Russian Debt: New Challenges and Restructuring Opportunities

Speakers

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Agenda

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1. Introduction of the panel
2. Overview of the Russian sanctions
3. Economic Situation
4. Restructuring: Strategies and Opportunities
5. Case studies
6. Q&A

Overview of the Russian sanctions

Emergence and Evolution of Economic Sanctions Against Russia

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- US sanctions authorized under three executive orders issued by President Obama in March 2014. Implemented through May 2014 *Ukraine-Related Sanctions Regulations*, 31 CFR Part 589
- EU sanctions were adopted in parallel in March 2014 via a series of restrictive measures
- Many other jurisdictions have imposed sanctions on Russia, e.g., Australia, Canada, Switzerland
- Prior to July 2014, both US and EU sanctions consisted of "blocking" sanctions
- In July, the United States and EU adopted "sectoral" sanctions; mainly financial sanctions targeting Russian companies in particular sectors

Blocking Sanctions

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- Broad ban on most business interaction

  Generally forbid direct or indirect participation in most transactions in which a "blocked person" has a direct or indirect interest

- Blocked persons' assets in sanctioning authority's jurisdiction are frozen

- Sanctions apply to individuals and organizations designated for placement on US "SDN" List, EU's consolidated list, other countries' lists; also apply to certain affiliates of listed persons

US Blocking Sanctions: To Whom Do Sanctions Apply? "Blocked Persons"

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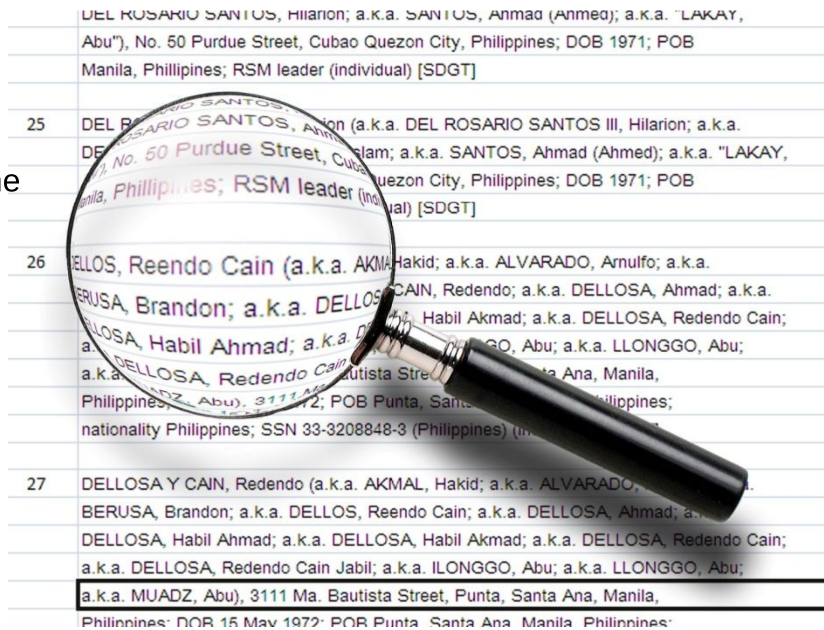
- Sanctions apply to individuals and organizations publicly designated by US Treasury Department's Office of Foreign Assets Control ("OFAC"); so far
  - » 57 Russian and Ukrainian individuals
  - » 33 entities, including 5 banks, 26 companies in energy and defense sectors, and 2 "People's Republics" in Eastern Ukraine



- Blocking "freezes" designees' assets in the United States or otherwise held by US persons; designees also denied access into United States

- **50% Rule:** Apart from designees, blocking sanctions also apply to entities 50%-or-more owned *in the aggregate* by designees or other blocked persons

US Blocking Sanctions: To Whom Do the Prohibitions Apply?

