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# Privatisation in Russia – what's in store for international investors?

It is almost impossible to begin any discussion of privatisation in Russia without referring to the privatisation programme of the 1990s. Then, large stakes or entire enterprises in important industries were transferred into private hands at what were, in retrospect, heavily discounted prices that showed little correlation to the true market value of the assets.

As a result of deficiencies in the private auction processes of that time (on occasion, the auction was won by the auctioneer itself, after other potential bidders had been disqualified), 'privatisation' became an almost poisonous term in Russian culture and politics. Even some of the chief beneficiaries of the programme – the oligarchs – now express, at best, very guarded support for the process. As Vladimir Potanin, a leading industrialist, observed: "The word 'privatisation' has become a swear word in this country. I already participated in this and nobody is praising me for it. Let the young ones drink from the chalice of privatisation."

Despite the widespread ill feeling towards the privatisations of the 1990s, the Russian government is embarking on a new and ambitious privatisation programme with the intention of raising at least US$50 billion over the next five years. However, before outlining the intended scope and shape of the current privatisation programme, it is important to understand the various political and economic forces that are shaping the development of the privatisation process.

## Catalysts for Russia's new privatisation programme

The primary catalyst for privatisation is basic budget economics. Russian state revenues are highly dependent on worldwide oil prices. These revenues have been significantly diminished since the financial crisis of 2007/2008. Budgetary surpluses from a few years ago have given way to a deficit. The simplest way to solve this problem is to monetize some of the state's main assets.

The finance ministry predicts that the sales will reduce the deficit from four per cent to three per cent in 2011, and to two per cent in 2012. In Russian politics, maintaining economic stability is crucially important to the party in power to enable it to support social spending. Although


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Prime Minister Putin's United Russia Party commands broad electoral support, that support remains closely linked to the relative stability of the period of Putin's tenures as president and now as prime minister.

There is also a less pragmatic economic reason for the privatisation programme. In the darkest days of September and October 2008, Russia glimpsed the edge of an economic abyss that brought back memories of the financial crisis it suffered in 1998. The bitter experiences of 1998 and the speed of capital flight from Russia in 2008 have undoubtedly reinforced the understanding that Russia needs to sustain its state finances diligently. While a desire to balance the books is not unique to Russia, it does play an important role in the context of the privatisation process for one simple reason: price will matter.

Another catalyst for the privatisation programme is President Medvedev's modernisation drive. The Russian government remains deeply enmeshed in the day-to-day process of capitalism in the country. The extent of the government's involvement is, in part, reflected in the potential scope of the new privatisation programme. Approximately 5,500 enterprises have been earmarked for potential sale.

A carefully conducted privatisation programme can, in effect, act as a vehicle for 'outsourcing' the modernisation of these state entities to international investors. Indeed, as the intention to raise at least US$50bn over the next five years from the sales far exceeds the capital available on the local market, sales of the to-be-privatised stakes will necessarily (but not exclusively) be targeted at foreign investors.

In the event that a privatisation occurs by way of a listing, the relevant security exchange rules will necessarily impose significant further disclosure and governance obligations on the relevant entities. Even if the stake sales occur through private transfer, any foreign investor is likely to require clarity about corporate governance. The government clearly understands that privatisation is likely to bring about such changes. As economics minister Elvira Nabuillina has stated: "The privatisations should not just be a fiscal matter and not so much oriented toward raising funds for the budget, although that's also important...They are in large part a way for us to influence the structure of the economy."

This means that, while the Russian government welcomes foreign investment and is actively seeking it, investors will need to appreciate that some of the entities will require significant investment, both in terms of infrastructure and of management time.

However, the privatisation process is unlikely to be implemented with universal support. One of the main challenges to it will be the opposition of the entrenched interests whose personal positions – whether directly economic, or in terms of established power – will be affected. One such group of entrenched interests is the existing management bodies. In particular, the existing institutional management bodies of entities that are currently fully controlled by the state are likely, in certain cases, to see the influence of outside forces to be directly detrimental to their positions (in part, because of the likely changes including increased disclosure and corporate governance). Arguably, this issue has already been seen in the current privatisation process. The initial list of entities targeted for the first privatisation wave included Russian Railways. Following institutional objections, the stake to be privatised was significantly reduced.

Despite such pressures on the government, it is worth noting Deputy

Prime Minister Alexei Kudrin's comments that the managers "will not get out of it, because it is not those officials who make the decisions but the government. The government has, on the whole, decided on this issue…I do not think that the opinions of individual managers will change the government's position". The determination to push ahead with the privatisation programme can be seen even in the example of Russian Railways. Institutionalised interests had called for the complete removal of Russian Railways from the privatisation process. This did not occur. These contrasting positions show that, at a macro level, opposition to the privatisation process is likely to be overcome if the political will exists. At a micro level, opposition may be more concentrated and may still present problems for investors holding stakes in these entities.

