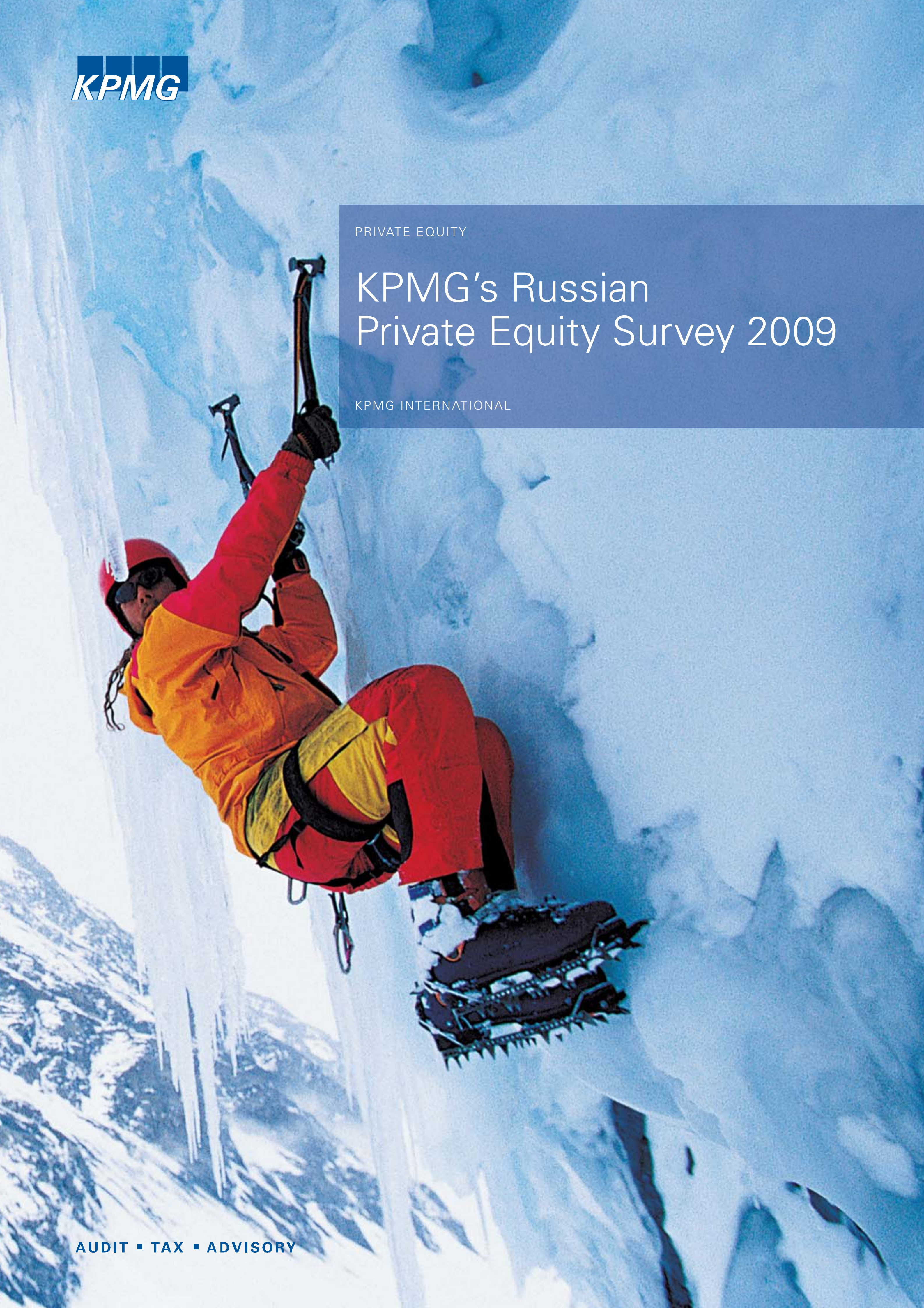

PRIVATE EQUITY

KPMG's Russian Private Equity Survey 2009

KPMG INTERNATIONAL

AUDIT ▪ TAX ▪ ADVISORY

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KPMG's Russian Private Equity Survey 2009 was completed as the full impact of the current economic crisis made itself felt at the end of 2008 and in the first quarter of 2009.

Up until this point the Russian economy had enjoyed an almost unprecedented period of sustained growth, much of it driven by increasing prices for oil and commodities and a rapidly expanding consumer market. The impact of the current economic turmoil has been felt all the more acutely as, despite almost boom economic conditions over the previous ten years, Russia still lags behind many western economies in the development of its infrastructure, robust financial institutions, and a diversified industrial base.

