



AEB M&A WORKING GROUP NEWSLETTER

Prepared by Association of European Businesses in cooperation with mergermarket.com
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INTRODUCTION FROM THE CHAIRMAN

The AEB M&A Working Group was founded in spring of this year and has no equivalents at other chambers of commerce and industry in Russia. Its primary objective is to create a communication platform where all M&A related issues may be discussed freely between business owners and managers, M&A professionals (such as investment bankers, lawyers, auditors, etc.) and all those who have a genuine interest in one of the most talked about subjects in finance.

Going into its second half-year of existence, the AEB M&A Working Group felt that a medium needed to be created, through which relevant facts and ideas could be conveyed to a larger audience. Together with our information partner mergermarket, the present bi-monthly M&A newsletter has been devised. It attempts to give a synthetic view of Russian M&A by presenting the most significant recent transactions, selected charts, in-depth analysis and professional tips on various aspects of dealmaking.

Due to its all-encompassing nature, which touches upon all sectors of the economy, the M&A activity of a given market is often a fairly accurate indicator of its current state and future prospects. We hope you will find this first edition both informative and useful, either in your M&A practice or in gaining further insights about the Russian market.

Joel Lautier

Chief Executive Officer of RGG Capital
Chairman of the AEB M&A Working Group

PART I

TOP DEALS OCTOBER/NOVEMBER 2009

Announcement Date	Target Company	Bidder Company	Seller Company	Deal Value USD(m)
20-Nov-09	United Aircraft Corporation (32.67% stake)	The Federal Agency for Federal Property Management; and Vnesheconombank		1,566
16-Oct-09	Belon Group OJSC (41.30% stake)	Magnitogorsk Iron and Steel Works OJSC	Sapwood Investments Limited	634
19-Oct-09	OSAO Rossija	Viktor Pinchuk (private investor)	OAO UK Trastkom	361
25-Nov-09	Paterson	X5 Retail Group NV	CorpInvest Inc	275
09-Oct-09	JSC Sitronics/Rusnano (Joint Venture) (49.90% stake)	Russian Corporation of Nanotechnologies	Sitronics JSC	219
16-Oct-09	Carbofer Metall	Evrax Group SA	Carbofer Group S.A.	Not Available

Source: mergermarket

COMMENTARY:

Two notable recent deals are the acquisition of the remaining 50% in an entity controlling Russian coal group Belon by MMK and the acquisition of steel trader Carbofer Group by Evraz Group. This is a refreshing development in the steel sector after Russian steel producers slowed down their “shopping spree” following the collapse of commodity prices in late 2008.

Only time will tell whether this indicates a long-term rebound in acquisition activity by Russian coal and steel producers, which are still reported to be burdened (with rare exceptions) with significant debt loads after expanding aggressively abroad in previous years.

DEAL OF INTEREST

Ann. Date	Target Company	Bidder Company	Seller Company	Deal Value USD(m)	Revenue USD(m)	Exit Multiples		
						Revenue	EBITDA	PE
05/08/2009	OAO Comstar United TeleSystems (50.91% stake)	Mobile TeleSystems OJSC	AFK Sistema	2034	1647.67	1.9791	4.7292	14.5854

