M&A In The Current Environment

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EGOROV PUGINSKY AFANASIEV & PARTNERS LAW OFFICES

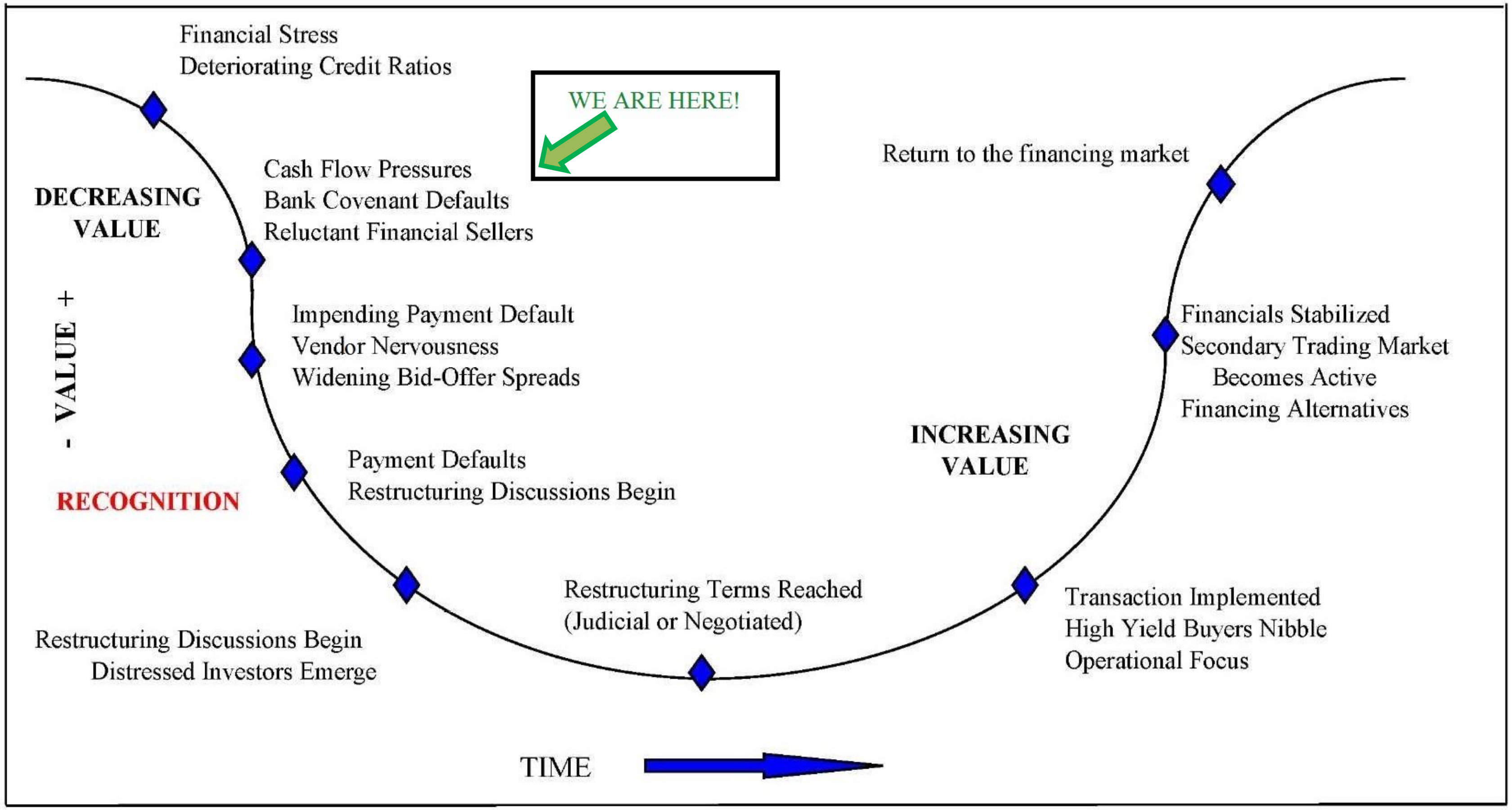
Introduction

- **Current Situation May Creates Opportunity For Cash Rich.** M&A could become a battle between those with questionable credit & those with cash or access to sound credit lines as in 2008-09 when distress deals dominated. Unclear whether impact will be limited to inbound investment or if availability/affordability of debt issues will trigger distressed M&A deals

