Inside Perspectives:
An Interview with Michael Calvey of Baring Vostok

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Michael Calvey, Founder and Senior Partner of Baring Vostok, shares his perspectives on the private equity landscape in Russia and the Commonwealth of Independent States (CIS), and discusses some memorable transactions throughout his career in the region. Baring Vostok is one of the oldest and largest private equity firms focusing on Russia and the CIS; it recently closed its fifth fund with US$1.5 billion in aggregate capital commitments, constituting the largest fund raised for the region to date.

You have been investing in Russia with Baring Vostok for nearly 20 years, during which time Russia and the CIS have undergone a tremendous amount of change. From your perspective, how has the market evolved since you began investing in it?

When we first started investing in 1994, the Russian economy was still contracting sharply after the end of the Soviet Union. During the first four years of our firm's existence, Russia's GDP fell by about 40–50% as the elimination of subsidies and state orders led to a collapse in unsustainable Soviet economic activity. At the same time, the private sector was growing rapidly, but from a small base, so there were not many private companies of size in which to invest.

So we invested about two-thirds of our first fund in former Soviet businesses that had been privatized, and about one-third in new private companies. Some of the private companies were big successes—companies like VimpelCom, for example, which became Russia's biggest mobile player. However, we also made a lot of money from investing in privatized businesses, which was a different type of opportunity requiring different skill sets. For most of these formerly state-owned businesses, there were huge assets that could be acquired very cheaply, but they needed to be restructured, cleaned up and repositioned to be profitable over the long term. This opportunity existed only briefly, but we took advantage of it, and the profits we generated helped us both to survive the Russian financial crisis of 1998 and to keep investing afterwards.

This was one of the big lessons over the last 20 years: periodic crises are inevitable in rapidly evolving emerging markets, and while most investors develop a "bunker mentality" afterwards—getting depressed and being reactive—these periods often present the best opportunities both to buy great companies and to transform existing businesses. From 1999 onwards, Russia has been an excellent growth market, with GDP growing by more than 8x in U.S. dollar terms and some truly outstanding businesses being created. The "survivor" private equity firms of 1998 benefitted from this enormously, and generated returns mainly from growth.

For years, LPs have viewed Russia as one of the least attractive markets for private equity investment—it ranked last in EMPEA's Annual LP Survey both in 2010 and 2011. Yet Baring Vostok had success raising US$1.5 billion for its fifth fund—the largest raised for the region to date. Are LP perceptions toward Russia changing?

Russia is irrationally unpopular with mainstream investors since the returns on investing in private equity in Russia have been better than those in most other emerging markets over the last 18 years. Obviously, there have been individual funds in Russia that were disasters and some funds in other markets that have been highly successful, but if you look at the industry overall, IRRs and cash multiples in Russian PE have been higher on average than those in other regions. Russia's macroeconomic fundamentals are also relatively good, with low debt, budget surpluses and gradually declining inflation. Clearly, investor perceptions today are based on variables besides investment results or economic realities.

To illustrate this point, we recently asked a number of investors to participate in an exercise where we disguised countries as planets. Then we put up 10 statistics on each planet that were relevant when making investment decisions, such as GDP, growth, budget deficit/surplus, net debt position and the price-earnings ratio of the stock market. We even let the audience pick the parameters. When the audience ranked the planets in order of which was most attractive for investment, Russia came out number one, China was number two, Germany was number three and Brazil was number four.

That is anecdotal evidence, but it demonstrates that there is an irrational bias about Russia. It's not a paradise, of course, but there isn't an investment paradise anywhere in the world. I think people's perceptions about Russia are based mainly on a lot of other variables, especially external politics, which is probably important and certainly intellectually intriguing, but doesn't reflect the real economic situation or affect the types of businesses in which we invest. And whenever a country's or a company's image becomes disconnected with economic and business reality, it usually presents an opportunity for investors to profit from it.

Right now your portfolio is invested only in Russia and Kazakhstan. Beyond these two countries, where do you see the most attractive opportunities, if any, within the CIS?