Source: mergermarket

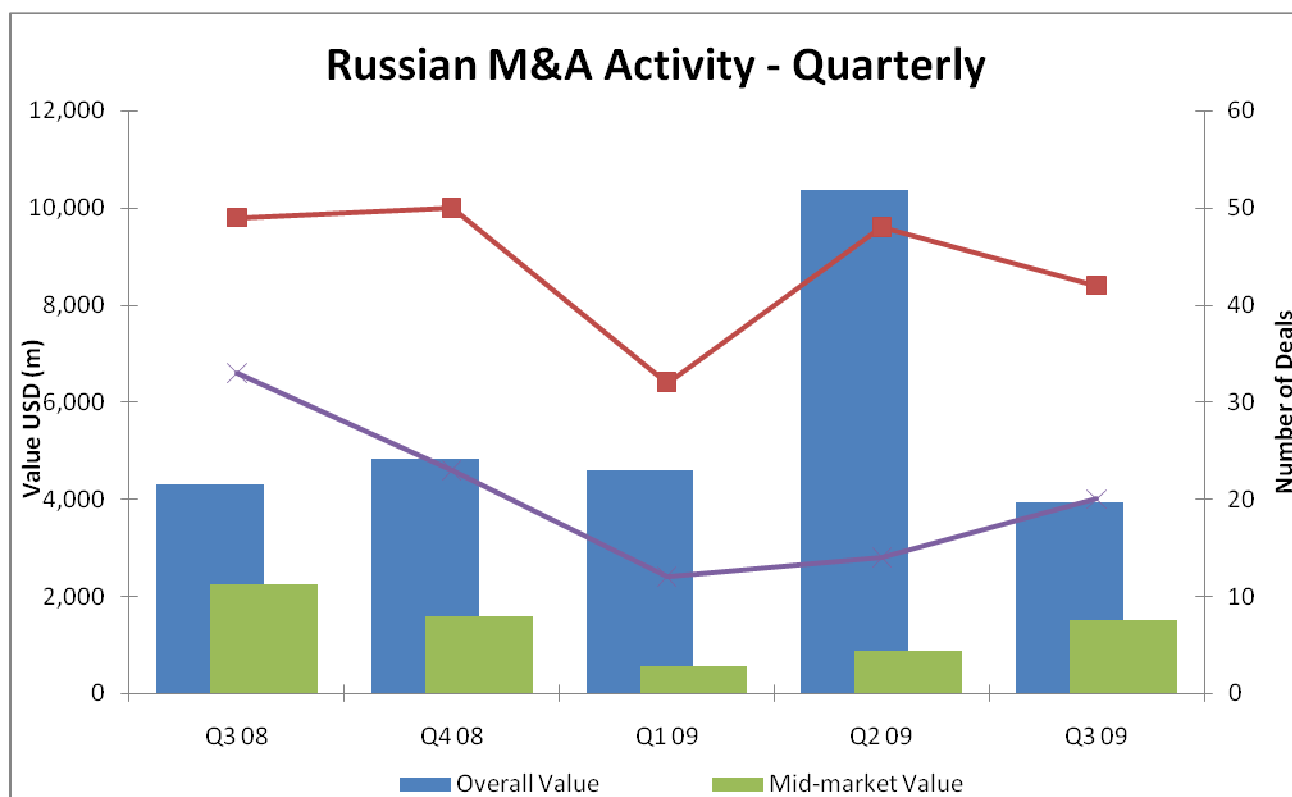
COMMENTARY:

An interesting example of crisis style M&A is a deal on the acquisition of a 50.91% stake of Comstar by OAO MTS from AFK Sistema. The deal was conducted on August 5th, 2009 with a bid premium one day before of 23.3%. To date this is the highest premium among top Russian announced deals. The deal was finalized at October 13th, and the deal value reached RUR 39.15bn. This intercompany deal is in line with the global AFK Sistema plan of business restructuring and at the same time it was used for providing additional financing to the parent company. MTS obtained financing for the deal from Sberbank.

Consolidating mobile and fixed line under the umbrella of OAO MTS is a repetition of market practice by Vimpelcom, which acquired Golden Telecom – an alternative operator – two years ago. The merger of Comstar and MTS has been rumored since the end of nineties. It was planned for 2008 but due to the crisis it was postponed to mid-2009. MTS has now gained direct control over the operations of Comstar, compared with the mediating influence of AFK Sistema, which controlled both companies (50.91% in Comstar and 52.8% in MTS).

PART II

CHART OF THE MONTH



Notes:

Based on announced deals valued over US\$ 5m with target geography being Russia, excluding lapsed and withdrawn bids.

Activities excluded from table include property transactions and restructurings where the ultimate shareholders' interests are not changed

Source: *mergermarket*

COMMENTARY:

The financial crisis has predictably hit M&A activity in Russia. In early 2009 both the quantity of deals and their value have gone back to the numbers of 2004: from about 90 deals worth over USD 15bn in Q208 to only 49 realized deals worth USD 4.29bn in Q308. Q109, the peak of the crisis, has been followed by a rather sharp rise of the numbers in Q209, where we saw 48 deals worth USD 10.3bn in total. However, the reason for the sharp rise in deals value are likely to be few major, and to certain extent crisis-driven, deals like the sale of a 40% stake in Rostelecom to Vneshekonombank by KIT Finance (USD 2.16bn) and the sale of 20% in Gazpromneft by ENI to Gazprom for USD 4.2bn.