- **Long Term Trends v Short Term Noise.** (a) In terms of the commodities super-cycle & emerging markets play and the deal strategies & structures that have operated in Russia (also no change to the golden rules of M&A which are fundamentally universal with additional country issues) (b) Russia is not voluntarily turning inward (c) Western investors are not voluntarily boycotting Russia (BP/Abbott etc.), they are not collapsing existing financings (Rusal), they are being forced to comply with political sanctions and are "pausing" waiting for things to become clearer

- **Special Situations In A Sanctions Driven Credit Squeeze.** (a) Companies are and are going to run short of capital given (i) reliance on external foreign finance (ii) potential (localised) liquidity crisis (iii) reliance on "relationship banking", all of which creates a refinancing/restructuring/deleveraging/distress angle and creates the context of the current M&A climate (b) Sanctions-driven deals: (i) offloading of holdings by sanctioned Russian business to divest away from sanctions (ii) localization of operations & partnership arrangements (iii) outbound deals to replace banned functionality provided by EU & US providers (c) Energy sector & other projects that have not been targeted (d) Under pressure banks willing to sell distressed portfolios/assets at distressed prices? (e) Small and medium sized enterprises with less secure credit lines and limited alternatives and which are not too big to fail?

Where Are We?


Financial Stress
Deteriorating Credit Ratios
WE ARE HERE!
Cash Flow Pressures
Bank Covenant Defaults
Reluctant Financial Sellers
DECREASING VALUE
Return to the financing market
- VALUE +
Impending Payment Default
Vendor Nervousness
Widening Bid-Offer Spreads
Financials Stabilized
Secondary Trading Market Becomes Active
Financing Alternatives
INCREASING VALUE
Payment Defaults
Restructuring Discussions Begin
RECOGNITION
Restructuring Terms Reached
(Judicial or Negotiated)
Transaction Implemented
High Yield Buyers Nibble
Operational Focus
Restructuring Discussions Begin
Distressed Investors Emerge
TIME

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Long Term Trends

- **Russification.** Prominence of state-owned players (particularly in the energy & financial services industries) even if they choose to partner with foreign (strategic) investors

- **Private Equity Model.** Russian sponsors targeting consortium deals with foreign investors

- **"German" Model.** Locating production & distribution in Russia, often using joint ventures, investing in phases, building on proven demand for their products and then combining plant investment with strong commitments to training staff and developing sophisticated logistics systems to support component imports & local distribution

- **Maturing Market**. (i) Shift away from new greenfield investments to acquisitions of fully-fledged businesses (ii) Focus away from natural resources in inbound M&A (iii) Inbound M&A no longer about seeking cheap labour & resources but foothold in consumer markets

- **Outbound M&A Motivated By Energy Considerations & Desire To Acquire Tech.** Bulk of Russia outbound has targeted US, Canada and Ukraine

- **Some Positives.** (i) Privatisation programmes open to foreign strategic investors (ii) PPP (actively looking to bring foreign investment to Russian) infrastructure to develop roads, rail, airports and utilities) (iii) WTO

Acquisition Finance In A Credit Squeeze

- Offer seller equity (in buyer, its parent or another entity) not cash
- Syndicate with strategic alliance partner (cornerstone investor), giving away some equity value but deleveraging
- Offer loan stock/bonds to seller
- Consensual refinancing (existing credit lines pushing out maturities of debt repayment and reducing interest rates) to free up cashflow for acquisitions
- Source longer dated, higher coupon subordinated (to bank loans) “mezzanine financing” possibly with equity kicker (right to equity in the future) to free up acquisition funds
- Seize on any general or opportunistic drop in valuation expectations & any forced sellers who face margin calls or who cannot consensually refinance and face restructuring or insolvency
- Push for deferrals & earnouts

