



## Private Equity in Russia and the CIS

October 2006



### The case for investing...

As a private equity manager, our clients come to EPEG with the knowledge that an investment in Eurasian Private Equity Group is a commitment to maximize yield and minimize worry. Dr. Igor Kostikov, Russia's "most famous fund markets figure of the last several years" (*Business Magazine*, 20 April 06) has created a unique opportunity for Western investors. With EPEG, feel secure your investment team has an unequalled level of expertise in the markets of Russia and the Commonwealth of Independent States.

There has been much discussion about where the development of Russian capitalism and its financial markets is headed. From the financial difficulties of 1998, the Russian economy has rebounded strongly and has been a leading developing market performer over the last five years. GNP growth has returned a muscular 7% (annualized) over the last six years while the current Russian administration has made doubling GNP over the next decade a central plank. The economic outlook is bright with continued pricing strength of the natural resources sector providing windfall receipts to the country's tax coffers. While the future is impossible to predict, the continuing quick pace of reforms, the judicious use of the country's 'petro dollars' to pay down debt and fill a reserve fund and the focus on fighting inflation are all foundations for Russia to outperform over the short-to-mid term.

### Exceptional Opportunities in:

- Middle Market Expansion Stage Majority Equity Investments
- Small Company Share Consolidation
- Government Privatizations
- Selected Real Estate Opportunities
  - Amalgamation for securitization
  - Unique development projects
  - Renovations for sale or lease

Realize superior returns, capital appreciation, attractive capitalization rates and portfolio diversification in one of the world's top emerging markets.

With the continuing economic development in mind, only in the last few years have we seen a noticeable level of M&A activity. Securitization of Russian companies has also lagged with only the largest having undertaken public listings. Investors desiring exposure to Russia and its recent history of high yields have generally been forced to choose from a handful of large mutual funds investing in the few liquid stocks of the Russian stock exchange. With its paucity of issues, 'blue chip' companies, and liquidity, these funds have experienced a tremendous amount of volatility. Political market drivers often alter the risk correlations between an investor's Russian and other holdings, diminishing the benefits of inverse risk correlation and diversification.

The EPEG Small Company Buyout Fund aims to give Western investors an opportunity to realize high returns while lowering the volatility and risk of investing in Russia. By realizing investments in privately held growth companies, former Soviet companies and selected real estate opportunities, EPEG invests in real assets where it can add value through a disciplined approach.

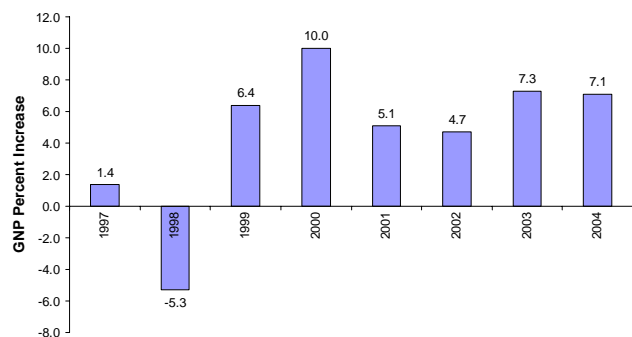
The EPEG Small Company Buyout Fund is a unique opportunity for foreign investors to invest in the most dynamic aspects of the small company buyout and property markets of the former states of the Soviet Union. By focusing on arbitrage opportunities that benefit from additional profit centers through reorganizing and rehabilitating the acquired assets, EPEG endeavors to offer greater returns than competing global property securities, developing market hedge funds and buyout funds. Greater returns with lowered risk by focusing on real assets; adding real value by improving transparency, management and profitability; trust and security, our commitment to you.

### ...in Russia.

Russia has been one of the fastest growing developing economies over the last five years. According to the Center of Macroeconomic Analysis and Short-term Forecasting, over the next four years Russia will attract \$83 billion in direct foreign investment. This volume is roughly double the previous 11 years combined. The financial troubles of 1998/1999 have given way to investment grade sovereign debt ratings; national debt has decreased significantly due to the judicious use of windfall tax income from strong natural resource prices and gross national product has grown at a favorable rate.