Already in Q309, the deals value went down to USD 3.9bn with the number of deals realized falling to 42. However, the number and quantity of mid-market deals is stably growing from Q109, which indicates a slow recovery of the market and may be source for optimism as to the outlook for 2010.

PART III

WHAT WILL HAPPEN IN RUSSIAN M&A IN 2010?



Russian M&A to be largely defined by banks cleansing their balances in 2010, oil and gas majors will continue looking to acquire abroad – analysis

- Companies who escaped financial crisis early will initiate M&A
- Machine making, oil and gas to see significant activity
- Recovery from crisis and banks' swollen balance sheets among driving factors for M&A

Several main trends will dominate Russian M&A activity in 2010, Russian market participants said.

One trend will be horizontal M&A initiated by companies who got out of the crisis earlier than their peers, said a banking source. The latter are likely to become targets, instead of making acquisitions. An international M&A advisor working on the Russian market added that this will primarily affect consumer-oriented sectors of the economy like retail, construction and telecom.

M&A activity will depend on Russian companies regaining access to credit resources, a second advisory source said. Accessibility of credit would for certain companies enable quick recovery and grant them the possibility to invest and do M&A. The accessibility of credit is improving, but it is likely to take a further six months to get to the normal level, the second source said.

Bad debts are another issue that will strongly define Russian M&A in 2010, both advisory sources said. Increasing numbers of non-performing loans will leave the banks with "swollen balance sheets" and the banks will be forced to look for acquirers for the pledged assets, the second source said. However, the activity related to these assets will be limited for state-controlled banks: the banks will not be able to sell the assets with a loss because of receiving state support, the first source noted.

Private funds are likely to become an important party to initiate M&A in Russia in 2010, the banker and the second source said. There will probably be a new wave of funds acquiring problematic assets, the banker said. "Funds that are more cautious or those who will understand that asset prices won't go down any more will come into play," the banker explained.

However, there is only a relatively small number of private investors who managed to sell businesses in late 2007 or early 2008 and therefore have cash available for acquisitions, the second source said. This group of investors may have institutionalised funds like Onexim, Alfa Group,

Renova, but are also represented by individual investors, the second source said. Machine building and oil and gas are likely to be active in 2010 M&A.

Industrial machinery, including production of mining equipment, is likely to be the sector with the most M&A taking place in 2010, the banker said. The government may facilitate consolidation on the market and private players are likely to use the opportunity, the banker said. The second source agreed that M&A may be expected in machine-building. Besides that, the government is likely to initiate changes in large Russian car makers, such as Avtovaz, the second source said. The companies may be split, the current shareholders might lower their stake, the source suggested.

Oil and gas will also be a sector where M&A may be initiated in 2010, the second source said. As a result of the economic crisis, new attractive oil and gas assets will be available for sale in Western Siberia and in the regions of Irkutsk and Krasnoyarsk, the second source said. Due to construction of the Eastern Siberia – Pacific Ocean oil pipeline, to be finished by 2011, the potential value of these assets is going to increase. Gazprom, Lukoil and Rosneft are likely to be interested in acquiring but foreign investors could also be granted access, the source said.

Exceptional deals involving Rostekhnologii are also likely, the second source added. Deals could eventually be expected in the banking sector, where the market entrance of foreign banks is already taking place, the second source said. Additionally, Russian brewing companies will be affected by rising excise duties for beer, which may lead to a 15% to 20% drop in demand, the first source said. The weaker players may be picked up by stronger players, the source concluded. Businesses related to ecology, waste management and energy efficiency are on the rise in Russia, the second source added.

There are minor local players in the Russian regions that could become targets for foreign players, the source also suggested. Russian energy giants are still looking to acquire abroad, although hindered by cost limitations.

