cutting through complexity

M&A in Russia 2013

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KPMG IN RUSSIA AND THE CIS

Contents

Foreword

Sean Tiernan
Head of Advisory

The analysis, commentary and survey responses set out in this publication were collated prior to the escalation of tensions in Ukraine. Readers of this report should therefore consider comments and survey respondent's expectations for economic growth and the outlook for Russian M&A in 2014 in this context.

At the date of publication it is difficult to predict how the crisis will unfold or what sanctions the US and EU may impose on Russia beyond the travel bans and asset freezes already in place. It is therefore not easy to foresee with any degree of certainty what impact the crisis may have on the Russian economy.

On 11 March 2014, Citigroup cut its GDP forecast for Russia from 2.6% to 1%, significantly below the Central Bank of Russia's (CBR) mid-February forecast[1]. However, economic growth had been slowing in Russia long before the escalation of the Ukraine crisis and yet the level of underlying M&A investment has continued to grow over the last three years.

Russian M&A has historically been heavily weighted toward domestic activity – and increasingly so in 2013 following a sharp reduction in outbound investment during the year. While inbound M&A has grown steadily over the last four years, it is logical to assume that foreign investors, particularly those in US and EU, will be the first to re-evaluate potential acquisitions in Russia while the threat of further sanctions remains.

While there will be a time lag effect of the crisis on Russian M&A, it is worth noting that Q1 2014 saw a total of 102 deals announced – the highest level during the last five years. Although the value of transactions fell by 30% in Q1 2014, to USD10.8 billion, this was still 7-8% higher than the same period in 2010 and 2011.

It remains to be seen how the crisis is resolved and whether its impact on Russian M&A will be principally limited to a reduction in inbound investment or not. Fundamentally we expect the market dynamics of Russia to continue to provide opportunities to realize value through M&A over the long-term.

[1] *Central Bank of Russia revised its 2014 GDP forecast from 3% to 1.5-1.8%*

Headlines

Another strong year for M&A in Russia, following 2012's record-breaking performance:

- Russian M&A **values reach highest level since 2007**[2]
- **Energy and natural resources** industry **continues to lead the market**
- Russian **power and utilities sector** sees the **9th largest deal globally in 2013**
- **Real estate** sector sees a **57% increase in value** year-on-year
- **67%** of survey respondents **expect the value of M&A in Russia to increase** in 2014[3]

Executive summary

2013 proved to be another strong year for Russian M&A following the record-breaking value of deals announced in 2012, which was driven by Rosneft's acquisition of TNK-BP. Excluding this deal, Russian M&A reached its highest level for six years, with USD108.4 billion-worth of acquisitions in 2013.

The strength of Russian M&A is even more impressive when compared to global and European deal-making, where deal values fell by 3% and 12% respectively over the same period. These figures highlight the comparative resilience of the Russian market to global economic drivers.

The solid performance in Russia was driven by a return to dominance of the energy and natural resources industry which saw a significant increase in deal value across all three sectors.

Due to the magnitude of Rosneft's acquisition of TNK-BP by contrast to the overall M&A market in Russia, we have excluded this deal from the subsequent analysis in this report in order to provide a more meaningful comparison between 2012 and 2013.

[2] Excluding USD56 billion Rosneft/TNK-BP deal from 2012's results
[3] The survey was conducted between 31 January and 19 February 2014

M&A in Russia in 2013

Global overview

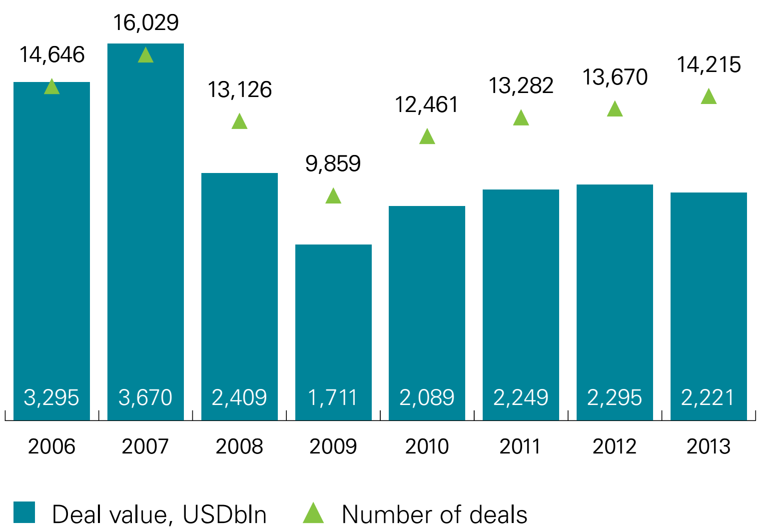
A total of 320 deals worth USD108.4 billion were announced in Russia during 2013. While this represents an overall decline in both deal volume and value, it should be remembered that 2012 was a record breaking year following Rosneft's blockbuster USD56 billion acquisition of TNK-BP – the largest deal ever announced in Russia.

The underlying trend in Russia remained strong; excluding the Rosneft/TNK-BP deal, 2013 saw a 35% year-on-year rise in M&A deal value, the highest level since 2007, notwithstanding the 6% fall in deal volume. 2013 was also the third consecutive year that M&A volume exceeded 300 deals for the first time since 2006-2008.

Interestingly, Russia's performance was the opposite of global M&A which saw deal values fall by 3% from USD2.3 trillion in 2012 to USD2.2 trillion in 2013 despite US-based Verizon Communications USD124.1 billion acquisition of a 45% stake in Verizon Wireless from the UK's Vodafone Group – more than twice the size of the largest transactions in 2012. The strength of Russia's performance is even starker when compared to European M&A which saw deal values fall by 12% from USD893 billion in 2012 to USD783 billion in 2013.

Global deal volumes on the other hand continued their steady rise since the crisis, growing by 4% in 2013, compared to growth of 3% in the previous year. The increase in deal volumes reflects growing confidence levels among executives and pressure on cash rich corporates to do deals. The pressure for deal-making is expected to intensify in 2014 as deal capacity, in terms of net debt to EBITDA, continues to rise, and global markets maintain some level of stability.[4]

Global M&A deal value and volume, 2006–2013



[4] *KPMG M&A Predictor – January 2014*

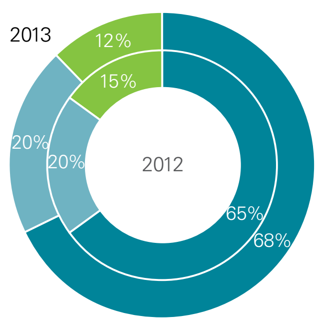
Russian overview

M&A continued to be a predominately domestic affair in Russia, although the weighting was more heavily skewed toward domestic deals in 2013 due to a considerable fall in the value of outbound investment.

Domestic transactions accounted for 80% (USD86.9 billion) of the value of deals announced in 2013, compared to just 60%[5] (USD48.5 billion) in 2012. The share of domestic deals increased marginally in volume terms to 68% in 2013.

Although the relative share of outbound deals only declined by 3% in 2013, the value of foreign acquisitions by Russian buyers sank by 71% to USD4.6 billion; the lowest level for a decade as investors continued to focus on deploying capital in the domestic market.

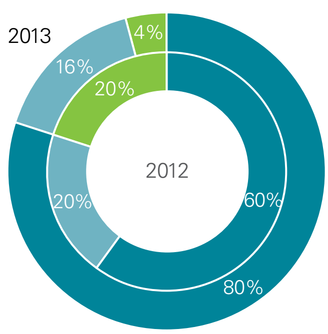
Volume of deals by type, 2012–2013



- Domestic
- Inbound
- Outbound

Russian inbound M&A accounted for 16% of the market and increased by 6% in value terms (to USD16.9 billion) despite a 6% fall in volumes. However, Russia far outperformed other important emerging economies; China recorded an increase of just 0.2% in inbound M&A value to USD27.8 billion over the same period, while the other BRIC economies, Brazil and India, both saw the value of inbound deals plummet year-on-year – 29% (to USD20.0 billion) and 19% (to USD14.4 billion) respectively.

Value of deals by type, 2012–2013



- Domestic
- Inbound
- Outbound

Russia's energy and natural resources sectors returned to dominate the M&A market in 2013, accounting for 61% of total deal value. The oil and gas sector made up a quarter of all Russian deal value, while metals and mining (19%) and power and utilities (17%) saw their share of the market increase by three times or more compared with 2012. Rosneft once again had a significant influence on M&A activity in Russia, accounting for six of the ten largest deals[6] in the oil and gas sector during 2013, while Russian Grids' USD14.4 billion acquisition of a 79.64% stake in the Federal Grid Company of Unified Energy System was the ninth largest deal globally in 2013.

Communications and media, which attracted the highest proportion of deal value of any sector in 2012, saw its share fall from 20% to 10% in 2013. The sector was driven by a power reshuffle between telecoms giants Altimo, MegaFon and VimpelCom in 2012, which led to four deals that accounted for three quarters of total deal value in the sector. In this context, a 31% decline in the value of deals announced in 2013, to USD11.3 billion, represents a credible performance.

In terms of volume, M&A activity fell by 6% in 2013 to 320 deals, due mainly to the consumer markets, retail and agriculture sector, which saw volumes nearly halve as the value of deals tumbled by three quarters to USD1.6 billion –

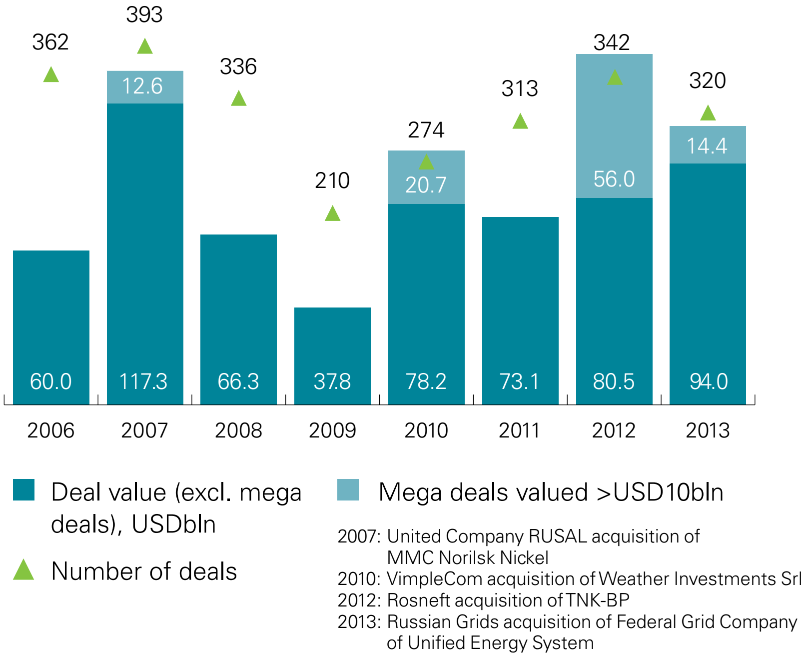
[5] Excluding Rosneft/TNK-BP
[6] Excluding deals where the transaction value was not publicly disclosed

lower than the previous trough during the 2009 downturn. This could turn out to be a timing blip based on data from the Mergermarket Heat Chart, which tracks companies for sale, and showed a potential pipeline of 90 deals in the sector – the highest in Russia.

The real estate and construction sector proved to be the most active sector, with its 61 deals cornering a 19% share of the overall market. While the volume of deals increased by 7%, the value rose by 57% to USD10.1 billion – a post-crisis high – driven by the availability and quality of stock, greater availability and affordability of debt, as well as consistently high return for investors.

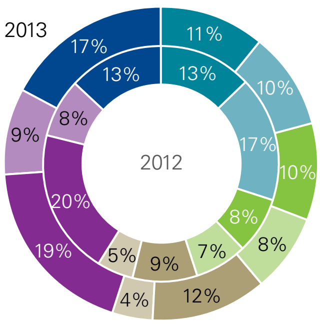
Russia's privatization agenda continued to move forward in 2013, albeit more slowly than originally anticipated. The two largest privatizations of the year raised USD4.6 billion between them; a 13.8% stake in VTB Bank was sold to a number of foreign investors for USD3.3 billion, while the IPO of a 16% stake in diamond miner Alrosa attracted a large proportion of US investors, and raised USD1.3 billion.

Russian M&A deal value and volume, 2006–2013

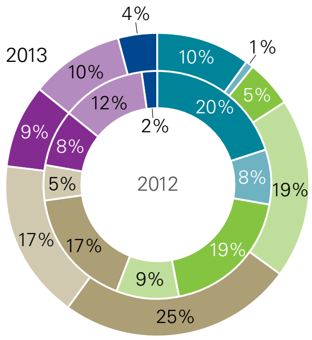


- Communications and media
- Consumer markets, retail and agriculture
- Financial services
- Metals and mining
- Oil and gas
- Power and utilities
- Real estate and construction
- Transport, logistics and infrastructure
- Other markets

Volume of deals by sector, 2012–2013



Value of deals by sector, 2012–2013



Russia heat chart by sector

Consumer markets, retail and agriculture	90
Other markets	57
Communication and media	49
Financial services	36
Metals and mining	35
Real estate and construction	33
Transport, logistics and infrastructure	27
Oil and gas	23
Power and utilities	6

Hot	Warm	Cold
≥90	≥60	≥30
≥80	≥50	≥20
≥70	≥40	≥5

Note: The intelligence heat charts are based on ‘companies for sale’ tracked by Mergermarket in the respective regions between 25 August 2013 and 25 February 2014. Opportunities are captured according to the dominant geography and sector of the potential target company. Mergermarket’s heat chart of predicted deal flow is based on the intelligence collected in Mergermarket’s database relating to companies rumoured to be for sale, or officially up for sale in the respective regions.