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US Persons

- US citizens and residents
- entities organized under US law
- anyone <u>acting in the United States</u>

Action in United States key to US enforcement against BNP and other European banks; transactions involving US correspondent accounts allegedly made banks "US persons"

EU Blocking Sanctions: To Whom Do Sanctions Apply? "Blocked Persons"

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- Sanctions apply to individuals and entities listed in Annex I to Council Regulation 269/2014, as amended; so far
  - » 119 Russian and Ukrainian individuals
  - » 23 entities, including 1 Russian bank, 14 companies in Russia and Crimea, and 8 illegal separatist groups and self-proclaimed "People's Republics" in Eastern Ukraine
- Blocking "freezes" assets of and prohibits provision of funds and economic resources to designees and individuals and entities associated with them
- **Ownership & Control Rule:** Apart from designees, blocking sanctions also may apply to entities *owned, held or controlled by* them, which is assessed on a case-by-case basis
  - » **EU Guidance on Ownership:** Having **"***possession of more than 50 per cent of the proprietary rights of an entity or having a majority in it*"
  - » **EU Guidance on Control:** Meeting any of the *8 criteria*, including, for example, the right or exercise of the power to appoint or remove a majority of the administrative, management or supervisory body, sole control of a majority of shareholders' or members' voting rights, and management of the entity's business on a unified basis

EU Blocking Sanctions: To Whom Do the Prohibitions Apply?

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- EU Nationals
- Entities incorporated or constituted under the law of a Member State
- Anyone in respect of any business done in whole or in part within the European Union

Sectoral Sanctions

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- In July 2014, United States and EU promulgated new type of sanctions; target designated Russian entities and individuals in finance, energy and defense sectors
- Sectoral sanctions do not, like blocking measures, forbid virtually all transactions involving designees
- Rather, they forbid transactions relating to specified *financial instruments* issued by designees and certain affiliates
- Also restrict supplies for Russian oil exploration and production in certain areas

Sectoral Sanctions – US

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- Directive 1: Targets financial sector (banks).
  - Forbids US persons to transact in, provide financing for, or otherwise deal in **new debt** of longer than 30 days maturity, or **new equity**, if that debt or equity is issued on or after the sanctions' effective date, with respect to named **banks**.
- Directive 2: Targets energy sector
  - Forbids US persons to transact in **new debt** (but not new equity) of longer than 90 days maturity, if that debt is issued on or after the sanctions' effective date, with respect to named **energy companies**.
- Directive 3: Targets defense sector
  - Forbids US persons to transact in new debt (but not new equity) of longer than 30 days maturity, if that debt is issued on or after the sanctions' effective date, with respect to named defense sector companies.
- Directive 4: Targets oil sector
  - Forbids US persons from entering certain transactions related to deepwater, Arctic offshore, or shale projects that have the potential to produce oil in the Russian Federation, with respect to named oil sector companies.

Sectoral Sanctions – US

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US Sectoral Sanctions Targets

Entity Name	Directive No.
Bank of Moscow, OJSC	Directive 1
Bank for Development and Foreign Economic Affairs (Vnesheconombank) State Corporation	Directive 1
VTB Bank, OJSC	Directive 1
Gazprombank Gas Industry OJSC	Directive 1
Sberbank of Russia	Directive 1
Russian Agricultural Bank (Rosselkhozbank)	Directive 1
State Corporation Rostekhnologii (Rostec)	Directive 3
Transneft OJSC	Directive 2
Novatek	Directive 2
OJSC Rosneft Oil Company	Directives 2 & 4
OJSC Gazprom Neft	Directives 2 & 4
OJSC Gazprom	Directive 4
Lukoil Oil Company	Directive 4
Surgutneftegas OJSC	Directive 4

