Legal Week
18 May 2012

BULLISH ON THE BEAR

Hogan Lovells' Richard Cowie assesses moves by Russia to encourage funds to invest in the national economy

Shutterstock

One hundred and forty million consumers, massive foreign reserves and the world's sixth largest economy. An economy that is expected to see annual average real growth of 4% from 2011 to 2015. This is Russia – one of the most promising of the BRIC markets. Investors are traditionally cautious about investing into Russia, with concerns centring on transparency issues.

Despite this, private equity investments have increased and government-backed funds have taken prominence. This is coupled with clear signals from the Kremlin that Russia is open for further investment, with significant changes to the investor legal framework and Russia's membership in the World Trade Organisation.

Are there still opportunities?

Russia is an opportunity rich country with enormous growth potential. Its economy seems to be steadily recovering and the Kremlin is actively looking to improve the investment climate. President Vladimir Putin recently stated his intention for Russia to rise from 120th to 20th in the World Bank investment attractiveness index and ministries have been instructed to develop roadmaps for change. Changes to tax, customs and construction regulations are also under discussion.

What is the status of private equity investments?

Private equity activity is increasing, with an approximate rise of 20% in deal volume from 2010 to 2011. This is a change from the start of the financial crisis when most limited partners made it clear that cash calls should simply not be made. The exception to this seemed to be family offices and private funds of high-net-worth Russians who were less affected by the crisis.

Now, funds have restructured their commitments and are looking at new investments and setting up new funds, with approximately 15 new funds reportedly established in 2011. Russian private equity funds tend to be general funds rather than sector specific. Nevertheless, certain dynamic sectors are consistently invested in, including telecoms, retail, energy, healthcare and high tech.

What about government-backed funds?

The Russian Direct Investment Fund (RDIF) is a $10bn (£6.2bn) fund set up in 2011 and is the crown jewel of Russian government-backed funds. The RDIF was established to co-invest, alongside some of the largest and most sophisticated investors, in the Russian economy – the RDIF will co-invest on a parity basis. This is private equity, Russian style – to qualify, prospective investors must either have assets under management exceeding $1bn (£622m) (for financial investors) or revenues over $1bn (for strategic investors). The priority of the fund is to deliver excellent returns to its investor, the Russian state, and to facilitate equally strong returns for co-investors.

The idea behind the RDIF is simple – security, market knowledge and local presence. The fund provides the security of investing alongside a government-backed fund and the co-investors benefit from the fund's knowledge of the Russian market and local presence. In addition to bringing funds, the co-investors also bring their knowledge of the international markets. Like other funds in Russia, the RDIF is not limited to particular sectors or industries. However, Prime Minister Dmitry Medvedev has identified 10 sectors that require investment by the RDIF – five for modernisation and another five for innovation.

The modernisation sectors identified as requiring investment by the RDIF include advanced processing of natural resources, agriculture and food retailing and transport and logistics. The advanced processing of natural resources is likely to focus on energy efficiency or clean power rather than traditional oil and gas investments. The identified innovative sectors requiring modernisation include aerospace, pharmaceuticals, healthcare, telecommunications and IT.

Pharma is important and is driven by Russia's rapidly growing consumer market. The sector has seen significant change over the past few years, including the 2009 introduction of price controls of essential pharmaceuticals. The Kremlin's overall strategy on pharma is encapsulated by the Pharma 2020 Strategy aimed at increasing domestically produced medicines from 20% to 50% by 2020.

The RDIF, along with co-investor the European Bank for Reconstruction and Development (EBRD), made its first investment in January 2012 and it plans to make 30 to 40 investments in the next seven years. Its first investment was in MICEX–RTS, Russia's main stock exchange (formed in December 2011 by the merger of Russia's two leading Moscow-based stock exchanges). This investment also meets another of the Kremlin's stated aims – to transform Moscow into a leading international financial centre.

Another government-backed fund is RUSNANO, which was formed in March 2011 out of state corporation Russian Corporation of Nanotechnologies. RUSNANO was created to encourage investment in nanotechnologies and it has approximately $6bn (£3.7bn) in assets. Recently, RUSNANO invested in BiOptix Diagnostics, an American label free biodetector and bionanoslides developer – its first equity investment into a US company and a reminder that Russian private equity is not limited by the borders of the Russian Federation.