Russian M&A largest deals in 2013

	Target	Sector	Acquirer	Vendor	% acquired	Value USDm
1	Federal Grid Company of Unified Energy System	Power and utilities	Russian Grids	Federal Agency for State Property Management	79.6%	14,375
2	Stroygazconsulting	Transport, logistics and infrastructure	Ruslan Baysarov (private investor)	Ziyad Manasir (private investor)	30.0%	4,800
3	RN-Holding (formerly TNK-BP International Limited)	Oil and gas	Rosneft Oil Company	Minority shareholders	5.3%	4,561
4	Moscow Integrated Power Company	Power and utilities	Gazprom Energoholding	Moscow City Government	90.0%	3,786
5	Polyus Gold International Ltd	Metals and mining	Gavril Yushvaev; Zelimkhan Mutsoev (private investors)	Onexim Group	37.8%	3,616
6	Tele2 Russia	Communications and media	VTB Bank	Tele2 AB	100.0%	3,550
7	Uralkali	Metals and mining	Onexim Group	Suleyman Kerimov Foundation	21.8%	3,543
8	VTB Bank	Financial services	Investor group[1]	n/d	13.8%	3,272
9	Uralkali	Metals and mining	Uralchem	Filaret Galchev; Anatoly Skurov (private investors)	20.0%	2,955
10	SeverEnergia	Oil and gas	Yamal Development	Eni SpA	29.4%	2,940
	Ten largest transactions total					**47,398**
	As a % of the total Russian deal value					*43.7%*

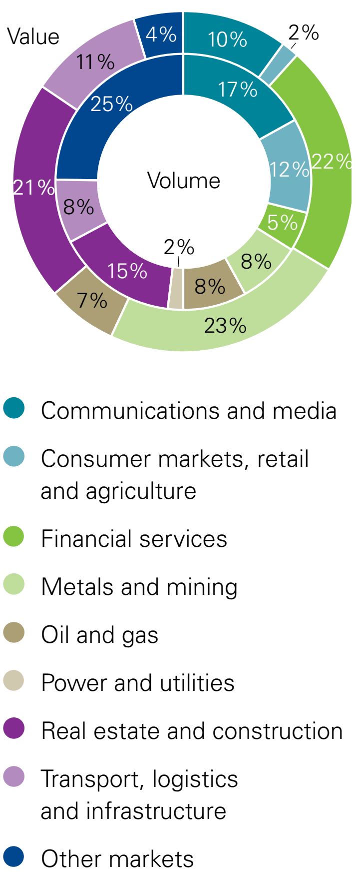
n/d = not disclosed

[1] Banco BTG Pactual, China Construction Bank Corporation, Norges Bank Investment Management, Onexim Group, Qatar Holding and State Oil Fund of the Republic of Azerbaijan

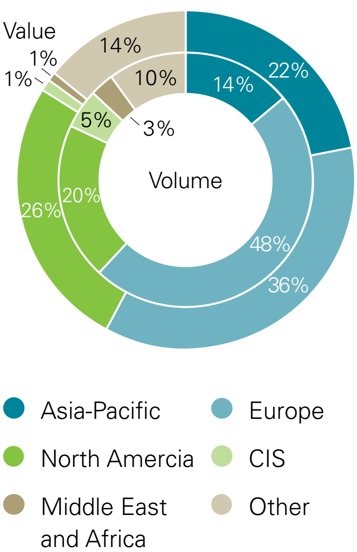
Inbound

While the volume of Russian inbound M&A has been in steady decline since 2011, the value of deals increased by 6% in 2013, to USD16.9 billion, due in large to foreign investor interest in the privatization of State-owned enterprises and prime real estate assets.

Inbound share by sector, 2013



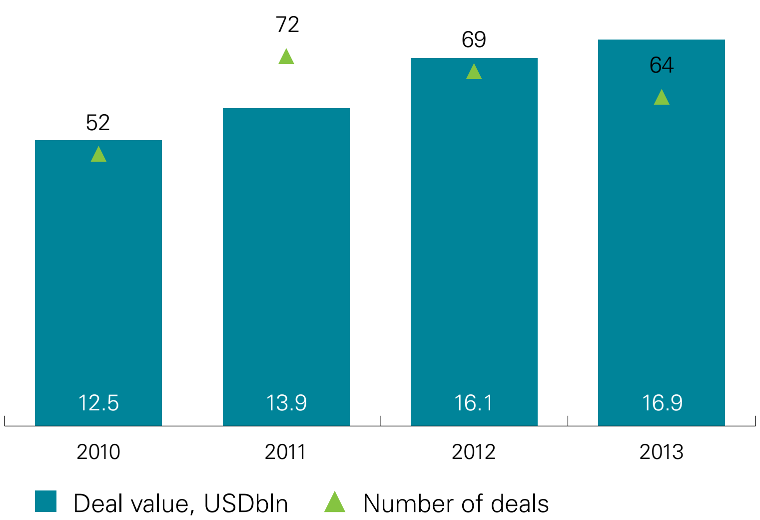
Inbound share by bidder region, 2013



In addition to the privatization of stakes in VTB Bank and diamond miner Alrosa, inbound M&A was boosted by the USD2 billion acquisition of a 12.5% stake in potash producer Uralkali by the Chinese sovereign wealth fund, China Investment Corporation. In the real estate and construction sector, Morgan Stanley Real Estate Investing (MSREI) acquired the Metropolis shopping and entertainment mall in Moscow for USD1.2 billion.

In terms of sectors, Metals and mining was the area attracting the most foreign interest in 2013, accounting for 23% of inbound acquisitions by value, followed closely by Financial services (22%) and Real estate and construction (21%).

Russia inbound M&A deal value and volume, 2010–2013



Outbound

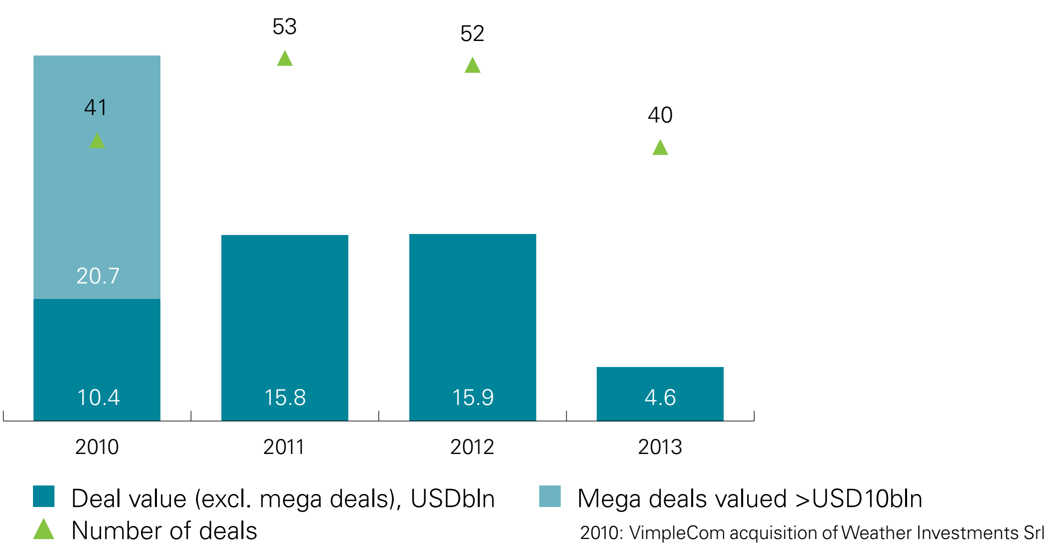
2013 saw the value of Russian outbound M&A fall to its lowest level in a decade. Deal volume declined by 23%, to a similar level as in 2010, while the value of announced deals collapsed by 71%, to USD4.6 billion.

The decline reflects the increasing appetite of investors in recent years to deploy capital in the domestic market, and is also symptomatic of the number of deals without disclosed values – such as Rosneft's announced acquisition of Morgan Stanley's oil trading business. Interestingly, the average transaction size increased by 43% in 2013 to USD221 million for deals with disclosed values.

While the volume of acquisitions in Western, and Central and Eastern Europe declined by 9% in 2013, the value of such deals fell by 84% to USD2.2 billion – conversely the number of transactions announced in North America by Russian acquirers has been stable since 2011, yet the value of these deals increased to USD1.7 billion in 2013, the highest level for several years.

The largest and only Russian outbound deal valued at more than USD1 billion in 2013 was ARMZ's agreement to take control of Canada's Uranium One for USD1.5 billion and subsequently delist the company from the Toronto stock exchange. Indeed, six of Russia's ten largest outbound deals centered on the energy and natural resources sector – metals and mining (3), oil and gas (2), and power and utilities (1) – reflecting the overall return of Russian M&A to these sectors.

Russia outbound M&A deal value and volume, 2010–2013



Sector analysis

Methodology

Data is based on transactions where either the target (inbound), acquirer (outbound) or both (domestic) are Russian. All data is based on transactions completed between 1 January 2013 and 31 December 2013, or announced during this period but pending at 31 December 2013, valued at over USD5 million.

Transactions with undisclosed deal values are included where the target's turnover exceeds USD10 million.

All data and is based on Mergermarket's M&A deals database supplemented with information from the DealWatch M&A deals database, together with news sources such as Bloomberg, Factiva and Reuters.

Deals are allocated to industry sectors based on the dominant industry of the target, which may involve using our judgement and in such cases the allocation may therefore be subjective.

We have not extensively verified all data and cannot be held responsible for its accuracy or completeness. Analysis of different deals databases and information sources may yield deviating results from those presented in this report.

Communications and media

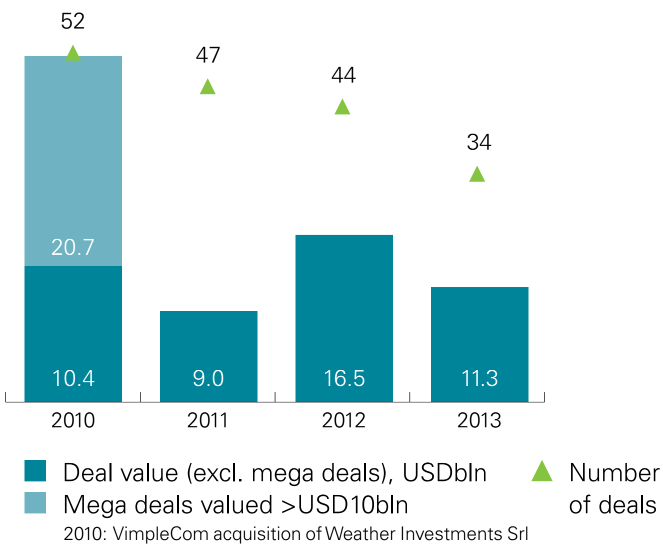
2013 M&A drivers

The communications and media sector remained highly attractive to investors during 2013, driven by rising personal incomes, the launch of fast-speed 4G (LTE) services by most Mobile Network Operators (MNOs), continued growth of mobile and fixed-line internet penetration, and increasing use of smartphone and tablet devices.

MNOs continued to focus on the quality of their service and the provision of value-added services in order to retain customers. In the wake of rolling-out 4G services, some players sought opportunities to dispose of tower and fixed-line assets in order to reduce capital and operating costs.

Last year also saw the creation of a fourth national mobile operator through the acquisition of Tele2 by VTB and Bank Rossiya. This could lead to increased competition in the sector, and paves the way for further substantial investment as the leading operators' battle for market share in Europe's largest mobile market.

Communications and media M&A deal value and volume, 2010–2013



2014 Outlook

In the wake of Gazprom-Media-Holding's announcement that it is to acquire Profmedia, which will create the country's largest TV, radio, print and digital media outlet, and the State amalgamating media assets in Rossiya Segodnya, we expect other players in the media sector to respond through consolidation strategies of their own during 2014.

The recently announced and long-awaited introduction of Mobile Number Portability (MNP) will make it easier for customers to switch between mobile providers and will see customer retention become ever-more important to MNOs.

Operators are also likely to pursue enlargement of their retail networks and test strategies for increased collaboration with banks/payment providers, as they look to capitalize on the enormous potential growth in this area. Meanwhile, increasing debt burdens may well force some players to sell their foreign holdings to focus on core markets.

Fixed line operators can be expected to seek growth opportunities through acquisitions in new Russian markets, while for the larger players, privatization, fundraising or even an exit to a strategic partner are likely to be on the agenda.

Communications and media largest deals in 2013

	Target	Sector	Acquirer	Vendor	% acquired	Value USDm
1	Tele2 Russia	Telecom	VTB Bank	Tele2 AB	100.0%	3,550
2	Scartel	Telecom	MegaFon	Garsdale Services Investment Limited	n/d	1,780
3	Tele2 Russia	Telecom	Bank Rossiya; Alexey Mordashov (private investor)	VTB Bank	50.0%	1,252
4	MegaFon	Telecom	Russian Technologies State Corporation; USM Holdings Ltd	Telconet Capital Limited Partnership	6.8%	1,080
5	Rostelecom	Telecom	Mobitel	Gazprombank	7.5%	768
6	VKontakte	Technology	United Capital Partners Advisory	Vyacheslav Mirilashvili; Lev Leviev (private investors)	48.0%	720
7	Yandex	Technology	n/d	Baring Vostok Capital Partners; Arkady Volozh; Ilya Segalovich (founders)	7.4%	607
8	Mail.ru	Technology	n/d	USM Holdings Ltd	7.4%	532
9	Epam Systems	Technology	n/d	Russian Partners	21.7%	324
10	Qiwi	e-commerce	n/d	Principal shareholders; directors and executive officers	19.3%	288
	Ten largest transactions total					**10,901**
	As a % of the total communications and media sector deal value					*96.4%*

n/d = not disclosed

Consumer markets, retail and agriculture

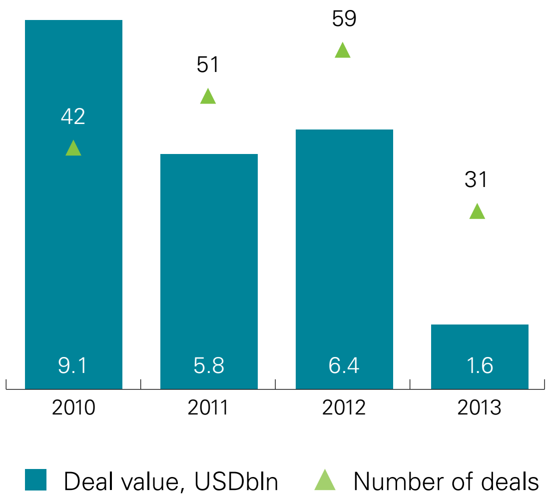
2013 M&A drivers

Consumer markets continued to perform strongly during 2013, with retail growth driven by increasing disposable incomes. However, this strong environment did not translate into M&A activity, with the volume and value of deals in 2013 falling to a four year low in the sector.