Distressed M&A Russia 2008-09 Experience

- Bank borrowing from most to least attractive form of finance
- Pre-Financial Crisis strategic purchasers often outbid by financial buyers, such as private equity houses, due to their easy access to credit & a higher tolerance of leverage. In a credit squeeze it is strategic buyers that are best-placed to lead on M&A deals.
- Minority investments popular as financing outright acquisitions difficult
- Much of the private M&A activity distressed
- Cash-constrained forced to sell holdings to meet pending margin calls
- Those exposed to construction sectors offloaded assets and froze developments
- Government affiliated entities prevalent on the buyside
- <u>**But**</u> 2014 is not 2008-09!

Avoiding Pitfalls In The Transaction: Some Golden Rules

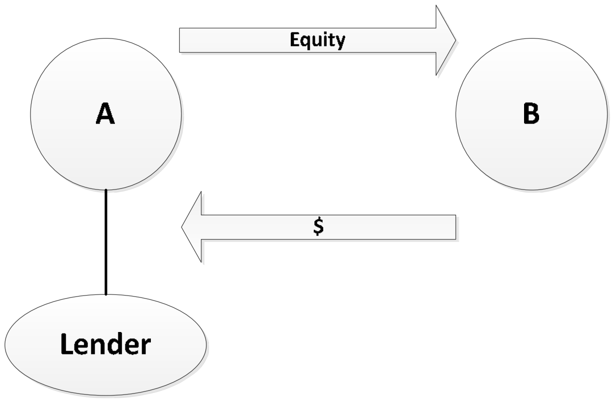
- **Stakebuild.** Do joint ventures & alliance to start and then bolt on
- **Control.** Do not manage by remote control
- **Strong Personal Relationships.** Partner well with shared vision
- **Know Your Counterparty.** Watch for "silent shareholders"
- **Watch For Corporate Conflict & Arbitrage.** Be cautious if the state or a rival owns target equity directly or through collateral pledged to banks. Same with "noisy minorities"
- **Independent Lines Of Communication.** Relationship with government authorities independently from a partner is healthy
- **Diligence.** Watch for troubled histories of tax & environment & disputed ownership
- **Value Leakage.** Transparency is key
- **Exit Strategies.** To avoid a potentially costly dispute

Distressed M&A

- **Definition.** Sale & purchase or some other form of ownership transfer of solvent entity/good business. Target/its owners may have breached financing covenants giving the lender the right to accelerate and enforce
- **What Is Going On.** If nothing happens there will be insolvency. Equity is going to get hurt, it is a question of how much, perhaps the creditors too depending on what the realisation on liquidation would be
- **Golden Rules Generally Applicable.** But in distress (i) the bank(s) may be the sellers & driving the process and depending on the capital structure & who controls the liquidation endgame may actually "own" the company (ii) timetables are accelerated
- **Seller.** Need for speed and buyer who can offer a high degree of execution certainty
- **Lender.** Where there is junior and senior, secured & unsecured, contractually & structurally subordinated debt (in many Russian financings there will be offshore and onshore elements) the fight between the different layers of debt as to who can force a sale & who is "in the money" (covered by the proceeds of sale) will determine deal structure
- **Buyer.** Limited contractual protection will be on offer so due diligence and valuation even more important. Successful distress buyers (i) understand insolvency (ability to cramdown (force) other creditors and shareholders, interested party and minority squeeze out considerations, issues relating to the ability of third parties to claw back acquired assets and general debtor- or creditor-friendliness of liquidation process) and (ii) have a watchlist and then pounce opportunistically

Distressed M&A Structures: (1) "Normalised"

(A) Straight Sale



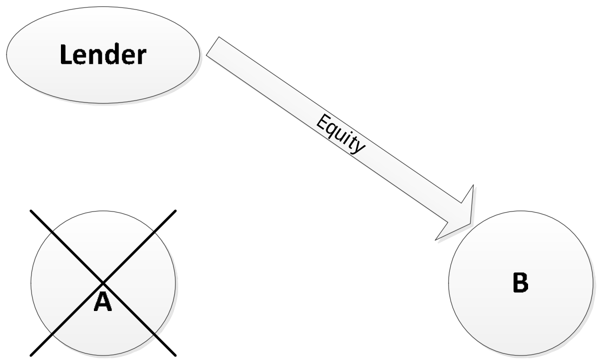
Buyer (B) buys equity (some or all) from current owner(s) (A)

