sova capital

The view

#1 Anatomy of Russian equity capital markets

Sova Capital • London • 2021

Introduction

Russia's ECM history began in 1996, when TMT company VimpelCom held an IPO on the NYSE. Since then, Russian issuers have raised more than US$150bn in almost 400 equity placements.

As Russia's market economy has developed and the country has become more closely integrated into global financial markets, its ECM space has been evolving and changing too.

Since that first IPO, Russia has built and developed its own efficient financial infrastructure, with MOEX becoming a competitive listing venue.

As markets have evolved, so too have issuers and investors. Russian investors today seek a fully professional service from their banks when undertaking ECM transactions.

In this issue of The View, we offer a detailed overview of the history, structure and mechanics of Russia's primary equity market.

Here to help you to raise capital, wherever you choose

Here at Sova Capital, we understand that raising capital requires a great deal of management's time. We are here to ease this process. Combining the high levels of expertise of a large financial institution with the care and attention of a boutique company, we will be delighted to assist you in raising capital for your future growth, be it via equity, equity-linked or debt financing.

Evolution:
From the first IPO to the present

Early days

Russia's primary equity market started becoming active as early as 1994. However, the true watershed moment in the development of the country's IPO market came in 1996. In November that year, Russian telecoms company VimpelCom (now known as Veon) listed its shares on the NYSE. Though the deal was small by current standards (US$127mn), it was highly significant. By listing c.24% of its equity capital, VimpelCom opened a new chapter in the development of Russia's capital markets and corporate sector. This was followed by the country's first privatisation deals, with Gazprom's US$429mn IPO in October 1996 and Tatneft's US$120mn offering in December of the same year. Both issuers double listed in Russia and on the LSE.

In the following seven years, Russia's primary market developed slowly alongside its broader financial markets as the corporate sector matured and the country integrated into the global economy.

Eight Russian companies conducted IPOs between 1996 and 2003. Two of these were TMT companies MTS and Golden Telecom, both of which listed in the US. Three Russian companies floated shares in 2002: food producer Wimm-Bill-Dann, gold-mining firm Highland Gold, and (most notably, in our view) RBC Information Systems. RBC became the first company to complete a fully domestic IPO when it listed on MICEX (one of MOEX's two predecessors). The transaction was small at just US$13mn, but it was historically significant. This early period in the Russian market ended with pharmacy retailer 36.6's IPO on MICEX.

Most of the deals closed in the early period of the market's development were priced at or around the middle of their ranges, with a fair degree of international demand.

The abovementioned IPOs were followed by 13 follow-on offerings from the same companies.

In 1997, a major Russian oil producer - Lukoil also tested the waters with the first convertible bond, followed by VimpelCom.

The golden age

The Russian ECM's first decade was followed by what could be confidently be called a golden age. By 2004, the number of Russian companies mature enough to go public market had increased dramatically compared to the early 1990s. And as global GDP and oil prices started rising, bolstering Russia's economy, the country's primary equity market soared, with a lot of placements being made. Over the following four years, Russian companies raised more than US$65.4bn in 111 equity placements, including US$39.8bn from 54 IPOs. The 2007 record of more than US$35bn from 47 deals looks unlikely to be repeated.

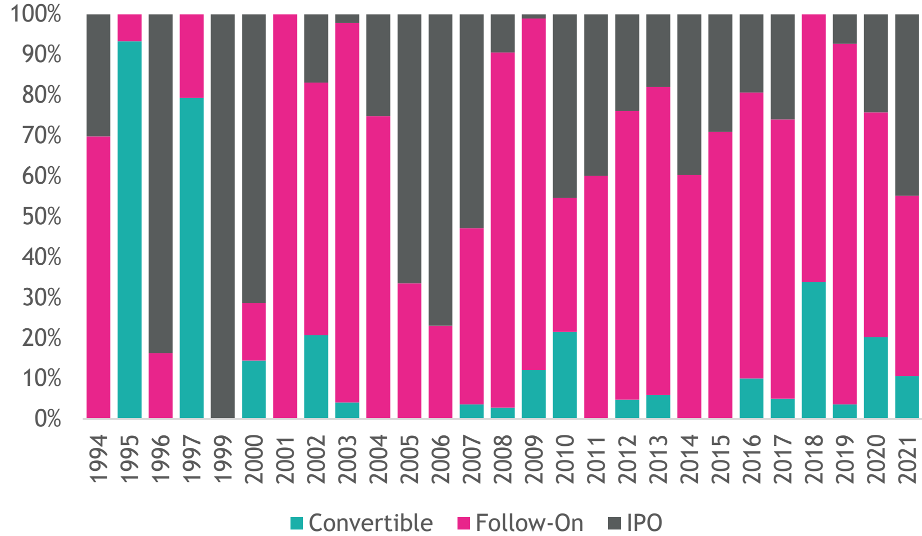
More than **US$35bn** was raised in 2007, the most successful year in the Russian ECM's history

