GETTING THE DEAL THROUGH

market intelligence

M&A

2018 – the return of the ‘mega-deal’

Global interview panel led by Alan Klein

2018

North America • Asia-Pacific • Europe • Latin America
Keynote deals • Sector focus • Shareholder activism • 2019 outlook

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Welcome to GTDT: *Market Intelligence*.

This is the 2018 edition of *M&A*.

Getting the Deal Through invites leading practitioners to reflect on evolving legal and regulatory landscapes. Through engaging and analytical interviews, featuring a uniform set of questions to aid in jurisdictional comparison, *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 interesting cases and deals.

Market Intelligence is available in print and online at www.gettingthedealthrough.com/intelligence.

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M&A IN RUSSIA

Alexei Roudiak is the managing partner of the Moscow office of Herbert Smith Freehills and the head of corporate for Europe, the Middle East and Africa. 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 breakup), defending against hostile takeovers (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.

Justin Vaughan is a corporate of counsel, practising in Russia since 2009. He helps Russian and international clients with all aspects of their most innovative and complex investment projects in Russia and the Commonwealth of Independent States. He has particular expertise in private M&A, cross-border joint ventures and restructurings, and private equity.

Stefan Kecman is a senior associate at Herbert Smith Freehills. 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.

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GTDT: What trends are you seeing in overall activity levels for mergers and acquisitions in your jurisdiction during the past year or so?

Alexei Roudiak, Justin Vaughan and Stefan Kecman: Although market conditions are generally improving, it has been a mixed year for Russian M&A: on the one hand, the value of the Russian rouble has stabilised over the past couple of years and the economy continues to strengthen following a short period of technical recession; on the other hand, investment conditions remain challenging due to continuing geopolitical risk. Although investors have started to come back to the Russian market, having adapted to the new economic and geopolitical realities, certain foreign investors from the United States and European Union remain deterred from entering the market. For several years now, various sectors of the Russian economy (including defence and arctic offshore drilling) and certain major market participants (including Gazprom, Rosneft and Sberbank) have been targeted by US and EU sanctions imposed following Russia's actions in Crimea and mainland Ukraine starting in 2014. The latest round of sanctions announced by the US in April 2018 in response to, among others, alleged Russian interference in the US 2016 presidential elections has added to the concerns of many European and US investors.

Although deal values are up over the last 12 months, the volume of M&A transactions in the Russian market has dipped slightly. The uptick in value is due primarily to a mild resurgence of big-money deals, among them the US$4.4 billion acquisition of 14.16 per cent of Rosneft by the Qatar Investment Authority. In addition, as noted by the UN Conference on Trade and Development (UNCTAD) in its 2018 World Investment Report, there is currently a sharp contrast between inbound and outbound investment flows in Russia. According to the UN report, inbound investment declined in 2017 by 32 per cent compared to 2016 to US$ 25.3 billion, while outbound investment increased by a similar percentage, to US$36 billion.

Inbound M&A activity has been largely fuelled in the past few years by Middle Eastern and Asian investors – in particular, those from China. Headline-grabbing deals such as Silk Road Fund's acquisition of a 10 per cent stake in Russian petrochemical company Sibur in 2017 illustrate this shift to the East. The expectation is that business cooperation and mutual investments between Russia and Asia (particular China, Japan and India) will continue.

GTDT: Which sectors have been particularly active or stagnant? What are the underlying reasons for these activity levels? What size are typical transactions?

AR, JV & SK: The natural resources sector continues to drive M&A activity in the Russian economy. The 2018 UNCTAD World Investment Report estimated that inbound foreign direct investment into this sector accounted for 30 per cent of all inward investment into Russia in 2017. As US and EU firms reduce their exposure to the natural resources sector due to continued US and EU sanctions concerns, Middle Eastern and Asian investors (predominantly those from China and Japan, but also other jurisdictions) are pursuing a number of investment opportunities. The Chinese government is particularly supportive of investments into energy projects that tie into its 'One Belt; One Road' initiative. Given the wealth of Russia's natural resources and the increasing technological complexity of developing new fields in ever harsher environments, such investments are expected to continue to be mega-deals.

