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M&A Attractiveness Index 2017:
Focus on Russia

Russia: count the roubles not the politics
M&A Research Centre – MARC

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MARC – Mergers & Acquisitions Research Centre

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September 2017

Overview

*A*n invasion of the Crimea, interference in the Ukraine, a large list of companies blacklisted overseas, concerns over the openness of the next election and accusations of interference in the US presidential election. Not a good time to invest in Russia then. But Russia is a country of vast natural resources, is the world's largest nation by geographic site, has a large population (144 million) and has one of the cheapest stock markets in the world (trading on just 7x historic earnings). So, do the latter attractions outweigh the opening issues?

This report investigates the relationship between changes in political risk levels and the long-term success of cross-border acquisitions in Russia.

First, by focusing on Russia specifically, it fills a geographic gap in current political risk and FDI research, which has mainly focused on emerging countries as a group or on developed economies. Second, this study aims to examine the influence of a wide array of political variables on M&A performance in Russia, rather than the impact of the single political risk factor.

Our analysis includes twelve independent political risk variables from the International Country Risk Guide (ICRG) for the period 1998-2016 and five control variables, accounting for firm and sector-specific characteristics and changes in economic and financial risk. For comparison, the analysis was conducted with time frames of both one and two years before and after acquisitions.

Just one of the eleven political risks has an impact in each time frame

Our most significant finding is that of the eleven political risks tested only external conflict (in the medium-term model) and corruption (in the long-term model) have an impact. Also noteworthy is the lack of impact of financial risk. Predictably economic risk does have an impact, but not in the long-term model.

Some surprising results

Findings showed that an improvement in economic risk ratings is negatively associated with performance for companies whose ROA grew after the acquisition, and positively for those whose ROA decreased. The former could be safer, 'high quality' deals which don't need the tailwind of an economic boost, the latter 'strategic deals' expressly carried out for that tailwind. Improvement in external conflict risk ratings was positively associated with performance for companies whose ROA has increased after the acquisition, and negatively for those whose ROA.

The second model, considering ROA changes two years before and after the acquisition, showed corruption as the only significant political risk variable. An improvement in corruption risk ratings was negatively associated with performance for companies whose ROA increased after the acquisition, and positively for those whose ROA decreased. This suggests that the former type of 'successful' companies benefits from a less transparent context and may apply nonmarket strategies to improve performance, while the latter type sees corruption as detrimental to post-acquisition success and are looking for a long-term corruption decrease to be an element contributing to the business turnaround.

The insignificant predictive values obtained with the models in this report's analysis suggest that rather than being major determinants of M&A success in Russia, political variables act as moderators between strategic motives and post-acquisition integration, and performance. The larger responsibility for success seems to remain with the acquirers themselves and their post-acquisition integration strategy.

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Background

While Russia's current president has at times been known to express a strong commitment to international cooperation and growth, spreading specks of hope for international investors, the jury is still out on whether the country's situation has seen any actual improvement in recent years. Russia's political instability, both internal and external, has long been perceived as a considerable investment deterrent. Nevertheless, the PRS Group who publish the ICRG found that Russia's country risk has improved from "Low" in 2011 to "Moderate" in 2017. However, the OECD's latest Russian survey (2014) puts Russia behind OECD and BRICS peers in terms of corruption perception, even though its overall score has improved since 2010.

Perhaps more worryingly, Russia scores much worse than fellow countries in terms of the rule of law and the independence of the judiciary system, and exhibits a particularly poor governance quality, which is highly detrimental to the business climate. This perhaps explains why Russia ranks 34th in the 2017 M&A Attractiveness Index published by the M&A Research Centre at Cass Business School[1]. It has, however, risen five places in the past five years.

