KEY POINTS
- With new US sanctions causing market disruption, 2018 saw some of the lowest levels ever of new issuances by Russian issuers.
- However, Russian issuers used the political and economic situation to get in on the global frenzy for buybacks.
- Key legal issues in 2018 included the application of the EU Market Abuse Regulation to buybacks and the use of "currency toggles" to mitigate sanctions risks.
- 2019, while having good potential, could be another difficult year for Russian capital markets if geopolitical tensions remain high.

Feature

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Buybacks or bust: Russian issuers make the most of a bad year

"Everything's fine, but we can't go on living like this" was how one politician in Russia somewhat perplexingly summarised the situation in his region in 2018. He could just as well have been describing the situation in the Russian capital markets. A flurry of buybacks kept overall market activity ticking over, but the year was characterised by a sanctions-induced dearth of new issuances, and buybacks alone cannot sustain a market. With the outlook for 2019 uncertain, an understanding of the key politico-economic and legal issues of 2018 will hold issuers and their lawyers in good stead.

2017 was a year of robust performance for the Russian capital markets. The year saw Russian corporates issue over US$20bn of eurobonds (PwC, January 2018) and US$6.5bn of equity, including US$2.8bn in IPOs (*Bloomberg*, December 2017). With reports of a promising deal pipeline (*Intellinews*, January 2018) and the Russian economy achieving a year of GDP growth for the first time since 2014, hopes were high going into 2018. Sadly, it was not to be…

2018 was an exceptionally poor year for the Russian capital markets. For the first time in a decade, there was not a single IPO of a Russian issuer on the Moscow Exchange, let alone on international venues (*Reuters*, November 2018). IPOs planned by petrochemicals company Sibur, meat processor Cherkizovo Group and pipemaker IPSCO Tubulars (part of TMK Group) all fell by the wayside in 2018, with many more unannounced equity transactions also shelved. Debt fared little better: while the likes of Rusal, Polyus and Gazprom were able to issue eurobonds in the early part of 2018, total corporate eurobond issuances for the year amounted to less than US$5bn (author's review of public filings, December 2018). Even without adjusting for inflation, this was the lowest corporate eurobond volume for at least 17 years! (RBS, November 2011; *Financial Times*, October 2012; PwC, January 2018)

Purchases by issuers of their own equity securities, ie buybacks, were the one bright spot in the markets. In 2018, Russian issuers announced buybacks with respect to over US$6.8bn worth of their equity securities (BCS, October 2018; author's research, December 2018).[1] The lion's share of this was attributable to two giants of the Russian oil industry: Lukoil announced and commenced a programme for the purchase up to US$3bn of its equity securities by the end of 2022, while Rosneft announced (but has not yet commenced) a programme for the purchase of up to US$2bn of its equity securities by the end of 2020. Other significant buyback transactions were launched by telecoms provider MTS and retailers Magnit and Lenta, which will purchase the equivalent of up to US$430m, US$320m and US$165m of their equities, respectively.

THE POLITICAL AND ECONOMIC DRIVERS

On 6 April 2018, in response to alleged aspects of Russian foreign policy, the US Treasury unexpectedly imposed comprehensive sanctions on seven high-profile Russian businessmen, together with companies controlled by them. Subject to the grant of licences, the sanctions prohibit all dealings with such persons that fall within US jurisdiction (which includes any involving a US citizen, a US resident, or an interbank transfer of US dollars). In addition, any person knowingly facilitating a "significant" transaction with a sanctioned person is at risk of itself becoming sanctioned, even where such transaction falls entirely outside US jurisdiction – the so-called "secondary sanctions" risk.

The effectiveness of sanctions and their net impact is much debated. Is it, however, safe to say that the April sanctions contributed to the creation of an uncertain business environment for new issuances. Previously, US sanctions against Russia had mostly targeted state-owned enterprises and government and military officials. By contrast, the new targets included privately owned international businesses, including the London-listed metals and energy group En+ and the systemically important aluminium producer Rusal. This change of tack challenged investors' understanding of the scope of US sanctions against Russia. As a result, many Russian issuers appear to have concluded that it would be prudent to give investors time to adjust before launching new transactions.

Simultaneously, other politico-economic factors were driving Russian issuers to conduct buybacks. The trend in fact extended far beyond Russia: US companies alone purchased over US$1trn of their own equities in 2018, compared to US$625bn in 2017 (*CNN*, December 2018). Worldwide, issuers with healthy cash flows but a reluctance to embark on long-term investment and expansion projects seem to have concluded that using buybacks to return value to investors, implement management incentive programmes or support their share price was the best use of cash reserves. It is, however, possible to discern factors supporting the popularity of buybacks in Russia specifically:

- First, market uncertainty made for cheap Russian equities. In press releases and remarks to journalists (*Interfax*, August 2018), Rosneft, Lenta and footwear retailer Obuv Rossii explained their respective buybacks by reference to undervaluation of their stock by the market. The message appears to be that these businesses are in good shape, but Russian equity valuations are being weighed down by temporary external factors. Uncertainty around sanctions, oil production cuts and the health of emerging markets in general may be considered important (but by no means the only) such factors. Issuers taking this view are therefore likely to have seen such uncertainty as creating an opportunity to buy back their stock (and thereby reduce their expensive equity financing) more cheaply than would normally be the case.