Russian primary equity market transactions

Source: Dealogic, SOVA Capital

Russian primary-market activity started increasing dramatically in 2004, peaking in 2006–2007. This was due to both the favorable market conditions and the upcoming changes (albeit marginal) to the political system. Incumbent President Vladimir Putin was not running for reelection in 2008, and many companies were eager to enter the market quickly ahead of the potential uncertainty presented by the quasi-new setup. These years saw two of the largest deals in Russian market history, namely Rosneft's landmark US$10bn IPO in 2006 and VTB's US$8bn privatisation in 2007. These four years could be said to have marked the formation of the very core of Russia's modern financial market, with blue-chip companies such as Polymetal, Evraz and Mechel debuting on the public market.

Russian primary equity market transaction structure by deal type



Source: Dealogic, SOVA Capital

Crisis and stable years

However, 2007 was to be the Russian ECM's last prosperous year, with the global financial crisis hitting the world economy, depressing market activity. The number of Russian market deals more than halved in 2008 versus the previous year, with Globaltrans conducting the only IPO. Second-tier companies made 18 follow-on offerings that year, though few investors are likely to recall them today.

The following five years were characterised by a fairly stable deal flow. Around 20 deals per year were made on the Russian market, with a slight uptick in 2010, which saw 34 (mostly small) transactions. These years of post-crisis recovery were dominated by follow-on offerings, including the government selling down more than US$1bn of Sberbank shares.

The period was also characterised by IPOs from the new generation of Russian non-resource companies, including Yandex (US$1.4bn, 2011), Mail.ru (US$1.0bn, 2010), MegaFon (US$1.8bn, 2012) and Tinkoff/TCS Group (US$1.0bn, 2013).

Rusal, Russia's privately owned metals giant, floated its shares on the Hong Kong stock exchange in a US$2.2bn IPO in 2010. This was widely seen at the time as the dawn of a new era of Russian companies listing in Asia (though this era would never actually materialise).

The steady post-crisis recovery and unprecedentedly benign geopolitical environment (the "peregruzka", or "overload", in Russia-US relations was still just an unfortunate typo on the now-infamous button) were favourable for Russian ECM transactions. All of the abovementioned deals were priced close to the top of their ranges, and saw notable oversubscription and significant international demand. Investors perceived Russia as a 'proper' developing country, with moderate political risk and a sustainable economy.

Dark days

Things changed rapidly in 2014, when geopolitical tensions with Ukraine resulted in Western countries imposing sanctions on Russia. Russian GDP growth started sinking towards negative figures, accelerated by falling oil prices. As the country's sovereign ratings were cut to speculative levels and major state-owned companies were deprived of the ability to raise long-term financing, international investors started revaluating their risk appetite. This all came close to bringing about the demise of Russia's ECM; there were only seven IPOs over the next three years, most of which were below the median of their respective price ranges. All of these listings, with the exception of Lenta's US$974mn IPO, took place exclusively on MOEX. The market was surviving due mainly to repeated accelerated bookbuilds (ABBs) by Russian blue-chip companies, mostly from the metals & mining sector.

The Russian ECM appeared to show some signs of recovery in 2017, with EN+'s US$1.5bn IPO on the LSE, Detsky Mir's successful $324mn listing on MOEX, and more than US$5.3bn being raised in follow-on offerings.

Another round of sanctions made 2018 the first year ever without a Russian IPO

Despite geopolitical tensions, international investors remain receptive to high-quality Russian assets

However, any perceived light at the end of the tunnel faded in 2018 with a new round of sanctions. This was the first ever year without a Russian IPO, and saw record-low ECM proceeds of US$740mn, raised via four ABBs and one convertible-bond placement.