State ownership in the economy remains unusually significant compared to other OECD and BRIC countries, and, even though an ambitious plan to privatize around 1,500 companies was adopted in 2010, most of it has been held off due to unfavourable market conditions. Agency problems are therefore widespread and are seen by some as the driving force behind the negative performance of acquisitions in Russia (Bertrand and Betschinger, 2012[2]). While this is unlikely to change overnight, some encouraging trends should be noted. In fact, the World Bank's

2017[3] study on the ease of doing business ranked the Russian Federation 40th, up from 120th in 2012, even as Mr Putin has emphasised his commitment to driving the country to 20th place by 2020.

Political risk and M&A – current views

The relationship between political risk on M&A activity remains ambiguous and three main conclusions emerge:

Numerous studies have confirmed the positive impact of political stability, well-established institutions and governance efficiency on corporate investment decisions and post-deal outcomes. Political risk was found to decrease the acquirer's profitability potential by increasing M&A costs, such as permits and government approvals (Bertrand and Betschinger, 2012), while discouraging further deals due to underlying high uncertainty and corruption (Dikova et al., 2016[4]). Companies entering a foreign market via M&A sometimes face strong political opposition, especially in strategic sectors. This was illustrated by the strong political opposition to M&A seen by Chinese firms in the US.

Conversely, Hur et al. (2011)[5] have considered cross-border acquisitions in developing countries and concluded that, while control of corruption and government effectiveness had a limited positive effect on M&A inflows, political stability did not exhibit a significant relationship with M&A levels. In addition, other studies found that changes in political stability in developing countries had no influence over FDI surges or falls.

Finally, some studies outlined positive effects of an increase in political risk on M&A. By increasing their political contributions before

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[1] M&A Attractiveness Index 2017, M&A Research Centre Working Paper Series, February 2018.
[2] Bertrand, O. and Betschinger, M., Journal of Comparative Economics, 2012

[3] World Bank, 'Doing business 2017: Equal Opportunity for All', World Bank, 2017
0948-4
[4] Dikova, D. et al, International Journal of Emerging Markets, 2016
[5] Hur, J., Parinduri, R.A. and Riyanto, Y.E., Pacific Economic Review, 2011

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and after the merger or acquisition, companies have been able to better mitigate M&A regulatory risks. Studies on the energy sector concluded that companies used nonmarket strategies in the form of contributions to political campaigns to protect M&A generated rents from dissipation by regulators. In the same vein, (Chen and Xu, 2014[7]) considered M&A in China and found that democratization deters Chinese investment, as it infers higher levels of "industry protection and greater power of trade unions", which constitutes an institutional risk for Chinese firms.

While the impact of political risk factors is clearly particularly relevant for Russia and is often perceived as one of the key barriers to foreign investment in the country, studies on the subject remain divided. An understanding of the Russian risk landscape would help foreign companies protect their interests by hedging against the appropriate risks. Although many studies have focused on the impact of cultural and political factors on the likelihood of observing M&A activity in a given country, few have considered the impact of these variables on M&A performance. Note that the pattern of M&A acquisitions by year in our Russian sample is similar to that of most countries, showing typical procyclicality (see Figure 1 below).

Figure 1: Russian acquisitions in our sample by year
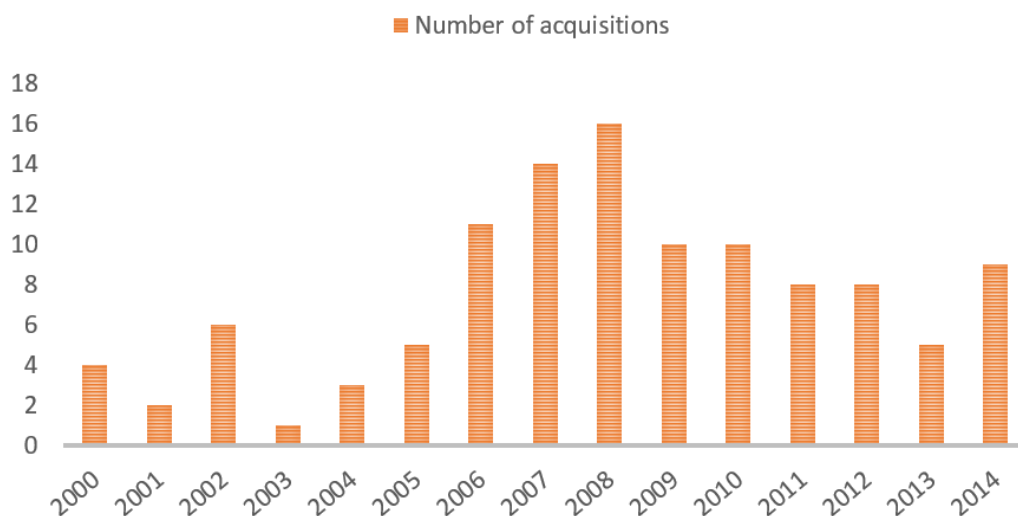
Source: Cass Business School