Consumer markets transactions were weighted toward food and beverage, and non-food retail as ailing businesses were acquired and foreign investors pounced on opportunities to enter the market or expand their existing operations.

As predicted last year, agriculture was a key segment, accounting for over one third of deal volume and two thirds of deal value in the sector. Russian fisheries undertook the three largest deals, consolidating domestic markets and expanding abroad. Meanwhile, deals in other agriculture segments focused on vertical integration and consolidation of land banks by the largest players.

Consumer markets, retail and agriculture M&A deal value and volume, 2010–2013



2014 Outlook

We expect the relatively low level of forecast inflation and regional growth to promote consolidation in the regions by the leading retailers, with consumer demand in the regions also driving acquisitions of regional food and beverage production assets.

Further margin pressure and changes in customs legislation could create potential opportunities for traditional retailers to acquire e-commerce sales channels, and for interested foreign players to enter the market.

Vertical integration combined with the need for investment in agricultural infrastructure to develop the competitiveness and operating efficiency of Russian producers will lead to continued M&A activity in the year ahead. Russian agriculture also continues to interest foreign, and particularly Asian, investors, which may crystallize into deal activity during 2014.

Consumer markets, retail and agriculture largest deals in 2013

	Target	Sector	Acquirer	Vendor	% acquired	Value USDm
1	JSC Turnif; Intraros	Agriculture	Russkoe More-Dobycha	n/d	100.0%	350
2	Sovgavanryba; Vostokrybflot	Agriculture	Russkoe More-Dobycha	n/d	100.0%	190
3	West African fishing operations of Samherji (including Katla Seafood Canarias)	Agriculture	Murmansk Trawl Fleet	Samherji	100.0%	159
4	Milstrim-Chernomorskie Vina APK	Food and beverage	Rosglavvino	Bank of Moscow	100.0%	155
5	AFG National	Agriculture	AF Group and Angstrem Trading	n/d	100.0%	131
6	Spar (retail network in Moscow region)	Retail (food)	Azbuka Vkusa	SVA Trading; SVA Region	100.0%	85
7	Russia Baltic Pork Invest	Agriculture	Charoen Pokphand Foods Public Company Limited	CapMan Russia	67.0%	80
8	Digital Center ION	Retail (non-food)	VimpelCom Ltd	n/d	100.0%	75
9	Tönnies Fleisch Agroimport joint venture	Agriculture	Tönnies Lebensmittel GmbH & Co KG	Agroimport	n/d	60
10	PTI Global	Food and beverage	Frutarom Industries Ltd	n/d	75.0%	50
	Ten largest transactions total					**1,335**
	As a % of the total consumer markets, retail and agriculture sector deal value					*83.6%*

n/d = not disclosed

Financial services

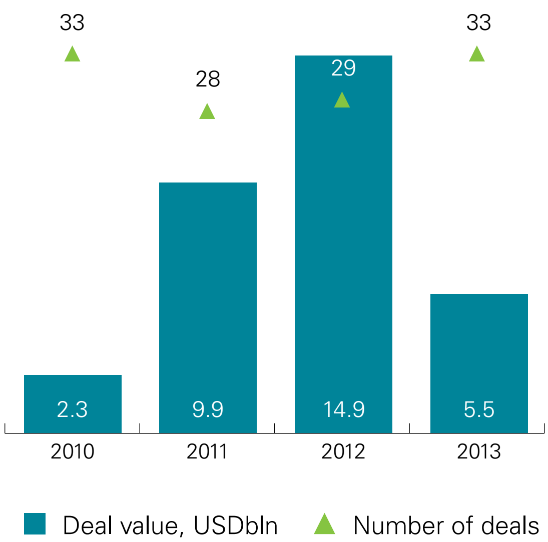
2013 M&A drivers

Even though the volume of M&A activity in the financial services sector increased in 2013, the value of deals announced slumped to a three year low, notwithstanding the government's privatization of a 13.8% stake in VTB for USD3.3 billion.

Integration of the Basel Accords into regulation by the Central Bank of Russia (CBR) and commencement of capital adequacy calculations from 1 October 2013 led to constrained activity in the sector as banks focused on cleaning their balance sheets and reviewing the quality of their loan portfolios.

In contrast, despite ongoing concerns regarding the ambiguity of legislation in the sector, there continued to be steady activity in the insurance market, with Sogaz Insurance Group's acquisition of IC Transneft the largest deal in the insurance segment during 2013.

Financial services M&A deal value and volume, 2010–2013



2014 Outlook

We expect to see the level of M&A in the financial services sector increase during the year ahead as the CBR forges ahead with plans to further tighten capital requirements in the banking sector. This, in turn, will see banks seeking new equity investments.

The insurance sector will remain attractive to investors given the government's commitment to opening up the market. While some local banks which lack an insurance platform may seek organic growth, further acquisitions could materialize, particularly if some foreign players look for an exit amid ongoing uncertainty surrounding legislation in the sector.

Financial services largest deals in 2013

	Target	Sector	Acquirer	Vendor	% acquired	Value USDm
1	VTB Bank	Banking	Investor group[1]	n/d	13.8%	3,272
2	Bank Petrocommerce	Banking	Otkritie Financial Corporation	Financial Group IFD Capital	95.0%	581
3	PJSC IC Transneft	Insurance	Sogaz Insurance Group	AK Transneft	98.9%	295
4	Rosbank	Banking	Societe Generale SA	VTB Bank	10.0%	270
5	GE Money Bank (Russia)	Banking	Sovcombank	DRB Holdings BV	100.0%	229
6	MTS Bank (formerly Moscow Bank for Reconstruction and Development MBRD)	Banking	Mobile TeleSystems	AFK Sistema	25.1%	165
7	Stalfond Private Pension Fund	Pensions	O1 Group Ltd	Alexey Mordashov (private investor)	100.0%	138
8	Generali PPF Holding BV (Insurance operations in Russia, Ukraine, Belarus and Kazakhstan)	Insurance	PPF Group	Generali PPF Holding BV	n/d	105
9	Troika Dialog Bank	Banking	3D Distribution Limited	Sberbank CIB	n/d	100
10	NPF Naslediye	Pensions	United Capital Partners Advisory	MMC Norilsk Nickel	100.0%	85
	Ten largest transactions total					**5,240**
	As a % of the total financial services sector deal value					*95.8%*

n/d = not disclosed

[1] Banco BTG Pactual, China Construction Bank Corporation, Norges Bank Investment Management, Onexim Group, Qatar Holding and State Oil Fund of the Republic of Azerbaijan

Metals and mining

2013 M&A drivers

The decision to exit the legal export cartel, Belorussian Potash Company, resulted in a change in ownership for fertilizer producer Uralkali, which contributed to the significant increase in the value of M&A in the metals and mining sector during 2013 – deal volumes remained stable for the second consecutive year.

However, the underlying value of M&A in the sector, excluding deals in the fertilizer industry, virtually doubled in 2013 driven by the sale of non-core assets and minority stakes, including Russian investment fund Onexim's decision to sell its 37.78% stake in Polyus Gold for USD3.6 billion and the privatization of a 16% stake in diamond miner Alrosa for USD1.3 billion.

The value of outbound M&A also increased as Russian players made strategic investments. This included uranium miner ARMZ gaining control of Canada's Uranium One for USD1.5 billion and subsequently taking the group private as part of its integration plan.

Metals and mining M&A deal value and volume, 2010–2013

2014 Outlook

The outlook for the global metals and mining sector remains subdued with majors currently focusing on their existing operations and performance improvement, and therefore we see scope for only limited growth in deal-making within the Russian market. However, we do expect to see a continuation of the restructurings seen in the sector during recent years, which in turn are likely to lead to further disposals of non-core assets as companies look to strengthen their balance sheets and reduce debt burdens.

Acquisitions are likely to be focused on licences for greenfield projects, as well as the potential consolidation of smaller non-ferrous assets, whose owners have suffered due to low commodity prices in the segment. Meanwhile, as we saw last year, some Russian players may also seek to pursue selective strategic opportunities overseas.

Metals and mining largest deals in 2013

	Target	Sector	Acquirer	Vendor	% acquired	Value USDm
1	Polyus Gold International Ltd	Gold	Gavril Yushvaev; Zelimkhan Mutsoev (private investors)	Onexim Group	37.8%	3,616
2	Uralkali	Fertilizer	Onexim Group	Suleyman Kerimov Foundation	21.8%	3,543
3	Uralkali	Fertilizer	Uralchem	Filaret Galchev; Anatoly Skurov (private investors)	20.0%	2,955
4	Uralkali	Fertilizer	Chengdong Investment Corporation	Suleyman Kerimov: Filaret Galchev; Anatoly Skurov (private investors)	12.5%	2,008
5	UK Kuzbassrazrezugol	Coal	Ural Mining and Metallurgical Company	n/d	49.0%	1,943
6	The Sibuglemet Holding	Coal	Akhmed Palankoyev (private investor)	Valentin Bukhtoyarov; Anatoly Skurov; Vladimir Melnichenko (private investors)	100.0%	1,600
7	Uranium One Inc	Uranium	ARMZ Uranium Holding Co	n/d	48.6%	1,525
8	Alrosa	Diamonds	Investor group[1]	Government of Russian Federation	16.0%	1,300
9	Schmolz + Bickenbach AG	Steel production	Renova Group	n/d	59.5%	934
10	Voskhod Mining Plant and Tikhvin Ferroalloy Plant	Chorme	Yildirim Group	Mechel	100.0%	425
	Ten largest transactions total					**19,849**
	As a % of the total metals and mining sector deal value					*96.0%*

n/d = not disclosed

[1] Including Capital Group, Highbridge Capital Management, Lazard Asset Management, Oppenheimer Funds, PIMCO and Russia Direct Investment Fund

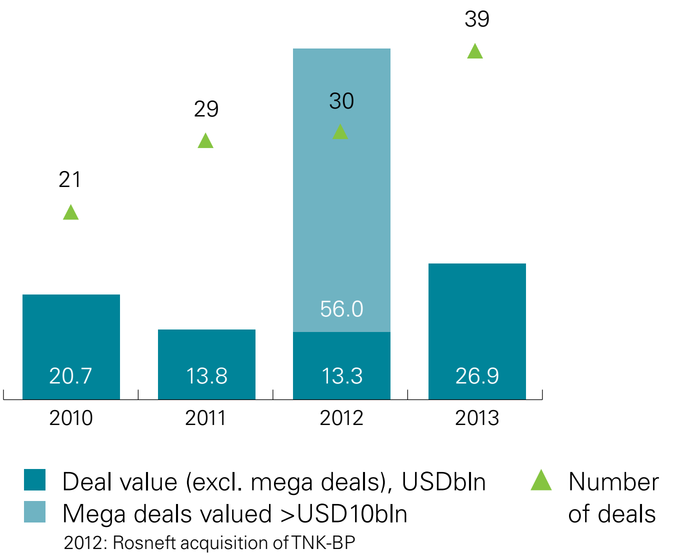
Oil and gas

2013 M&A drivers

The value of deals announced in the oil and gas sector fell by over 60% in 2013, following last year's USD56 billion acquisition of TNK-BP by Rosneft. However, excluding this transaction, the value of deal-making more than doubled in 2013 – driven once again by Rosneft acquisitions which totalled USD14.7 billion.

Having bought TNK-BP in 2012, Rosneft moved to secure a greater proportion of its value chain through upstream acquisitions to expand its production volumes and resource base, as well as other select segments – most notably the agreement to acquire Morgan Stanley's oil trading business, which was announced in December 2013 and will provide Rosneft with its own global trading, distribution and storage network (the value of the transaction was not disclosed).

Oil and gas M&A deal value and volume, 2010–2013



The past year also saw a notable increase in strategic alliances between Russian companies and foreign majors for the development of challenging projects. These included China National Petroleum Corporation's acquisition of a stake in Yamal LNG, which is looking to develop a liquefied natural gas plant in the north-east of the Yamal Peninsula, as well Rosneft signing joint ventures with ExxonMobil, Statoil and Eni, for the development of offshore and arctic fields.

2014 Outlook

We expect the oil and gas sector to see a continuation of last year's trends throughout 2014, with Rosneft expected to remain a driving force behind deal-making in the sector.