We have a large fund with US$1.5 billion in capital, and we don't want to have 50 portfolio companies, so we're looking for individual opportunities that can generate exit proceeds of at least US$100 million to US$200 million per deal. With that limitation in mind, the only three countries that are likely to generate opportunities that are material to our fund will be Russia, Ukraine and Kazakhstan. We used to own a few companies in Ukraine and still look at opportunities there, but today we own businesses only in Russia and Kazakhstan.

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Roughly 34% of your investments have been consortium deals. What are the opportunities and challenges these deals present, and are there any idiosyncrasies in the Russian market that lead to more consortium deals than in other emerging markets?

You have to be careful with definitions, because what we might consider a "consortium" deal, other people might consider a minority deal, a growth deal, or something else altogether. We view deals as having basically three types of shareholding structure: one is a pure minority investment where the founder/management team has control; the second is a control investment where we own 51% or more of the company directly; and the third is a shared-control situation where no single party has control, and we have to work with other local partners to control the business effectively. What you don't see in our portfolio are many 100% buyouts, because while there have been a lot of those in Russia, we are almost always outbid by other local groups.

One of the features where Russia is an outlier compared with other emerging markets is the extent of domestic capital in the hands of individuals—such as oligarchs and other Russian businessmen—who have accumulated vast amounts of personal capital over the last 10 or 15 years, and who are very acquisitive. These individuals have lower return expectations than our LPs, so they will generally pay a higher price and move faster than we would to buy an asset in a straight control deal, particularly when the seller only cares about getting the highest price, and he doesn't care who the buyer is.

This leads to an important point on consortium deals. Typically, when one or more of the existing shareholders of the company retain their stake, they can have a decisive role in determining who the investor will be. These shareholders are not, in most cases, likely to welcome an oligarch or a huge state company as a minority shareholder in their business even if they offer a higher price; and if they did, they might not be able to work together harmoniously and successfully. For a similar reason, consortium deals have been difficult for global buyout firms. Most consortium deals involve local individuals as partners, rather than institutions, and global buyout firms take a legalistic or contractual-based approach with them, rather than working together quickly and informally as like-minded commercial people. As a result, the competitive situation for firms that can pursue consortium deals is more favorable than it is for straight buyouts or for public market investing.

Roughly 23% of Baring Vostok's deals have been in the natural resources sector, with approximately US$400 million invested into 19 companies. Many investors outside of Russia might wonder about potential risks involved in investing in a so-called "strategic sector." How has BV been able to pursue deals in oil and gas companies without running afoul of local regulations?

Only the largest oil and gas assets are considered "strategic." Since Russia has vast oil and gas reserves, "large," by Russian standards, is more than 400 million barrels of reserves, which is huge by U.S. and emerging market standards. Anything below that size in Russia faces no formal investment restrictions.

There are about 1,000 oil and gas companies in Russia, of which two are state-owned and another eight are major companies. Together, those 10 companies control somewhere between 90–95% of Russia's oil reserves and production. The balance is controlled by the remaining 990 companies, within which there are dozens of quality businesses that have undeveloped assets, as well as owners who want to develop and de-risk the assets before exiting. That is where we play a role: helping to finance development, and then selling producing and cash generating assets at a higher price.

Generally, our natural resources investments have lower risk but also lower potential returns than our domestic-growth oriented investments. However, we have never actually lost money on a natural resources deal, and we did have one really big winner with Burren Energy, which generated more than a 15x return on investment and helped transform the return profile of our first and second funds. While we have made more money than that in some of our internet and media investments, Burren Energy is still one of the top three or four returns we've had. I would not expect natural resources to constitute more than 20–25% of our investments or assets, but we have a lot of valuable experience in the sector and it is a strategy that we expect to continue.

The Russian government has been making overtures to global investors through the Russian Direct Investment Fund (RDIF)—a US$10 billion vehicle with a mandate to co-invest alongside foreign investors—and has been supporting RUSNANO, Skolkovo and the Russian Venture Company (RVK). Why is encouraging private equity investment so important to the Russian government?