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[7] Chen, F. and Xu, Y., Quality and Quantity, 2014

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Our findings

In the Appendix you can see the details behind our final sample of 112 cross-border acquisitions which had an effective / unconditional date between 01/01/1998 and 01/01/2015. The geographic range of the acquirers is broad as can be seen in Figure 2 at the end of this section, with no one country representing more than 11% of the deals.

The results of the regression analysis are shown in Figure 3 at the end of this section. The clearest finding is that of the eleven political risks tested only external conflict (in the medium-term model) and corruption (in the long-term model) have an impact. Also noteworthy is the lack of impact of financial risk. Predictably economic risk does have an impact, but not in the long-term model. As you can see in Figure 3 the other potential drivers we tested for did not have a significant impact.

The directional results obtained offered interesting insights, but were interpreted with caution given the transformation performed on ROA. As the squaring of the ROA change removed straightforward indications of the directionality of the change, results were interpreted considering two scenarios for each model (Figure 4 at the end of this section):

-   ROA change was positive
-   ROA change was negative

Taking the drivers in turn:

Economic risk as a performance driver?

The PRS Group includes the following components in its economic risk rating:

-   GDP per head
-   Real GDP growth
-   Annual inflation rate
-   Budget balance as a percentage of GDP
-   Current account as a percentage of GDP

When ΔROA (t+/-1) < 0, better economic conditions were associated with enhanced (a smaller fall) post-acquisition performance. For companies whose ROA decreased after the acquisition, this could be interpreted as a difficult / strategic deal that in the short term may struggle but is an intended beneficiary of Russian economic improvement.

When ΔROA (t+/-1) > 0, the relationship between ROA change and economic risk improvement was an inverse one. Findings suggesting that for firms that have seen an increase in ROA after the acquisition, a decrease in economic risk was associated with a decrease in ROA change may seem counterintuitive. However, these could be safer, 'high quality' deals which don't need the tail wind of an economic boost.

For all values of ΔROA, it is particularly interesting that economic risk was only significant in the medium term. As numerous acquisitions in Russia are carried out for restructuring purposes, this phenomenon may be explained by the fact that the acquirer is likely to take advantage of M&A to reshuffle assets to his advantage in the first year after the acquisition (Bertrand and Betschinger). This is also in line with Quer et al. (2011)[9] and Bunyaratavej and Hahn (2007)[10], who have found Chinese investors to be eager to invest in high-risk countries to buy an asset cheaply, while gaining a first-mover advantage. After the first year, however, the acquirer would have reshuffled assets and taken steps to hedge against economic risk exposure, which would therefore have a weaker impact on ROA performance change.

External conflict: a recipe for failure?

The PRS Group includes several subcomponents in its external conflict category:

-   War
-   Cross-border conflict

[9] Quer, D., Claver, E. and Rienda, L., Asia Pacific Journal of Management, 2011
[10] Bunyaratavej, K. and Hahn, E.D., AIB 2007 Annual Meeting, 2007

- Foreign pressures (diplomatic pressures, trade restrictions, sanctions, territorial disputes, etc.)