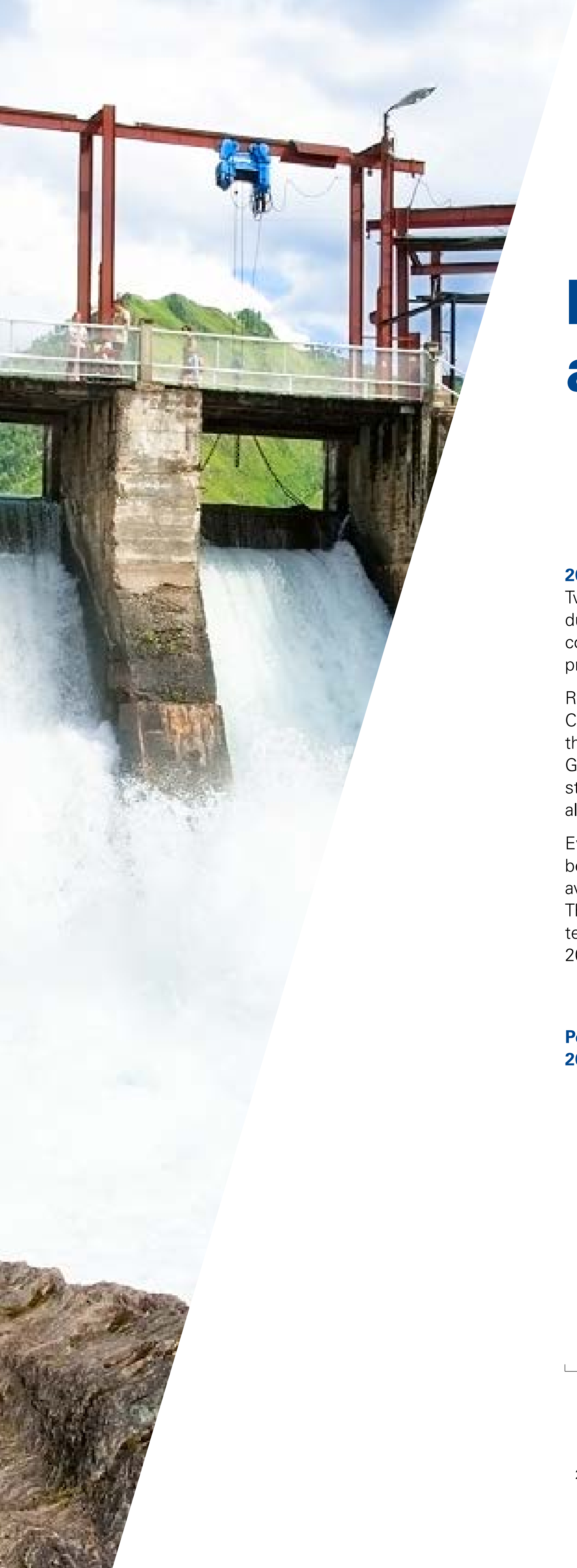
In addition, as the quality and transparency of financial reporting continues to improve, the benchmarking of Russian players against global industry leaders and comparison of the effectiveness of capital allocation is becoming easier. We expect this to drive an increased focus on portfolio analysis by Russian majors, which could lead to the disposal of non-core assets and/or those at the upper end of the production cost-curve during 2014-2015.

We also anticipate further investment from Asian oil majors as they seek to secure access to energy resources through alliances with Russian players.

Oil and gas largest deals in 2013

	Target	Sector	Acquirer	Vendor	% acquired	Value USDm
1	RN-Holding (formerly TNK-BP International Limited)	Upstream	Rosneft Oil Company	Minority shareholders	5.3%	4,561
2	SeverEnergia	Upstream	Yamal Development	Eni SpA	29.4%	2,940
3	ITERA Oil and Gas Company	Upstream	Rosneft Oil Company	Itera Holdings Limited	49.0%	2,900
4	ZAO Samara-Nafta	Upstream	Lukoil	Hess Corporation	100.0%	2,050
5	Taas-Yuriakh Neftegazodobycha	Upstream	Rosneft Oil Company	Finfund Limited; Yakut Energy Ltd	54.2%	1,907
6	SeverEnergia	Upstream	Rosneft Oil Company	Enel Investment Holding BV	19.6%	1,800
7	Sibneftegaz	Services	Rosneft Oil Company	Novatek	51.0%	1,800
8	Geotransgaz; Urengoi Gas Company; Irelyakhneft; ALROSA-Gas	Upstream	Rosneft Oil Company	Alrosa	100.0%	1,380
9	Alliance Oil	Services	Alliance Group	n/d	57.0%	1,206
10	RussNeft NK	Upstream	Mikhail Shishkhanov; Felix Dlin (private investors)	AFK Sistema	49.0%	1,200
	Ten largest transactions total					**21,744**
	As a % of the total oil and gas sector deal value					*80.8%*

n/d = not disclosed



Power and utilities

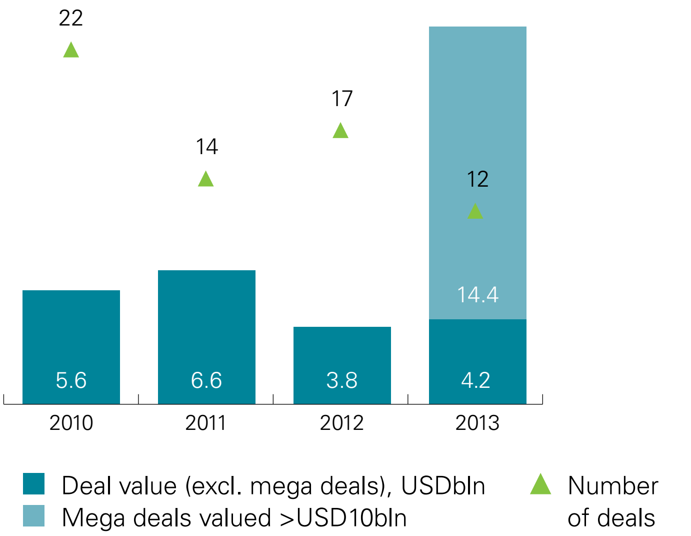
2013 M&A drivers

Two deals dominated M&A in the power and utilities sector during 2013, as activity levels were suppressed by the continued uncertainty surrounding the future direction of price tariffs.

Russian Grids' acquisition of a 79.64% stake in Federal Grid Company of Unified Energy System for USD14.4 billion was the ninth largest deal globally in 2013, which, combined with Gazprom's USD3.8 billion auction winning bid for a 89.98% stake in Moscow Integrated Power Company, accounted for all but 2% of deal value in the sector.

Even State-owned enterprises, who in recent years have been key M&A participants in the sector, kept a low profile awaiting the outcome of developments in industry regulation. The Ministry of Economic Development's updated long-term macroeconomic forecast published in November 2013 did little to raise investor sentiment toward the sector.

Power and utilities M&A deal value and volume, 2010–2013



2013: Russian Grids acquisition of Federal Grid Company of Unified Energy System

The forecast assumes no netback pricing[1] for domestic gas supplies, which leaves generation and transmission companies facing the prospect of lower tariff growth.

2014 Outlook

With 2014 tariffs for natural monopolies frozen, and those for 2015-2016 significantly reduced, we do not expect to see any significant increase in M&A across the sector as a whole during the year ahead.

The possible exception could be the heat generation and distribution (HG&D) market, as proposed reforms to tariff setting[2] could lead to an increase in activity for this segment. Furthermore, the creation of unified heat supply organizations could see consolidation of HG&D companies in larger Russian cities.

Note: [1] Netback pricing refers to the equalization of domestic gas prices with European prices after adjusting for export taxes, transportation costs, and transit tariffs

Note: [2] If introduced, the "Alternative Boiler Principle" method of tariff setting could lead to a significant increase based on economically justified pricing

Power and utilities largest deals in 2013

	Target	Sector	Acquirer	Vendor	% acquired	Value USDm
1	Federal Grid Company of Unified Energy System	Power distribution	Russian Grids	Federal Agency for State Property Management	79.6%	14,375
2	Moscow Integrated Power Company	Power generation	Gazprom Energoholding	Moscow City Government	90.0%	3,786
3	Gebeleisis Wind Farm	Power generation	Lukerg Renew GmbH	Vestas Wind Systems A/S	100.0%	144
4	Teploenergoremont	Services	Mosenergo	n/d	65.0%	61
5	Avtozavodskaya CHPP	Power generation	Irkutskenergo	n/d	51.0%	58
6	Trest Gidromontazh	Services	Mosenergo	RusHydro	32.0%	52
7	TGK-5	Power generation	n/d	Government of Russian Federation	25.1%	33
8	Teploenergoremont	Power distribution	Mezhregionenergosbyt	n/d	35.0%	33
9	Bogoslovskaya CHP	Power distribution	United Company RUSAL	Integrated Energy Systems	100.0%	30
10	Hrabrovo Wind Farm	Power generation	Lukerg Renew GmbH	Vestas Wind Systems A/S	100.0%	23
	Ten largest transactions total					**18,595**
	As a % of the total power and utilities sector deal value					*100.0%*

n/d = not disclosed

Real estate and construction

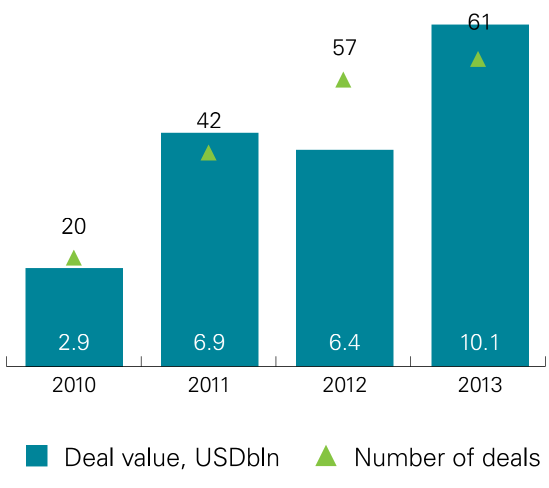
2013 M&A drivers

Notwithstanding pessimistic macroeconomic forecasts deal volumes increased by 7%, while the value of transactions in the real estate and construction sector increased by 57% in 2013 to reach USD10.1 billion – the highest level post-crisis.

Continuing appreciation of real estate values during 2013 meant that capitalization rates for prime office and retail space in Moscow fell to historic lows. As a result, the real estate and construction sector continued to be an attractive asset class for investors.

As well as consistently strong returns for investors, the attractiveness of the sector has also been driven by an increasing supply of high-quality stock across all categories along with increasing availability and affordability of debt financing.

Real estate and construction M&A deal value and volume, 2010–2013



2014 Outlook

Sentiment towards the real estate and construction sector remains positive; asset values are expect to continue rising and debt financing is increasingly available from both Russian and foreign banks. This means that commercial real estate will remain an attractive segment, particularly to foreign investors with yields currently 5% higher than in other parts of Europe.

Therefore, with capitalization rates forecast to remain stable, we expect steady levels of activity in 2014 albeit with the value of deals likely to fall slightly given the comparatively lower volume of premium real estate assets currently under construction.

Deal-making in the sector may also be prompted by changes in property tax legislation introduced at the start of 2014. These changes may lead some owners of older or heavily depreciated properties to become forced sellers in order to avoid higher tax burdens based on the use of cadastral values.

Real estate and construction largest deals in 2013

	Target	Sector	Acquirer	Vendor	% acquired	Value USDm
1	Metropolis (phases I and II)	Retail	Morgan Stanley Real Estate Investing (MSREI)	n/d	100.0%	1,200
2	Lotus City	Retail	God Nisanov; Zarakh Iliev (private investors)	n/d	100.0%	900
3	White Gardens	Office	Millhouse Capital	VTB Capital; AIG	100.0%	800
4	October Cinema Center	Retail	Alfa Group	Gazprom	n/d	800
5	MLP Group	Warehouse	Bin Group	Renova Group; OBO MLP	100.0%	758
6	Metropolis (phase I)	Retail	CalPERS JV Hines	Morgan Stanley Real Estate Investing (MSREI)	50.0%	600
7	PIK Group	Construction	Private investors	Suleyman Kerimov Foundation	35.9%	515
8	Legenda Tsvetnogo	Office	O1 Properties	Capital Group	100.0%	415
9	Four Winds Plaza	Office	Millhouse Capital	AFI Development; Snegiri	100.0%	370
10	RGI International (Rose Group)	Real estate	Direct Finance; AMG Group Limited	D.E.S. Commercial Holdings Limited	92.4%	346
	Ten largest transactions total					**6,704**
	As a % of the total real estate and construction sector deal value					*66.2%*

n/d = not disclosed

Transport, logistics and infrastructure

2013 M&A drivers

Deal activity in the transport, logistics and infrastructure sector declined by 10% during 2013, although the value of announced transactions reached a post-crisis high of USD10.8 billion.

The acquisition of a 30% stake in Stroygazconsulting, the infrastructure construction company, by Ruslan Baysarov for USD4.8 billion accounted for nearly half of the total value of deals announced in the sector.

Russia's seaports, rail transport operators and logistics providers continued to attract both domestic and foreign acquirers, with 17 deals totalling USD5.4 billion in 2013. A large proportion of this activity was driven by strategic investors securing access to infrastructure for the shipment of their own cargos.

Transport, logistics and infrastructure M&A deal value and volume, 2010–2013

2014 Outlook

We expect to see a continued focus on transport, logistics and infrastructure assets during 2014, as attention switches from preparation for the Sochi Olympics to the 2018 FIFA World Cup. The need to attract private investment to develop and modernize Russia's transport, logistics and infrastructure remains, while the construction of the Federal road network should increase the appetite for development of logistics hubs and terminals along its route.

Government investment in the Far East of Russia combined with infrastructure projects in the region, such as the Amur railway bridge, should provide opportunities for private investors to participate in the development of ports and logistics assets – and in particular, Asian investors. Meanwhile, a number of infrastructure assets have yet to be sold under the government's privatization program for 2013-2016, and it remains to be seen whether or not these will come to market in 2014.