The general view from private equity funds on the ground is that the RDIF has not, as yet, impacted on their investments. However, most expect this to change as the RDIF picks up momentum.

Have there been any recent legislative changes,impacting investments?

Last year saw a series of measures announced by the then president to improve the investment climate in Russia. These included new laws in the last quarter of 2011 on investment partnerships and business partnerships. The idea behind these is to create a framework for investments and start-up businesses. Historically, most investments in Russia are made either through offshore investment structures or, to a lesser extent, directly into Russia. Offshore investment structures are preferred for a variety of reasons including more flexible corporate governance structures.

Investment partnerships

The investment partnership law came into effect on 1 January 2012 and introduced a vehicle for joint investment activity. The law was based upon US/English limited partnership law and the key features are:

- It is not a separate legal entity.
- The maximum term of the partnership is 15 years with a limit of 50 partners (there is no foreign ownership restrictions on limited partners).
- The scope of activities is limited to buying and selling non-publicly traded shares, other securities and shares in the capital of business partnerships (discussed below).
- Limited partners can only contribute monies, while general partners can contribute assets, knowledge, skills and business reputation.
- The partnership agreement (including the identity of the limited partners) is confidential.

Operationally, investment partnerships have a general partner to manage the business and limited partners to provide funding. Foreign entities with no permanent presence in Russia cannot act as general partners. A limited partner's liability in the ordinary course of business is limited to the amount of its paid-up share, while general partners bear liability with all their property. Since the investment partnership is not a legal entity, the parties are taxed only once.

Civil code changes

On 27 April 2012 the Russian Duma passed significant changes to the Russian civil code and it seems they should take effect in September 2012. The changes are broad and will be the subject of detailed discussion and analysis. On the investment side, the changes introduce many legal concepts that are new to Russian legislation, but well known in its Western counterparts, including indemnities, escrow arrangements and companies being classified as either public companies or private companies. This is another step by the Kremlin in creating an investment friendly climate.

Russia's WTO accession

On 16 December 2011, after 18 years of negotiations, Russia became a member of the WTO. Ratification is expected to happen in July 2012 and, from ratification, Russia will be bound by a series of trade rules and commitments creating investment opportunities. This should contribute to a more transparent and predictable investment climate – areas that foreign investors traditionally raise concerns about. Key changes in the following sectors include:

- Telecoms – increased market access to the telecoms section with the current limit of 49% foreign equity ownership being phased out four years from accession. Russia has also agreed to the WTO's basic telecommunications agreement aimed at promoting fairness and competition.
- Insurance increased market access for foreign insurance companies.
- Financial services – a liberalisation of the financial sector, including allowing 100% foreign ownership of banks and investment companies (subject to certain restrictions).
- Goods – a general reduction in tariffs with the average falling from 10% to 7.8%.

Russia has committed to join the information technology agreement that provides for duty free treatment of relevant goods (computers, etc) within three years.

Some analysts are estimating that Russia's WTO membership will see gains of at least $50bn (£31bn) a year. Whatever gain there is, WTO membership should have a positive effect on trade and transparency and give comfort to foreign investors of an integrated rules based system.

Russia continues to provide opportunities for investment and there is an increase in investment by private equity and government-backed funds. The Kremlin is playing its part by trying to create the right environment for investment, first with government-backed funds and secondly by creating a legal framework to allow for increased investment activity. Investors will continue to have traditional concerns about transparency and corporate governance. Many of the new investment structures are untested and foreign investors are likely to prefer the more traditional models until the new ones have been thoroughly tested in the courts. The key to success for an investor is being able to align its interests with their Russian based co-investors/ partners and continued interest from the Kremlin in creating the right investment climate.

Richard Cowie is a partner at Hogan Lovells.

> Russia is an opportunity-rich country with an enormous growth potential. Its economy seems to be steadily recovering and the Kremlin is actively looking to improve the investment climate Richard Cowie, Hogan Lovells