Against this background, it should not be not surprising that the private equity ('PE') market, which expanded during the period of growth up to the end of 2008, has had to adjust rapidly to changed economic conditions.

Despite accounting for a relatively small proportion of total mergers and acquisitions ('M&A') activity in Russia, PE investments grew steadily in terms of both volume and deal size until the impact of the current crisis. Growth capital was the primary focus, and many PE funds secured high returns from investments in rapidly growing businesses during the last decade.

But as in other markets, the crisis has changed this. Exits have become increasingly difficult, and many PE houses currently find themselves having to work much more actively with their portfolio companies to protect their investment – focusing more closely on the consolidation of fragmented industries, operational restructuring and working with underperforming or distressed assets.

Many large international PE houses are also in the process of rethinking their approach to Russia, not least due to the continuing constraints on investment opportunities in more developed economies. However, given the difficulties involved in doing deals and the serious impact which the current crisis has had on the Russian economy, why should PE investors look for investment opportunities in Russia? This survey confirmed the interest in Russia, largely due to its potential to move back into sustained and high growth as soon as the economy stabilizes and moves out of recession. With a wealth of oil and other natural resources, underdeveloped infrastructure, a relatively underdeveloped manufacturing base and a very large population of potential consumers, Russia offers attractive opportunities in the medium term, particularly for those funds willing to invest in understanding the specific challenges of the local business environment. Although the current environment is particularly challenging, it can be expected to offer increasing opportunities to enter the market at comparatively low valuations.

About the Survey

This report is a follow-up to KPMG's first Private Equity in Russia study undertaken at the end of 2007. It is based on research conducted by KPMG in Russia and Mergermarket in December 2008 and January/February 2009. Mergermarket canvassed the opinions of 42 PE houses based in Western Europe and the U.S.A. ('international sample') to uncover their views of the PE market in Russia. KPMG in Russia interviewed 30 Russia-based PE houses ('Russian sample'). All copyright belongs to KPMG International.

The international sample is split as follows:

- 62 percent have current investments in Russia
- 28 percent have not invested in Russia but are looking to do so
- 10 percent have invested in Russia in the past but have no current investments

The international sample responses were collected in strict confidence, with the results made available to KPMG in aggregate form only.

We would like to take this opportunity to thank all of the respondents for their time and contribution to this research.

Snapshot of respondent views

The following is a high-level summary of the opinions expressed by participants in the survey:

- Of the international sample:
  - 46 percent think emerging markets are now more attractive in the wake of the crisis
  - 73 percent think Russia will be the emerging market offering the most opportunities for PE houses in 2009
  - Only 33 percent consider Russia to be the easiest emerging market in which to conduct business, compared to 73 percent who favour Central and Eastern Europe ('CEE')
  - The energy, mining & utilities, and consumer sectors are seen as providing the most attractive returns in 2009
  - 77 percent indicated knowledge of the Russian market as the most critical factor for successful M&A transactions in Russia, a view which was also supported by the vast majority of the Russian sample
- Of the total sample:
  - Three quarters believe that Russian PE deals will be driven by reasons other than growth in 2009; the same proportion agree that distressed M&A activity is currently the principal driver of M&A
  - 72 percent think that PE houses will focus on portfolio management to drive value in 2009
  - 45 percent cite the shortage of professional management skills as a key problem encountered after deal closure

How attractive is Russia as a private equity market?

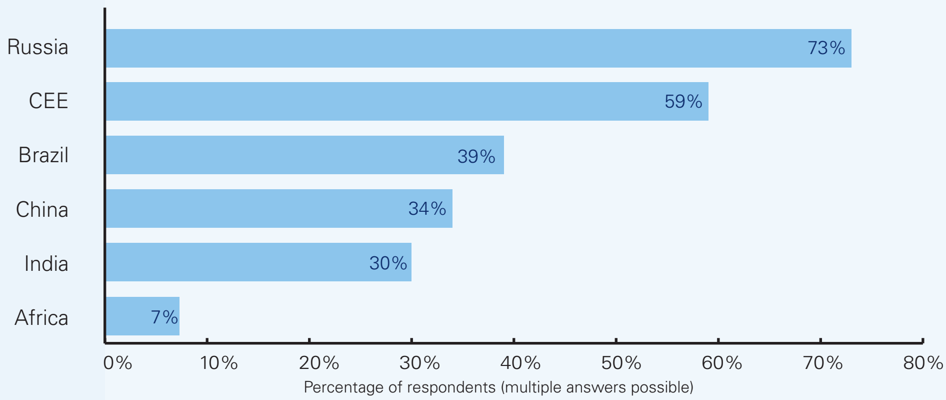
In 2005, Russian PE deals totalled US$489 million, rising to US$2.2 billion and US$4 billion in 2007 and 2008 respectively[1]. In 2007 and early 2008, Russia was considered to be an alternative to and not a victim of what was then seen as a Western credit crunch. As a result the Russian PE market looked promising, with around 50 established local funds and global investors becoming more visible.