Transport, logistics and infrastructure largest deals in 2013

	Target	Sector	Acquirer	Vendor	% acquired	Value USDm
1	Stroygazconsulting	Infrastructure (construction)	Ruslan Baysarov (private investor)	Ziyad Manasir (private investor)	30.0%	4,800
2	National Container Company	Infrastructure (ports)	Global Ports Investments	Vitaly Yuzhilin; Andrey Kobzar (private investors)	100.0%	1,568
3	Megapolis Distribution BV	Logistics	Japan Tobacco	TK Megapolis	20.0%	800
4	Megapolis Distribution BV	Logistics	Philip Morris International	TK Megapolis	20.0%	800
5	Multinational Logistics Partnership (MLP)	Logistics	Mikhail Gutseriev (private investor)	Renova Group	100.0%	700
6	Multinational Logistics Partnership (MLP)	Logistics	Renova Group	Igor Kolomoisky; Alexander Mamut (private investors)	60.0%	560
7	Ilyushin Finance Company	Transport (aircraft)	Vnesheconombank	United Aircraft Corporation	48.0%	300
8	Kusbass Transport Company	Transport (rail)	ZapSib-Transservis	Kusbasskaya toplivnaya kompaniya; Sibuglemettrans	n/d	240
9	TransContainer	Transport (rail)	n/d	Natixis SA	14.6%	199
10	StalTrans	Transport (rail)	Freight One	Waytrend	n/d	160
	Ten largest transactions total					**10,127**
	As a % of the total transport, logistics and infrastructure sector deal value					*94.1%*

n/d = not disclosed

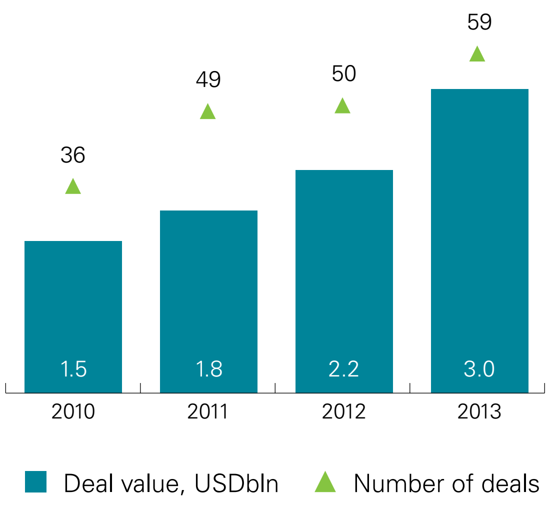
Other markets

2013 M&A drivers

M&A in the remaining sectors of the Russian economy was largely dominated by three industries – pharmaceuticals, equipment and machinery, and leisure – which between them accounted for almost 80% of announced deal value, and slightly less than half of all deal activity.

The pharmaceuticals sector continued to provide attractive opportunities for both domestic and foreign investors to consolidate their market presence. Russia's Pharmstandard completed the largest outbound deal in the sector with the acquisition of Singapore-based Bever Pharmaceutical for USD590 million, while Germany's STADA Arzneimittel acquired Russia's Aqualor through its local subsidiary Nizhpharm for USD179 million.

Other markets M&A deal value and volume, 2010–2013



Foreign investors were the driving force behind activity in the equipment and machinery sector, the largest being Schneider Electric's acquisition of a 50% stake in Electroshield TM-Samara for USD329 million – a move that will further expand its presence in Russia and Central Asia.

Meanwhile, activity in the leisure sector was boosted by Sberbank's acquisition of a 42% stake in Krasnaya Polyana for USD433 million, which helped enable the ski resort operator to finance construction for the 2014 Winter Olympics in Sochi.

2014 Outlook

Outside of the eight core Russian industries, M&A in Russia remains comparatively less mature with activity in the 'other' sectors continuing to develop. We do not anticipate a significant increase in the overall level of activity within these other sectors of the Russian economy during 2014.

However, as we have seen in 2013, the pharmaceutical and healthcare sectors continue to provide attractive opportunities for both domestic consolidation and market entry for foreign investors given the population demographics and overall objective to increase access to quality healthcare.

Other markets largest deals in 2013

	Target	Sector	Acquirer	Vendor	% acquired	Value USDm
1	Bever Pharmaceutical Pte Ltd	Pharmaceuticals	Pharmstandart	Bristley Enterprises Ltd	100.0%	590
2	Krasnaya Polyana	Leisure	Sberbank CIB	Mikhail Gutseriev (private investor); Krasnodar Government	42.1%	433
3	Veropharm	Pharmaceuticals	GardenHills	Pharmacy Chain 36.6	100.0%	345
4	Electroshield TM-Samara	Equipment and machinery	Schneider Electric SA	n/d	50.0%	329
5	Aqualor	Pharmaceuticals	Nizhpharm	Pharmamed; Butterwood Holdings Ltd	100.0%	179
6	Uralmashzavod	Equipment and machinery	Gazprombank	n/d	32.1%	154
7	A&R Packaging (Russian operations)	Other	Mayr Melnhof Karton AG	AR Packaging Group AB	100.0%	134
8	Voltyre-Prom (controlling stake)	Automotive parts	One Equity Partners; Titan International Inc.; RDIF	Cordiant	n/d	94
9	Kalashnikov Corporation	Aerospace and defence	Andrei Bokarev; Alexei Krivoruchko (private investors)	Russian Technologies State Corporation	49.0%	79
10	Nearmedic Pharma	Pharmaceuticals	Nearmedic Plus Ltd	RusNano	34.5%	70
	Ten largest transactions total					**2,407**
	As a % of the total pther markets sector deal value					*81.3%*

n/d = not disclosed

A perfect marriage or a smooth parting of the ways?

Synergy benefits, whether through increased revenues, reduced costs, operational efficiencies or economies of scale, are more often than not key drivers of mergers and acquisitions.

Fifty eight percent of our survey respondents identified efficiencies and cost savings as a key driver for doing deals in Russia. Over half (58%) factored synergy benefits into their valuation, while the majority (88%) stated that the target's post-deal performance was in line with pre-deal expectations, and that anticipated deal synergies were captured.

Perhaps this is indicative of three quarters (78%) of respondents stating that a detailed step-by-step integration plan was implemented either before or shortly after deal completion. However, despite this, 41% of respondents said that M&A in Russia failed to deliver shareholder value – astonishingly, 80% of those who did not implement an integration plan had actually gone to the effort of preparing one.

When it comes to evaluation of potential synergies – such as back office integration, shared use of existing infrastructure, rationalization of plant and equipment, or renegotiation of contracts with both customers and suppliers to gain economies of scale – it should be done in parallel with the broader due diligence process to aid development of the integration plan.

Shareholders and financial analysts will want to see genuine evidence that the new organization is delivering what was promised pre-completion. Implementing monitoring and benefits tracking tools help to keep control over the integration processes and provide a reliable way to quantify and measure the benefits for the first 100 days and beyond, while minimizing business risks arising from a delayed completion of the integration activities. A dedicated integration team should be assembled to prepare a detailed integration plan ('blueprint') for the new combined entity, in order to free up management to focus on the day-to-day business. The blueprint should identify quick wins and strategic priorities which need to be addressed in the first 100 days post completion to ensure control of the new entity and quickly implement actions required to realize synergy benefits.

Beyond the financial, technical and social impact of integration, companies are also likely to be faced with the challenges of organizational change and cultural alignment, particularly when entering new geographies. The impact of change on people and cultural sensitivities should not be underestimated, especially where synergies are planned to be derived from right sizing the new organization post-acquisition.

Failing to plan for integration until late in the process or, worse still, failing to implement a step-by-step integration plan altogether, can have a significant impact on the value created. Furthermore, failure to appreciate the challenge of aligning two cultures – whether organizational or geographical – is frequently overlooked or seen as a lower priority, but can have a significant impact on value creation. The speed, degree and priority of integration should also be carefully considered before and re-evaluated during implementation to ensure that value is maximized.

Separation is often viewed as simply the flip side of integration but the reality is often much more complex. Even in the simplest of corporate structures there are likely to be a number of key touch points between the target and retained operation which will need to be resolved prior to disposal of the entity. The challenge becomes even more difficult when the disposal involves a carve out from a complex and highly integrated global business.

Early planning to identify key touch points or 'separation hotspots' is critical for establishing a detailed separation blueprint. This provides bidders with a detailed understanding of how the entities will be physically separated. It may be that separation hotspots relate to shared services such as IT, treasury, HR, finance and so on, which have been provided by the seller group, where transitional arrangements can be put in place until the buyer is able to either integrate such functions into its own corporate structure or replace them. In more complex situations, where the entity being disposed receives services from the operation(s) being retained, one solution may be to continue to provide such services on a third party basis, at least in the short-to-medium term.

Value is often created through separation by right sizing the business for sale prior to disposal and implementing robust transitional and long-term service arrangements to ensure the seamless transition of the business at close. Importantly, thorough and detailed separation planning can go a long way in helping to inform a buyer's own integration planning – which can ultimately help to maximize value for the seller and increase the speed of execution.

“Never do things for ‘strategic’ reasons where economic benefits are unclear.”

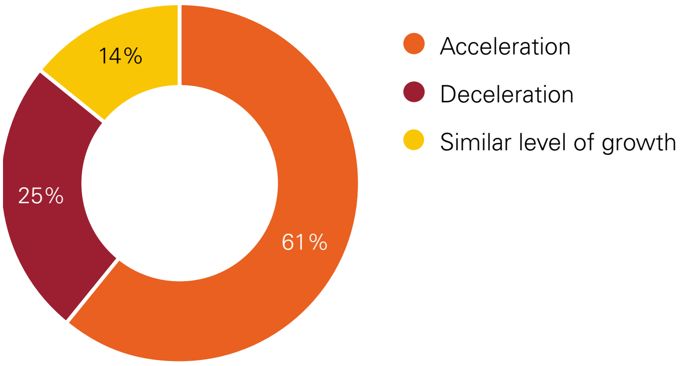
– former CEO of a major Russian telecommunications company

Methodology

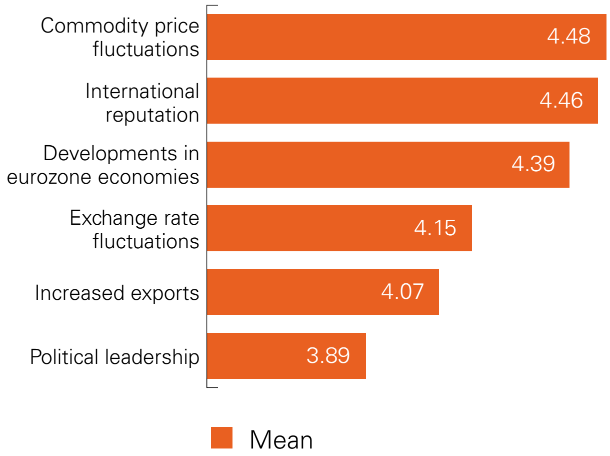
For this year's survey, KPMG commissioned Mergermarket to canvass the opinions of 50 corporate executives, 25 private equity practitioners and 25 investment bankers based in Russia to gain insight into the Russian M&A process and to gauge expectations for the coming 12 months. The survey was conducted between 31 January and 19 February 2014, and as such respondents' feedback does not take into consideration the escalation of the situation in Ukraine since 1 March. Respondents' feedback covers a variety of M&A-related topics, including deal structures, financing strategies and post-deal difficulties, and also provides detailed predictions for the broader economy in the year ahead. All respondents are anonymous and results are presented in aggregate.

Outlook

How do you expect Russian economic growth to perform in 2014 in comparison to 2013?



How strong an impact do you expect the following factors to have on Russia's economic growth over the next 12 months? (On a 1–5 scale; 1=not impactful, 5=extremely impactful).



Broadly speaking, respondents are optimistic that economic conditions in Russia are improving. Despite economic growth slowing from 3.4% in 2012 to just 1.3% in 2013[7], the lowest since the 2009 recession, the majority of respondents (61%) expect an acceleration over the course of 2014 and 14% expect the current growth rate to remain stable. Many of these respondents believe recent economic stagnation in Russia reflects global rather than domestic conditions. As the CFO of a Russian industrials group explains: "Russia is not fundamentally weak. The slowdown of 2013 was an effect of the global meltdown, which was experienced by every developing country including China and India. Russia has strong domestic demand and in 2014 the economy will bounce back."

These positive sentiments are not shared by all, however. A substantial 25% of respondents expect economic growth to decelerate in 2014, with a major point of contention being investor confidence. A corporate respondent from the communications and media sector believes growth will reach a stand-still as conditions of 2013 have left market participants in a bearish mood: "Companies and investors are still concerned by the poor economic performance of 2013. The economy will start growing again only when perception changes." A similar view is expressed by a private equity respondent, who explains that they and other investors "did not expect gross domestic product (GDP) to fall to such an extent", and are now wary of making any overly optimistic predictions for 2014.

Russia's economic growth in the next 12 months is expected to depend most heavily on commodity prices, international reputation and developments in Eurozone economies. Interestingly, these three factors are expected to be more powerful determinants of Russia's economic strength than exchange rate fluctuations, export activity and political leadership.

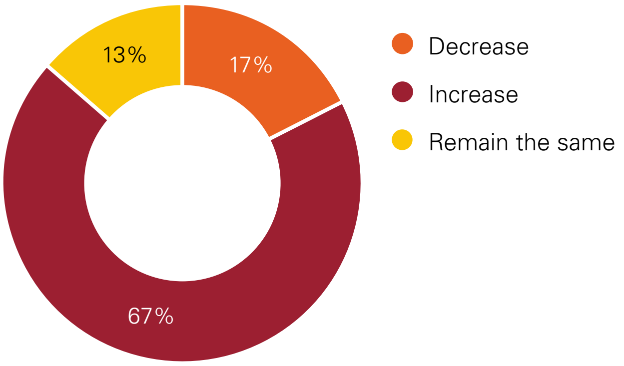
Though respondents tend to agree that commodity prices will play a pivotal role in shaping the Russian economy this year, there is no consensus on exactly how commodities markets will behave. A private equity respondent warns that "weak oil prices and a lack of foreign investments" will drag the economy down, but one of the more optimistic respondents – a corporate executive from the industrials sector – predicts the opposite in stating that "investment expansion by foreign firms and higher oil prices will help to accelerate economic growth".