Back to life

What does not kill you is said to make you stronger, and during the first five years of sanctions, the market shock gave way to a new reality. International investors and Russian issuers adapted to this new reality, and the ECM came back to life with HeadHunter's successful US$253mn IPO on the NASDAQ in 2019, priced at the upper end of its range and heavily oversubscribed.

This was followed in 2020 by the first privatisation in seven years, of Sovcomflot. The last 12 months have even seen Russian IPOs of more than $1bn, including Ozon (US$1.3bn, 2020) and Fix Price (US$1.7bn, 2021), both priced at the top of their ranges.

There have also been 30 follow-on offerings totalling more than US$8bn.

This current era has also seen the listing of the CIS's first special-purpose acquisition company (SPAC), in 2020.

This all suggests that, despite the geopolitical tensions, demand remains strong for high-quality Russian assets. Although another 2007 seems unlikely, Russian ECMs look set to survive as new companies grow and develop towards eventually going public.

A venue to float: Which exchanges Russian companies prefer

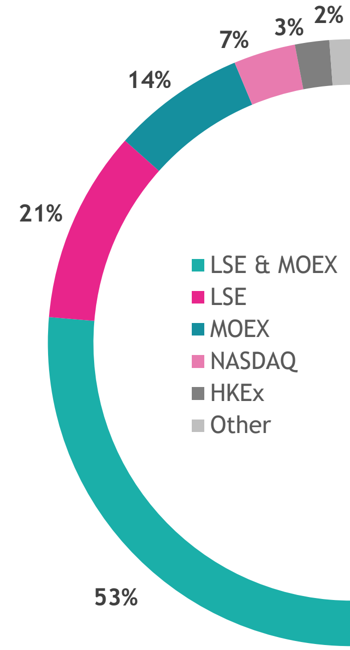
What governs their choice

The main factors behind an issuer's choice of venue are investor access, valuation, and market liquidity, listing and trading costs, as well as nonfinancial factors.
The globalisation of financial markets in recent decades has reduced the differences in listing costs and investor access between global stock exchanges. Nowadays, the investor bases of Russian companies listed solely on MOEX and those with a dual listing (on the LSE too) are almost identical.
Market liquidity and depth are also no longer differentiating factors for Russian issues (with the exception of US$2bn+ placements, which may still be challenging to conduct exclusively on MOEX).
Nonfinancial factors have become substantially more important, such as a market's regional and institutional proximity, investor awareness of a product and industry, and breadth of analytical coverage.
The more familiar investors in a target market are with an industry, the more accurately they should be able to value an issuer. And institutional proximity to the stock exchanges results in better understanding and assessment of the issuer's country risk.

Where Russian firms float

While the history of Russia's ECM began with the US stock exchanges, the popularity of the NYSE and NASDAQ has since faded, giving way to the LSE, then to MOEX. Today, US exchanges remain attractive mainly to Russian tech companies and firms with business models that are familiar to US investors.
The LSE started gaining popularity among Russian issuers in 2005. Its geographical and institutional proximity meant investors were able to understand Russia's country risk as well as its resource-economy companies. More than 20% of all placements by Russian issuers have been made on the LSE, with a further 53% via dual listings on the LSE and MOEX.
The dual listing has become the most popular way for Russian companies to go public. If we were to ask issuers what drives this decision, they would likely reply that dual listings provide higher coverage during bookbuilding, that they result in higher valuations, and/or that they mean higher liquidity in aftermarket trading. While these arguments may all sound reasonable at first, there is no evidence of higher (or indeed lower) liquidity resulting from a dual listing on the LSE and MOEX, and investor access to the two exchanges is almost identical.
In recent decades, MOEX's close integration into the global financial system and its impressive development of proprietary infrastructure have made it a desirable venue for Russian issuers.
After another round of Western sanctions on Russia in 2018, MOEX has become a viable option for Russian issuers seeking to float their shares without the possibility of trading being suspended for geopolitical reasons.

