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# Economic Dip Drives Change in Advisory Sector

By Mark H. Gay

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Rosneft's talks to buy the Odessa oil refinery from lender VTB illustrate the regional character of the M&A market.

Smaller companies account for a growing share of the legal and consulting business. It is part of the reshaping of the sector that began with the 2007 to 2008 global financial crisis. Declining investment activity in the face of stronger sanctions has given the trend a further push.

Mergers and acquisitions, or M&A, declined sharply in 2013, and political events have further curtailed activity this year, especially among larger companies. While some consultants point to emerging market banks and startups as a growth sector, others say the increase in government regulation will increase the needs of larger companies for advisory services.

"In 2014 the scene has been getting more difficult for political reasons. The deals that were initiated at the beginning of the year, whether the buyers are U.S. or European entities, will go

on. However, an intense political state of affairs brought on by the events in Ukraine is likely to prevent a comeback on the M&A market. Once the deals initiated at the start of the year are completed, we will see a slower market," said Vladislav Zabrodin, managing partner of Capital Legal Services.

M&A activity in Russia declined 47 percent in value and 25 percent in volume last year, according to law firm Herbert Smith Freehills LLP. A handful of large deals in the energy and power sector accounted for almost half the volume of $60 billion.

The dominance of Russia's state-owned banks has helped make the M&A market an increasingly local affair: Russian buyers were involved in 82 percent of acquisitions of Russian companies last year.

Zabrodin saw an increasing trend of M&A in the small and midsize business, or SMB, market. Western companies were interested in acquiring their Russian partners and distributors. He also saw consistent interest from China.

Over the longer term, emerging market banks will increasingly be involved in cross-border acquisitions, according to auditors and consultants Deloitte Global, particularly when the opportunities for domestic expansion become limited over time. Backed by the state and with access to cheap funding, banks based in the emerging markets will expand into developed markets. Sberbank, the largest bank in Russia and CIS, has used acquisitions to enter new markets in adjacent countries.

"Emerging markets-based banks often have limited domestic expansion opportunities," Jim Reichbach, Deloitte global leader, Banking & Securities, wrote in a research note. "These banks are looking at international opportunities, including M&A transactions, as their clients expand into new markets and their citizens immigrate to new countries."

The World Bank expects acquisitions from emerging markets to grow, and the annual value of cross-border M&A transactions to double over the next 10 years.

This year, however, the World Bank expects growth in Russia to be barely positive at 0.5 per cent, rising to 1.5 percent and then 2.2 percent over the next two years.

Along with slowing growth and Russian capital flight, talk of stronger sanctions means legal and advisory companies are looking keenly at new business opportunities.

Governments create the need for high-quality advice as they find new ways to replenish their sources of revenue by raising taxes and increasing regulation, while new businesses as well as established companies look to minimize their obligations. Accounting and legal changes include new transfer pricing rules, enacted in 2012, which have just come into force.

The tax authorities want more information on transactions exceeding 1 billion rubles (about $30 million) or between Russian residents and nonresidents. "It seems to be that at the moment companies using offshore structures are in the focus of the tax authorities for such transfer pricing audits. But we suppose that sooner or later transfer-pricing audits will also cover all other companies working in Russia. In western Europe, transfer pricing audits are part of the normal tax audits and this practice will also come to Russia," said Helge

Masannek, director of the tax and legal departments at Russia Consulting.

The Russian government has adopted a large number of different amendments to legislation this year, said Pavel Karpunin, partner at Capital Legal Services. Many of them will affect Russian companies, he said. New provisions regarding the liability of major shareholders and collective bodies of companies will come into force soon; company management will become more flexible in September — two or more executives will be able to act simultaneously or jointly on behalf of the company — and the requirement to notify competition authorities is abolished in respect of a number of transactions affecting economic concentration.

As for new companies, startups often need advice on selecting a jurisdiction in which to register their enterprise. The choice of jurisdiction depends on the priorities that startups set for their business. Low-budget startups prefer the domestic jurisdiction due to lower transaction costs — registration fee, legal and financial support — at the initial stage and a better understanding of the local rules, said Karpunin.

Some companies, especially in the case of joint ventures, have a holding structure in jurisdictions like Cyprus, The Netherlands or Luxemburg and just an operating company in Russia. "In the past such offshore-holding structures had several legal and tax advantages. Recently however the Finance Ministry has published a draft law on the taxation of foreign-controlled companies and such offshore-holding structures should be carefully reconsidered as they might be subject to the CFC rules resulting in additional tax payments and reporting requirements in Russia," Masannek said.

In recent years, large companies have begun to create systems to account for intellectual property. These systems manage the interests of authors, customers and contractors, and holding companies create common business processes for the protection and disposal of intangible assets in Russia and around the world.

"In the information sphere, including the Internet, a practical and fundamental problem currently being reflected in Russian court battles is how to define the limits of liability for intermediaries for material added to their systems that may infringe upon the rights of a right holder. Almost all Internet companies have been respondents in cases of this nature," said Victor Naumov, head of the Russian I.P., I.T. and telecommunications practice, and managing partner at Dentons St. Petersburg.

What is clear is that recent events in Ukraine and the threat of harsher sanctions are not responsible for changes in commercial activity and the level of demand for advisory services. When the leaders of the Group of Seven leading industrial nations met in the first week of June they warned that the G7 would apply sanctions to whole economic sectors by July if Russia continued to supply pro-Russia rebels in eastern Ukraine. However sanctions have so far affected a few tens of individuals and even fewer companies.

Wealthy Russians have transferred $70 billion abroad this year, according to the Central Bank, while western investment has slowed. The economy was slowing and the ruble was widely seen as overvalued even before both were punished by further declines this year.

"Currently the economy in Russia is at a pre-crisis stage, although there is still room for an

optimistic scenario, provided the political situation is resolved soon and the government provides better support for developing mid-level business in the country," said Zabrodin of Capital Legal Services.

The crisis of 2007 to 2008 substantially changed the activity of legal and consulting firms, said Zabrodin, turning their focus away from M&A and high profile work to restructuring and optimizing costs for their clients. Legal and advisory companies also changed their fee structure, and though he sees little room for further adjustment, clients will continue to look for efficiency, quality and a fair price. "The existing clients will continue to seek legal advice. That said, it is possible that their projects will be on a smaller scale and the clients will be more selective about the price-quality ratio of the services," Zabrodin said.

Contact the author at m.gay@imedia.ru

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