Such divergent responses make clear that the outlook for the next 12 months is still largely uncertain, but one issue that respondents do tend to agree on is the importance of Russia's international reputation to long-term economic stability. More specifically, respondents voice concerns that Russia's reputation for bureaucracy and corruption could dissuade foreign investors from entering the country and curb foreign direct investment (FDI) over the long term. As the director of a Russian industrial firm explains: "Infrastructure, energy and the public sector will create opportunities for FDI, but it depends on how Russia manages its international reputation over time [...] the government must come forward and ensure that conditions remain attractive for foreign investors". Another respondent similarly warns that Russia's reputation could cause companies to "stay out of Russia and invest in neighboring countries such as Poland instead."

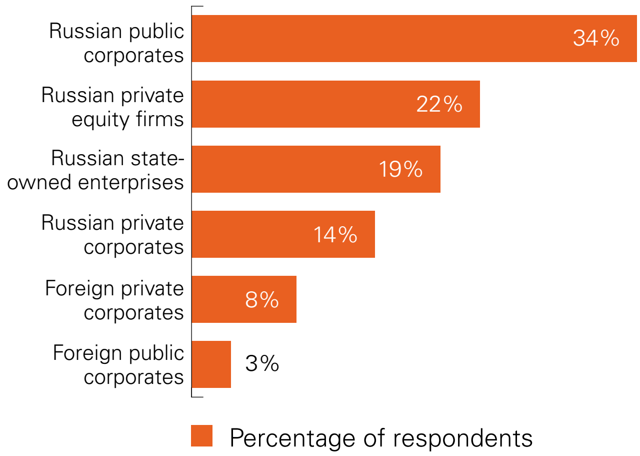
[7] *Federal Statistics Service, Rosstat, 31 January 2014*

M&A expectations

In 2013 there were $108.4bln worth of M&A transactions in Russia. Do you expect this figure to increase, decrease, or remain the same over the course of 2014?



Which type of acquirer do you expect to be most active in Russia over the next 12 months?



Not surprisingly, respondents' expectations for the Russian M&A market in 2014 are closely in line with their expectations for the broader economy. Roughly two-thirds of respondents (67%) expect the value of M&A in 2014 to increase from its 2013 level of USD108.4 billion.

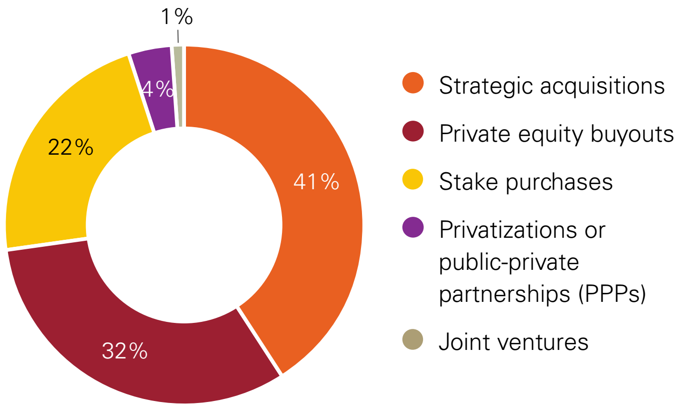
On the whole, respondents appear hopeful that low valuations, opportunistic investors and increased private equity activity will foster a robust M&A market in the year to come. A private equity respondent specializing in the communications and media sector draws attention to "the determination of potential sellers to dispose of their holdings" and notes their willingness to sell "at lower valuations that will attract buyers"; another respondent echoes this view in stating that the valuation climate in the next 12 months "will encourage buyers to make a move and buy assets while prices are low."

Still, respondents make clear that an increase in M&A will not happen overnight. As the director of a Russian private equity firm explains, concerns about economic stability still loom large: "Everyone will wait to see whether positive developments in the economy are sustainable before making a decision on M&A. It will take at least six months for M&A activity to increase." Others stress that economic growth in Russia will depend on whether the climate for foreign investment is made more favorable. Voicing a common concern of the respondent pool, a communications and media executive states that international investors – a "major source of capital" in developing "sectors like infrastructure and real estate" – will move their funds elsewhere if the bureaucracy and transparency-related problems associated with M&A in Russia do not improve.

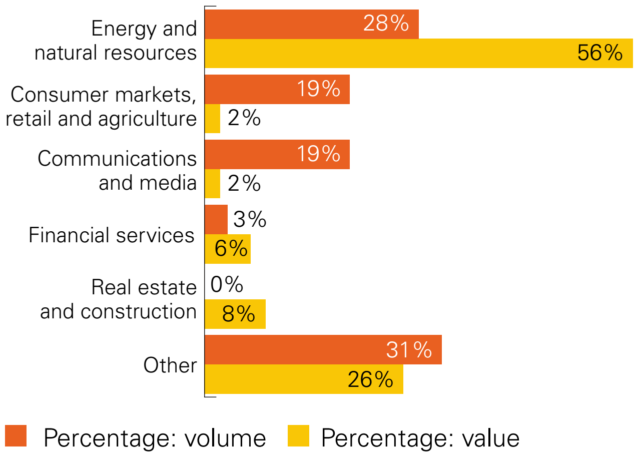
The largest portion of respondents (34%) expect the Russian public companies to be the most active buyers in 2014, followed by Russian private equity funds (22%) and State-owned enterprises (19%). Foreign acquirers are expected to feature less prominently: only 8% and 3% of respondents, respectively, believe foreign private and public businesses will be the most active buyers in 2014 – broadly reflecting the overall structure of Russian M&A.

Despite foreigners' purchasing power, in terms of the substantial cash reserves of Western corporates and Asian State-backed entities, many respondents believe domestic firms will predominate because they have the experience and expertise of doing business in Russia that a number of international players lack. One corporate respondent says that only firms with "vast experience in Russia and who understand the Russian economy completely" will be able to capitalize on Russian opportunities. A communications and media executive likewise noted that when it comes to M&A, domestic firms are often the preferred buyers because they are "at an advantage over foreign companies regarding regulatory clearance".

Which of the following deal types do you expect to be most common in Russia over the next 12 months?



In which of the following sectors/industries do you expect to see the most strategic/corporate M&A by volume over the next 12 months? And by value?



When it comes to specific deal structures, 41% of respondents expect strategic acquisitions to be most common in 2014, followed by public-private partnerships (PPPs) (32%) and private equity buyouts (22%). Encouragingly, both corporate and private equity acquirers are described as having the desire and the means to make acquisitions this year. One respondent believes the "enormous amount of cash on corporate balance sheets" will be used primarily for M&A in 2014 as companies seek attractively priced assets, whilst other respondents expect private equity to also take advantage of opportunities to acquire lower priced assets.

The finance director of a Russian consumer group believes private equity firms will be "staging a comeback and actively building up their portfolios" in 2014, whilst the CFO of a construction firm similarly predicts that Russian private equity funds will seek to "acquire targets at low valuations" over this period. It is worth noting, though, that strategic buyers will have the added motivation of geographic expansion. One corporate respondent noted that "Russia is an emerging market and is strategically very important to corporate acquirers. An acquisition in Russia puts companies in a position to target Central and Eastern Europe (CEE) assets and expand into the CEE region, which is a long-term strategy for many."

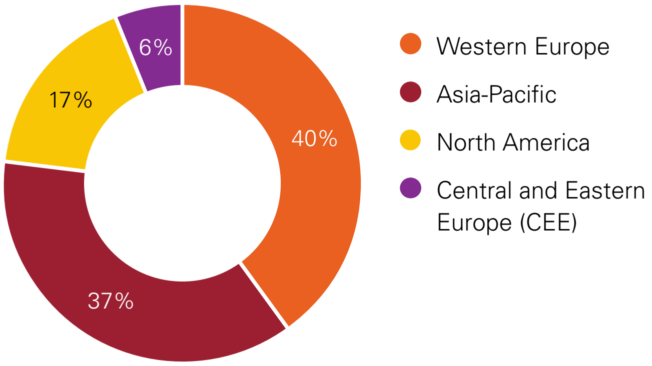
PPPs are also expected to be fairly common in 2014 and these deals are widely expected to facilitate Russia's economic growth. A corporate executive in the energy sector says these deals will "increase investments and stabilize economic development," while also strengthening Russia's non-extractive industries.

Not surprisingly, the majority of respondents (56%) expect the energy and natural resources sector to account for the lion's share of aggregate M&A value in 2014, followed by the industrial markets and chemicals sectors (26%) – classified within the 'other' sector. Respondents believe that deal flow in these sectors will be driven by a continued desire for further strategic alliances. One private equity respondent believes M&A in the energy and natural resources sector will be triggered by emerging opportunities in the Russian Arctic territory and the development of new liquid natural gas (LNG) pipelines: "These are areas of keen interest to international investors, who will bring technological know-how and will share financial risks with Russian partners". It will be interesting to see how M&A in the Russian industrial markets and chemicals sectors develops in 2014, given that there was less than USD1 billion of investment in 2013.

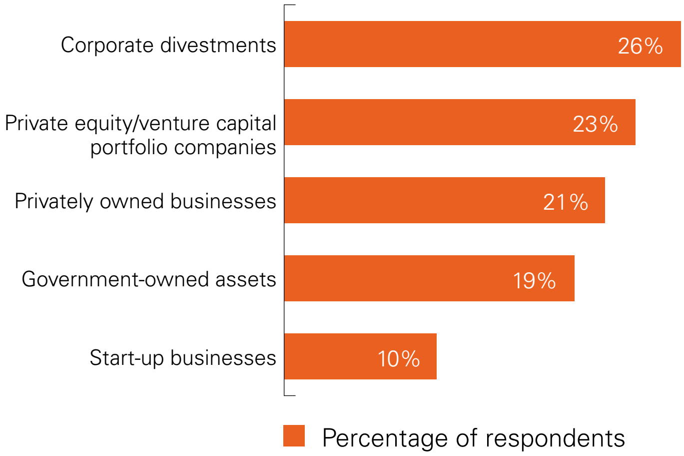
With regards to deal volume, respondents expect the highest levels of M&A activity to come from the industrial markets and chemicals sectors (30%), energy and natural resources (28%), consumer markets, retail and agriculture (19%) and the communications and media (19%) sectors. The consumer markets, retail and agriculture and communications and media sectors garnered especially enthusiastic responses, with many respondents saying that rising demand will trigger competition among domestic firms and pique the interest of foreign investors. One respondent expects increased domestic demand will give retail and consumer groups "the confidence to diversify: Growth will encourage consumer companies to quickly line up new products through acquisitions". A communications and media executive expects a similar dynamic developing in the sector: "Changing requirements of consumers and rising demand for world class communications and media products and services is causing Russian companies to consider M&A with foreign companies, in order to access the latest technology and services."

M&A expectations

Which of the following regions do you think will be the most active acquirer of Russian assets over the next 12 months?



In your opinion, which of the following M&A targets will present the most significant growth opportunities to foreign acquirers over the next 12 months?



Looking specifically at cross-border M&A, respondents expect the most active foreign acquirers to come from Western Europe (40%), Asia-Pacific (37%) and North America (17%), but they stress that these regional groups will not necessarily be competing for the same assets.

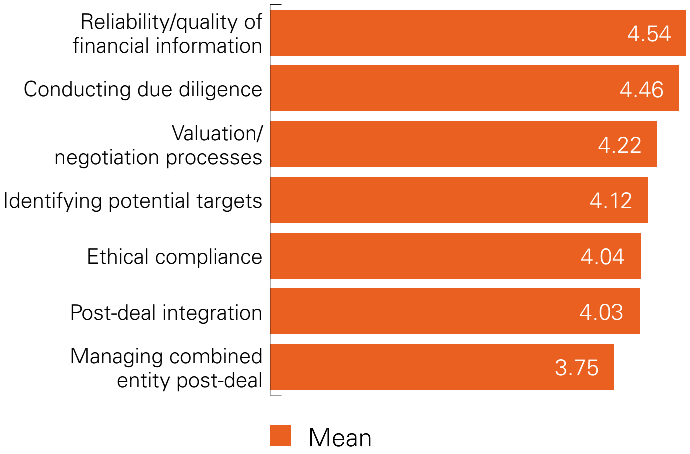
One investment banker explains that Russia "can provide European companies with the growth that they are not getting in their domestic markets," whilst a CFO in the industrial markets sector similarly described Russia as "the pivot point of CEE, occupying a key position along the major corridors that will allow Western Europe to connect with other CEE economies." Asia-Pacific acquirers, on the other hand, are more interested in energy and natural resources, and, defense opportunities. One private equity respondent points to increased interest in both of these fields from Indian and Chinese firms, while an energy and natural resources executive predicts that China will play a crucial role in helping Russia "to develop its remote far east regions, and will likely be the largest inbound investor in 2014."

In 2013, Western Europe accounted for the largest share of inbound deal volumes (45%), followed by North America (20%) and Asia-Pacific (14%) – China was involved in slightly less than 5% of inbound transactions. While we also anticipate an increase in M&A activity from the Asia-Pacific region, and in particular the oil and gas, and transport, logistics and infrastructure sectors, there would need to be a meaningful increase in interest from the region crystallizing into deal flow if our respondents' predictions are to be met.

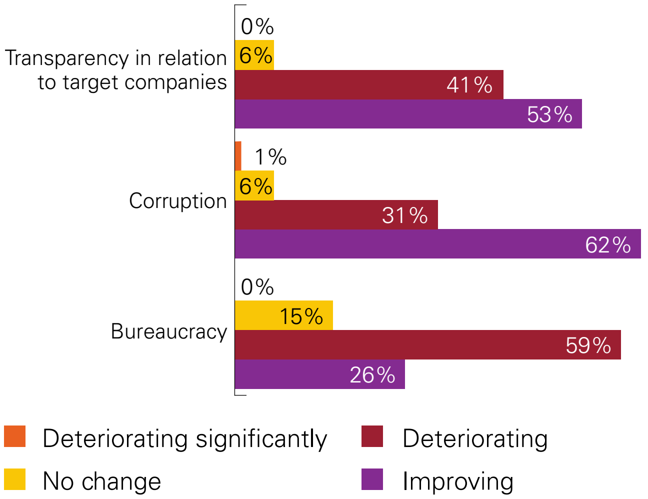
The diversity of foreign acquirers for Russian assets in 2014 will be met with an equally diverse mix of growth opportunities and deal structures. Just over one-quarter of respondents (26%) expect corporate divestments to present the most attractive growth opportunities to foreign acquirers, while 23% say the same of private equity or venture portfolio companies. Approximately one-fifth of respondents believe privately owned and government-owned assets will be most appealing.