Sectoral Sanctions – EU

- Art. 5(1) of Council Regulation 833/2014: Targets financial sector (banks)
  - Forbids EU persons to transact in, provide investment services for or assistance in the issuance of, or otherwise deal with, **transferable securities** and **money-market instruments** with maturity exceeding 90 days, if issued from August 1 to September 12, 2014, and exceeding 30 days, if issued after September 12, 2014, with respect to named **banks**.
- Art. 5(2) of Council Regulation 833/2014: Targets energy and defense sectors
  - Forbids EU persons to transact in, provide investment services for or assistance in the issuance of, or otherwise deal with, **transferable securities** and **money-market instruments** with maturity exceeding 30 days issued after September 12, 2014, with respect to named **energy** and **defense companies**.
- Art. 5(3) of Council Regulation 833/2014: Targets financial, energy and defense sectors
  - Forbids EU persons to make, or be part of any arrangement to make, new loans or credit of longer than 30 days maturity, with respect to named banks and energy and defense companies, with limited exceptions.
- Art. 3a of Council Regulation 833/2014: Targets oil sector
  - Forbids EU persons from generally providing certain services necessary for shale oil projects and for deepwater oil and arctic oil exploration and production in Russia.

Sectoral Sanctions – EU

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EU Sectoral Sanctions Targets

Entity Name	Sector
Gazprom Neft	Energy Sector
Gazprombank	Financial Sector
OPK Oboronprom	Defense Sector
Rosneft	Energy Sector
Rosselkhozbank	Financial Sector
Sberbank	Financial Sector
Transneft	Energy Sector
United Aircraft Corporation	Defense Sector
Uralvagonzavod	Defense Sector
Vnesheconombank (VEB)	Financial Sector
VTB Bank	Financial Sector

Sectoral Sanctions − Oil Sector Supplies

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- United States and EU established sectoral sanctions restricting supplies for deepwater, Arctic offshore, and shale oil exploration and production projects in Russia

- United States sanctions forbid US persons to supply any goods, software, services or technology in support of such projects that involve named oil companies
  - » US export controls extend restrictions to non-US persons supplying US-origin items and items with US-origin content

- EU sanctions forbid EU persons from providing certain services necessary for such projects in Russia, including drilling, wells testing, logging and completion services, and supply of specialized floating vessels

Sectoral Sanctions: US vs. EU

US Sanctions – broader

Cover more financial instruments – any "new debt" and/or "new equity" with a maturity over 30 days

50% Rule: Also apply to entities *50%-or-more* owned *in the aggregate* by designees and other blocked persons

EU Sanctions – narrower

Limited to certain tradeable financial instruments; primary function is to cut off designated entities from EU capital markets

Not cover instruments issued by EU subsidiaries of targeted banks

50% Rule: Also apply to entities whose proprietary rights are owned for *more than 50%* by a designee and designee agents

Economic Situation

ECONOMIC SLOWDOWN BECOMES MORE EVIDENT

Depleted economic growth and high inflation impel rising share of non-performing consumer loans, while businesses suffer from declining consumer confidence, sanctions imposed against Russia and Russian companies (either directly or indirectly) and ruble devaluation

Comment

Economy stagnates

- GDP growth is projected to **fall to 0.3%** in 2014 (consensus forecast);
- Growth is challenged by capital outflows, which jumped 2.2x yoy in 1H'14 to $74.6 bn; Ministry of Economy expects $100 bn by year-end;
- Ruble to remain under pressure mirroring weakening economy;

Inflation picks-up

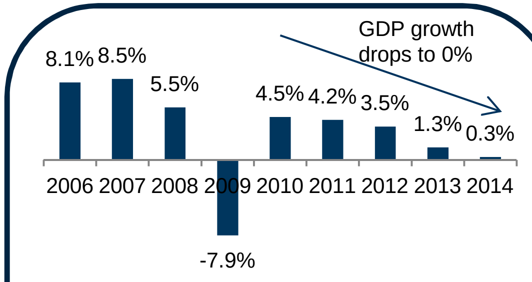
- Inflation accelerates in 2014 mainly due to currency devaluation;
- Food prices rose by 7.5% in Jan-Jul 2014 compared to -0.8% drop in EU;
- Food import sanctions imposed by Russian government in Aug 2014 may have a negative impact on inflation later this year;