For ΔROA (t+/-1) > 0, the magnitude of positive ROA change after the acquisition increased as external conflict ratings improve, suggesting a positive association with performance. These findings are consistent with existing literature. Given Russia's recent history of cross-border conflicts, including Ukraine and Georgia, as well as subsequent international pressures, including sanctions and trade bans, such results are to be expected.

For ΔROA (t+/-1) < 0, it is harder to offer an explanation as to why an increase in external conflict risk ratings would be associated with a negative impact on post-acquisition performance change. Perhaps the increased FDI is drawn to businesses with a clearer path to improved performance?

For all values of ΔROA (t+/-1), it is interesting to note that external conflict ratings are only significant in the medium term, but not in the long term. This could partly be explained by the fact that recent conflicts involving Russia, with the notable exception of the Syrian operations, have been relatively short-lived. Companies would therefore only need to deal with the initial shock of the conflict, which would most likely subside within a one-year time frame. After that, firms' hedging strategies would allow the mitigation of risks posed by subsequent sanctions. As such events have been reasonably frequent in Russia in recent years, it is most likely that companies would have such strategies in place, which would explain why acquirers would be less exposed to external conflict risks in the long term.

Corruption in the long term: friend or foe?

For ΔROA (t+/-2) < 0, findings showed that an improvement in corruption ratings was associated with a more favourable change in ROA for companies that have seen a decrease in their ROA after the acquisition (i.e., a smaller fall). This is consistent with studies that found corruption to be detrimental to the business environment and FDI inflows.

Interestingly, for ΔROA (t+/-2) > 0, the findings were consistent with Helmy's (2013)[11] "helping hand" theory of corruption. This would suggest that companies which have seen an improvement in their ROA after the acquisition tend to benefit from lower degrees of transparency. Quer et al. suggested that higher levels of political risk did not discourage Chinese investors, who were more likely to perceive it as an opportunity.

Investors may prefer an environment where they can impact governmental decision-making (Elfakhani and Mackie, 2015[12]). They may resort to strategies such as those outlined by Holburn and Vanden Bergh (2014)[13], increasing political contributions around the time of specific M&A or on a per-need basis. In addition, O'Donnell (1988)[14] pointed out that foreign investors and autocrats may often share a privileged relationship, as autocrats shield foreign capital to reap the overall economic benefits of FDI. Adding to this, other studies found that FDI inflows could be lower in more transparent regions, as corruption allows multinational companies to enjoy certain advantages.

Finally, returning to the overall study, the regressions' coefficients suggested that the variance in ROA attributable to corruption is much greater than that attributable to economic or external conflict risks, which highlights the potential importance of this factor in the M&A process.