It is bewildering sometimes how many different state-backed private equity initiatives there are in Russia. However, the fact that the government wants to support private equity is clearly a positive thing, and it stands in contrast with the view toward private equity that you often see in developed markets today. RDIF, in particular, is off to a good start; they hired a professional investment team; they have made their first investments; and I think that people who have been skeptical about it are starting to change their view. It's still unclear what will happen with entities like RDIF in the long term, but in the meantime, I would expect them to continue to generate positive results and have a healthy impact on the market overall.

On your new website, you disclose distributed dividends since 1998. What prompted you to go public with information on your performance, and do you think this is something we'll see from more GPs in the future? If not, how can industry bodies, such as EMPEA, encourage more private equity players to follow your lead?

The results are good; we have nothing to hide so we decided to put it on our site. We still do not publicly disclose the finest details about IRRs and cash multiples, since some of our LPs are not comfortable with us disclosing those metrics on a fund-by-fund basis, but of course we share all the details directly with LPs. The trend across the industry is clearly toward more transparency, and there are a number of LPs—pension funds and endowments from the United States, in particular—that have high standards of disclosure. As long as people are comparing apples to apples in terms of valuation methodologies, such disclosure is a good a thing. Of course, if you look at the websites of all GPs around the world, they're all amazingly top-quartile; it's a miracle of mathematics that every GP is a top-quartile fund!

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What's the most memorable transaction you've done, and why?

Yandex is the Google of Russia. My partner, Elena Ivashentseva, sourced the original investment opportunity and put US$5 million of capital into the business (via a holding company we controlled) for 35% of the company's shares. It took several years for the company to break even and to demonstrate its business model, but its customers and users always loved it. Yandex consistently reinvested whatever profits it was making to innovate and develop new services that continued to garner customers' loyalty. Amazingly, the US$5 million that Elena invested in 1999 was the only capital the company raised and utilized until its IPO in 2011.

Now, Yandex is a massively profitable business with rapid and sustainable revenue growth, and is publicly listed on NASDAQ with a market capitalization of roughly US$7.5 billion. So it has been a big windfall to our limited partners which, sadly, will likely never be repeated on such a scale. The company, however,

has created an enduring benefit in terms of our relationships throughout Russia's internet and new media sector, and the resulting deal flow has led to several attractive investments for our recent funds.

What issues in the region give you pause or concern?

In general, most people, including government officials, recognize that the role of state companies in the economy has gotten too big, and the trend needs to go in the other direction. The reversal hasn't started yet, and that is a misgiving that we have not only at our firm, but it is also one about which the government has expressed concern.

Demographics are a challenge for Russia, but not mainly for the reasons that most people think. Russia's population is actually growing again due to an increase in the birthrate and immigration; but the concern is due to the big drop in the number of live births in the 1990s. What this means today is we're facing a large decline in the number of university graduates entering the workforce right now, and probably over the next five to seven years. We see that in our portfolio companies through wage inflation and challenges in recruiting entry-level workers. Additionally, people in Russia tend to burn out at an earlier age than in many other markets. So there are a lot of people nearer the other end of the demographic spectrum—say 40 or 50 years old—who would still be in the prime of their productive lives in the rest of the world, but who in Russia are retiring and moving elsewhere. This is a shame because Russia is losing a lot of its most productive people.

I think the important point is: what people think of as the risks in Russia tend not to be serious risks. Risks are here, but not where people are looking and most GPs can address them. At the same time, people discount or ignore the positive things about Russia. That is what makes Russia a buyer's market most of the time, and why it has generally been quite profitable for private equity firms.

Finally, given your focus on a country with such a rich literary history, we would be remiss not to ask you: what is your favorite Russian novel?

Anna Karenina. Tolstoy is really one of the great writers of all time, and Anna Karenina is my favorite of his novels. It really is one of the best novels ever written.