A year on and with poor performance in the second half of 2008, the picture is now somewhat different. Many of the attributes of the Russian economy which were drawing investors are looking less attractive – for example oil is no longer US$133 a barrel as it was in July 2008 and the ruble has lost significant value against the dollar.

Nevertheless, many investors continue to be attracted by the longer-term growth prospects for the Russian economy, driven by a large but underdeveloped consumer market, and a significant back-log of investment needs in infrastructure and manufacturing industries. There is also a sentiment in the market that, due to its rich natural resources base, the Russian economy may be an early beneficiary of any recovery in the global economy.

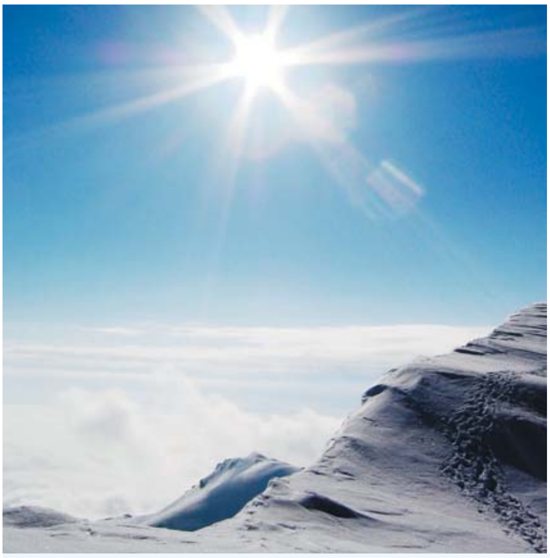
This opinion was supported by 73 percent of the international sample, who think that of the emerging markets, Russia will provide the most acquisition opportunities in 2009.

Which of the emerging markets do you believe will provide the most acquisition opportunities for PE houses in 2009?



Source: International sample respondents, KPMG International, 2009

[1] According to Mergermarket's Deal Database, December 2008; several large transactions occurring in Q2 2008 and a growing number of secondary buyouts contributed to the achievement of the 2008 total.

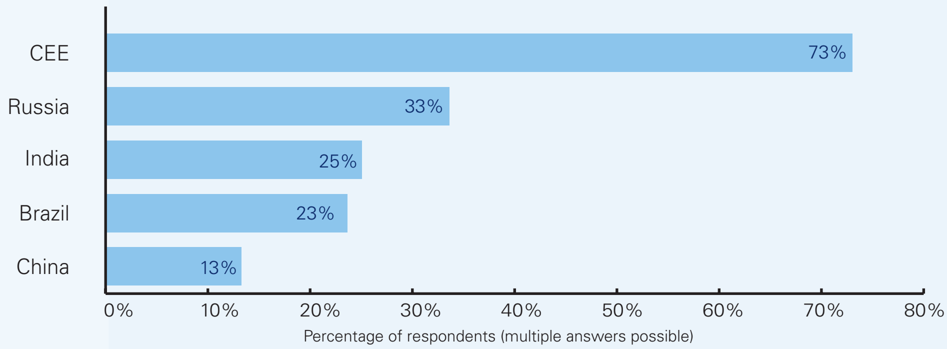


However, this does not mean Russia will be the destination of choice for emerging market funds. When asked which emerging market they considered the easiest for conducting PE deals, three quarters of the international sample indicated the CEE. One respondent commented that "the CEE region might be the most lucrative since it is more stable… I would imagine China to be attractive though it carries political risk as well."

The perception of the international sample that the CEE was the easiest emerging market in which to conduct deals is perhaps understandable given its proximity to Western Europe and the fact that many CEE countries are now either members of the European Union or hoping to join.

KPMG firms' experience is that this perception can be misleading. Geographical and political proximity to the EU does not necessarily guarantee ease of doing business, as shown by the example of Ukraine, which can be considered as least as difficult an environment for international investors as Russia.

Which of the emerging markets do you believe is the easiest to conduct M&A deals for PE firms?