As to the foreign activity of Russian companies, Gazprom is likely to continue targeting assets to secure its gas exports to Europe, the banker and second adviser said. Refining and storage companies in Europe could be of primary interest to Gazprom, the banker suggested. Rosneft is also likely to target European refineries. Both companies may need sources of oil and gas, the banker added.

The second advisory source added that Gazprom has initiated joint ventures in Russia with European players such as EDF and Total, which, in turn, could be a sign that the company hopes to get relevant preferences in Europe.

However, the first source added that the company may face obstacles in acquiring abroad. Besides that, both Gazprom and Rosneft are in fact facing the same issues as Lukoil: falling oil prices and cost inflation, the first source explained. The second source added that Gazprom, Rosneft and Lukoil have concentrated a significant amount of debt that is likely to prevent them from large scale acquisitions. Rosneft has also undergone a “management shakeup” that hasn’t stabilised yet, so considering new people coming to manage the company, it is unclear what its M&A strategy will be, the second source concluded.

By Alexander Čajčyc

PART IV

TIPS FROM THE PROFESSIONALS



TAX ASPECTS IN M&A

Prepared by Andrey Shpak, Director, Tax & Legal Services, Mergers and Acquisitions, PricewaterhouseCoopers Russia B.V.

When asking for tax warranties / indemnities on acquired Russian company - ask for limitation period of at least five years after completion

A common question that is raised when finalising SPA is the time period during which the tax warranties and indemnities should apply.

The principle underlying determination of this time period is the statutory limitation period for tax matters established in each of the jurisdictions that the company operates in. In Russia this period is three calendar years preceding the year of audit.

A common defence strategy for the seller would be to try to use three years as the limitation period but start counting from the date of completion. Such an approach, however, does not provide adequate protection to the buyer: for example, if you close a deal in April 2010, this would mean that the indemnity will expire in April 2013. At the same time, the tax authorities may not start an audit covering part of 2010 until the end of 2013, and may not raise the assessment until some time in 2014 - but the indemnity will expire by then. Also, even if the tax audit for 2009 starts at the end of 2012 it will not necessarily result in assessment raised before April 2013.

For this reason it is not uncommon for the buyers in Russia-related SPAs to ask for tax warranties / indemnities to extend four years. However, four years is often not sufficient to fully cover the pre-completion tax risks when the Russian tax authorities come to audit the target at the end of the limitation period (eg for deals completed in 2010 this would imply coming at the end of 2013).

First of all, although no specific statistics are disclosed in this area, anecdotal evidence suggests that the Russian tax authorities tend to start larger tax audits in the second half of the year. Also, it is not uncommon in complex and “big-ticket” cases for the tax audit process proceedings to last more than a year between the date of the start of the audit and issuance of the final assessment.

Therefore, setting the time limit to five years for Russia-related tax claims provides a lot better protection to the buyer against such a worst case scenario.

Don’t forget to verify how taxes are treated in pricing calculations in an SPA.

It is a common misconception that a tax professional in a deal should review only tax warranties/indemnities and tax gross-up clauses.

It is true that these are important, but they deal primarily with something that happens AFTER the deal (and what, in most cases, parties hope they will not have to deal with or enforce in any case).

What, in fact, is a lot more important – but not often properly looked at – is how tax assets and liabilities are treated when calculating the price of the transaction.

For example, when the price is determined based on Completion Accounts (ie financial information compiled as of the Completion date), actual cash paid by the buyer may be significantly impacted by:

- (a) whether a particular tax asset (eg a VAT receivable or a deferred tax asset) is treated as a cash-like item, as part of working capital, or not taken in account at all; and

- (b) whether a particular tax liability should be part of net debt (and thus directly deductible from price) or form part of the working capital.

These decisions often have a lot more direct impact on the immediate price the buyer pays (and the seller gets) as compared to decisions on which tax warranties to request and how to formulate the gross-up clauses. So don't forget to pay attention to treatment of taxes in pricing calculations!



