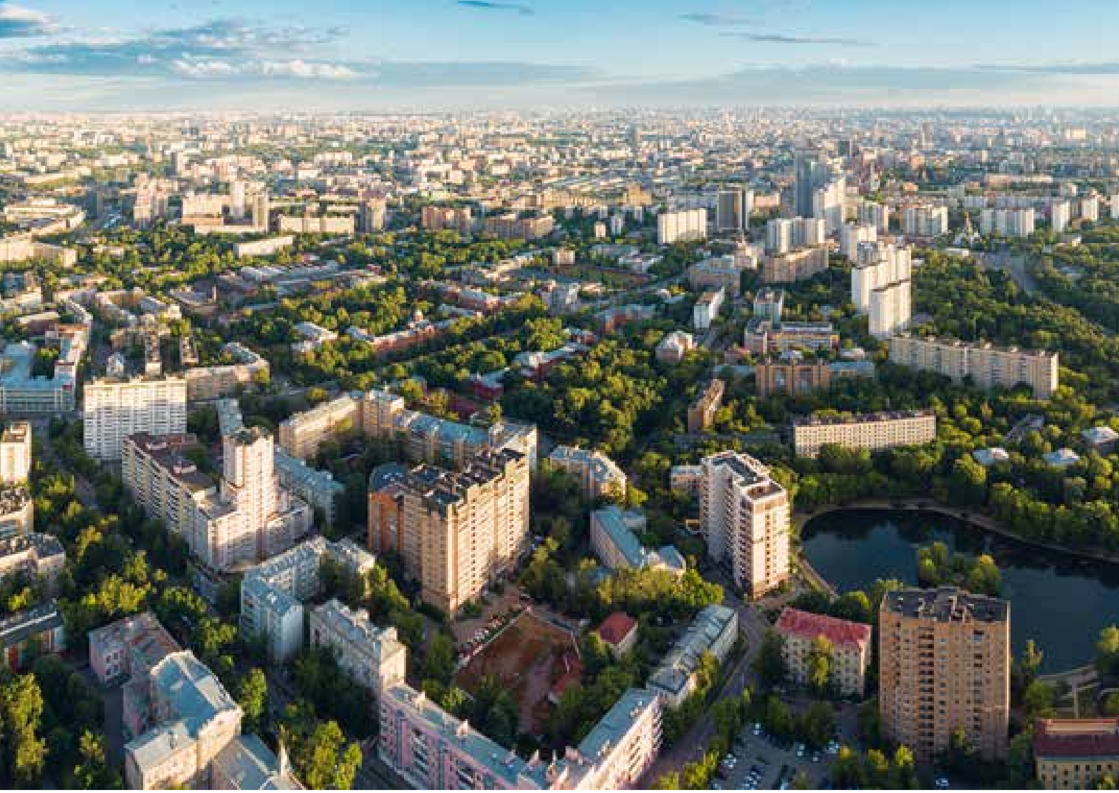


Photo by Mike Laptev on Shutterstock

should apply to dividends and interest payments flowing out of Russia (compared with the 5 to 10 per cent rates for dividends and 0 per cent for interest often obtainable under double taxation treaties (DTTs)). The President acknowledged that this will require amendments to be made to DDTs and instructed the government to make such amendments, or if the countries with which DTTs are in place do not agree to such amendments, to unilaterally terminate such DTTs. Russia has already notified several traditional investment jurisdictions (Cyprus, Luxembourg, the Netherlands and Malta) that it wants to renegotiate the relevant DTT (or to withdraw, if the negotiations fail). The proposed increase in the taxes applicable to dividends and interest is likely to have a greatly negative impact on foreign investment in Russia and may impact the investment structures traditionally used by private equity investors. This will be a key issue for private equity investors to watch in the next year. Additionally, the government is considering abolishing the availability of the 'look through approach' to dividends paid to offshore jurisdictions (ie, where Russian dividends are paid abroad, but Russian persons indicate that they are the beneficiaries and enjoy a lower tax rate or participation exemption). In combination with the amendments to the DTTs, this would further discourage the use of offshore joint ventures, which is often a corporate-driven requirement of foreign investors.

As part of the same trend, interest taxation rules have been heavily amended, with specific transfer pricing regulation introduced for interest in 2016 and thin capitalisation rules revised with effect from 2017. Amendments to the thin capitalisation rules effectively codify the recent court practice and restrict deductibility of interest under loans extended by foreign sister companies. However, according to the most recent amendments to these rules, interest under a loan relating to an investment project should not be subject to these restrictions if the borrowed funds are used solely to finance investment projects in Russia, the repayment of the loan is deferred for at least five years, the lender's direct or indirect ownership of the Russian borrower does not exceed 35 per cent and the lender's place of registration (tax residence) is a state with which Russia has a double taxation treaty.

In addition, changes to certain obligations have been imposed on members of international corporate groups. They are obliged to notify tax authorities that they belong to such groups. If the consolidated revenue of a group exceeds certain limits, its members are obliged to disclose certain information, such as the structure of ownership and control of the group, main indicators of activity, profits gained and losses incurred and taxes paid. A breach of these obligations will be punished with fines.