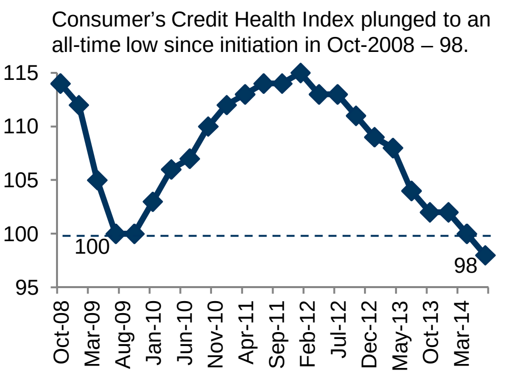
Retail NPLs reach record high

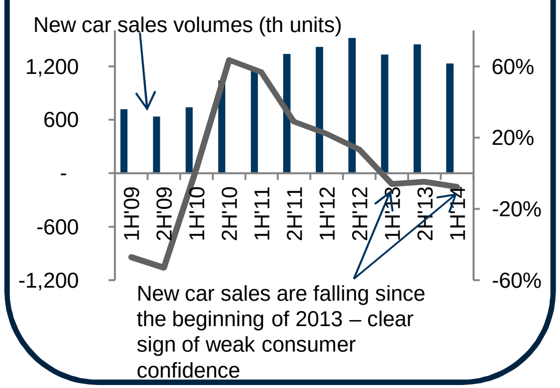
- Share of "bad debts" (delinquent by more than 60 days) in total volume of loans to Russian individuals reached record-high 12.2% overbeating that of crisis of 2008-2009;
- Credit Health Index, which illustrates share of these "bad debts", printed 98 in Jul 2014 – the lowest value since Jul 2009, when it bottomed at 100;
- Weakening economic environment combined with slowing consumer lending growth signifiy that NPLs are going to rise further;

Business activity deteriorates

- Activity in the industries most sensible to economic environment is falling dramatically:
  - New car sales dropped by 9.9% YoY in Jan-Jul 2014, drop in July was 22.9%;
  - Aeroflot – the largest Russian airline – reported a loss in 1H'14 largely attributed to economic slowdown, which led to bankruptcies of several large travel agencies as well as to decline in international flights utilization (passenger turnover contracted -1.1% YoY, cargo turnover fell -42.2% YoY)







Alvarez & Marsal

Source: CBR (Central Bank of Russia), Consensus Economics May 2014, FICO, Association of European Businesses

ECONOMY TO SUFFER FROM BANKING SYSTEM FUNDING PROBLEMS

Liquidity crisis, caused by regulatory issues and closure of a number of large private banks as well as by the "Ukrainian crisis" followed by sanctions and ruble devaluation, has led to substantial funding problems for Russian banks. Government becomes a primary source of loan growth funding, which may have severe consequences

Client deposits flow out of private banks

Share of government-linked funding in the banking system increases

Repo – 1 of 2 main CBR instruments of providing funding – becomes a source of long-term funding instead of being a source of liquidity

Using repo to fund loan growth carries risks to assets-liabilities balance of the banking system

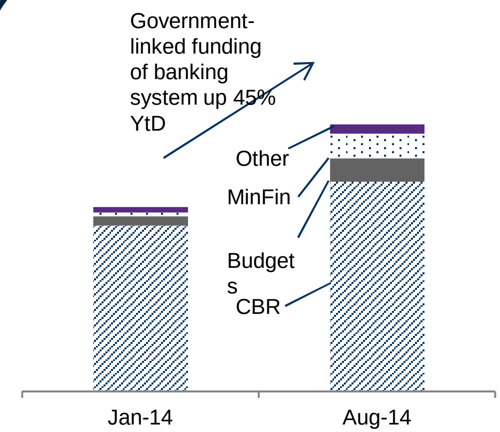
Credit risks are transferred from banks to CBR