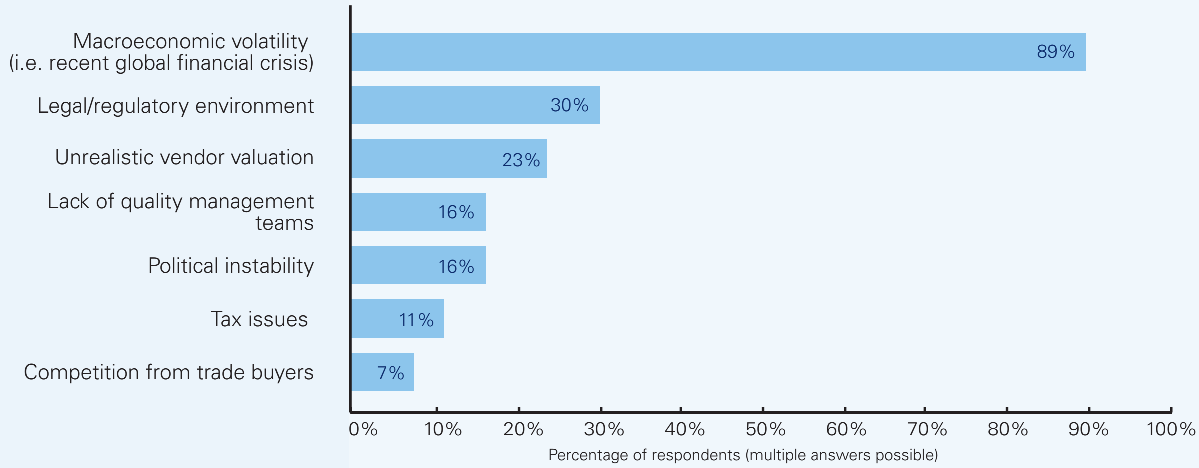
Source: International sample respondents, KPMG International, 2009

Interestingly, the Russian sample mirrored the opinions of their international counterparts. When asked if they believed that Russia looked more attractive for PE investors than other BRIC countries, 58 percent disagreed. As one noted "judging by the number of funds and deals completed in Russia by global private equity firms, Russia probably has a more difficult environment than other BRIC countries." Another commented that "the M&A environment [in Russia] is undoubtedly tough, as the large number of international corporate deals that have failed can testify to." Yet another commented that PE "can find greater stability and better deals in Asia and Brazil."

What are the challenges for the global private equity community in Russia?

Not surprisingly given the current state of the global economy, macroeconomic volatility is cited as the main obstacle to PE investment by 89 percent of the international sample.

What do you believe will be the principal obstacles to PE investment in Russia in 2009?

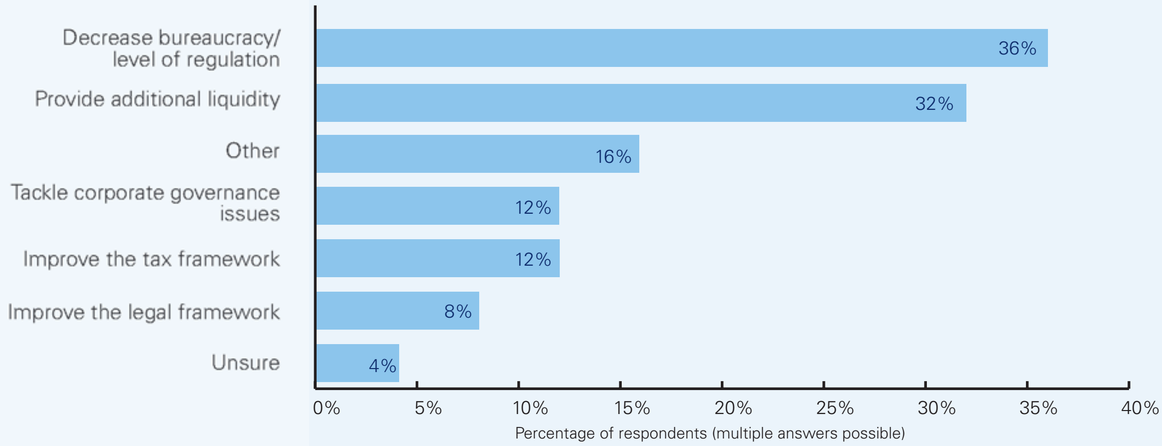


Source: International sample respondents, KPMG International, 2009

The impact of the current financial turmoil on the Russian economy has been significant, bringing to an abrupt halt a period of sustained high economic growth over the last decade. As one international player noted, "China and Brazil look more attractive over the five-year horizon," because "they are not as dependent on oil prices and their currencies are more stable than the Russian rouble."