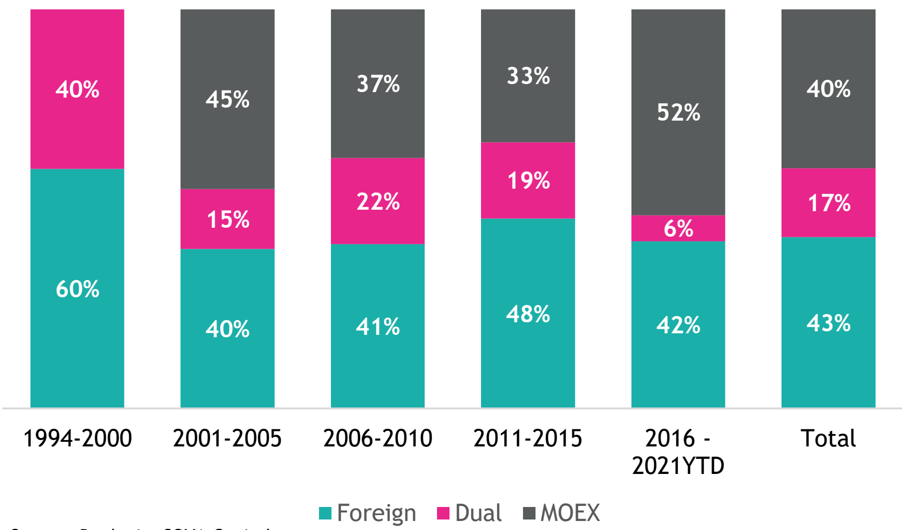
Proceeds raised in placements by Russian companies, 1996-2021 (YTD)



Source: Dealogic, SOVA Capital

MOEX's close integration into the global financial system and its impressive development of proprietary infrastructure have made it a desirable venue for Russian issuers

Listings of Russian issuers on foreign exchanges vs MOEX by number of deals



Source: Dealogic, SOVA Capital

Looking at the broader picture beyond IPOs, we see a significant shift in issuer behaviour.

Homecoming

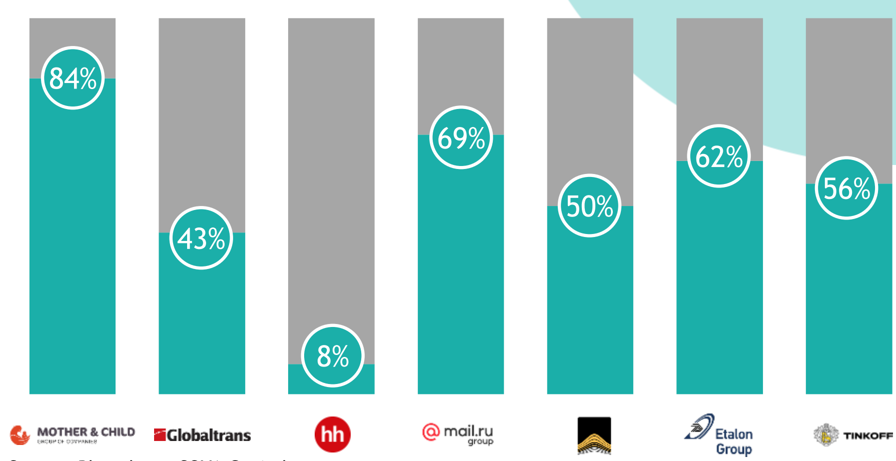
The suspension of trading in EN+ GDRs on the LSE in June 2018 was taken as a warning signal by Russian issuers that they should consider having a backup facility, which led them to revisit MOEX. While listing on MOEX ensures seamless trading and the ability to rapidly transfer volumes there in case of geopolitical tension or actions by foreign regulators, the wave of secondary listings on MOEX by Russian issuers has not been driven solely by concerns about sanctions. The sanctions against EN+ demonstrated the possible benefits to issuers of the increasing involvement of Russian retail investors in the capital markets. Secondary listings on MOEX were found not to split liquidity and thereby create two illiquid markets; rather, one tranche is more liquid than the other. Furthermore, the significant hike in retail-trading volumes contributed to the decision of seven Russian public companies listing their shares on MOEX since October 2019.

According to MOEX, the number of retail accounts in Russia has increased to 24mn in the 12 months to October 2021. Today, on average, 60% of liquidity in these issuers' stocks comes from MOEX. On the institutional side, Russia-focused and local investors tend to stabilise stock volatility and absorb selloffs by international accounts. This is because the former generally have shorter investment horizons and set lower stock-price targets for taking profit, thereby providing additional liquidity support.

Asian angle

Many Russian issuers have considered listing on Asian stock exchanges, particularly HKEX (and some still are). But only two have thus far conducted IPOs on the Hong Kong Stock Exchange, namely Rusal (US$2.2bn, 2010) and IRC (US$241mn, 2010). There are several reasons why Asian stock exchanges have not proven popular among Russian issuers since then, even amidst the sanctions. These include institutional and cultural market differences and the fact that HKEX investors can only participate in offerings by companies with significant Chinese production and sales exposure. Despite efforts at the government level and significant progress in mutual regulatory recognition, these factors look set to remain substantial obstacles for Russian issuers.