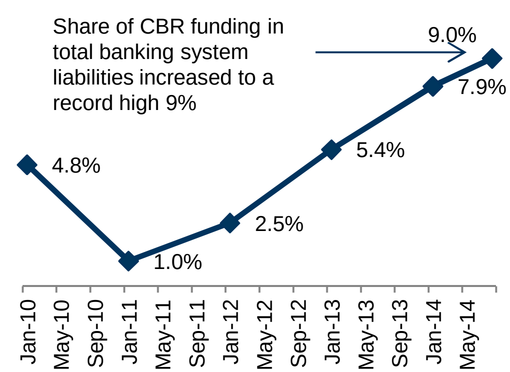
Drawdowns by CBR and the government may lead to inflation growth and/or decrease in loan volumes

Loan portfolios structure shifts towards large and state-owned companies, as loans to these companies can be pledged to get CBR funding

Small and medium enterprises are limited in banking sector funding

Economy stagnates, NPLs are rising sharply





Source: CBR (Central Bank of Russia), Fitch Ratings, A&M

FOREIGN BANKS TO CUT THEIR EXPOSURE TO RUSSIA

As sanctions against Russian and Russian companies become tougher, foreign banks follow them by cutting their exposure to Russia either by decreasing operations of local subsidiaries or by cutting limits on Russian counterparties

Foreign banks in Russia

- Foreign banks operate through their subsidiaries in Russia and play visible role in the country's banking sector; the biggest are: Raiffeisen Bank (#12 by assets), Rosbank (Societe Generale Group, #13 by assets);
- Foreign banks may cease granting new financing;
  - EBRD was the first to announce stop of new investing in Russian entities;
- Banks may start to repatriate equity capital to parent-banks;
  - Question 1: how to manage NPLs?
  - Question 2: how to manage reimbursed collateral?

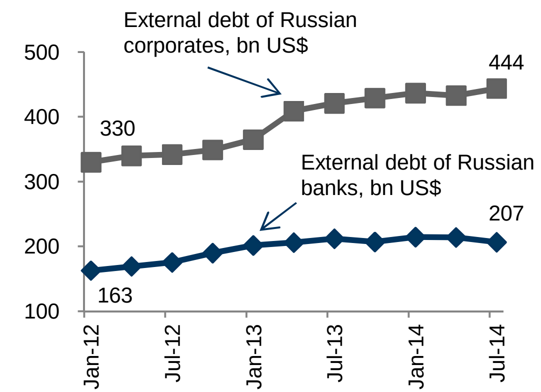
Largest foreign banks in Russia (bn RUB)

	Bank name	Assets	Equity	Corp. loans	Share of interbank loans in liabilities	CAR, %
1	Societe Generale Group	964	141	224	19%	
2	ZAO UniCredit Bank	881	129	483	17%	13.1
3	ZAO Raiffeisenbank	770	98	319	16%	11.4
4	ZAO Citibank	351	57	84	8%	16.8
5	OJSC Nordea Bank	327	31	193	62%	17.3
6	ING BANK (EURASIA) ZAO	214	31	51	29%	19.5
7	Credit Europe Bank Ltd	135	17	37	28%	13.7

*Societe Generale owns Rosbank, DeltaCredit Bank and Rusfinance Bank in Russia

Access to external funding by Russian companies

- External funding in the last 15 years was a significant source of cheap financing, now most companies and banks in Russia doesn't have access to cheap external funding;
- There are currently 2 yield curves for Russian-based borrowers: for those with access to external financing (primarily subsidiaries of foreign banks or companies), and for those that may borrow only domestically;
- Overall Russian banks owe to foreign institutions $206 bn, $21bn of which should be paid by the end of 2014, and $30bn – in 2015;
- Russian corporates owe $444 bn (including $269 bn of banking loans), around $70-90bn is repaid every year;
- Inability of companies to refinance external debt at a previous "external" cheap cost will further slow down the economy;
  - The largest and state-owned oil company in Russia – Rosneft – already asked the government for support in form of buying out company's new bond issue amounting to 1.5 trln RUB ($42 bn), which is around company's net debt figure;