There is a steady trend of consolidation in the agricultural market (mainly bigger players acquiring smaller players), which resulted in a resurgence of activity in recent months. Investment activity in the consumer, and technology, media and telecoms (TMT) sectors is also up. For example, Yandex's e-commerce joint venture with Sberbank valued at approximately US$1 billion and its US$3.7 billion business venture with Uber in respect of ride-sharing, food delivery and logistics services.

GTDT: What were the recent keynote deals? What made them so significant?

AR, JV & SK: While Chinese investors made headlines in 2016 for major investments into the Russian energy sector, 2017 saw the arrival of renewed interest from the Middle East. Following its acquisition (in consortium with Glencore) of a 19.5 per cent stake in Rosneft in December 2016, this year the Qatar Investment Authority agreed to increase its direct stake in Rosneft by acquiring Glencore's consortium shares for US$4.4 billion. The expectation is that the trend of significant inbound investment from the Middle East will continue as sanctions concerns reduce the appetite of US and EU market participants.

Key deals in the consumer and technology sphere include Gazprombank's acquisition of a 19 per cent stake in Russian mobile phone operator MegaFon for just over US$1 billion in October 2017 and two joint ventures by Russian internet services provider Yandex. In late 2017, Yandex expanded its e-commerce business through a joint venture with Sberbank valued at approximately US$1 billion and, earlier that year, partnered with Uber to provide ride-sharing, food delivery and logistics services in Russia

and the Commonwealth of Indepedent States in a deal worth roughly US$3.7 billion. This year, another Russian bank, VTB, purchased a 29 per cent stake in Russia's second largest food retailer Magnit from its founder Sergey Galitskiy for US$2.5 billion, selling on an 11.82 per cent interest three months later to a Russian investment firm, Marathon Group, for US$1 billion.

GTDT: In your experience, what consideration do shareholders in a target tend to prefer? Are mergers and acquisitions in your jurisdiction primarily cash or share transactions? Are shareholders generally willing to accept shares issued by a foreign acquirer?

AR, JV & SK: Cash remains overwhelmingly the preferred form of consideration in Russian M&A deals. Acquisitions involving the issue of shares by a Russian purchaser as an alternative (or in addition to) cash consideration are quite rare as shares in Russian companies (including listed securities) are perceived as relatively illiquid assets. Also, the restrictions on the issue of new shares by Russian companies targeted by US and EU sanctions further hinders the use of Russian shares as consideration in M&A transactions. Accordingly, the expectation is that consideration shares will continue to appear less attractive in the eyes of investors – even where the issuer is not affected by US and EU sanctions.

However, some Russian shareholders are prepared to accept shares issued by foreign investors, especially if those shares are listed on foreign exchanges. Nonetheless, this is still uncommon and typically only seen where the foreign purchaser is an overseas holding company of a Russian group.

GTDT: How has the legal and regulatory landscape for mergers and acquisitions changed during the past few years in your jurisdiction?

AR, JV & SK: As recognised by the World Bank in its 2018 'Doing Business' Report, the Russian government has made efforts at reforming the legal and business landscape in recent years to make Russia a more attractive market for overseas investors. Russia now sits in 35th place out of 190 countries in the World Bank's 2018 rankings (up from 124th only five years ago). However, US and EU sanctions targeting specific Russian market sectors or market participants have dampened growth and investment in certain sectors. Nevertheless, some M&A (private equity, in particular) has been aided by government-backed sponsors and financial institutions, set up to give the economy a much-needed boost. Key names in this field include RDIF and RCIF (a partnership between RDIF and China Investment Corporation). Simultaneously, with making capital available through these institutions to co-fund acquisitions, the Russian government has put in place regulatory reforms to try to ensure that capital stays in Russia. The 'deoffshorisation' initiative is the centrepiece of these reforms. As part of the initiative, the government introduced controlled foreign companies (CFC) legislation (broadly consistent with the approach of the Organisation for Economic Co-operation and Development and the European Union) and a prolongation of the tax and capital amnesty.

The CFC legislation sets out rules in four areas of tax structuring. First, it addresses the taxation of profits received by foreign companies controlled by 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

Stefan Kecman

> "Russian civil and corporate law has been updated in recent years in order to adapt legal instruments that are commonly used in Western jurisdictions (such as warranties, indemnities and option agreements)."

beneficial ownership of income for the purposes of double tax treaties.