- Second, a "decoupling" of the rouble and the price of oil left Russian oil companies with surplus cash. Historically, the value of the rouble has been in nigh-perfect correlation with the price of oil. However, investors have an increasingly intense focus on geopolitical risks to the Russian economy (*RBK*, September 2018) and the Central Bank of Russia has from mid-2017 implemented a policy of selling roubles in the forex market whenever the price of oil is above US$40/bbl, so as to reduce the currency's volatility (*Bloomberg*, June 2018). These two factors resulted in the rouble-oil correlation breaking down almost completely in 2018, with the rouble barely reacting to fluctuations in the oil price. Russian oil companies were therefore well placed to reap increased US dollar revenues from the surge in oil prices lasting until October, without seeing their rouble-denominated expenses rise commensurately. Buybacks were one way of sharing the resulting windfall with equity-holders.

LEGAL AND PRACTICAL CONSIDERATIONS FOR RUSSIAN ISSUERS

The developments of 2018 have brought a number of legal issues to the fore:

- First, Global Depositary Receipts (GDR) issuers must comply with MAR (ie EU Market Abuse Regulation 596/2014) even when conducting buybacks wholly outside the EU. MAR applies not only with respect to financial instruments traded on an EU trading venue, but also with respect to financial instruments whose price affects the price of financial instruments traded on an EU trading venue. The price of a GDR is entirely dependent on the price of the shares that underlie it, and both GDRs and shares are financial instruments for the purposes of MAR. Counter-intuitively then, issuers with EU-listed GDRs are subject to MAR when conducting buybacks of the underlying shares, even when such shares trade on the Moscow Exchange and not on an EU venue. In the UK, failure to appreciate this could land the issuer with a public reprimand, unlimited fine or even mandatory delisting.
- Second, GDR issuers should conduct buybacks with due regard to the MAR safe harbour. Buybacks carry elevated market abuse risks given issuers' untrammelled access to inside information regarding their own businesses and their control over how and when to conduct buybacks. However, recognising that buybacks have legitimate purposes, MAR sets out disclosure, price and volume parameters within which buybacks are guaranteed not to constitute market abuse. Unfortunately, GDR issuers may not rely on this safe harbour; it is only available for buybacks of *shares* admitted to trading on an *EU regulated market*. GDR issuers should not dismiss the safe harbour entirely, however: it remains a legislatively enshrined statement of prudent practice and hewing close to it is likely to reduce issuers' MAR risk greatly.
- Third, some Russian market participants are increasingly unfamiliar with the requirements of international listings. In the halcyon days of 2006, the London Stock Exchange celebrated 19 Russian IPOs (PwC, September 2014); in the five-year period 2014-2019, it saw just three. The Russian corporate eurobond market has also declined, albeit less markedly. It is therefore reasonable to suppose that memories of the intricacies of international listings are fading among some of those playing important transaction support roles, such as industry experts and various service providers. This poses a risk to the efficiency of future transactions as such players play catch-up, or worse – reveal part-way through that they are unable or unwilling to carry out their role in line with the requirements of the listing process. Issuers and their lawyers should pre-empt this at kick-off by reminding each participant in the transaction of exactly what is required of them and, if possible, specifying the same in detail in their engagement letters.
- Fourth, currency toggles are potentially a useful tool for debt issuers, but not a cure-all. As noted above, the US Treasury generally considers transactions involving transfers of US dollars to be within its jurisdiction for sanctions purposes. Accordingly, the extension of sanctions to an issuer of US$-denominated eurobonds could prevent the issuer from fulfilling its obligation to pay principal and interest thereon, which is bad news for the bondholders hoping to get their money back, and potentially an event of default for the issuer. Currency toggles – clauses permitting the issuer to settle payments under the bonds in a pre-agreed alternative currency if sanctions are imposed – are an attempt see off this risk. Originally devised for loan financing, such clauses began to be adapted for eurobonds in 2018. Although untested, it is reasonable to think that well drafted currency toggles put in place before sanctions are imposed would be effective in removing the US dollar jurisdictional "hook". However, such clauses are unlikely to be a complete solution as it is likely at least one of the agents, correspondent banks or clearing systems involved in settling payments will be a US person (who is required to give effect to US sanctions) or a person that has regard to US sanctions as a matter of policy. In addition, payees may be wary of secondary sanctions where receiving a payment can be considered a "significant transaction" with a sanctioned person. Issuers should therefore discuss the legal limitations and marketing impact of currency toggles with their lawyers and investment bankers before considering any transaction making use of them.