MOEX turnover: contribution to overall liquidity over last 12 months to October 2021 or since listing on MOEX (whichever period is shorter)



Source: Bloomberg, SOVA Capital

What it's all about:
IPO pricing and follow-on discounts

IPO pricing

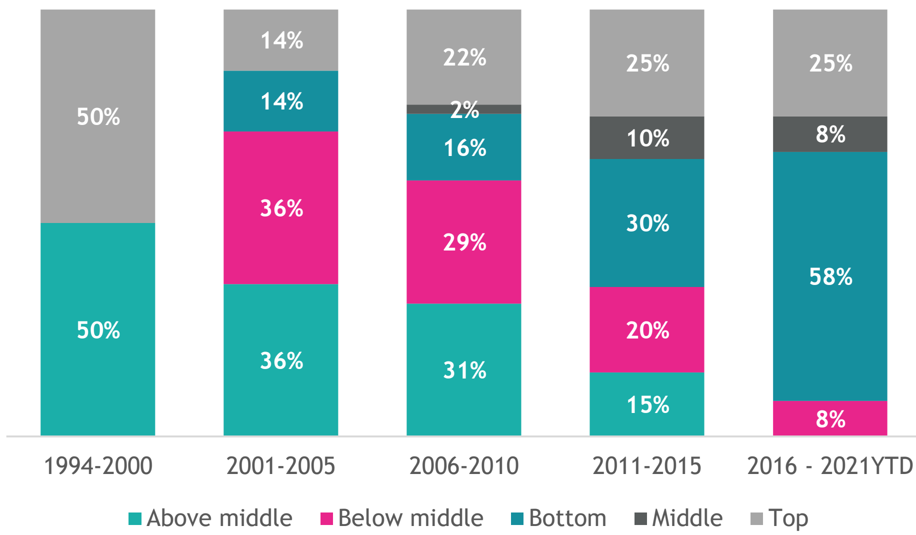
An ECM transaction will occasionally fail due to insufficient demand at the requisite price. Pricing IPOs is complex, and many academic papers have been written on how economic cycles, information asymmetry, syndicate compositions and marketing strategies have led to IPOs being mispriced. Rather than engage in academic debate, we will examine how Russian IPOs have been priced since the 1990s.

The number of deals priced at the bottom of their ranges has increased significantly over the last decade, due largely to foreign investors reassessing Russia's country risk. There has also been a clear polarisation in IPO pricing, whereby most deals in the last five years have been priced either at the top or bottom of their ranges. The deals priced at (or above) the top of their range mostly represent high-quality assets with significant oversubscription during bookbuilding, such as Ozon and HeadHunter.

Fair pricing

Despite the increased number of deals being priced at the bottom of their ranges, most deals have been priced fairly. To assess whether a particular IPO was priced fairly, we calculated stock-price changes 30 days after placement. If we found that the stock price had deviated by more than ± 20%, we concluded that the transaction had been significantly mispriced; if the deviation was less than ± 5%, then the deals were priced fairly.

