Guest Commentary: Investment Strategies for Russia: XENON Capital Partners' Experience

XENON Capital Partners, founded by Natasha Tsukanova in 2009, is a Moscow-based investment advisory and investment management firm. In this article, Stanislav Song, Chief Strategist of XENON Capital Partners, describes how private equity participants can successfully navigate and invest in the challenging Russian market based on lessons XENON learned via structuring, marketing and investing in Russia's largest private equity deal in the utilities sector.

Introduction

Emerging markets are commonly perceived as extremely risky—and Russia is frequently seen as one of the least attractive markets in the context of emerging markets private equity. However, compared to other emerging economies, Russia's long-term private equity returns have been consistently strong (see Exhibit 1). And while political risk, governance issues and legal uncertainty in Russia have led investors to conclude that the risks are high, positive investment indicators, such as an abundance of natural resources, continued consumer growth, low household debt, and minimal sovereign debt, are regularly ignored. For example, Russia has the second lowest global sovereign debt burden after Saudi Arabia.

Finding, structuring, and funding attractive investment opportunities in Russia, however, remains a challenge for many investors. In March 2012, XENON Capital Partners (XENON) led a consortium of international and domestic investors in acquiring a minority stake in the Russian power generation company Enel OGK-5. The challenges associated with the transaction were manifold—the overall size of the investment of US$750 million required partners with deep pockets, and the timing around the Russian presidential election process added market volatility and a deterioration of investor confidence. Throughout the investment process, several key strategies, including a disciplined approach, dedicated local expertise, and intelligent structuring, helped to ensure the successful completion of the transaction. This article describes these strategies in greater detail, highlighting how investors can capitalize on attractive long-term opportunities in Russia.

Lesson #1: Focus on attractive sectors that are undervalued and have long-term growth prospects

While the European Bank for Reconstruction and Development (EBRD) has been a pioneer in taking significant equity stakes in utilities (such as Enel OGK-5 in 2007), the sector has not seen the same amount of private equity attention and enthusiasm in Russia as the classic consumer, telecommunications, or natural resource plays. Nevertheless, the underlying fundamentals are compelling.

The Russian power market, with over 1,000 TWh of electricity consumption per year, of which 60% is driven by industrial demand, shows a strong correlation to GDP growth (see Exhibit 2). The electricity sector is supported by a continuously expanding Russian economy and comparatively low electricity per capita consumption. To date, Russian consumption per capita is about 50% below that of both the United States and Scandinavia. With continued GDP growth and improving consumer prosperity, we believe the Russian power market, currently the fourth largest in the world (see Exhibit 3), is set to experience long-term stable growth.

Unlike other sectors that are dominated by the state, the Russian utilities industry has undergone a massive and far-reaching reform process since the mid-2000s. Over the years, the vertically integrated state monopoly ceased to exist and more than 80 companies were formed, divided into separate sub-sectors such as generation, transmission, and distribution. Since 2011, electricity supply (excluding households) has been deregulated, therefore giving rise to a thriving electricity market that favours efficient generation companies. Annual demand is expected to continue to grow at a compound annual growth rate of 2.5% between 2011 and 2014.

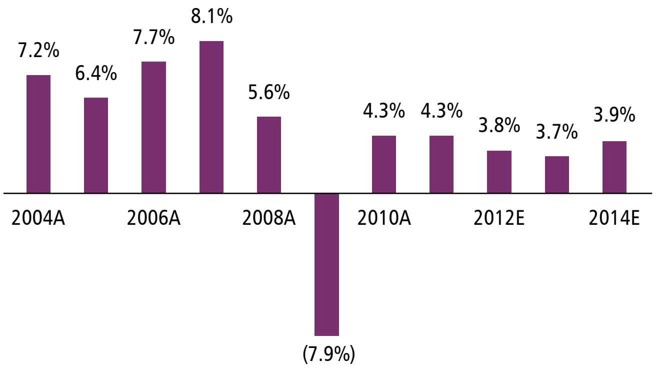
Exhibit 1: ERBD Net Horizon Returns

Returns as of 31 December 2010	Three Years	Five Years	Ten Years	Since Inception
USD				
Cambridge Emerging Markets Venture Capital & Private Equity Index	(5.86%)	10.90%	14.86%	12.62%
Russia/CIS	0.76%	20.15%	22.91%	14.56%
EUR				
EVCA: All Private Equity	(3.00%)	5.40%	5.10%	9.70%
Russia/CIS	3.83%	16.26%	16.17%	11.72%

Source: EBRD, EVCA, Cambridge Associates data.