Again, confidence is key in shaping respondents' expectations, as it seems that growth-hungry international firms will still be fairly risk-averse in their approach to M&A. Though one respondent praises Russian start-ups as well managed, "out of the box" entrepreneurial businesses, other respondents believe investors will gravitate toward established, lower-risk targets. One investment banker says private equity-backed companies will be especially appealing to risk-averse foreign buyers, as these companies can provide a proven track record of stability: "Investors can rely on the private equity portfolio companies for their better management and governance."

How difficult are the following processes for foreign acquirers in Russia at the moment? (On a 1–5 scale; 1=not difficult, 5=extremely difficult).



How would you describe each of the following obstacles to foreign investors in Russia at the moment?



When asked about the most difficult aspects of conducting M&A in Russia, respondents pointed to a wide range of challenges. Determining the reliability and quality of financial information; conducting due diligence; valuations and negotiations; and identifying potential targets all rank highly on their list, as do concerns about ethical compliance, post-deal integration and post-deal management. Respondents rated all of these areas as more difficult than average, and many point out that these different obstacles are rooted in common concerns about transparency and corruption – while a large number of respondents perceive that there has been an improvement in this regard, views are mixed (see next column).

As one corporate respondent says of his experience with pre-deal due diligence: "Corruption and lack of transparency in Russia are major issues. Even when external resources are used for due diligence, the reliability of information is a major problem." Another executive expands on this point in explaining the shortcomings of available data: "The quality of statistical information is only as good as management is willing to report, which limits the reliability of publicly available data. All of this stems from a poor governance system in Russia that allows companies to tamper with their annual books and hide liabilities."

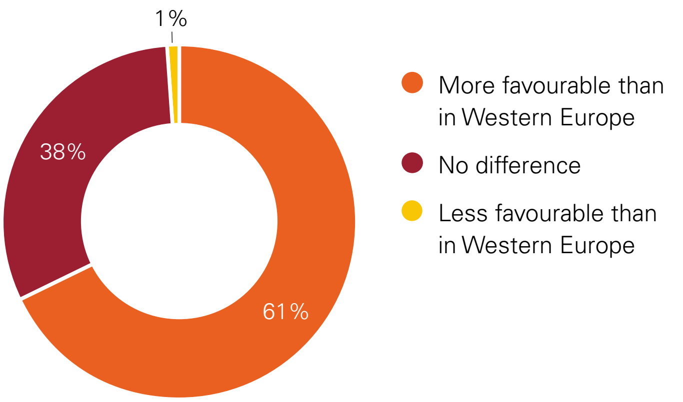
Respondents are divided as to whether the problems plaguing M&A in Russia are improving. More than half of those polled believe there have been improvements to transparency (53%) and corruption (62%), and on the whole respondents are more likely to say the climate is improving or stabilizing, rather than deteriorating outright.

Some respondents credit the Russian government's adoption of "international standards for governance with special attention to transparency" and their attempts to move Russia "to a better position in the global index" for making the country more accessible to foreign firms. Other respondents, however, believe change is happening at too slow a pace. More than half of respondents (59%) believe bureaucracy has not seen significant improvements in recent years and a sizeable portion of respondents say the same of transparency (41%) and corruption (31%).

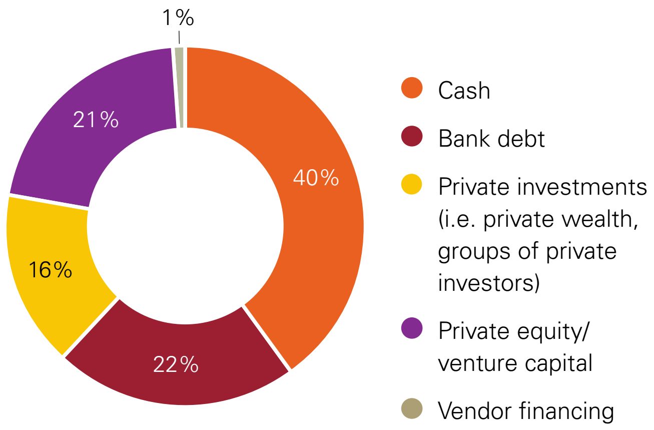
Respondents are keen to stress that ameliorating problems in all three of these areas will be critical to Russia's economic development. A communications and media executive believes that officials need to be more proactive in condemning corrupt practices if they want to attract much-needed foreign investment: "The concern for foreign investors is whether the government will take action against corrupt officials. Another respondent added that actions are moving in the right direction but that the pace of change needs to happen more quickly: "Bureaucracy is an everlasting battle for foreign firms in Russia and for many years there has been no improvement, even with Russia joining the World Trade Organization (WTO). There have been marginal improvements on transparency and corruption as the government has adopted international governance practices and come down more heavily on corruption."

Financing environment

Compared to Western European countries, how would you describe the lending environment in Russia at the moment?



Which of the following M&A financing sources do you expect to be most common over the next 12 months?

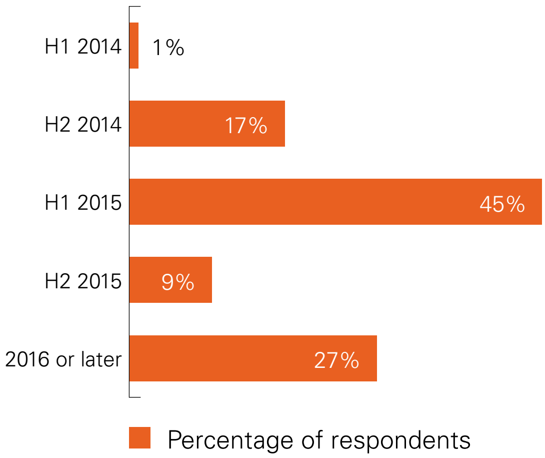


Russia is widely seen as having a more favorable lending environment than Western Europe – most respondents believe that the Russian market is more favorable than (61%) or on par with (38%) Western Europe. One respondent notes that Russia has fared much better through the global crisis than its Western peers, explaining that "State banks in Russia have remained stable and did not experience the same capital crunch as European banks".

This optimism seems to reflect the wide variety of funding sources available in Russia. In 2014, respondents expect cash (40%), bank debt (22%) and private equity (21%) to be significant sources of funding for M&A, with many respondents believing that the availability of financing will encourage competition for assets. As the managing director of a Russian investment bank explains: "Private equity financing is gaining momentum in Russia as both local and international private equity firms return to the market. These firms have a lot of capital and will compete with strategic buyers for assets".

Such comments paint a far more favorable picture of the Russian financing environment than we might have seen just a few years ago, and survey results seem to support these positive views. Indeed only 1% of respondents expect vendor financing – a common funding strategy for overcoming financing difficulties during the credit crunch – to be a prominent financing tool in the year ahead. At the same time, funding from private investors – who, according to one respondent, stepped in to finance M&A at a time "when access to debt was difficult and companies were having a tough time maintaining balance sheets" – is expected to be outmatched by more traditional funding sources such as bank debt and corporate cash in the year to come.

When do you expect the Russian government's on-going/ lagging privatization programme, which aims to sell stakes in a variety of state-owned assets by 2016, to pick up speed?



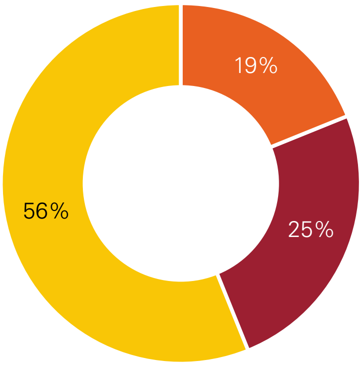
An improved financing environment will hopefully translate into a more competitive environment for the Russian government's privatization program, which has been lagging for several years in response to economic uncertainty and lackluster demand. Respondents are reasonably optimistic that the program will restart in the second half of 2014 (17%) before gaining greater momentum in the first half of 2015 (45%) – though a sizeable 27% believe the program will remain on hold until at least 2016.

Respondents tend to bring the focus back to confidence: as one private equity director explains, a lack of "competitive bidding" in recent years has made the government understandably reluctant to put assets on the auction block, and officials will likely wait to see "signs of the economy stabilizing" before reviving privatizations.

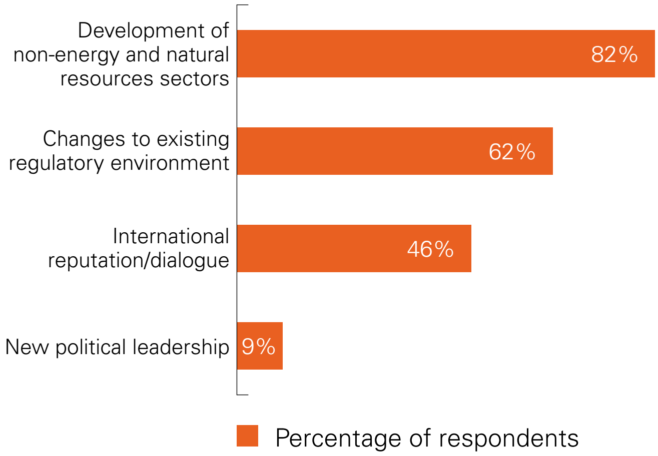
In fact Prime Minister Dmitry Medvedev cautioned in February that the privatization of State-owned companies such as Rostelecom or shipping group Sovcomflot would be dependent on good market conditions. This follows on the heels of the privatization of a 16% stake in the State-owned diamond miner Alrosa in October 2013, at the lower-end of its planned price range, and more recently the retail chain Lenta, which floated at the bottom of its price range.

Financing environment

Which investor group do you expect to be most active in targeting these state-owned assets over the next 12 months?



Which of the following do you think will be most important to the level of M&A activity in Russia over the next 24 to 36 months? (Please select the top two)



When state-owned assets do come to market, respondents appear confident that auctions will see adequate demand from both domestic and foreign groups. More than half of those polled (56%) believe asset sales will attract a combination of foreign and domestic firms while remaining respondents are most likely to select Russian investors as the more active group. The largest privatizations in the last two years[8] have attracted a mix of both domestic and foreign investors, including Asia-Pacific, the CIS, Middle East, North and South America, and Western Europe.

Competition among local and international players should help to push valuations upward, but it is not clear whether successful bidders will be those with the most money or those with the most experience. Several respondents believe that the purchasing power of Chinese investors – particularly State-owned enterprises – will make it difficult for domestic firms to compete; a private equity respondent specializing in the industrial markets sector predicts that these groups will "aggressively vie for state-owned assets in Russia" in forthcoming privatizations. But others believe Russian firms with an established presence in the market will be better suited to capitalize on government asset sales. Domestic bidders, according to the managing director of a Russian investment bank, enjoy "the advantage of less bureaucracy" and have "better connections for conducting due diligence and meeting regulatory requirements".

When asked to provide their own personal stance on M&A drivers of the next 24-36 months, the majority of respondents (82%) said they were primarily concerned with the development of industries outside of the energy and natural resources sectors, as well as changes to the existing regulatory environment (62%). A corporate respondent from the energy and natural resources sector says of Russia's notoriously confusing legal environment: "The current regulatory environment is very complex, opaque and involves significant bureaucracy. To make M&A a more viable option, changes to the regulatory environment will be very important". Respondents were less likely to cite international reputation as a major factor in determining M&A levels in the next 24-36 months, though many respondents stressed that international reputation is closely related to other deal drivers.

Respondents were also keen to highlight the connection between the development of Russia's non-energy sectors, including transport, logistics and infrastructure, communications and media, and consumer markets, retail and agriculture, and economic growth. Several respondents believe government officials have not given these sectors the attention they deserve, leaving Russia highly vulnerable to commodity prices swings. One respondent in this group describes the government as being in a state of "policy paralysis" and suggests that future economic reform should focus more heavily on reducing Russia's sensitivity to commodity prices and lessening the country's "dependency on energy". Indeed, several respondents point out that positive developments in the economy – including increased consumer spending and declining unemployment – can too easily be wiped out by a dip in oil prices, making it difficult for Russia to sustain economic growth over the long-term.