Lender gets paid or rolled over (with(out) "haircut")

Could be escrow/deferral

A receives excess of purchase price minus Lender entitlement

(B) Sale Via Lender



Lender enforces over Target

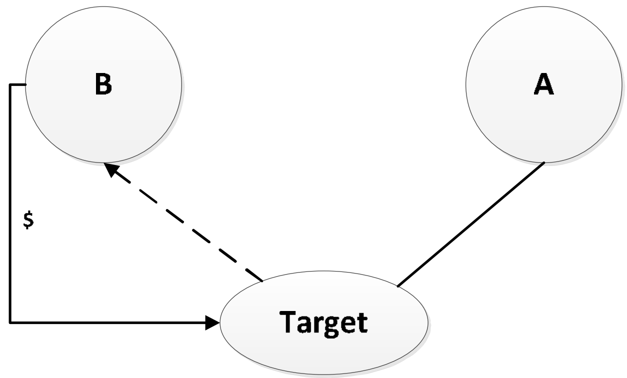
Buyer (B) buys Target from Lender

Lender may exit or rollover

A receives any excess

Distressed M&A Structures: (2) "New Money" & "Pre-Pack"

(A) Dilution

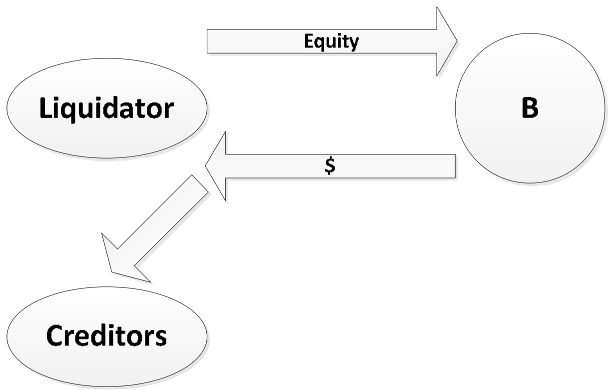


B injects capital diluting A

Lender (partially) repaid

May be part of refinancing

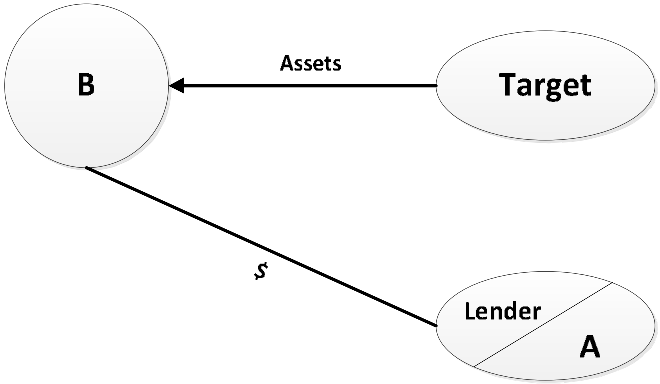
(B) Sale out of insolvency process



Target into liquidation

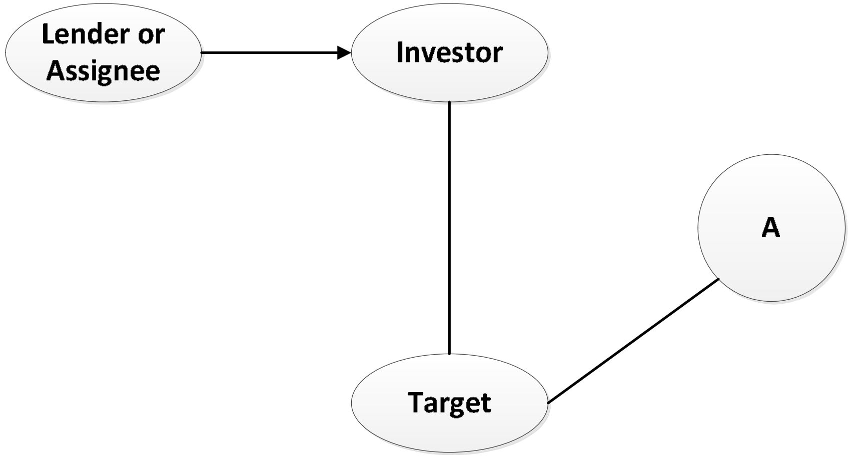
Target sold with consent

(A) Asset Sale



Driver of a cherry picking approach is concern about inherited liabilities in target