Exhibit 2: Russian Power Consumption Driven by Industrial Demand

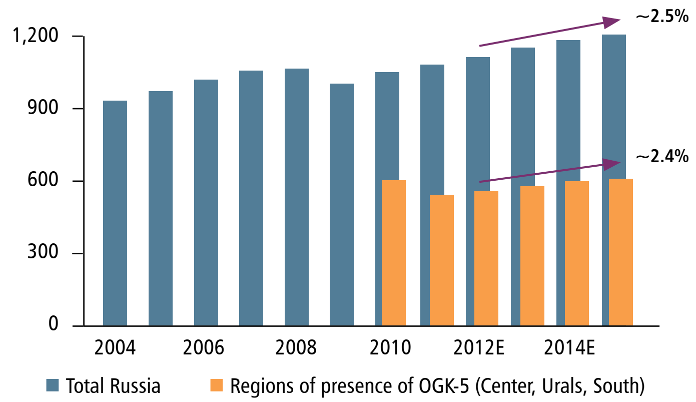
Real GDP growth, %



Source: Company data, Ministry of Economy.

Estimated energy demand, TWh

CAGR 2011–2014E



We believe the fair value of Russian power is not realized and, leaving aside efficiency, tariff and consumption growth, simple improvements in liquidity will provide a significant upside for Russian utilities. Specifically, most utility companies are listed on the Russian stock exchange, with only a few traded on a more active market—thus access to international stock exchanges will change the outlook for many companies in this sector. This assumption led to our initial interest in Enel OGK-5.

Lesson #2: Pick the right target—avoid widely shopped opportunities

XENON's knowledge of the power sector in Russia enabled us to evaluate opportunities within a growth market that was not widely recognized in the private equity community. However, it took some time for the right opportunity to present itself. Based on our experience and outlook for the sector, we felt that an attractive investment would be a significant minority stake in a highly efficient power generation company, which would benefit most from power sector liberalization, tariff changes, and price increases.

Through our long-established industry relationships, which date back to the beginning of the power sector reorganization, XENON early on became aware of the intention of INTER RAO UES, an integrated Russian utility, to divest its existing minority positions in the power sector. INTER RAO's long-term strategy was to sell most of its non-control shareholdings and concentrate on its core capabilities. One of the assets it was looking to divest was its 26.4% shareholding in Enel OGK-5.

Enel OGK-5 is an interregional thermal power generation company in Russia. Since 2007, the company has operated four large power plants with a total capacity of nearly 10,000 MW. Enel OGK-5 strategically benefits from the locations of its generation assets situated in both electricity deficient and/or high consumption growth areas. The company's key fundamentals are healthy with an expected EBITDA margin close to 22% and an estimated compound annual growth rate of roughly 17%. With EBRD acting as a minority shareholder since 2007, corporate governance has been a key focus for Enel OGK-5.

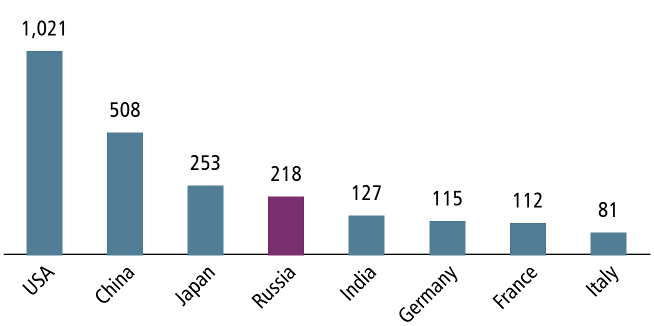
We found the opportunity attractive for a variety of reasons. The fact that the company was run by an experienced operator would enable us to exert substantial influence over key strategic and commercial decisions, while the day-to-day operations would be controlled by an experienced and efficient management team. Additionally, based on the size of the stake, the investor was guaranteed three Board positions and veto rights over key decisions. XENON worked with INTER RAO UES from the beginning to secure proprietary access to this target.

The entry valuation at which we came to an agreement with INTER RAO UES was compelling, reflecting the challenges within the Russian utilities sector. Compared to international and emerging market peers, the entry price was at a 70% discount to fair value, and the attractiveness was further enhanced by an estimated dividend yield of around 4–6%.