It is clear from the law and recent court practice 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.

Within the same trend, interest taxation rules have been heavily amended, with specific transfer pricing regulations 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. Finally, the Common Reporting Standard, launched in Russia at the end of 2017, is expected to significantly contribute to the ability of Russian tax authorities to trace evasion schemes.

In parallel, Russian civil and corporate law has been updated in recent years in order to adapt legal instruments that are commonly used in Western jurisdictions (such as warranties, indemnities and option agreements) for the Russian market and to enable investors to implement certain typical Western-style corporate governance and shareholder arrangements at the onshore Russian company level. However in practice, the uptake of these new instruments has been slow due to their novelty and the consequent scarcity of court decisions regarding their use in practice.

Over the years, for a number of reasons, foreign participants in the Russian market have avoided investment structures that would lead to having significant corporate disputes adjudicated in the Russian courts due to concerns about Russia not being a fair forum for dispute resolution. In an effort to address these concerns – among them whether corporate disputes with Russian entities could be referred to arbitration – Russian law now expressly allows such disputes 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, no foreign institution has obtained a licence to administer Russian corporate disputes, although at least one highly-regarded international arbitration institution has shown a strong interest.

GTDT: Describe recent developments in the commercial landscape. Are buyers from outside your jurisdiction common?

AR, JV & SK: As explained above, investors from the Middle East and Asia, as well as some domestic state-owned banks, have predominantly been behind the major M&A deals of the past 12 to 18 months. This is a reflection of the ongoing concern with which Western investors view the Russian market due to continued geopolitical and US and EU sanctions risks.

GTDT: Are shareholder activists part of the corporate scene? How have they influenced M&A?

AR, JV & SK: Shareholder activism is much less common in Russia compared to the United States and the United Kingdom due to the prevalence of low free floats and large controlling shareholder stakes. That said, there have been some examples of shareholders engaging actively in the management and governance of publicly listed and unlisted companies in Russia in recent years. One such example is the removal of Peter Hambro from the board of gold miner Petropavlovsk (a company he co-founded) in June 2017 by its shareholders following a motion called by Russia's Renova Group (although Mr Hambro has subsequently been reappointed to a senior position within the company). Another example is the three-year battle between shareholders of Eurasia Drilling concerning proposals to take that company private, that pitched minority shareholders against the majority and management of the energy services company.

GTDT: Take us through the typical stages of a transaction in your jurisdiction.

AR, JV & SK: Although some deals are conducted through auction processes or intermediaries, the majority are sourced through direct contact between the prospective business partners. Once the deal is initiated, the process tends to follow those adopted in other markets with a period of due diligence ahead of the final negotiation of transaction documents.

Certain transactions involving Russian entities or those that may have an effect in Russia may require regulatory approval. Subject to certain exemptions, the acquisition of 'control' by foreign investors of Russian companies operating in 'strategic business sectors' requires government consent. Such sectors include the development of subsoil fields of federal significance and the nuclear, military and aviation industries. Companies incorporated in Russia and operating in any of these strategic business sectors will be presumed to be 'strategic companies' and therefore within the remit of the Strategic Investment Law. The concept of 'control' for these purposes is broadly defined and generally includes controlling the majority of the votes at a shareholders' meeting, having the power to appoint the majority of the board of directors and being entitled to appoint the CEO of the company.

Separately, and in common with many other jurisdictions, anti-monopoly laws must be considered in relation to proposed mergers in Russia. The consent of the Federal Antimonopoly Service (FAS) will be required for transactions that may affect competition in Russia where certain prescribed thresholds are met. As the thresholds are relatively low, it is necessary to approach the FAS for consent on most transactions.

GTDT: Are there any legal or commercial changes anticipated in the near future that will materially affect practice or activity in your jurisdiction?

AR, JV & SK: Considering the current geopolitical climate, the expectation is that the US and EU sanctions on Russia will not be lifted and will remain in the near future. This is, accordingly, likely to continue to have a cooling impact on inbound investment (particularly from Western investors), although as mentioned above, not all foreign investors are deterred.

In addition to the tax reforms discussed above, starting from 2018–2020, members of international groups of companies are obliged to notify tax authorities that they are part of such groups, and to disclose various information, such as the structure of ownership and control of the group, main indicators of activity, profits gained and losses incurred and taxes paid, if the consolidated revenue of a group exceeds certain limits. A breach of these obligations will

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THE INSIDE TRACK

What factors make mergers and acquisitions practice in your jurisdiction unique?

