Lessons in Putinomics

Recent events refute the decoupling theory

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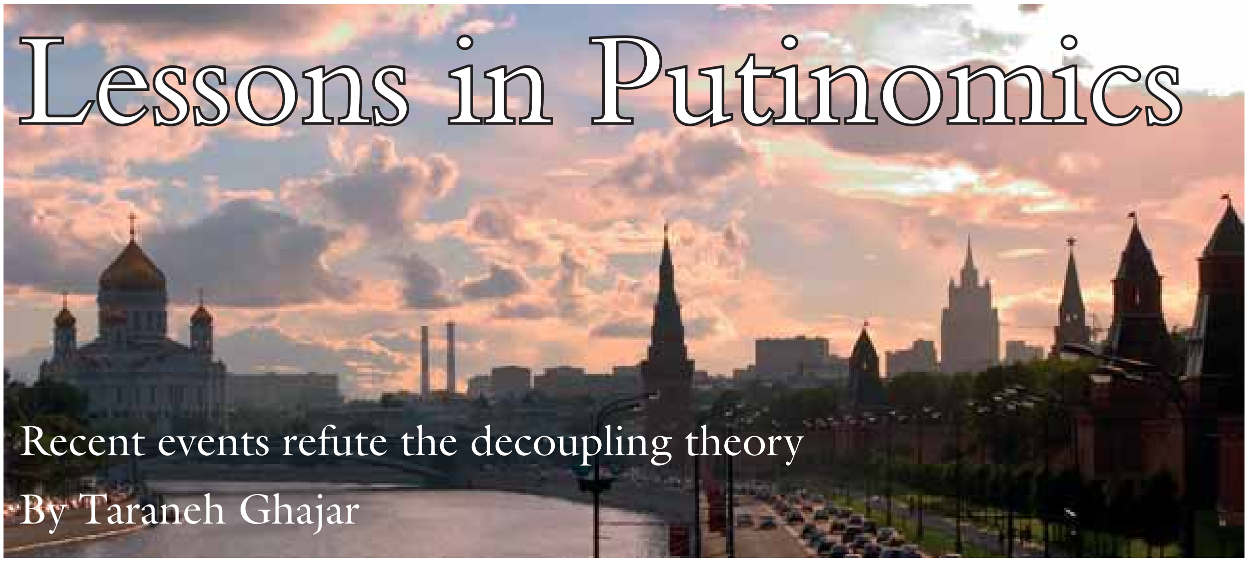

For a while it seemed as if the world financial crisis would not diminish emerging market appeal. Despite the onset of adverse symptoms in Europe and the US in 2007, emerging market growth figures maintained an upward thrust, indicating they had indeed decoupled. In fact, global emerging markets' private activity peaked in Q2 2008, meaning they grew for a full year after more developed markets peaked in Q2 2007.

Jump ahead to the fourth quarter of 2008 and emerging market confidence came crashing down. The decoupling theory has been swiftly debunked. As Fitch downgraded Russia's investment grade from BBB+ to BBB this February, the second lowest rating and inches away from junk, the leaders at Davos were also clear: BRIC growth has considerably slowed and key indicators forecast further drops. Rather than proving to be the motor that pulls the world out of a recession, the world looks likely to drag emerging markets down as well.

Private equity firms in Russia
Top ten by size
Baring Vostok Capital Partners
Russia Partners
Troika Private Equity
Renaissance Capital
Delta Private Equity
Alfa Capital Partners
UFG Private Equity
Renova Capital
Aurora Investment Advisors

In Russia, times are particularly tough. The downgrade damage has been compounded by a deadly cocktail of exposure to foreign loans, rapidly falling world oil prices and loss of confidence in the ruble. While China's annual growth has been reduced from 9% to a predicted 6%, Russian growth dropped from 8% to 5.6% in 2008, and the forecast for this year is close to zero. The ruble has since hit a historic record low. Putin's boldly issued comments about Russia's immunity from the global recession appear borderline ridiculous as he back-tracked in a speech at Davos.