Russian IPOs' final pricing vs announced price ranges



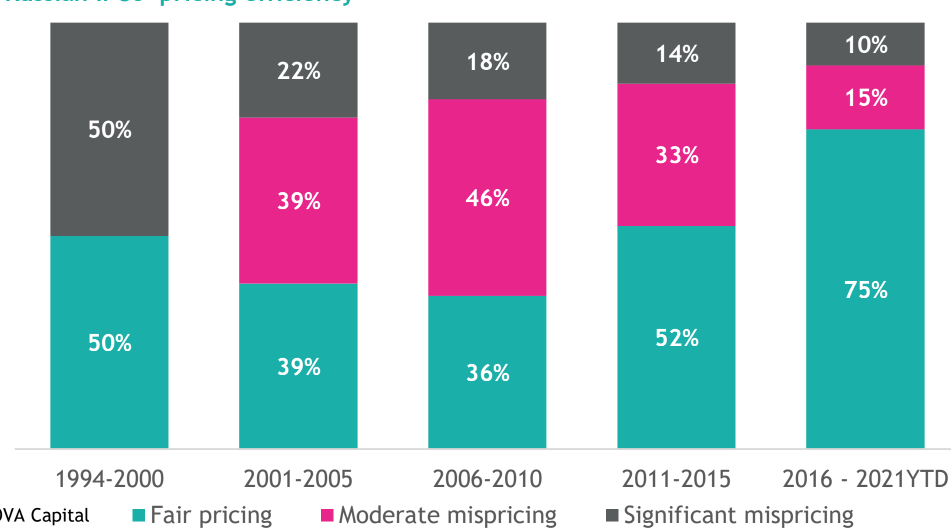
Source: Dealogic, SOVA Capital

We found that Russian IPOs have historically been priced fairly, with only c.17% being significantly mispriced since 2001.

Pricing accuracy has increased further still in the past decade, with only 12% of transactions being significantly mispriced. This is especially interesting considering that market volatility has increased dramatically in recent years.

An ECM transaction will occasionally fail due to insufficient demand at the requisite price