In addition to economic volatility, Russia is still perceived as having a complex legal and regulatory environment. It is understandable, therefore, that 64 percent of respondents also think the Russian government has a role to play in encouraging PE investment and 36 percent believe that a decrease in the level of bureaucracy and the number of regulations would be beneficial.

How should the Russian government play a role in encouraging PE investment?



Source: International sample respondents, KPMG International, 2009

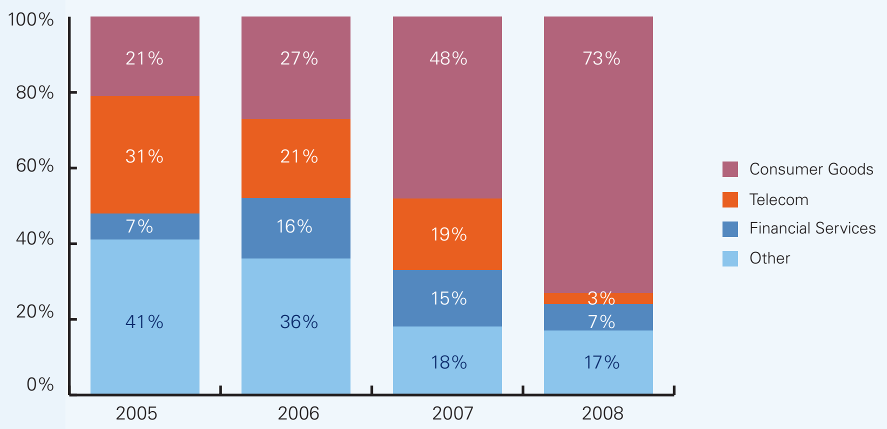
One international respondent commented that the government needs to "fix corporate governance issues like Romania did once it entered the EU", whilst another highlighted further increasing "the transparency and stability of the legal and tax framework as well as relaxing regulations for strategic sector investments."

Political instability has been a concern for international investors. As one respondent stated "the gas crisis and the war with Georgia really do not build confidence in the Russian economy." Another respondent from the international sample interested in making their first purchase in Russia commented more positively that "current geo-political events make me more cautious, but I still think that there is great potential in Russia." Our Russian firm's experience is that such events have had only a very limited impact on the business environment. What they do achieve is to deter investors who have either no experience of Russia or only a limited understanding of the local business environment.

Investment opportunities

More than 80 percent of all PE investments made in Russia to date have been made in consumer goods, financial services and telecommunications. Until recently, these sectors experienced high growth fueled by rising incomes and the growing availability of consumer credit. In the current downturn, consumer centric industries are suffering significantly. Therefore, at first sight it is perhaps surprising that 71 percent of the international sample think that the consumer sector will provide the most attractive returns in the near term.

Russian PE investments by sector, 2005-2008



Sources: Mergermarket Deals Database, 2009

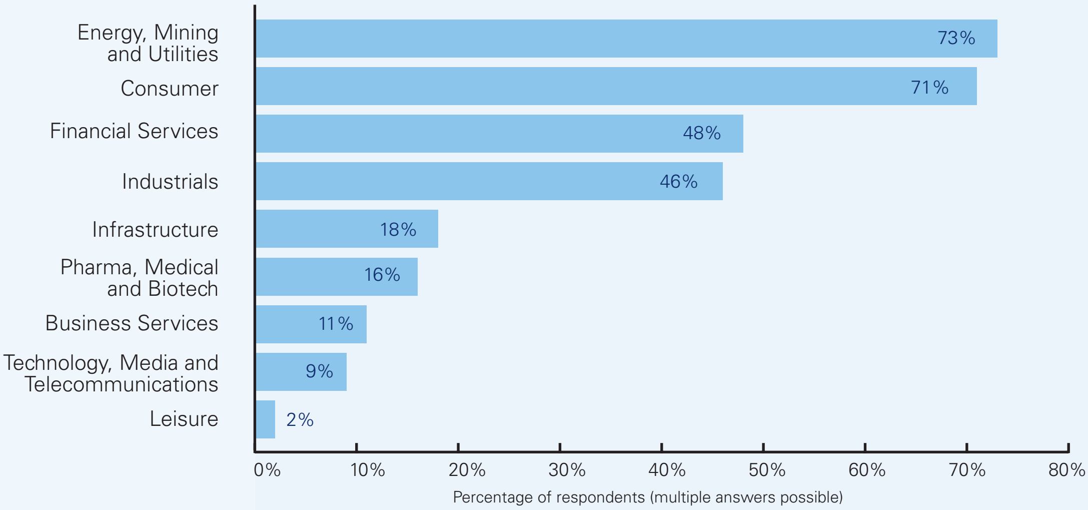
Confidence in the energy, mining and utilities sector appears to be driven by the assumption that this industry will be among the first to benefit from a global economic recovery and an increase in the demand for energy and natural resources. Whilst direct investment in mining or utilities may not be the easiest of transactions politically for international PE investors in Russia, we suggest this may well be an area where PE could play a role, investing together with or alongside a strategic investor.