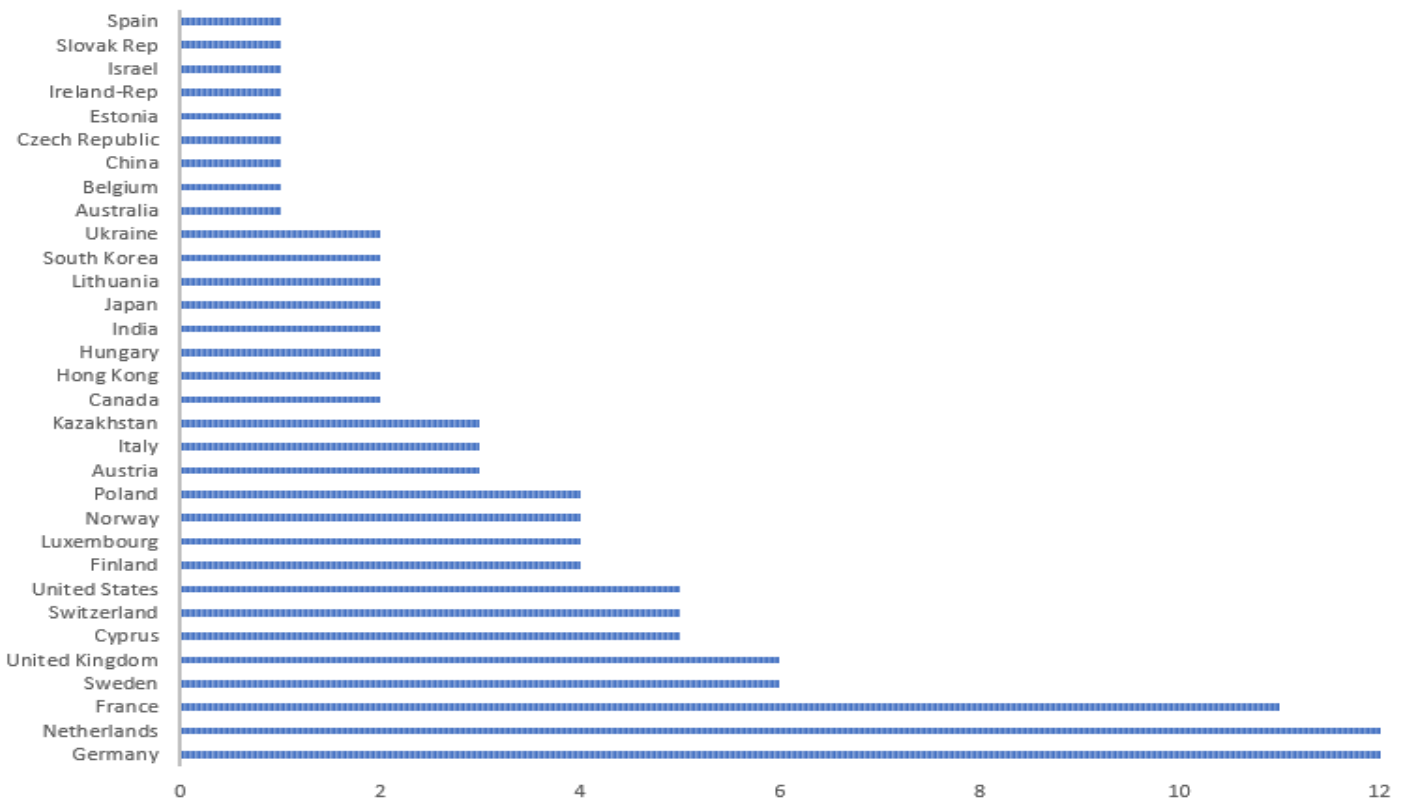[11] Helmy, H.E., International Review of Applied Economics, 2013
[12] Elfakhani, S. and Mackie, W., Competitiveness Review, 2015
[13] Holburn, G.L.F. and Vanden Burgh, R.G., Strategic Management Journal, 2014
[14] O'Donnell, G., Quality and Quantity, 1988

Figure 2: Home country of acquirers in our sample

Source: Cass Business School

Figure 3: Results of regression analysis

Model 1 is the analysis measuring from one year prior to acquisition to one year after, while Model 2 is the analysis measuring from two years prior to acquisition to two years after.

	Model	1	Model	2	
	Beta	t-value	Beta	t-value	Status*
Acquirer sector	-.092	-.924	.117	1.139	Excluded
Same industry acq./target	-.086	-0.862	-.091	-.860	Excluded
Europe	.131	1.323	-.077	-.751	Excluded
Asia Pacific	-.085	-.857	.123	1.216	Excluded
Economic risk	-.454	-3.609**	.010	.095	Included - 1
Financial risk	.188	.979	-.032	-.289	Excluded
Government stability	.087	.493	.177	1.735	Excluded
Socioeconomic conditions	-.063	-.530	.109	0.943	Excluded
Investment profile	.032	.320	.081	.764	Excluded
Internal conflict	.063	.603	-.047	-.446	Excluded
External conflict	.260	2.066**	-.150	-1.481	Included - 1
Corruption	-.093	-.939	-.262	-2.575**	Included - 2
Military in politics	-.062	-.624	.157	1.195	Excluded
Religious tensions	-.100	-1.006	-.024	-.096	Excluded
Law and order	-.097	-.979	.136	.907	Excluded
Ethnic tensions	-.088	-.876	-.074	-.338	Excluded
Democratic accountability	.059	.567	.035	.341	Excluded