Russia is becoming a destination of choice for large multinationals, investment banks, developers, and investment funds. No other country shares borders with the European Union, United States and China. Russia's advantageous geography, highly skilled, low cost labor force and immense natural resource wealth has it poised to continue as a leading investment destination over the next several years.

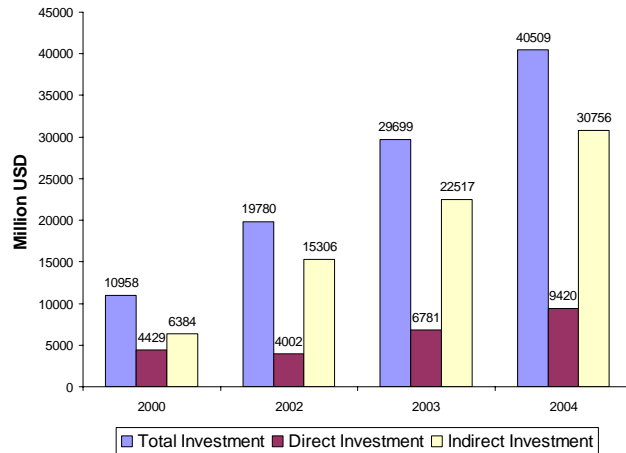
Russian Economic Growth



Large foreign investors have created a history of successful investments with high yields and attractive total returns. However, the investment market has not seen a corresponding level of small and mid-sized investors. We believe that the small and mid-market is significantly underserved due to a weak mortgage and loan sector, lack of middle class and small investors and the limited implementation of Western business practices. The result is a unique opportunity for Western investors to take part in obtaining, developing and

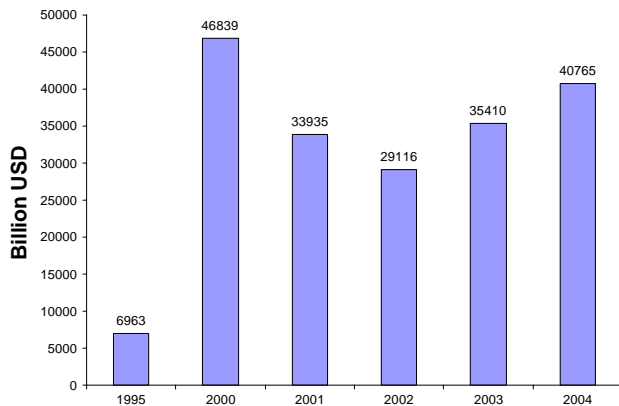
securitizing small companies and properties that are significantly undervalued.

### Investment in Russia



The creation of an emerging markets private equity fund in Russia focused on small and mid-cap assets is a relatively new opportunity. From a strategic perspective, the EPEG Small Company Buyout Fund can give investors access to a greater variety of investment opportunities than are normally available. It offers greater portfolio diversification and enhances your ability to add value over the long term.

### Balance of Payments, Russia

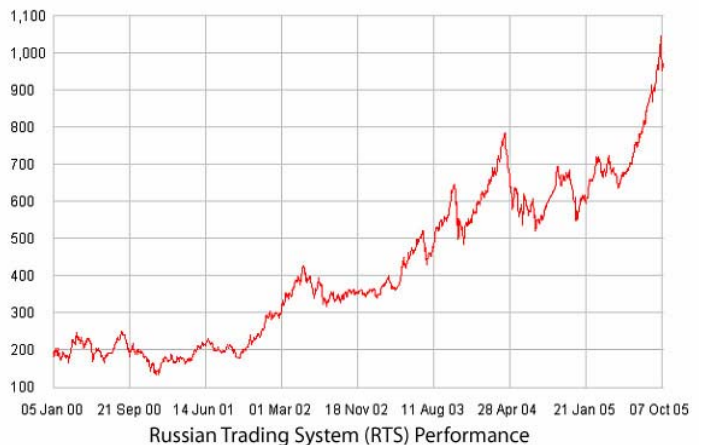


We believe that the macro-economic situation will continue its steady improvement. Recent events, such as the YUKOS affair, are serious, but must also be viewed in the proper context. We believe such events are irregular and of a personal nature and are unlikely to impact the prospects of small- and medium-sized investments.