Source: CBR (Central Bank of Russia), Vedomosti, Banki.ru, Fitch Ratings, A&M

Capital Outflow

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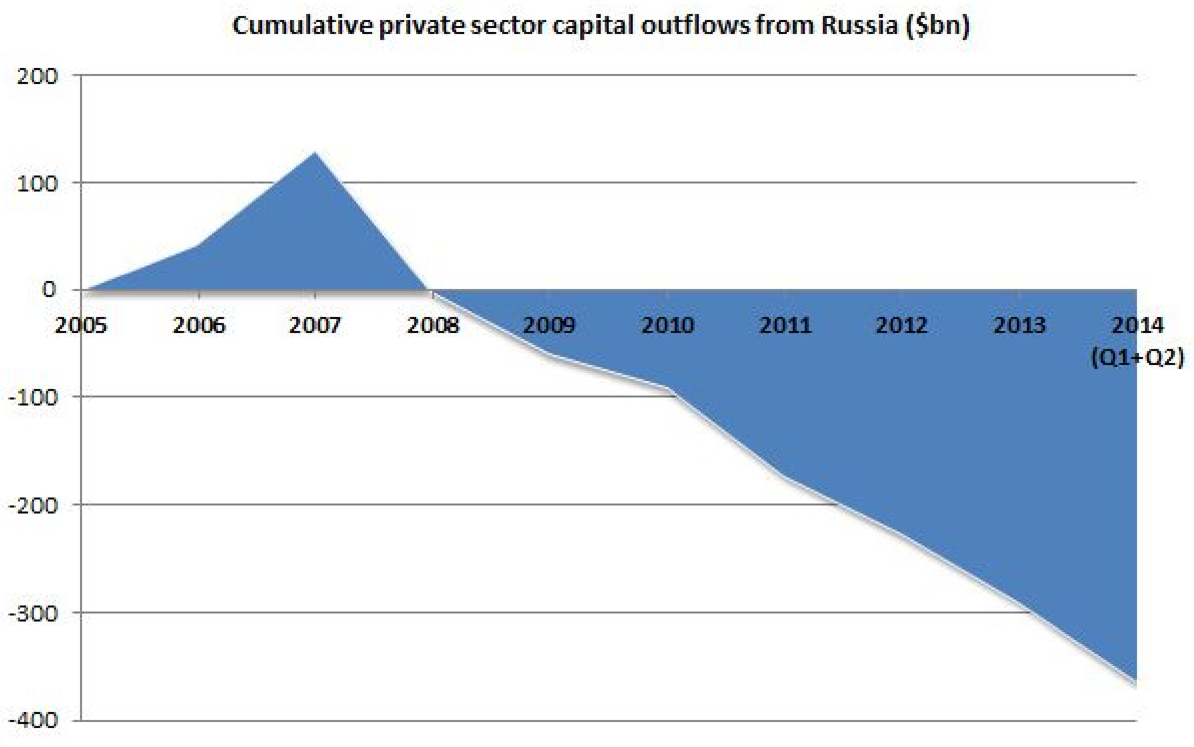

Source: Central Bank of Russia
Net Inflows/Outflows of Capital by Private Sector in 2005 – 2013 in the First and Second Quarters of 2014

Restructuring: Strategies and Opportunities

Strategies for Dealing with Distressed Borrowers

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Possible actions for creditors of distressed borrowers:

- Enter a standstill / extend the credit / make minor amendments which “kick the can down the road” / umbrella agreements
- Enforce security
- Do nothing (often leads to “freefall” liquidation)
- Sell the debt instrument at a discount
- Restructure – considering a) local procedures and b) international tools to avoid 100% consent requirements