Biog box
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LOOKING FORWARD TO 2019

2019 appears likely to have the macroeconomic potential to support capital markets transactions:

- First, 2019 is building on the relatively favourable economic situation in 2018. Russian GDP growth in 2018 appears to have increased by a moderate 1.6%, broadly in line with the 1.5% growth experienced in 2017 (OECD, November 2018); the average price of oil rose from US$54/bbl in 2017 to US$71/bbl in 2018 (World Bank and *Reuters*, December 2018); and the Russian economy ran a budget surplus in 2018 of nearly 3% – the first surplus since 2011 (*Financial Times*, December 2018; *Reuters*, May 2018). This means the Russian capital markets go into 2019 with a solid macroeconomic foundation.
- Second, economic conditions in 2019 are forecast to be benign. Russian GDP growth is predicted to remain moderate in 2019, with the economy growing 1.5% (OECD, November 2018); the price of oil is forecast to increase slightly to US$74/bbl (World Bank, October 2018); and the Ministry of Finance expects to run another budget surplus in 2019 – this time of 1.8% (*TASS*, November 2018).

That 2019 is shaping up to be a healthy year for the Russian economy is good news for the capital markets. However, as 2018 showed, clement economic conditions are far from sufficient to guarantee a good crop of transactions. If the geopolitical situation is as turbulent in 2019 as it was in 2018, it could significantly shape or hamper the development of the markets:

- First, eurobond issuers may increasingly seek to raise funds in currencies other than US dollars. As noted above, currency toggles are potentially one way of mitigating the sanctions risk associated with US$-denominated fundraising. Issuing bonds in a different currency in the first place is another. Gazprom's move to issue €1bn of eurobonds in late 2018, followed a day later by the issuance of a record-breaking US$200m worth of renminbi-denominated eurobonds by RusHydro (*Vedomosti*, November 2018) may signal that Russian issuers in 2019 will explore fundraising in a more diverse range of currencies.
- Second, Russian companies with international listings may repatriate themselves. At a time when maintaining an international listing is becoming increasingly difficult for Russian businesses, the Russian government has been supportive of them returning to the Motherland. For example, a law passed in summer 2018 establishes Russian offshore zones to which the foreign parent companies of internationally listed Russian businesses (among others) may re-domicile, thereby receiving favourable tax treatment and access to the Moscow Exchange. With En+ and Rusal having announced their intention to rely on the new law, 2019 could see more Russian companies return home.
- Third, Russian issuers may tire of the public markets altogether. The April sanctions showed that even being listed on a Western stock exchange does not put an issuer beyond the reach of sanctions. At the same time, since Russian issuers are currently paying the highest average dividends in the world (*Intellinews*, June 2018) and many are actively returning capital to their equity-holders through buybacks, it does not appear they are particularly in need of additional financing at this time. With public status being as costly and onerous as ever, 2019 could see more issuers re-evaluating their listing and following in the footsteps of telecoms operator Megafon, retailer Dixy and pharmaceuticals company OTC Pharm, each of which went private in 2018.
- Fourth, investors traditionally interested in Russia may seek opportunities elsewhere. At present, the choice of international investors targeting corporate securities in the former Soviet Union is largely limited to Russian and Kazakh issuers. There are, however, signs that the Belarusians and the Uzbeks intend to get involved. The attempt of retailer Eurotorg to conduct the first ever IPO of a Belarusian business on the London Stock Exchange in 2018 – while ultimately unsuccessful – shows that issuers from Russia's western neighbour may have good potential. As for Uzbekistan, it expects to issue its first sovereign eurobond in 2019, thereby establishing a pricing benchmark that will allow Uzbek corporates to enter the eurobond market too. If issuers from such countries can convince investors that they have lower geopolitical risks, Russian issuers could face stiff competition.

The announcement by the US Treasury in late 2018 of its intention (effective January 2019) to lift sanctions on En+ and Rusal is likely to be a shot in the arm for market sentiment going into 2019. However, what happens in 2019 may ultimately come down to timing. The economic stage seems set and Russian issuers are waiting eagerly in the wings. The question is whether the geopolitical storm clouds will hold off long enough for the show to go on, and whether the audience will stick around to find out! ■

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1 Excludes Megafon's tender offer for up to US$1.26bn of its own equities, which was a precursor to its delisting from the London and Moscow exchanges, not a conventional buyback.

Further Reading:

- The scramble for shares: the return of Russian equity deals (2018) 2 JIBFL 104.
- The dash for debt: Russian issuers return to the market (2017) 2 JIBFL 82.
- LexisPSL Banking and Finance Practice Note: The effect of sanctions on loan agreements.