With approximately 78 percent of Russia's total population (of nearly 142 million) living in European Russia, this region is potentially the largest single national consumer market in Europe. Combined with the relatively underdeveloped state of the Russian consumer sector compared to its Western counterparts, it is understandable that PE investors identify the consumer sector as one of the most attractive areas to invest. Whilst short-term prospects are poor this could change

rapidly once conditions stabilize and incomes start to rise, as consumer aspirations have risen steadily over recent years and there are high levels of unsatisfied demand and low levels of personal borrowing. And, in the current downturn, we would expect to see increasing opportunities to buy into the market at relatively low valuations.

A resumption of consumer credit clearly depends on a return to more stable conditions and the effectiveness of current measures to inject capital into the country's banking sector, but the underdeveloped nature of this and the financial services industry generally is clearly one factor driving PE firms to identify this as a sector which could provide attractive investment returns. Whilst we would support this view in general, we believe that it will take time to resolve the current problems of the Russian banking sector and overcome the legacy of a lack of transparency, weak governance and poor controls, which have exacerbated the impact of the current financial crisis on the country's financial services industry.

Which sectors in Russia do you believe will provide the most attractive returns in 2009?



Source: International sample respondents, KPMG International, 2009

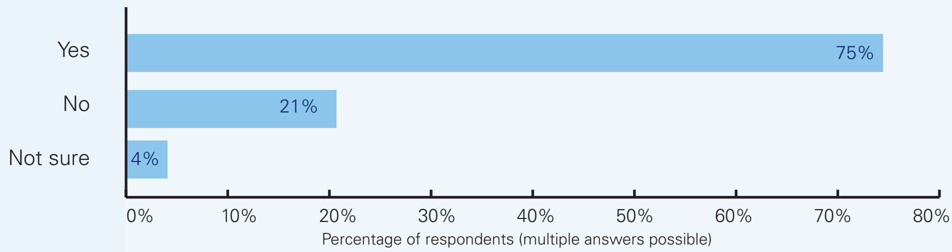
Industrials were identified by respondents as significantly less attractive than the consumer or energy, mining and utilities sectors, but almost 50 percent of respondents still regard this as a potentially attractive sector. This no doubt reflects the fact that, despite rapid growth in the last decade driven by growing demand for Russia's natural resources, the development of local value-added manufacturing did not keep pace with growth in the rest of the economy.

Interestingly, infrastructure ranks low in the areas of focus identified by the international sample, as do service industries. This probably reflects a perception that opportunities in these sectors will only develop in the medium to longer term. We consider that healthcare could emerge as an attractive area for investment in the medium term. There is a significant gap between consumer aspirations in relation to Western standards of healthcare and the level of existing provision, which can be expected to drive expansion as income levels rise.

Deal drivers

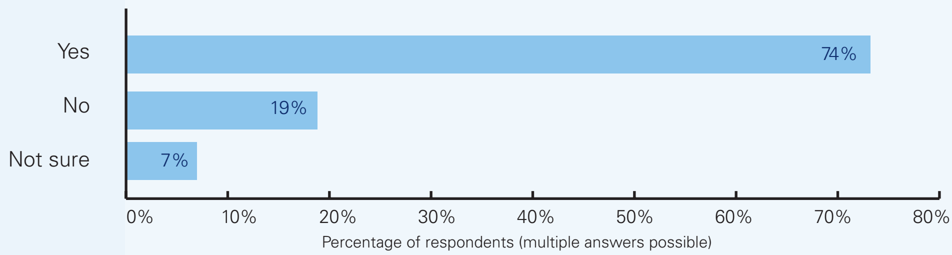
Approximately three quarters of all respondents believe that low valuations and distressed situations will be the most significant drivers of M&A activity in the short term. KPMG firms expect to see increasing opportunities driven by sellers who are forced to realise investments to solve current liquidity problems.

Will distressed M&A activity be the principal driver of M&A activity in Russia in 2009?