Implementation of a Restructuring / Opportunities for Investors

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Restructurings typically involve one or more of the following:

- Injection of new money
- Write down of existing debt
- Debt for equity swap
- Reduction of interest / extension of maturities
- Sale of strategic assets

Restructurings often afford opportunities for investors to:

- Buy or refinance distressed loans at a discount
- Provide new debt or equity to distressed corporates

Restructuring in the Russian Federation – Themes

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- Standstill arrangements versus “beggar my neighbour” approach
- Will creditors have different approaches to dealing with borrower distress? Given the size of the problem, are we likely to see a more creative approach from creditors?
- Bonds – will holders of local Russian bonds be treated differently to holders of Eurobonds? Have recent changes to Russian Law resulted in a more favourable Russian bond market?
- Export credit agencies – do ECAs, which traditionally provide a leadership role, have less effect on the Russian market than they had 6 months ago?
- LPNs / CLNs – how are these structures going to play out in a restructuring?

Case Studies

Restructuring in the Russian Federation – ChelPipe Case Study

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Closed in February 2013

All outstanding bank debt was converted into two syndicated loans for the total amount of RUB 86,5 billion and domestic bond issue of RUB 8,2 billion

The syndicate was arranged by Sberbank of Russia and ZAO Raiffeisenbank and comprised of 14 Russian banks

Bond issue was arranged by ZAO Raiffeisenbank; bonds were placed among 5 banks

49.99% of the principal under both syndicated loans were guaranteed by the Russian government

Restructuring in the Russian Federation – ChelPipe Case Study

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All collateral that secured the loans being refinanced was pulled together to secure two syndicated loans on *pari passu* basis

Existing ECA facilities were left outside the perimeter of the restructuring

Distinctive features of the ChelPipe restructuring:

- Heavy involvement of the Russian state that monitored the process
- All documentation was governed by Russian law
- No write-offs of restructured debt
- Relatively fast process: 8 months from the beginning of the standstill and term sheet stage to the closing

EMEA Finance Award 2013 - Best restructuring in CEE

«CEDC» – EXAMPLE OF A "WESTERN" RESTRUCTURING IN SEVERAL JURISDICTIONS

Situation before restructuring

- CEDC – one of the largest vodka producers, importer and distributor in Russia, Poland, Hungary and Ukraine. The Company was listed on NASDAQ and WSE;
- In 2009-2012 the Company issued public bonds in the USA in the amount of $1.3 bn and acquired a number of companies in Poland and Russia;
- Sharp increase in spirit excise in July, 2012 and January, 2013 caused decrease of the market and drop in sales in Russia;
- Conflict between shareholders has caused a cancellation of banks' credit lines and sharp reduction of available working capital;
- A&M was appointed in December, 2012, 3 months before an inevitable default on public bonds;
- Total debt - $1,4 bn. Debt to adjusted EBITDA ratio was about x12. Forecast for 2013: consolidated EBITDA margin 11%, Net Profit margin 5%.

Shareholders

In conflict

Shares: -90% in 2011-12

Creditors (2012YE)

Total debt: $1.4 bn

Public debt: $1.2 bn

Debtor

(financials as of 2012)