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Impacting the private equity market

"The market will be tricky going forward," predicts Alessandra Pasian, senior banker at the European Bank for Reconstruction and Development (EBRD), the largest investor in Central and Eastern Europe. "2009 does not look positive, not just for Russia but for the whole CIS region."

The most immediate repercussions of the crisis are amplified risk for portfolio companies and a halt on new investments. "Our fund managers are currently looking after their existing portfolio companies, trying to preserve and add value. They keep an eye out for new opportunities but are cautious in taking new exposures," Pasian said of the EBRD's future plans.

Mike Calvey, co-managing partner of Baring Vostok Capital Partners, upholds Pasian's projections. "The three biggest challenges for Russian private equity firms are: liability management issues in existing portfolio companies, particularly in light of the recent substantial devaluation of the ruble; lack of revenue visibility for portfolio companies in 2009 and beyond; and fundraising from LPs." With so many Russian companies dependent on foreign loans, the currency devaluation makes interest rate payments particularly threatening.

Fundraising is more than a challenge at the moment, with LPs running scared and investor confidence waning. Russia's foreign direct investment situation can best be described as record capital flight. Of the massive influx of foreign money that poured in over the last few years, more than $83bn has left since August, indicating how quickly speculative capital departs.

"Only the most successful funds with long-term established LP relationships have a chance of raising new capital," said Calvey of the current environment. He also indicated that the existing players will have to attract considerably more LPs to get up to fund targets since LP "bite-sizes" are now much smaller.

Invest now, prevail later?

Typically, every doom and gloom scenario has a silver lining and this is no exception. Like in other economies, the crisis has driven down stock prices, making assets appear undervalued – Russia's RTS index has reversed its upward growth trajectory (it rose by a compound annual rate of 40% from 2004-2007). This could mean sweet pickings for acquisition-hungry private equity firms.

"Given the fall in stock market valuation there might be a chance now to de-list companies that would not have been possible two years ago," Pasian says. "It might be possible that some of the fund managers will start looking at listed companies as possible acquisition targets to take them private."

When it comes to sector attractiveness, the silver lining is harder to locate. Pasian noted: "In the last few years, private equity looked at investments in every sector, from retail, to IT, to financial services. It was truly opportunistic. Now it is hard to predict a sector focus." Of course the more resilient sectors will be targets of new investment, but it remains to be seen which sectors pull through. Meanwhile, the instability in valuation plays on investor insecurity and makes the market fairly inactive. As with elsewhere in Europe, vendor price expectations remain pie in the sky in relation to what buyers are willing to pay.

BRIC Real GDP Growth

	2007	2008	2009
Brazil	5.4	4.8	4
Russia	8	5.8	Less than 1
India	9.0	7.8	6.9
China	13	9	6

Sources: OECD and The Economist. Russian growth 2009 came from the Russian government press statements

Putinomics: From growth-oriented to survival economy

Since the onset of low oil prices and recession symptoms, Russia has spent approximately $200bn, about one third of its substantial foreign reserves, in an effort to combat currency depreciation. While Russia had indeed learned from the 1998 ruble crisis and made policy revamps, this is now proving insufficient to weather the storm.

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According to the Russian Ministry for Economic Development, the bottom-out is predicted to persist beyond two quarters. In the short term, Russia will simply have to continue with carrot and stick bail-out and stimuli packages. Over $250bn has been distributed so far with further liquidity injections pledged. At this rate, the foreign reserve cushion is expected to hold out for only another 18 months.

Putin's tone can best be described as sincere flip-flopping. Since last autumn, he has transitioned from blame-oriented and critical of the west for its role in the downfall of global capitalist system, to Mr Team Player. At the recent Davos forum, Putin noted: "We cannot afford being isolationist or economically selfish. We are all in the same boat." It seems his cooperative sentiment is both strategic and true. In the long-term, Russia's way out of the crisis is dependent on the US and Europe's way out. We are seeing the collapse of the whole system.