Russian IPOs' pricing efficiency

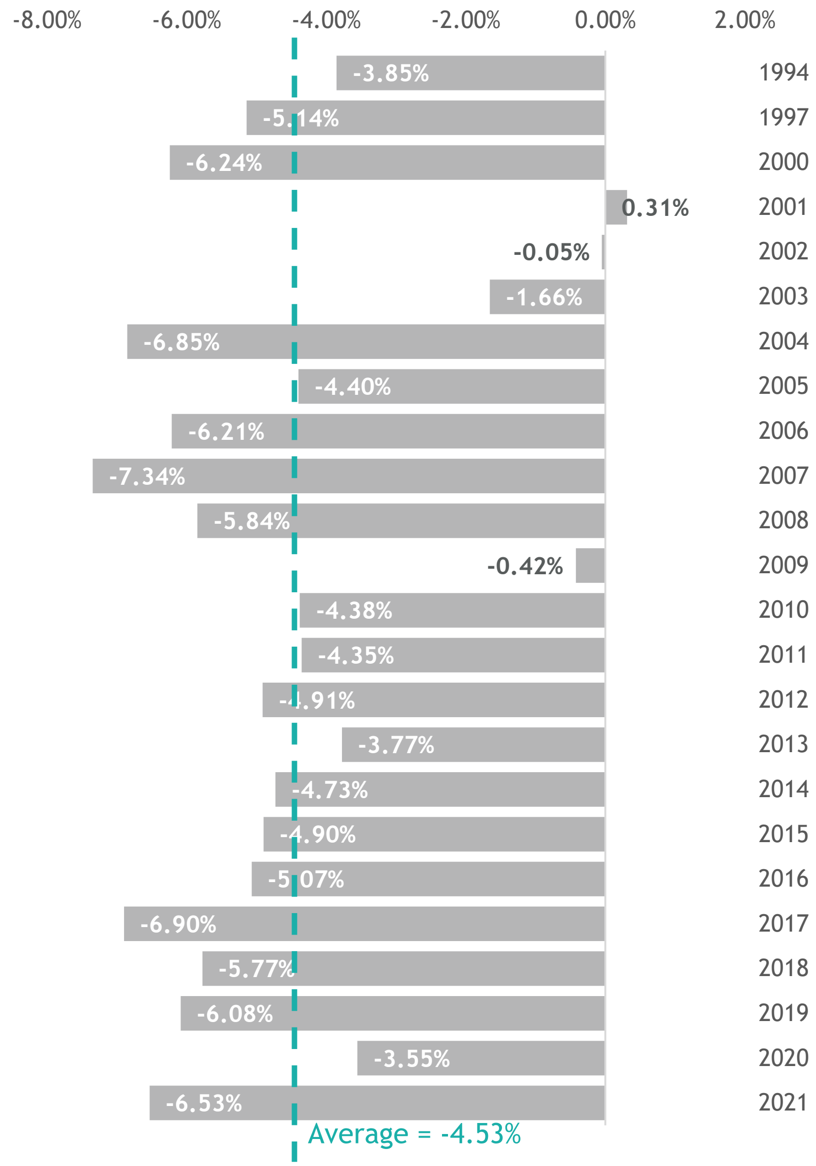


Source: Dealogic, SOVA Capital

Pricing follow-on offerings

SPO discounts depend greatly on market conditions, company performance and investor perceptions of the issuer's equity story.
The majority of Russian secondary placements between 1994 and 2021 were executed with discounts of less than 5% to the market price, and only 13% had to give up more than 10% of the shares' market price to cover the book.
Deal structure in terms of primary/secondary components does not seem to have a significant impact on discount size. However, 100% primary deals are generally easier to market to investors, as they signal that a company plans to expand and that its management sees growth opportunities.
Another interesting trend in recent years has been companies frequently preferring to make follow-on offerings via ABBs. This has been due to volatility increasing in recent years, making market risk exposure much more significant and turning what was previously known as ECM windows into ECM momentum.
However, ABBs can only be effective for highly liquid stocks and solid equity stories, and only when the timing is opportune.

Average discount for Russian follow-on offerings



Source: Dealogic, SOVA Capital

Source: Dealogic, SOVA Capital

Market risk exposure being low to zero means follow-on offerings completed via ABBs tend to have lower discounts than fully marketed transactions. But ABBs can only be effective for highly liquid stocks and solid equity stories with the right momentum

Behind the veil: Russian ECM as a business opportunity

Competition

The relatively low number of transactions and many participants make Russian ECM competitive, with more than 20 banks sometimes competing for fewer than 10 deals in a single year. Syndicates in Russian transactions remain relatively small, with 60% of Russian ECM transactions generally being closed with syndicates of between one and four banks, and more than 80% being closed by syndicates of no more than five banks. We see no strong link between deal size and the number of banks in a syndicate (at least for transactions under US$1.0bn).

We also see no evidence that syndicate size or composition significantly influence a deal's pricing or likelihood to succeed or fail.

A typical syndicate for a Russian IPO consists of one or two international banks (if it is a US-listed deal, these are likely to be US banks), one or two Russian state banks (main issuer's lenders), and one or two boutiques to handle incremental demand for the transaction. In recent years, it has also become typical to have a retail-focused broker involved in the transaction.

More than 20 banks sometimes compete for fewer than 10 deals in a single year, making Russia's ECM highly competitive

The focus on Russia's ECM has declined since 2006–2010, when banks' cumulative proceeds totalled US$760mn. While international banks have been closing Moscow offices and cutting Russia-focused staff in London over the past five years, these banks, refocused on future sources of ECM fees such as Kazakhstan and Uzbekistan.

Who generates profit

Russian ECM can broadly be defined as a combination of the following:

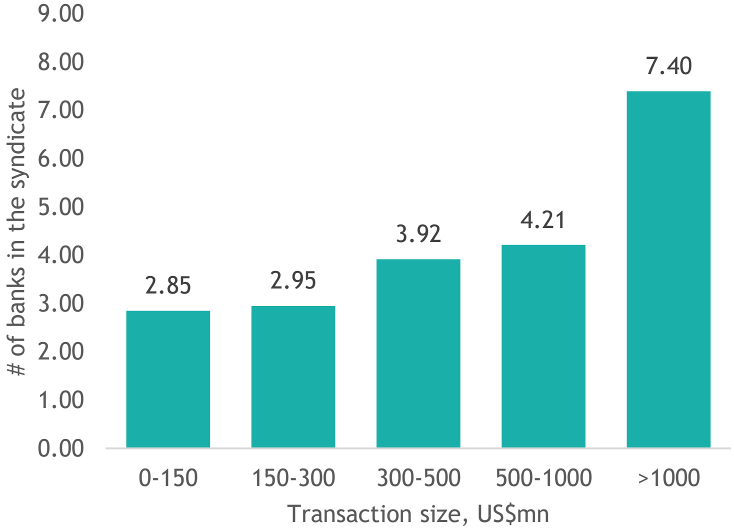
Blue chips. These are mature, highly liquid companies with long trading histories, and are well known among investors. They are typically from the metals & mining and TMT sectors. At least one will typically conduct an ABB each year, with success almost guaranteed. These transactions are conducted by the same relationship banks each time (specific banks for each company), and are practically immune to market shocks or volatility, thus creating stable cashflows for the few fortunate selected banks.

Wallflowers. These are Russian medium-sized companies, typically with solid equity stories. They have undergone the IPO preparation process with banks, but keep postponing their placements due to market volatility.

Steady middle. These are medium-sized public companies with moderate liquidity. They conduct follow-on offerings from time to time, hiring banks on rotation.