Source: Total sample respondents, KPMG International, 2009

Will the majority of PE deals in Russia be done for reasons other than high growth expectations?



Source: Total sample respondents, KPMG International, 2009

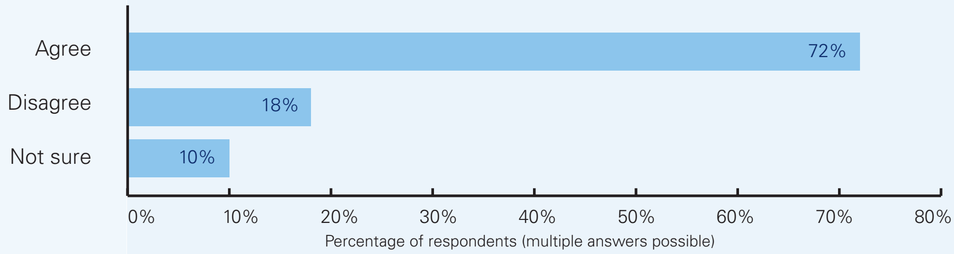
One respondent from the international sample commented that “the market will be driven by distressed sales where the sellers are primarily motivated by a need to improve their liquidity” while another notes that “due to the current climate, growth equity is not particularly applicable. There will be a lot of distressed deals and forced deals, especially with banks taking over assets.” A third thought that there “is definitely a perception of a ‘fire-sale’ climate at the moment.... There is restructuring taking place across the board...”

Lower valuations mean that many companies will only dispose of assets in the short term if they are forced to do so out of economic necessity. Seventy percent of the Russian sample consider that oligarch funded PE may opt to exit investments to provide liquidity for the owners’ core businesses. And, as one member of the international sample noted, “there are large groups in Russia that are in the position to acquire distressed assets as these strategic opportunities arise.”

Focus on portfolio management

Mirroring the prospects for overall M&A activity in Russia, a significant recovery of PE investment activity in the short term is very unlikely. Seventy two percent of the total sample thinks PE firms will focus on portfolio management in 2009 – the fact that there were no material exits in the fourth quarter of 2008 or the first quarter of 2009 indicates that PE houses are indeed holding onto their investments. One respondent commented that "no one will exit this year if they are looking to make a profit on their investment".

Will PE firms spend more effort on portfolio management as opposed to M&A in 2009?



Source: Total sample respondents, KPMG International, 2009

Seventy six percent of the international sample sees improving business processes as the key task. Another issue mentioned frequently by the Russian sample was the value inherent in the current portfolio. This is probably because Russian PE houses have often managed their assets on a stand-alone basis, leaving the majority of synergies between individual portfolio companies untapped – which means that PE investors must now look to identify and explore synergies of scale and scope in their portfolios

Effective portfolio management requires capabilities that are scarce in Russia. The shortage of management skills is a concern for both sets of respondents, with almost half of the Russian sample indicating this as a typical problem encountered after deal closure. Sixteen percent of the international sample view the limited availability of quality management teams as an obstacle to acquisitions and a further 18 percent cite differences in management culture as a typical problem post acquisition.

To some extent the economic crisis has alleviated this issue, as it is now easier to recruit experienced operational managers at lower cost. But many of the Russian sample reported that it is a continuing challenge to recruit operational management teams with the skills required in a downturn. Many managers have only ever had experience of growing businesses with revenues and profits rising each year in a market where growth was taken for granted. The scarcity of experience has also challenged the PE houses themselves, who are struggling to adapt to changed conditions requiring closer involvement with their portfolio and the need to coach operational management teams, as well having to invest more heavily in managing relationships with their investors.