Sales:	$1,745 MM
EBITDA*:	$(236) MM
Net Profit*:	$(363) MM

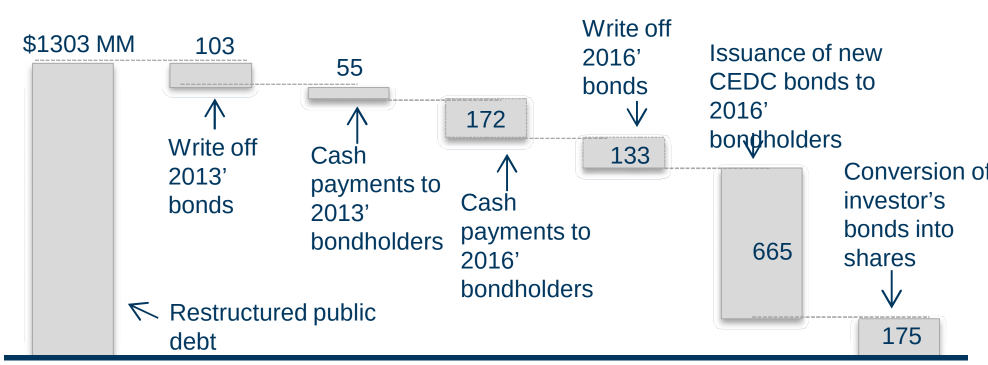
***** - Including an impairment charge in the amount of $373 MM

The process of restructuring

- A&M was engaged as a Chief Restructuring Officer (CRO). As a first step, A&M developed and implemented the system of payments control and liquidity control;
- A&M together with investment and legal advisers of the Company elaborated a plan of debt restructuring through the procedure of controlled bankruptcy of US legal entities of the Group (Chapter 11);
- The plan was supported by almost 100% of bondholders, which allowed to exit a bankruptcy procedure in a record-short timeframe - in 2 months after its initiation;
- As a result of the restructuring CEDC ceased to be a public company and is currently owned by Roustam Tariko, the owner of the company 'Russian Standard';
- For elimination of tax risks (~$266 MM) A&M implemented an intercompany cash flow reconciliation procedure, which applied to 10 companies in 5 jurisdictions.

Key elements of restructuring

- 2013' bondholders received $25 MM in cash and $30 MM of Roust Trading's bonds;
- 2016' bondholders received $172 MM in cash and $665 MM of bonds maturing in 2018



Questions?

Speaker Biographies

Harry Clark

Chair of Orrick's International Trade & Compliance Group, Orrick – Washington, D.C. office

Harry advises major companies and industry associations on a variety of international trade and investment rules. Harry has deep experience in areas such as CFIUS/Exon-Florio examinations of foreign investment, military and "dual use" export control regulations (ITAR/EAR), economic sanctions administered by the U.S. Treasury Department (OFAC), customs regulations, the Foreign Corrupt Practices Act, anti-money laundering rules, anti-boycott requirements and defense industrial security requirements. Chambers Global recognizes Harry as a leader in the field of international trade law and has recognized Mr. Clark with special distinction regarding the Foreign Corrupt Practices Act.

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Dmitry Gubarev

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Dmitry represents international and Russian banks and corporations, as well as multilateral lenders and development institutions on all types of financing transactions in Russia and other CIS countries, including syndicated loans, real estate and infrastructure financings, structured products and securitisations.

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Speaker Biographies

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Konstantin Kroll

Partner, M&A and Private Equity, Orrick – Moscow office

Dual qualified in Russia and England and Wales, Konstantin has over 17 years of experience advising corporate clients and financial institutions on complex cross-border transactions in Russia and the broader region of the former USSR. Konstantin's practice concentrates on M&A, joint ventures, debt and equity capital markets transactions, structured finance and derivatives. Konstantin also has significant experience in project finance, bankruptcies and restructurings. Konstantin has advised clients on some of the largest M&A transactions in the energy, manufacturing, consumer and banking sectors in the Russian market.

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Stephen Phillips

Co-European Restructuring head, Orrick – London office

Stephen has extensive experience in advising banks, bondholders and corporate groups on restructuring, corporate and banking matters. Chambers UK (2013) notes that Stephen is described by one client as "very savvy from a commercial point of view. He understands what goals we are trying to achieve and finds a legal way to get us there." He is also named as a highly recommended lawyer in corporate restructuring and insolvency by Legal Experts (2011) and regularly speaks at conferences and seminars in the UK and across Europe. He has published several articles in leading business sector titles and is regularly quoted in national and sector press

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