(B) Debt for Equity & Loan to Own



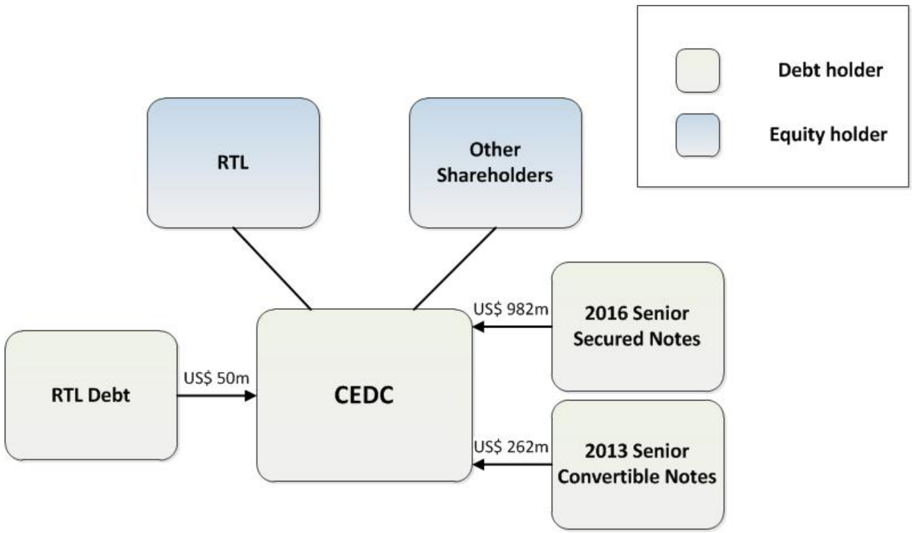
Lender converts some or all of its debt into equity & stays in the equity or immediately on-sells

OR

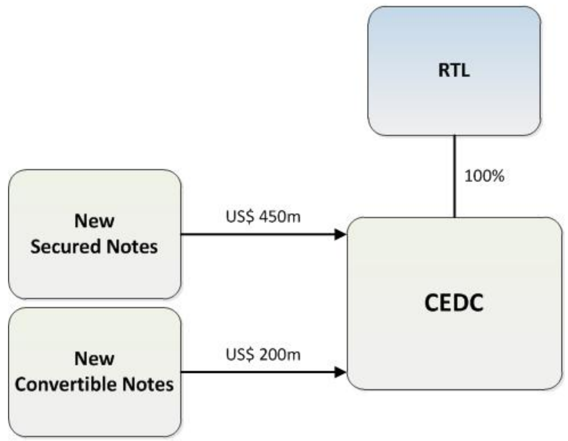
Lender sells debt at discount & new owner enforces and seeks to maximize value

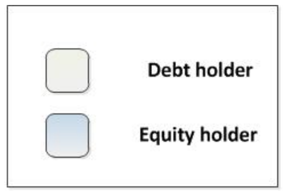
Distressed M&A Cross Border Case Study

Before restructuring



After restructuring





Notes:

(1) Approximately €90.8m of Euro 2016 Notes and $93.1m of USD 2016 Notes repurchased for cash.

(2) Approximately €339.2m of Euro 2016 Notes and $209.6m of USD 2016 Notes exchanged for new secured notes and convertible notes.

(3) $16.9m payment to holders of 2013 Notes.

(4) CEDC's existing common stock cancelled.