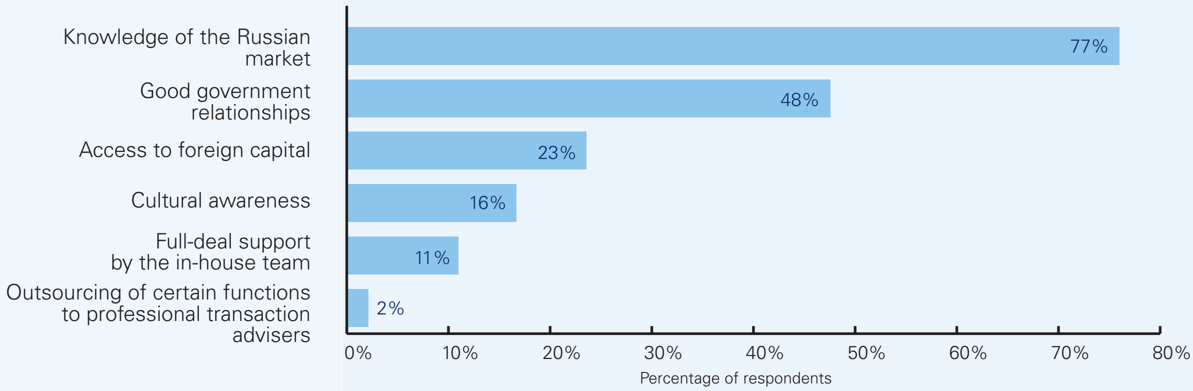
Key portfolio management issues cited by the international sample as specific challenges in the Russian environment are dealing with the burden of government regulation and the differences in local management culture. One international respondent noted that they had encountered "some problems with corruption and dishonesty from vendors – buyers need to be careful of that", but another commented that the bulk of post-deal issues "can be avoided by doing proper due diligence and having a partner who knows the market well." Local investors highlighted tensions with other shareholders and the lack of transparency as typical challenges in portfolio management.

Whilst Russian PE houses are clearly better placed to deal with the local management culture and government bureaucracy which many Western houses find challenging, current events are serving to demonstrate that in many cases they lack the depth of experience in portfolio management of many international firms. There is a great deal of logic for both groups in exploring tie-ups and co-investment as an approach to the Russian market, although there is little evidence to date of this model gaining popularity. Whilst one might imagine that international investors in particular would find cooperation with local players attractive, our international respondents were divided on the issue. When asked whether their firm would be interested in such cooperation approximately half said it would not.

Local knowledge a key success factor

Despite the divided response to the question as to whether they would consider cooperation on deals with local players, the international sample clearly cited knowledge of the Russian market and solid government relationships as key success factors for PE investments in Russia.

What do you believe drives the success of an M&A transaction in Russia for PE firms?



Source: International sample respondents, KPMG International, 2009

The importance of connections in Russia was elaborated upon by a number of the international sample, with one saying that "the best funds in Russia owe their success to being so well connected. For outsiders like us, we would almost always end up being losers." Another clarifies that it isn't necessary for PE houses to be on intimate terms with the Russian president or prime minister, saying that "connections don't always need to be high-level governmental contacts – they can be merely local." Indeed, local relationships are beneficial for doing deals in a number of ways. They are often the primary means of sourcing deals, as it is necessary to have a strong local network in order to identify and successfully negotiate with potential targets. But governmental contacts can be useful in terms of effective lobbying, can assist in dealing with bureaucratic licensing and regulatory processes, and can also provide insight into impending economic developments on a regional and industry level. Whatever the level of relationship, they cannot be successfully established and maintained by fund managers sitting in New York or London – a local presence is essential. The above graph is based on the responses of the international sample. The results, however, substantially mirror the sentiments of the Russian sample, who ranked local industry knowledge, access to foreign capital, cultural awareness and good government relationships as critical success factors in descending order of importance.

Outlook

Despite the effects of the credit crunch on the Russian economy, the longer-term outlook for PE investments in Russia remains attractive, primarily due to Russia's population of over 140 million, an underdeveloped consumer market and a significant backlog of investment needs in infrastructure and manufacturing industries.

The current focus on portfolio management as a result of the lower growth prospects of the Russian economy, means that the value creation capabilities that international PE houses can bring are increasingly important. However, the on-the-ground understanding and connections, and ability to identify potential targets that PE houses with a local presence possess are essential for successful deals.

Therefore, KPMG in Russia expects to see more international players co-operating with Russian houses in the future. Furthermore, with valuations at all time lows, this may be a very good time for international funds to test the water and to start to establish the necessary presence on the ground. Partnerships with local Russian houses present an opportunity to benefit from an established team and to avoid having to build one from scratch.

KPMG in Russia

KPMG in Russia has been one of the fastest growing member firms in KPMG's global network for the last four years, with growth in 2008 of 62 percent. In the CIS, KPMG now has offices in Moscow, St. Petersburg, Ekaterinburg, Nizhny Novgorod, Novosibirsk, Rostov-on-Don, Almaty, Astana, Bishkek, Kiev, Donetsk, Tbilisi and Yerevan, employing approximately 3,100 people.

KPMG in Russia is committed to capitalising on KPMG's global intellectual potential, combined with the practical experience of our Russian firm's professionals, to help leading companies to achieve their goals.

KPMG member firms aim to provide PE clients with an integrated, tailored service of the highest standard. Regardless of where we are based we strive to act as one team, adapting to the needs of clients and working together to provide them with the answers they need to make the best decisions on their investments.

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