To acquire the stake in Enel OGK-5, XENON needed to raise US$625 million up front, which we felt was only achievable through a highly structured club deal. XENON prepared a

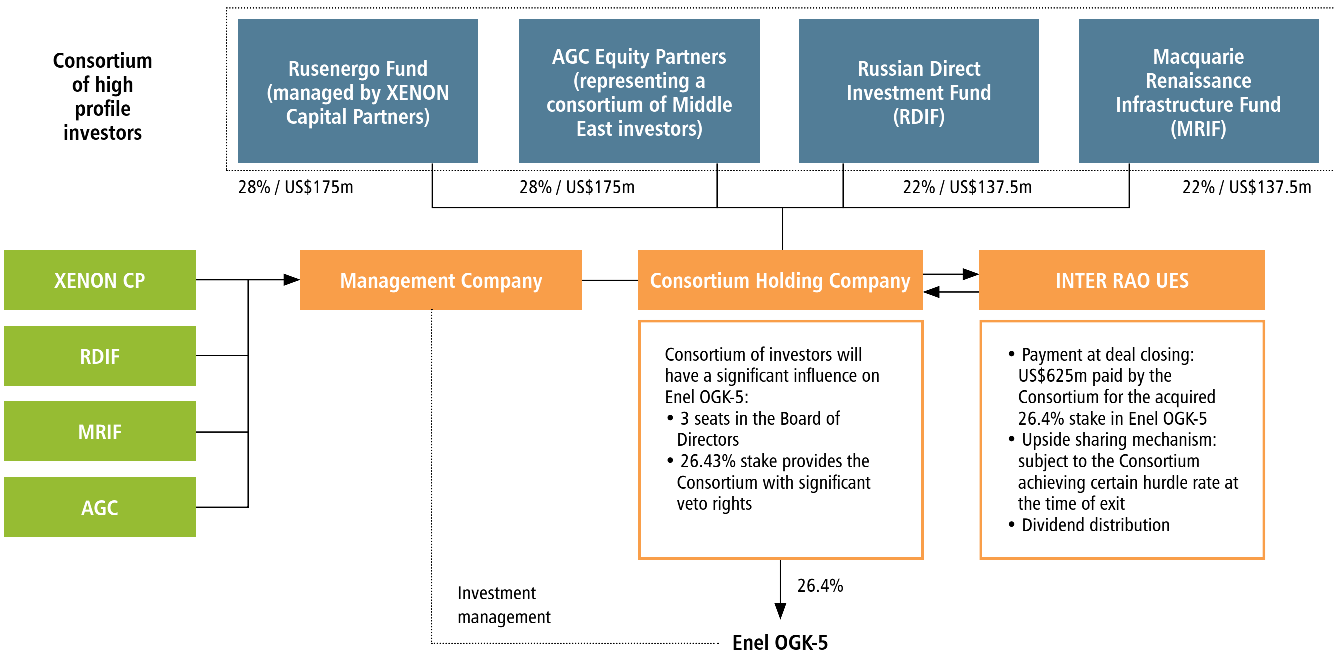
Exhibit 3: Russia is the World's 4th Largest Power Market, 2011

Generation capacity, GW



Source: Broker reports.

Exhibit 4: Deal Structure for Enel OGK-5 Transaction



Source: XENON Capital Partners.

comprehensive 'book' that outlined the company and the investment opportunity. While it was somewhat unusual for an investor in Russia to prepare such an overview of the investment opportunity, XENON's team successfully relied on its advisory background to raise co-financing. In fact, our partners later confirmed that the intense preparation of the project and the detailed information available made it easy to take a closer look.

However, the investor consortium did not materialize overnight. Many months were spent on the road, visiting old acquaintances and making new contacts, while repeatedly explaining the rationale for investing in Russia in general, and in the power sector in particular. In the end, XENON's international reach and relationships, combined with its domestic market knowledge and access, produced three quality large ticket investors.

Lesson #3: Build a global team with local expertise

As is generally true for private equity teams in Russia, the long-term presence of XENON's multi-lingual, multi-cultural team in Moscow, combining international reach with local insights, was a key distinguishing factor in successfully completing the project. In the case of the Enel OGK-5 investment, XENON's exclusive access to the investment target was generated through local relationships, while access to Middle Eastern and other international investors was facilitated by XENON's network of international advisors.

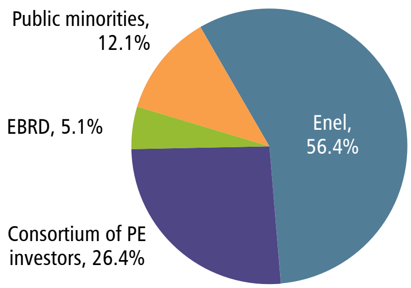
Large international funds have typically been reluctant to focus on a presence in the Russian market, leaving the playing field to a handful of very locally-focused funds and fund managers that have the experience, patience and stamina to invest in the country. In Russia, it is important not to lose focus and faith in the underlying fundamentals even if the road becomes rocky. Arguably more than in many other emerging markets, long-term personal relationships are a key ingredient for successful investing in Russia, where many business relationships develop out of friendships that have been forged over many years—often starting in high school or the university dormitory. As investors in emerging markets know, having a trustworthy partner is a prerequisite for any investment decision. And as many examples show, a badly chosen partner is probably one of the key reasons private equity investments in Russia sometimes fail.