...in a wealth of resources.

The Russian equity market is highly attractively valued using common valuation methods, such as price to earnings. Growth in earnings is strong for several sectors and companies. Assets on the balance sheets or employed by Russian companies are, on the whole, attractively valued relative to global peers. Significant growth kept track with gains in share prices in 2004 while earnings multiples have held steady.



Russia is not only the world's largest country, but the world's largest exporter of natural resources. The combination of often easy to access natural resources and cheap, cost-effective energy puts Russia in a competitive position in several fields. Its continuing political and economic development will allow it to leverage:

- the world's largest natural gas & oil reserves, and second largest coal reserves;
- its potential Arctic oil reserves (100 billion barrels) and new oil deposits between the Volga and Ural Rivers, referred to as the "Second Baku";
- the world's largest water reserves in lakes;
- the world's largest diamond deposits, gold reserves, second largest potassium reserves and fifth largest lead reserves;
- 27% of the world's reserves of iron and tin ores; over 40% of the platinum group minerals and 35% of nickel reserves;

- forest resources larger than America's mainland comprising 25% of the world's forests, over one third of the world's timber and including tremendous animal resources;
- enormous fish reserves off its coasts, including salmon, cod and herring;
- 20% of the world's fresh water resources

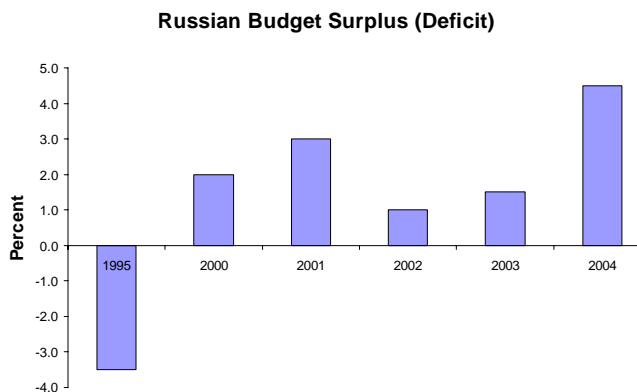
Other mineral reserves include uranium, asbestos, platinum, rhodium, palladium, copper, bauxite, vanadium, zinc, sulfur, tungsten, cobalt, and other precious gems.

Source: Ministry of Natural Resources of the Russian Federation official web site <http://ministr.mnr.gov.ru>.



### ...in a strengthening economy.

Russia enjoys one of the strongest macroeconomic positions in the world today, as measured by GDP growth, current account surplus, budget surplus, debt to GDP and international reserves. In addition, the interest rate has come down significantly and with negative real interest rates, investments are spreading from the export sector to the domestic sector.



Russia has moved towards political stability and boasts a quick pace of structural reforms. Corporate restructuring is starting to show significant results, with annual productivity gains of around 10 percent in many companies. The strong macroeconomic situation with lower interest rates will further improve the investment climate. With the continuing success of foreign investors in the market as a backdrop, we believe many mainstream global investors have tended to an exaggerated risk perception. This has been one reason

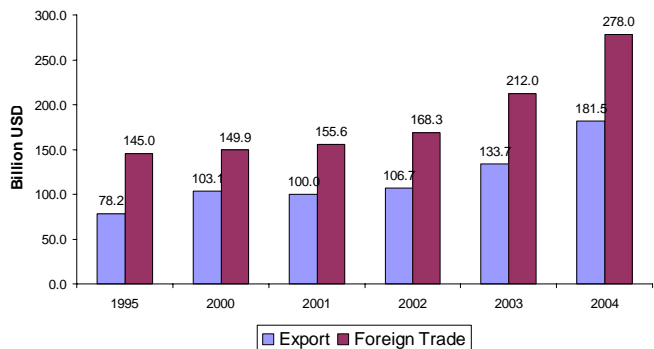
why the implicit risk premium on Russian assets including equities has been set so high. This premium should gradually decline as the economic and political system develops.