Last titans. The few remaining large private companies. They say that they plan to conduct Russia's last significant IPOs when they are ready. These issuers are highly developed corporates, and are ready for an IPO, but absent a pressing requirement for cash, they prefer to wait for an opportune moment to achieve the highest possible valuation.

Average number of banks in a Russian IPO



Based on deal data since 1996

Source: Dealogic, SOVA Capital

The future of Russian ECM market: From deals churn out to a tailored approach

The future of Russian ECM market:
Everything I've stated may prove to be total poppycock.... Perhaps time will tell. Perhaps time will do nothing of the kind.
DonDelillo

The last titans and the new Olympians.
When the last large Russian private companies – such as SIBUR – finally make it to the stock market, the era of IPOs of commodity titans will be over. But we do hope it will open the door for listings of a new breed of companies as the global economy emerges from the positive and negative outcome of the pandemic. The changes and trends that bulldozed their way into our lives as we all set in lockdowns are trickling to the public markets: retail participation (whether its Robinhood or Russian IC accounts on MOEX), ecommerce or anything e-consumer related (Ozon, Amazon's Deliveroo or DoorDash) and digitalization of all aspects of our lives has given momentum to a large number of new companies that will come to the market in the next few years.
The Russian ECM market, however, will also continue to flourish with larger deals being replaced by placements from small and mid-cap issuers. Small issuers will require a completely different approach to transaction execution. A thorough and deep investor education on the equity story, which might last much longer than currently expected, will be in order to close transactions successfully. This means that one should allocate valuable human resources for a long period to understand, develop, and communicate to investors the issuer's investment case – without anticipating multimillion dollar fees at the end. This is something that big banks just cannot afford. Hence, small and efficient institutional brokers with deep understanding of Russian markets and a broad western investor base will become the most popular underwriters for Russian companies in the coming years.
Alternative structures.
The Russian market is actually still in its infancy when it comes to equity instruments, perhaps due to a more conservative and sometime vanilla approach when it comes to finance. Convertibles or mandatory bonds (even though there are a few) have yet to gain popularity. But SPACs on the other hand, have gathered some attention amongst entrepreneurs. And COVID-19 has played a role in accelerating ESG transition and digital transformation, and many investors see this as a unique time of unparalleled opportunity. UK and Singaporean stock exchanges have significantly amended the listing rule to facilitate SPAC deals.
A long-standing and persistent challenge for IPOs is the determination of an issuers' fair price. The overheated IPO markets of 2020 resurrected two notable deal processes - auction style and the hybrid pricing approach when it comes to pricing. Although these structures are currently limited to the U.S., a global push for higher competition among exchanges means the Russian exchange and regulators will need to make adjustment to retain the competitiveness of the local market as not to lose issuers to the international markets again.
Gamification of trading by retail.
What is happening now is actually not different to 2000, when the lure of making easy money with tech stocks created almost a generation of day trading retail investors. In 2020, the combination of lockdowns, loss of jobs and low savings rates combined with trading apps and social media influence brought retails investors back to the game table. In the short term, Russian retail investors' involvement in the capital market will continue to increase, making them a valuable additional source of demand in ECM transactions. One could argue that a syndicate consisting of a strong retail broker and an institutional boutiques-like broker will perfectly suit future issuers from Russia. But if inflation proves not to be transitionary, interest rates will starts rising and market corrections will be imminent, then the dreams of retail investors will be shattered and the capital will shift from retail to professional money managers again.

Contacts

ALINA SYCHOVA
Head of Capital Markets Origination
T.: +7 (495) 223-2323 (11-8605)
alina.sychova@sovacapital.com

GEORGY LOLAEV, CFA
Associate
T.: +44 20 7826 8220
georgy.lolaev@sovacapital.com

Sova Capital combines its sales & trading and corporate-finance expertise to offer our clients a seamless service and sophisticated solutions for raising equity, equity-linked and debt financing

EQUITY FINANCING

- Originating, structuring and executing equity financing, such as IPOs and SPOs
- Equity buybacks
- Equity private placements

EQUITY-LINKED FINANCING

- Originating, structuring and executing equity-linked financing through convertible / exchangeable bond placements

DEBT FINANCING

- Originating, structuring and executing Eurobond financing
- Liability management

CORPORATE BROKING

- Developing market strategies for corporates to achieve high stock and bond liquidity
- Effective capital-structure management
- Assistance in developing comprehensive strategies for interacting with public capital markets