Lesson #4: Combine domestic and international investors to mitigate political risk while attracting foreign capital and know-how

In autumn 2011, XENON Capital Partners had secured the soft commitment of the consortium that was to jointly acquire the stake in Enel OGK-5. Key consortium partners included AGC Equity Partners, a fund representing institutional investors from the Middle East, the Macquarie Renaissance Infrastructure Fund, jointly managed by Macquarie and Renaissance Capital, the Russian Direct Investment Fund (RDIF), founded by the Russian government, and the Rusenergo Fund, a Russian utility fund managed by XENON Capital Partners (see Exhibits 4 and 5).

For Macquarie and AGC, the presence of RDIF was a compelling mitigant against political risk. At the same time, the

Exhibit 5: Ownership Structure of Enel OGK-5 (as of September 2012)



Source: XENON Capital Partners, company data.

presence of quality international investors was a prerequisite for RDIF to invest—its purpose being to facilitate the entry of private equity and other financial investors into the country. Indeed, the Enel OGK-5 investment was only the second investment RDIF had carried out since its inception; the first one being a co-investment with EBRD in the Russian stock exchange MICEX.

The transaction set records by being:

- The largest private equity transaction (by deal value) in the Russian power sector
- The largest single investment by a Middle Eastern investor in Russia
- The largest single investment by the Russian Direct Investment Fund
- The largest individual private equity stake held in any Russian power utility

Lesson #5: Be disciplined and do not lose faith in the underlying fundamentals even when the markets are jittery

The challenges associated with sourcing, structuring and closing this transaction sometimes brought the team close to a breaking point. While the team was working on legal documents and final due diligence arrangements, the Russian markets suffered from the tremors of pre-election rhetoric, a slowdown of the reform process, and general political risk jitters resulting from widely publicized demonstrations against the election process. With the quoted share price of ENEL OGK-5 dropping by over 15%, the entry valuation initially agreed to with INTER RAO UES was becoming increasingly challenging. In the end, and following tough and intense negotiations amongst all parties, XENON was able to propose a complex but fair upside sharing mechanism to close the valuation gap.

Given the large size of the transaction, the investment can easily be likened to a SPAC (Special Acquisition Company), which in XENON's view increased the attractiveness for investors. Nowadays, investors struggle with the concept of blind pools that are raising funds for undefined future projects, especially in high-beta markets. Indeed, the ability for the consortium members to make an informed investment decision based on detailed information provided for the target, including site visits and management and shareholder meetings, was a key selling point. In addition, classic private equity requirements, such as Board representation, key veto and shareholder rights and multiple potential exit routes, solidified confidence. Furthermore, the ability of the company to start paying dividends after the completion of the current investment program proved to be highly attractive.

Lesson #6: Add value to your investment at every juncture

One of the primary exit strategies for the consortium is an additional listing on an international stock exchange to increase liquidity and investor diversification. Investor confidence, inter alia, depends on the quality of the Board of Directors. Therefore, XENON brought Rod Peacock, former Vice Chairman of JPMorgan Chase's Investment Bank until 2003, into Russia to represent the consortium of investors on the Board of Enel OGK-5. We believe that Rod Peacock will bring his industrial and financial experience to play as a member of the audit committee of Enel OGK -5. While taking a proactive role in shaping the company's future, Peacock will, together with the two additional consortium Directors, protect and further the interests of the consortium.

Overall, the first six months of our investment have been encouraging. The Board of Directors is fully functioning, cooperation amongst consortium members is well established, and the company is doing well. In fact, given the overall softness of the Russian utilities sector, Enel OGK-5 is outperforming most of its peers and we are looking forward to further good news.

Stanislav Song is the Chief Strategist and a Managing Director at XENON. Stanislav is widely recognized as one of the key Russian strategists in the energy and utilities sectors. Prior to joining XENON, Stan worked for more than 12 years at J.P. Morgan, specializing in mergers and acquisitions in the energy, power and general industries. Prior to J.P. Morgan, where Stan was the Head of M&A for Russia and the CIS, he worked with Global Emerging Markets, a US$3.4 billion alternative investment group based in New York, which specializes in emerging markets private equity investments. Stan holds degrees in engineering and economics from the Moscow Bauman State Technical University, New Economic School and London School of Economics.