### ...in the strength to grow.

The Soviet Union produced several very large companies within various fields, often in the form of ministries for different industries such as natural gas, oil and precious metals production. Following privatization the number of large companies grew strongly as a result of split ups of Soviet monoliths. Even if most of these companies remained ineffective for many years, and still are in many cases, it has provided Russia with a large existing industrial base. Several of the largest 15 oil companies in the world are Russian. The largest natural gas company is Russian. Within nickel/copper and aluminum Russia has some of the largest companies in the world. In terms of output, its utility companies are often large on a global scale.

Russian Exports & Foreign Trade, 2000-2004



With an expected WTO entrance upcoming, Russia should be able to expand exports of particularly energy intensive goods to key growth markets such as China. The Soviet Union had an excellent educational system, particularly within the field of natural sciences. The economic hardship that the country underwent particularly in the 1990's has had a detrimental effect but it remains that Russia has an extremely high literacy rate and the percentage of the population with a higher degree is also very high in an international, and particularly emerging market, context. Wage costs are

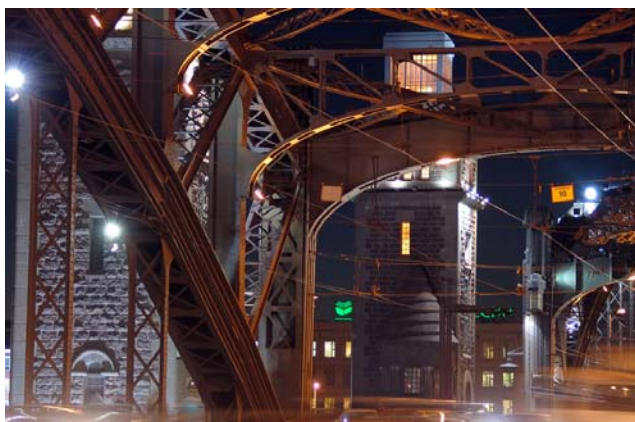
extremely competitive with the developed market, especially in a technically skilled context.



### ...for diversification.

The Russian market has historically had very low correlations with international equity and debt markets, as well as with oil prices. The latter is mainly due to the fact that the Russian market is to a large extent controlled by Russian interests and mostly driven by internal issues, rather than the international markets. Recent trends into offshore and international investment vehicles have made it easier to add higher levels of debt to emerging market properties with inadequate domestic banking facilities. The influx of foreign lenders has accelerated the broadening of choices for leveraging and securitizing properties in Russia and the former Soviet states.

The market for listed real estate is well established in mature economies yet the pace of creating holdings and securitizing them in the form of an investment trust, listed property management group or with more eclectic methods such as mortgage or asset backed securities has not developed in Russia and the countries of the former Soviet Union.



### ...in small company buyouts.

While investing in small growth companies is not a new strategy, it is largely unapplied in Russia and the former Soviet states.

Today, buyout firms seek to acquire large, established companies with stable cash flows, enabling them to raise sufficient debt financing to help generate their targeted investment returns. The larger the company and the more stable the cash flows, the better. The buyout world's increasing appetite for larger deals is evidenced by the dramatic growth in \$1 billion plus size funds. According to *Venture Economics*, 205 buyout funds with commitments in excess of \$1 billion were raised from 1997 to 2003.

From 1999 to 2003, active buyout funds raised an average of \$540 million per fund. This translates into minimum investment sizes of \$20 million to \$50 million in order to deploy the fund's capital efficiently, which equates to companies with revenues of at least \$50 million, and generally greater than \$100 million. By comparison, private equity transactions focused on "small market" companies, defined as those generating revenues less than \$50 million, typically require equity of only \$2 million to \$10 million.