The dominance of state-owned enterprises in the M&A market and the general political environment make Russia a challenging jurisdiction in which to do M&A transactions – particularly against the background of continuing geopolitical risk. Novel legal issues are frequent when dealing with the interaction between the Russian legal regime and international business practices. As a result, clients tend to rely heavily on their lawyers to help navigate the complexities of transacting in Russia and deliver legally robust and commercially appropriate outcomes.

What three things should a client consider when choosing counsel for a complex transaction in your jurisdiction?

- Can counsel provide seamless advice on Russian legal, regulatory and tax practices 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 in negotiating and bringing to fruition complex transactions based on practical experience across Russia and other markets?

What is the most interesting or unusual matter you have recently worked on, and why?

Corporate governance and shareholder arrangements for Russian co-investments always raise important issues. This is true now more than ever, as deoffshorisation 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 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 and certain anti-dilution protections and shareholder information rights) being beyond the scope of Russian law.

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be punishable with fines. Generally, the Russian government has shown a trend towards increasing the tax burden on business. In 2018, the VAT rate was increased by 2 per cent and amendments to the profit tax regime (which are mostly disadvantageous for taxpayers) were introduced in 2017–2018.

All these developments illustrate the continuing trend of Russian tax legislation becoming significantly more complex and nuanced. Alongside this, the Russian tax authorities are adopting an increasingly sophisticated and rigorous approach in their assessment of applications for double tax treaty relief. In the past 18 months, there has been a greater examination of the substance of ownership structures and the nature of the relationship between, and the respective functions of, the different 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 developing rapidly, and most of the cases are not resolved in favour of the taxpayers.

The expectation is that further hardening of the tax and regulatory requirements will continue in the coming years. The government's focus on achieving greater transparency around offshore involvement in Russia-focused transactions is also seen in the new foreign investment laws, which were introduced on 30 July 2017 and 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 classified as strategic and is located in Russia. The use of foreign investment vehicles – in particular, companies situated in Cyprus, Luxembourg or the Netherlands – is common in Russian M&A transactions, indeed, market analysts report that Cyprus and Luxembourg respectively accounted for 25 per cent and 14 per cent of the foreign direct investment into Russia in 2017.

GTDT: What does the future hold? What activity levels do you expect for the next year? Which sectors will be the most active? Do you foresee any particular geopolitical or macroeconomic developments that will affect deal sizes and activity?

AR, JV & SK: Market participants expect that geopolitical risk and US and EU sanction concerns will continue to weigh on investment decisions of

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foreign investors (particularly any new investors from Western jurisdictions), with such concerns less likely to deter investors from Asia and the Middle East – many of whom continue to look to take advantage of the economic opportunities present in the Russian market. Indeed, the World Bank predicted in May 2018 that the Russian economy would grow between 1.5 per cent to 1.8 per cent between 2018 and 2020. However the expectation is that geopolitical risk will persist and it remains to be seen whether the current US administration and the EU will impose additional sanctions.

While sanctions have had an overall negative impact on the value of the rouble against the US dollar, the expectation is that the currency will remain relatively stable due to underlying macro-economic factors (barring a significant extension to the US and EU sanctions regime). The low relative value of the rouble coupled with a relatively skilled workforce in Russia means that manufacturers can gain a competitive advantage over rivals, for example, those in Europe, by localising production in Russia to service the Russian market or to export abroad. One recent example of this is the US$17 million investment by WIKA (a German measuring device manufacturer) in a production plant in Moscow in late 2017.

In addition to the natural resources sector, other sectors expected to provide opportunities for foreign and domestic investors include TMT, industrials and chemicals, consumer and agriculture. If the Russian government recommences the privatisation of state assets that started in 2016, this will further stimulate M&A activity. Although the pace of privatisation has slowed down over the past year (partially due to the recovery in the oil price), the Kremlin had previously stated its intention to sell stakes in VTB Bank, the shipping company Sovcomflot and Novorossiysk Commercial Sea Port by 2019. However, it remains to be seen whether the sell-off of state assets will continue as planned.

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