The Russian government has continued to increase the tax burden on businesses. The VAT rate was increased by 2 per cent to 20 per cent starting from 1 January 2019 and amendments to the profit tax regime (which are mostly disadvantageous for taxpayers) were introduced in 2017 and 2018. The ability of Russian regions to introduce profit tax incentives is gradually being limited. Loss carry-forward was amended such that only half of carried losses can be deducted in a given year (although the carry-forward itself is now unlimited by time).

These developments illustrate the continuing trend of Russian tax legislation becoming significantly more complex and nuanced. Alongside this, Russian tax authorities are adopting an increasingly sophisticated and rigorous approach in their assessment of applications for double tax treaty relief. Since 2018, we have seen a greater examination of the substance of ownership structures and the nature of the relationship between, and functions of, the entities in these structures. The risk is that where foreign companies or non-corporate entities are acting as mere conduits or agents for the 'true' beneficial owners of income, they may be disregarded for tax treaty purposes. Court practice on the matter is evolving rapidly, and most resolved cases are not favourable to the taxpayers. Private equity investors need to be alive to this issue in the context of their investment structures and seek detailed legal advice accordingly.

> "Chinese and Middle Eastern sovereign funds and major Russian state-backed players have been comparatively active over the past year."

For private equity managers themselves, there are no special rules in relation to carried interest in Russia and so many of the more complex structures seen in other jurisdictions are not present.

14 | Looking ahead, what can we expect? What might be the main themes in the next 12 months for private equity deal activity and fundraising?

Market conditions are challenging and Russian private equity activity is relatively muted at present. Chinese and Middle Eastern sovereign funds and major Russian state-backed players have been comparatively active over the past year and we anticipate that they will continue to make their presence felt in the coming 12 months. Opportunistic and experienced local players have also continued to deploy capital through 'classic' private equity deals and there may be opportunities for stressed and distressed M&A in the short-term.

The low relative value of the rouble (following significant depreciation against the US dollar in 2020), means that production costs in Russia offer significant competitive advantages to investors localising production in Russia for export. This factor, combined with the government's localisation programme, suggest that the trend of diversification of investment activity across a broader variety of sectors is likely to continue. We expect that the energy, retail, innovation and technology, and media and telecoms (particularly e-commerce) sectors will continue to be active areas of the Russian economy and provide opportunities for domestic and international private equity investors during the remainder of 2020.

The continuing development of the government's de-offshorisation programme, and proposed changes to the withholding tax rate, will have an impact on overall investment activity. This, in hand with changes to the Civil Code aimed at creating a more flexible onshore legal environment, has put further pressure on Russian private equity investors to return capital to Russia and to invest directly in Russian companies. That said, the traditional approach of structuring deals using overseas intermediaries has not fundamentally changed as a result of this push towards de-offshorisation.

Major players in the private equity market will continue to watch global economic, political and regulatory changes closely, including sanctions and the development of the covid-19 pandemic, as these will play a key role in determining whether Russia can continue to develop into an investment-worthy market with substantial scale, depth and liquidity in 2021 and beyond.

Alexei Roudiak
alexei.roudiak@hsf.com

Stefan Kecman
stefan.kecman@hsf.com

Sergei Eremin
sergei.eremin@hsf.com

Graeme McIntyre
graeme.mcintyre@hsf.com

Herbert Smith Freehills CIS LLP
Moscow
www.herbertsmithfreehills.com

The Inside Track

What factors make private equity practice in your jurisdiction unique?

The current international sanctions regime and constraints on international liquidity have enhanced the challenges posed by the heavy influence of government-backed sponsors and financial institutions, alongside the generally unpredictable political environment. When this is combined with the often novel legal issues that arise when dealing with the intersection of the Russian legal regime and international business practices, clients rely heavily on their lawyers to help deliver legally robust and commercial outcomes.

What should a client consider when choosing counsel for a complex private equity transaction in your jurisdiction?

- Can counsel provide seamless advice on Russian legal, regulatory and tax issues and the legal, regulatory and tax issues across the range of other jurisdictions and governing laws involved?
- What experience does counsel have in dealing with local counterparties and regulatory authorities?
- Does counsel have experience of negotiating and bringing to fruition complex transactions based on practical experience across Russian and other markets?

What interesting or unusual issues have you come across in recent matters?

Corporate governance and shareholder arrangements for Russian private equity investments always raise important issues. This is true now more than ever, as de-offshorisation and other legislative reforms have encouraged a number of international and local investors seeking to explore, under Russian law, Western-style arrangements in respect of Russian companies. In a number of recent transactions, we have worked with our clients to resolve the structuring challenges that arise as a result of both the Russian legal framework, being new and evolving, and certain standard Western protections (such as put and call options, certain anti-dilution protections and shareholder information rights), being beyond the scope of Russian law.

Lexology GTDT Market Intelligence provides a unique perspective on evolving legal and regulatory landscapes.

Led by Simpson Thacher & Bartlett, this *Private Equity* volume features discussion and analysis of emerging trends and hot topics within key jurisdictions worldwide.

Market Intelligence offers readers a highly accessible take on the crucial issues of the day and an opportunity to discover more about the people behind the most significant cases and deals.

Covid-19 impact
Institutional strategy
Cross-border challenges
2021 outlook

an LBR business

ISBN 978-1-83862-420-0