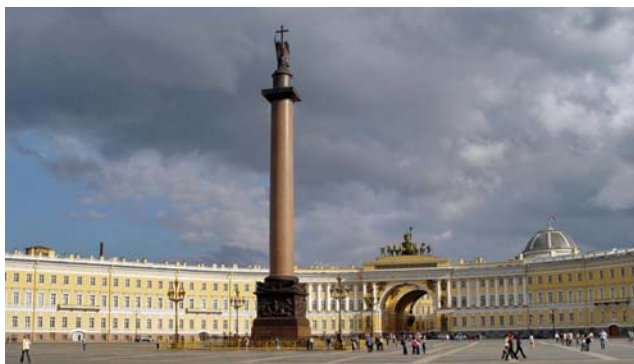
While this evolution in private equity bodes well for developed markets, promising technology start-ups, and larger companies with revenues of at least \$50 million, it does not fit with the most promising investment areas in Russia. Smaller, growth-stage companies and companies privatized with the fall of the Soviet Union, with revenues below \$50 million are tremendous opportunities. To compare, take as an example the US market. In 2004 there were 220,000 businesses in the US with revenues between \$5 million and \$50 million, and only 26,000 businesses with revenue greater than \$50 million. The lack of attention paid by the private equity world to this large segment results in less capital and operating expertise being available to guide these companies while in Russia, these companies are those most in need of expertise and working capital.

In Russia, as in the US, small market companies derive far greater benefits from active operating guidance than their larger peers, which can lead to higher financial returns to investors. The paradox is that while small non-tech companies are generally ignored by most of the private equity world, investments in this segment consistently outperform other private equity classes by a wide margin. The proof is irrefutable. Based upon a report published by *The Hewitt Investment Group*, deals in the small segment of the US buyout market returned approximately 25% annually to their investors over a 20 year horizon. These consistently high returns compare very favorably to the 15% returns earned in venture capital, and are double the returns of the buyout industry taken as a whole (approximately 12%) over the same period. Our experience in Russia has brought a significant premium as one would expect when opportunities to add value are so much greater.

Small companies have greater growth prospects than their larger peers, and significant opportunities to benefit from the operating leverage created by spreading their fixed costs over an expanding revenue base. These companies also receive a significant increase in the

valuation multiples applied to their operating profits as they become larger and more sustainable.

Small company investments also require a lot of work. Many would argue that these investments require as much time to manage – if not more – than larger deals. We here at Eurasian Private Equity Group agree; it is precisely this required commitment to add value and improve operating standards in Russia that fuels our passion for this segment of the private equity market.



### ...with Eurasian Private Equity Group.

Eurasian Private Equity focuses on these types of companies where our hands-on application of Western management principles, best practices and funding can add significant value. Augmenting the experience of EPEG is a team of advisors and service providers significantly deepening the management bench. These advisors are experienced in managing and successfully reorganizing struggling companies in Russia. Collectively, this pool of talent addresses the myriad operating issues confronting a growing business. Areas of expertise include organizational structure, business development, operating efficiency, corporate finance, expansion plan implementation, and strategic acquisition integration, to name a few.

As large foreign and domestic investors and financial institutions focus on the largest deals, EPEG's niche market affords plenty of opportunity for high return, managed risk investments. Eurasian Private Equity Group is looking to fill this void by focusing solely on opportunities to pick up undervalued assets coupled with a business that only requires capital and guidance to grow significantly. While investing in these situations carries with it a significant amount of risk, the financial return dynamics are compelling.

The key ingredient in Eurasian Private Equity Group's ability to ensure the success of its portfolio companies is our investment team. Dr. Kostikov brings one of the preeminent investment resumes in Russia to bear on the performance of the Fund. Formerly the chief regulator of the Russian financial markets, he holds exceptional insight into the opportunities and pitfalls of this exciting market. Our advisors, playing an integral part in the company, bring a history of results spanning the entirety of Russia's market transition.



### ...in the Future.

The private equity industry has been a valuable contributor to the success and prosperity of developed economies. Its relative absence in promising markets such as Russia and its insistence on scale to produce returns needs to be rethought. Simply entering Russia with deep pockets and a desire to invest is not enough. The prevalence of investors already focused on the biggest deals and the need to 'live your market' has limited the success of the largest private equity firms in Russia and it's near abroad.

Eurasian Private Equity Group is positioned to generate exceptional returns for its investors, and to add tremendous value to small market businesses that are starved for capital and strategic guidance. This market has consistently outperformed other sectors of the private equity industry, and Eurasian Private Equity Group believes that the combination of its investing acumen and operating expertise stations the firm to be the industry leader in its niche.

**Eurasian Private Equity Group's approach to private equity investing is not revolutionary - it is simply a compelling case to invest.**

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