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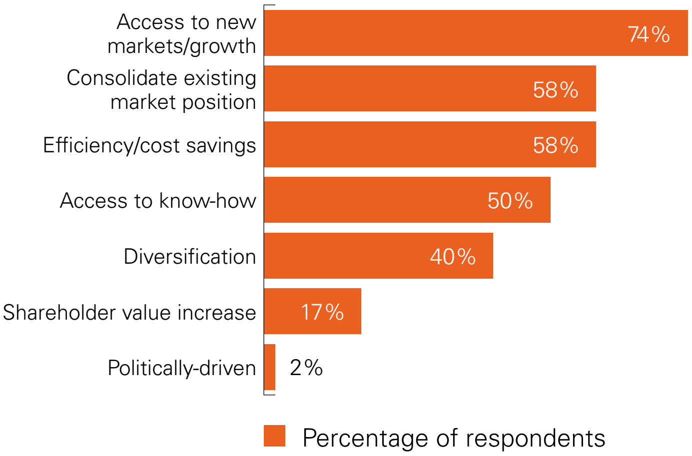
[8] *2013: VTB Bank (USD3.3 billion) and Alrosa (USD1.3 billion);*
2012: Sberbank (USD5.2 billion) and Freight One (USD1.6 billion)

Doing deals in Russia

In your experience, which are the key drivers for M&A in Russia? (Please select up to three)

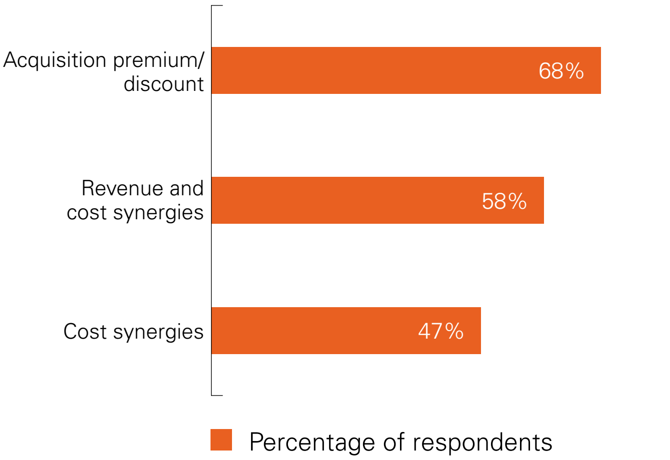


Respondents also provided insight into the major incentives for doing deals in Russia. Access to new markets; consolidation of existing market positions; efficiency or cost savings; and access to know-how were all cited by a majority of respondents as key reasons for pursuing M&A in Russia.

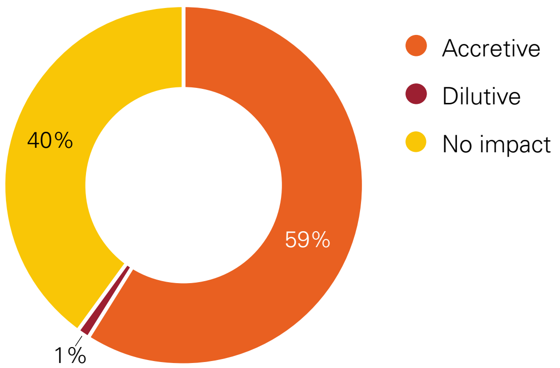
Again, many of these deal drivers are connected – as one respondent explains, Russian firms' appetite for technology will combine with international companies' geographic expansion efforts to create an ideal climate for M&A: "Russia is one of the key emerging markets and it is always on the radar of global companies seeking growth, as its position within Central and Eastern Europe provides access to the entire region. Russian companies too are using M&A to accelerate growth and to gain intellectual property assets and technology."

Doing deals in Russia

In your experience, what factors did the acquirer include in their valuation of the target?



In your experience, what impact does M&A in Russia have on the shareholder value of the acquirer?



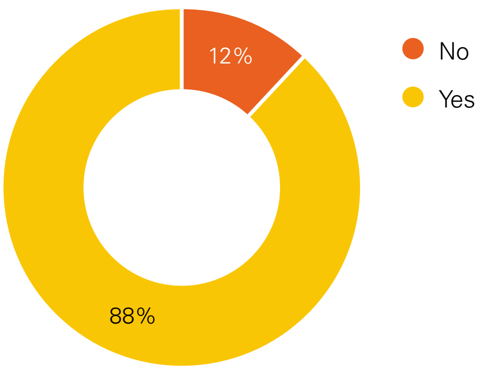
In respondents' experience, valuations in Russia are principally driven by the acquisition premium/discount (68%) as well as the opportunity to realize revenue and cost synergies from the deal (58%). Slightly less than half of respondents include cost synergies alone in their valuations. One respondent pointed out that valuation tactics depend largely on the objective of the deal: "Cost synergies are often the most important factor in valuing the target. But it also depends on the goal of the deal. If the deal is for gaining technology then cost synergy might not be as significant."

Given that Russia ranks highly on corporate buyers' list of priorities, it is somewhat surprising that respondents are so divided as to the effect of M&A on shareholder value. Most believe M&A deals undertaken in Russia have a positive impact on shareholder value, but a significant 40% say shareholder value is unaffected by M&A.

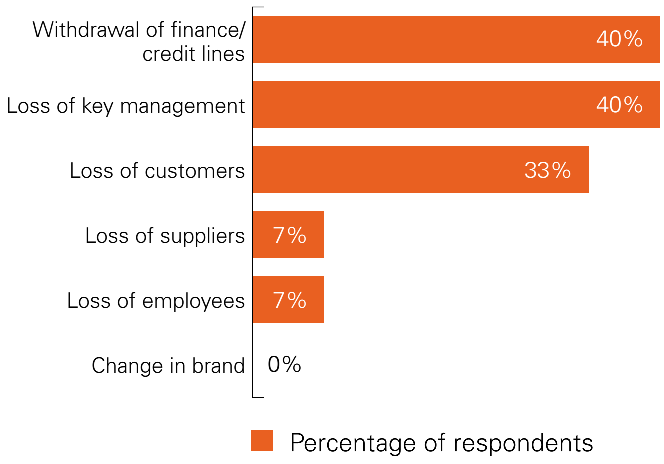
However, the sentiment of respondents is supported by share price analysis, which identified that shareholder value was enhanced for 50% of Russian deals sampled between July 2009 and December 2011.[9]

[9] *KPMG International survey of global M&A deals completed between July 2009 and December 2011*

In your experience, were the expected synergies captured and the target's performance in line with pre-deal expectations?



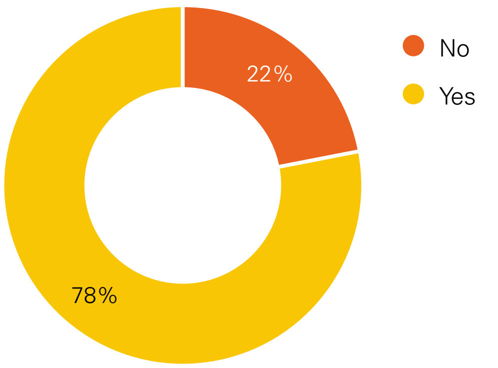
If "No", which of the following factors had a negative effect on the asset acquired either during or shortly after the transaction process?



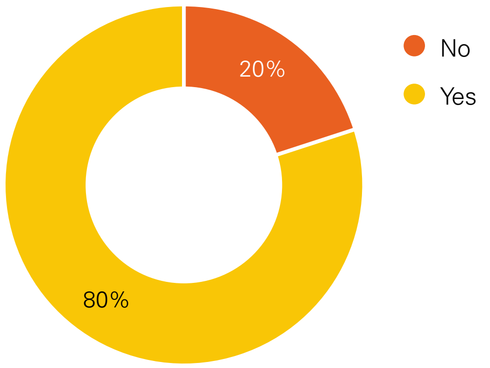
Respondents may be divided on the issue of shareholder value, but when it comes to overarching M&A success, respondents on the whole say that their experience in Russia has been positive. The large majority of respondents (88%) say M&A delivered expected synergies and achieved pre-deal expectations, with only 12% disagreeing. Of the respondents whose experience have not been so successful, the withdrawal of finance/credit lines, loss of key management and loss of customers were cited as the main drivers of value erosion.

Achieving and sustaining M&A success is a difficult task in any market, but in Russia common difficulties are compounded by concerns about transparency, corruption and unreliable data. Several respondents stress that valuations and negotiations are often clouded by uncertainty, as it is not always clear how targets assess their own performance. One respondent says buy-side and sell-side parties often have 'different ways of measuring' financial health, adding that failure to prepare for information-related problems can put post-deal benefits in jeopardy: "In my experience there was a lack of communication and information scrutiny was not done properly. During the finalization of the deal, the structure was changed and the integration plan could not be implemented."

In your experience, was a detailed stet-by-step integration plan implemented before or shortly after the deal?



If "No", was a step-by-step integration plan prepared?



Whether M&A does create value or not, respondents are clear that planning is critical to keeping objectives on track and guarding against value erosion. The majority of respondents (78%) said they implemented a step-by-step integration plan either before or shortly after completing a transaction in Russia, and even the majority (80%) of respondents who did not implement such a plan had still gone to the effort of preparing one.

A cursory look at respondents' comments on this issue reveals that conducting M&A in Russia requires not only attention to detail with regards to target information, but also realistic timelines and specialized team-building. One respondent with substantial M&A experience in the country recommends "assigning a specific, expert team to the task of due diligence so that the accuracy of captured data is not at stake" while another respondent – the director of a Russian private equity fund – highlighted the importance of closely monitoring a deals' progress: "Each decision is made by the right people at the right time with the best available information, and the integration taskforce is always ready to analyze results on a continuous basis after each step".

Another aspect of successful M&A planning involves frontloading as much decision-making as possible, so that all parties are prepared to cope with intensified pressure post-deal. As an investment banker explains of his most recent M&A transaction: "We began planning the integration process even before the deal was announced. We identified everything that had to be done prior to close and started making as many of the major decisions as we could, so that we could move quickly on the day the deal closed." Another investment banker echoes the same sentiment: "Before the deal was started our company was able to begin integration immediately rather than spending weeks waiting to gather the necessary data and making critical decisions in a rush."

Despite Russia's favorable financing environment and its attractiveness to foreign firms, Russia remains one of the more challenging jurisdictions for conducting M&A and it is in no way immune to the problems facing dealmakers in a global context. As one respondent explains, in Russia as in other Western markets "the macroeconomic situation" is making it difficult for investors to accurately measure 'the success of an M&A deal' and tackle new opportunities with confidence. In an environment like this, those considering M&A in Russia will need to plan carefully and realistically to ensure that transactions deliver intended results.

Maximizing value

When it comes to delivering value, 59% of survey respondents indicated that M&A in Russia enhances shareholder value. This sentiment is supported by share price analysis, which identified that shareholder value was enhanced for 50% of Russian deals sampled between July 2009 and December 2011 – twice as high as the impact in Brazil (24%) and India (25%), and significantly greater than China (32%).[10]

The value enhancing effect of M&A may result from the underlying reasons for doing deals – almost three quarters (74%) of respondents cited access to new markets/growth as the key driver for M&A in Russia, followed by consolidation of existing market position (58%) and efficiency/cost savings (58%).

Despite the more positive impact of M&A in Russia, up to half of deals still fail to deliver value for shareholders.[11] Respondents highlighted the reliability/quality of information and ability to conduct due diligence as the most significant challenges for foreign acquirers doing deals in Russia, while 41% believe there has been no improvement in the level of transparency of target companies. Sellers must be prepared to eliminate – or at the very least reduce – such barriers and elevate buyers concerns regarding transparency in order to create value.

Unforeseen risks can have a significant impact on the value of a transaction – the key to maximizing value is how such risks are identified and mitigated. The increasing professionalism and sophistication of acquirers combined with their use of specialist advisors to assess potential targets, means that there is an ever greater need for sellers to ensure that assets are appropriately prepared for sale if they are to maximize the value of their disposal.

Sellers have a limited but potentially valuable window of opportunity to prepare for a sale by identifying potential risks and mitigating their impact before marketing a business. Sellers need to look at their business from the buyer's perspective to identify value risks.

Performing a pre-sale review from the buyer's perspective is normally a cost effective way of preparing for sale, and frequently leads to the discovery of latent value – value which the seller then has the opportunity to capture instead of simply being left behind for the buyer.

Buyers will need to understand the historic track record of a business in terms of recurring profitability, normalized working capital and cash flow profile – this requires sellers to know the detail by scrutinizing financials to identify the key drivers of reported results. However, a business is acquired for its future potential rather than past performance, and as such it is essential to provide buyers with clear line-of-sight from the historic drivers to the assumptions underpinning forecast financials. Initiatives to realize latent value must be baked-in to forecasts with responsibility and accountability assigned to operational management for delivery of performance improvements.

Understanding the tax aspects of the business not only in terms of unrecognized historic liabilities but also the potential impact of changes in operating and legal structure of the business, as well as implementation of new tax legislation post-deal will be important to buyers. Sellers should assess the potential for unrecognized historic liabilities before marketing and identify mitigation strategies to protect value, and consider the deal structure and need for any pre-sale reorganization in advance to minimize the tax impact of the disposal.

Packaging a business is an important step in preparing for sale. The operational structure of the business may have made perfect sense under the seller's ownership but buyers could deem certain elements to be value dilutive – non-core assets, unprofitable product lines or non-complementary services – which, if restructured or even discontinued, could enhance value. Understanding the likely buyer population and assessing the business from their perspective could identify potential opportunities to generate further value 'up-side'.

Even in the simplest of corporate structures, the target business is likely to have some level of integration with the seller group – understanding the key touch points, the steps required to separate the business and associated costs is essential prior to disposal, if value is to be maximized. Sellers should be prepared to invest time and effort into creating clear separation plans and address costs which buyers will not need to acquire and would otherwise reduce their valuation of the business.

Sellers can increase the likelihood of maximizing the value of their disposals by undertaking a thorough pre-sale review of the business from a buyer's perspective, preparing robust financial information that demonstrates the drivers of historic and forecast financial performance, and considering the impact of operational structure and separation before marketing. Sellers must be prepared to do what they can to elevate buyers concerns regarding transparency and provide them with the information that is required to build their valuation model based on their plan for operating the business under their control.

[10] KPMG International survey of global M&A deals completed between July 2009 and December 2011
[11] Either having no impact on or reducing shareholder value

“Sellers should put themselves in the buyer’s shoes to assess areas of potential risk, value erosion and up-side opportunities before going to market.”

– Peter Latos, Director, Advisory, KPMG

KPMG in Russia and the CIS

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Contact us

Sean Tiernan
Head of Advisory
Partner
T: + 7 (495) 937 4477
E: seantiernan@kpmg.ru

Lydia Petrashova
Head of Transaction Services
Partner
T: + 7 (495) 937 4477
E: lydiapetrashova@kpmg.ru

Peter Latos
Advisory
Director
T: + 7 (495) 937 4477
E: peterlatos@kpmg.ru

www.kpmg.ru