FINANCING AN ACQUISITION

Prepared by Oxana Vladislavskaya, Deputy Chairwoman of the AEB M&A Working group, SG Corporate Finance Advisory

In current market conditions purchasing a business still requires capital; but not necessarily large amounts of cash as in times of booming economic growth. Keep in mind that a buyer can negotiate a purchase price with a payment schedule over time. A seller, especially a distressed one, is keen on closing a transaction and is flexible about the terms. When the target's future cash flow and therefore future valuation is uncertain, there are risks of future claims and disputes against a target company.

An instalment sale limits the exposure for a Buyer. At the same time a seller favours an instrument that links part of the transaction price to a target future financial performance, or earn-out. Therefore, future payments can be financed out of future cash flows and thus minimize the need for a buyer to raise capital.

A Buyer can try to attract a loan directly from a single financial institution. One should be prepared to provide additional information and explanations on prospective cash-flows of operating company of a Buyer and operating company of a Target, as both may be guarantors for a loan. Providing a financial institution with a rationale for an acquisition and merged operating model of both entities is highly appreciated as it allows valuating all available for loan repayment cash-flows from qualitative and quantitative perspectives. It is not unusual for a financial institution to ask for participation on the board of directors of a target company or equity upside, as well as the common recourse on assets.



LEGAL ASPECTS

Prepared by Vitaliy Dianov, Senior Attorney, Capital Legal Services

File Data with the Register of Participants

Pursuant to the recent amendments to the Law on Limited Liability Companies, a limited liability company is to establish and maintain a register of participants. The register needs to be maintained by each LLC and must disclose information on participants and their share stake in the LLC, as well as the shares in the LLC that belong to the LLC itself, and likewise any share pledges.

When acquiring a stake in an LLC the acquirer should obtain evidence that the selling participants are listed in the register and that in the course of the M&A transaction the respective data is included into such register.

Intra-Group Transactions and Antitrust Control

Pursuant to the recent amendments to the Law on Protection of Competition, prior consent of the Russian antitrust authorities is not required for intra-group transactions if such transactions are executed between holding companies and their subsidiaries. However, subsequent notification of the antitrust authorities on the transaction is still required (in the event thresholds for the notification are met, as set forth by the law).

When entering an M&A transaction, check whether you can avoid exhaustive scrutiny of the antitrust authorities over the transaction.

When acquiring over 30% of shares be ready to purchase more

The acquirer of more than 30% of shares of a joint stock company needs to bear in mind the obligation to make a compulsory offer to purchase shares and to send it to minority shareholders. The acquirer should budget carefully to foresee potential compensation for shares that may need to be purchased from the minority shareholders.



ENVIRONMENT ASPECTS OF M&A DEALS IN RUSSIA

By Valery Kucherov, Principal Consultant, ERM

Remember potential environmental and health & safety liabilities when contemplating an M&A deal

Results of multiple M&A deals conducted in the last 15 years in Russia show that transactions undertaken by international and domestic companies have resulted in a number of environmental and health & safety liabilities, which may represent a material or reputational risk to the deal value or in the course of ongoing operation of a company. A timely performed assessment of environmental and health & safety issues would help the investor or the owner of a business in identification and quantitative assessment of the cost of measures aimed at mitigation of material risks.

Create a “safe harbour” by agreeing the environmental liability thresholds in the purchase/rental agreement

Carefully evaluated levels of environmental liabilities and thoroughly drafted indemnity clauses are an important part of transactions involving manufacturing assets. In allocating responsibility for soil & groundwater clean-up costs, a properly created “safe harbour” can help to avoid responsibility for hundreds of thousands or even millions of Euros in liability. This is especially important for Russia, where at the moment there is a gap in legislation concerning transfer of environmental liabilities during land purchase, and in case of any legal actions it could be hard for the new owner to prove that soil pollution wasn't caused by him (the so-called “caveat emptor” principle).

Consider social issues in the course of the environmental due diligence process

Historically, social issues were not considered as the key in the course of the due diligence process. The situation started changing with the identification and increase of awareness about potential severity of reputational risks especially for those large-scale multinational companies, which are playing on the global arena. The main issues which may possess a serious reputational risk and jeopardize the deal are working conditions, discrimination, freedom of association, accommodation for workers, relationship with local communities and impact on neighbours, community dependence, grievance procedures for public and employees, impact on indigenous groups and NGO relations.

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