In a broader context, the privatisation process poses a significant political risk. The new privatisation process will inevitably be seen in light of the earlier controversial privatisations of the 1990s which continue to cast their shadow over Russia. There is also continuing debate in some quarters about the intrinsic merits of reducing the state's participation in and control over important parts of the economy. It is also not clear that the political will for the programme, which has been described as 'Medvedev's baby', is universally shared among senior government officials. Indeed, it is likely that the political appetite for the privatisation programme will be severely tested, should one of the main reasons for privatisation fall away (for example, because of a significant rise in oil prices). Such a development will provide an interesting litmus test for the government's economic approach.

## Scope of the privatisation programme

The privatisation plan is almost as broad and ambitious as its initial steps are modest. The intention to raise at least US$50 billion in the next five years is likely to be only a portion of the total funds generated should the government succeed in selling stakes in a large proportion (let alone all) of the 5,500 entities identified as being appropriate for privatisation. In reality, the privatisation of anything close to 5,500 entities is almost unthinkable in the short to medium term. It will probably require the longest horizon imaginable. However, the plan for the first set of privatisations is more practical. The initial list put to parliament for approval comprises 10 companies. Stakes in only a few of them are likely to be transferred within the next year.

The term 'privatisation' itself is, to a degree, misleading. It should be regarded as a partial privatisation. The government's policy is to sell stakes in the entities, but, in almost all instances, the government does not intend to reduce its stake to less than 50 percent +1 share.

## Recent developments

There has been some limited progress in the privatisation process. The list of entities approved for first sale has been submitted to parliament and approved (see Figure 1). The government intends to appoint intermediary arrangers (mainly banks) to conduct the sales on its behalf. A list of 10 intermediaries that qualify for appointment has been approved (see Figure 2). The government is also continuing to pass legislation describing the process for the actual alienation.

The process for a privatisation, in general, will follow one of five forms:

- general competitive auctions – envisaged to apply mainly to property matters (as opposed to shares)
- specialised competitive auctions – envisaged to apply mainly in respect of shares, and where there might be multiple bidders for different sized parcels of the available stakes and there are otherwise no restrictions on transfer
- competitive tender – envisaged to apply mainly where complex conditions will relate to the sale and/or the purchaser
- by way of a trade organiser – envisaged to apply when an arranger intends either to transfer a new stake of an existing listed entity, or to conduct a secondary offering of an otherwise unlisted entity
- by way of contribution of property or shares into the capital of an existing local or international company, in return for an issuance of shares by that entity to the government (although a minimum share consideration is to be paid for the property or shares, this process is not explicitly competitive).

As things stand, the draft law states that the relevant government decree putting a particular asset up for privatisation will specify the applicable procedure. In addition, the 'starting point price' for each of these processes will be determined by an independent appraiser to ensure that it represents 'fair value'. In the event that there are no purchasers for the determined fair value, at least for the competitive processes, they will become something of a Dutch auction, with the price declining until a bidder 'strikes'.

Naturally, many issues will arise for potential investors looking to participate in

**Figure 1. Entities earmarked for first sale**

**VTB Bank**

**SovComFlot**

**United Grain Company**

**RusHydro**

**FSK United Engineering Systems**

**SberBank**

**RosNeft**

**RosAgroLeasing**

**Russian Agricultural Bank**

**Russian Railways**

**Figure 2. Approved arrangers**

**Credit Suisse**

**VTB Capital**

**Deutsche Bank**

**VneshEconomBank (VEB)**

**JP Morgan**

**Merrill Lynch**

**Morgan Stanley**

**Renaissance Capital**

**Russian Auction House**

**Goldman Sachs**

the process, but, given the attractiveness and growth potential of some of the assets designated for sale, and the relatively low valuations attributed to Russian assets compared to their international equivalents, there is likely to be considerable value on offer to a prudent, well-advised and resilient investor.

Issues to be considered by any investor will likely include the following:

**Interaction with the existing regulatory regimes** – it is expected (although it has yet to be confirmed) that there would be no exemption from existing regulations for anti-monopoly consent, or regulations requiring state-approval for acquisitions by a foreign investor of assets qualifying as 'strategic' for the Russian Federation (the law is known as the 'Strategic Assets Law'). However, in respect of the Strategic Assets Law, it is often not be beyond doubt as to whether it applies in any given case. Moreover, the consequences of a breach are, on the face of the law, very significant – the entire transaction is deemed to be void. Although there are no known examples at this stage of the Strategic Assets Law being enforced, a prudent investor will likely seek prior approval before entering into an investment for any privatisation target, and the same will likely apply with respect to anti-monopoly consent. Such regulatory issues will need to be addressed at an early stage by a potential investor, which also means that late-entry into the process will make things more difficult.

**Acquisition financing** – acquisition financing in the emerging markets (particularly Russia) remains limited owing to the perceived risk profile of the jurisdiction, concerns around the enforceability of security, and the general caution of lenders. Given the scope and ambition of the proposed privatisation process (i.e., raising up to US$50 billion), there is, *prima facie*, potentially a funding shortfall that may be difficult to bridge. The additional issue that payment may well be due in roubles means that the ingredients are in place for a market that is going to be open only to investors who are prepared to accept whatever terms the lenders dictate, or those who have the ability and confidence to risk their own balance sheet. Acquisition financing will give an advantage to the biggest and perhaps boldest players, and particularly those who have a deep relationship with their lenders. In addition, sovereign wealth funds are likely to be actively courted.

**Governance structures of privatisation targets** – governance structures of privatisation targets, in particular those entities that are not currently listed, are likely to be in need of modernisation. It seems reasonable to suppose that their governance structures may need revision and updating and that investors will push for this change as part of their bid. It is not clear to what extent there will be any appetite from the government and the management teams to accommodate these requests. It is not difficult to envisage a degree of reluctance from existing management teams – particularly those in entities in which the intention is to dispose of a minority stake only – to accept any far reaching changes.

It is currently unclear to what extent the arranger will be empowered to address corporate governance issues before taking the assets to market. It is also unclear whether there will be scope to enter into an arrangement over governance in certain of the bid-formats (such as tenders). The privatisation process does, however, include some provisions that should reassure investors. An entity slated for privatisation will be required to disclose information roughly equivalent to that required of listed issuers. Investors may have to consider how best to respond to concerns around corporate governance and the possible difficulties in finding a suitable mechanism to

address such issues. One option may be for investors to 'price in' to their bid any concerns around governance.

**Structuring** – structuring for tax and other governance purposes (such as moving governance offshore to obtain the benefit of offshore dispute resolution) is a key consideration in most acquisitions, but it is not clear what the government's appetite is likely to be for investors' structuring arrangements in the public process. In addition, it remains to be seen whether these processes will be effected under Russian law with domestic style documentation or whether English law documentation will be used. This uncertainty may mean that investors may not be able to use all their structuring tools and may be forced to accept a Russian law process as the price for having the opportunity to invest in these assets.

**The government's role in the privatised entities** – the government will, in almost every instance, retain majority control of the entities being 'privatised'. This means that every investor will have to accept the government (acting through one of the state bodies) as the majority holder in its investment. An investor is not likely to have visibility or certainty in relation to the decision-making process of its co-shareholder, and will need to accept that certain decisions may be taken for reasons that are not based solely on economic grounds. Similarly, investors are likely to demand that the government waives its sovereign immunity in any disputes that may arise in connection with the exercise of its shareholder rights. Even then, many investors may continue to have concerns about the merits of taking the government to court, particularly in Russia. However, it should not be forgotten that the government will not be a one-time player in the privatisation market. It will be conscious that its behaviour in one venture could have significant value impact in other privatisations. Investors should therefore treat the government not just as part of the initial sale process but also as a potentially long-term partner and co-investor.

**Liquidity of new investments** – liquidity of the new investments will, in many instances, be limited. While this issue is less of a concern when the investment is made in an entity that is already listed or will become listed through the privatisation process itself, an investor may face more difficulty in exiting the investment in an unlisted entity. Unless an IPO or sale of the entire entity is feasible (and supported by the government at the time), an investor will need to find a purchaser for its minority stake, which may prove difficult. It will be interesting to see whether the government tries to address this point to avoid heavy discounting by potential investors in the privatisation process.

## Opportunities and challenges

That the privatisation process in Russia will inevitably bring with it a variety of challenges should not come as a surprise to any prudent investor. There are significant issues to consider and to digest. However, the prizes on offer are great. The privatisation process may offer significant opportunities to investors who are willing to take a medium-term view of the investments on offer.

The stakes are equally high for Russia. The government is embarking on a complex and hugely important programme of development and modernisation of the economy. It is in Russia's interest to ensure that leading international investors participating in the privatisation process are engaged and motivated in making the entities successful, as this is likely to have very positive implications for the entities themselves and for the state as a whole.

In the long run, it is likely to be the prudent, ambitious and the well-advised investors – particularly those that are dynamic enough to do business on the ground in Russia – who will be successful.

*To view Clifford Chance's webinar, **Global M&A – How Russia is emerging from the downturn**, go to http://www.cliffordchance.com/newsandevents/webinars/russia.html*



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