Source: Cass Business School

* Indicates whether the variable was significant, warranting inclusion in either Model 1 or Model 2.
** Significance at 5% level

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Figure 4: Result interpretation summary

Model	ROA	Independent Variables	Impact on performance	Interpretation
M1 *At* *t-/+1*	If ΔROA < 0	Better Eco conditions	Decrease ROA^2 Better performance	The negative value of ROA becomes smaller, indicating an improved performance.
		Increase Ext Conflict rating	Increase ROA^2 Poorer performance	The negative value of ROA becomes larger, indicating a poorer performance.
At *t-/+1*	If ΔROA > 0	Better Eco conditions	Decrease ROA^2 Poorer performance	The positive value of ROA becomes smaller, indicating a poorer performance.
		Increase Ext Conflict rating	Increase ROA^2 Better performance	The positive value of ROA becomes larger, indicating an improved performance.
M2 *At* *t-/+2*	If ΔROA <0	Increase Corr. score	Decrease ROA^2 Better performance	The negative value of ROA becomes smaller, indicating an improved performance.
At *t-/+2*	If ΔROA > 0	Increase Corr. score	Decrease ROA^2 Poorer performance	The positive value of ROA becomes smaller, indicating poorer performance.

Source: Cass Business School

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Conclusions and recommendations

Except for medium-term economic risk, all control variables used were found to be insignificant. A plausible explanation for this is the fact that the success of acquisitions is rather due to a proper implementation of post-acquisition strategies and a successful navigation through the integration phase (as per Hopkins, 2008[15]), rather than country, firm or sector characteristics. In addition, the insignificance of financial risk is in line with findings by Hayakawa et al. (2012)[16].

These findings were generally consistent with research from Burger and Ianchovichina (2017)[17], who did not find any relationship between political variables and M&A likelihood, even though this does contradict the widely accepted belief that the success of an acquisition in Russia is contingent on political risk factors.

Equally, Elfakhani and Mackie (2015) did not find political factors to be significant determinants of Russian FDI inflows.

This paper has implications for investors considering an expansion into Russia. While awareness of host country risk levels is important, these risks seem to play a secondary role in post-acquisition success. This would suggest that acquirers would obtain better results by practicing a coherent acquisition and integration strategy, rather than being overly focused on political risks. As such, some companies, arguably those already successful in their post-acquisition results that saw their ROA grow, could even benefit from the opportunities presented by political and economic risks by adapting their market and nonmarket strategies accordingly, thus driving their performance (again see Hopkins).

Research limitations

This research is not without its limitations. Results could be enhanced by expanding the sample to better understand the impact of industry and nation on acquisition performance, as the current model only gives a general indication of directionality. Furthermore, while ROA is commonly used to measure acquisition success, results should be corroborated by additional performance measures (see below). Finally, further research should be conducted to understand possible causes of the negative effect of an improvement in external conflict risk rating on performance of firms whose ROA was seen to decrease after the acquisition.

The choice of ROA as the dependent variable could be a limitation. Accounting rules may distort results, while accounting measures may be manipulated, which is particularly relevant for Russia, where the enforcement of accounting rules is sometimes viewed as less rigorous. As insights gathered were limited, given that only one measure of performance, ROA, was used, future research should expand the number of variables examined. In addition, while it is considered that a time frame of two years after the acquisition would be sufficient, it would be interesting to extend it to three years and more, as it is possible that in some cases more than two years is needed to observe acquisition success. The problem of such an extension is that the deal itself may become an insignificant driver of the ROA of the firm as compared to other business factors.

More generally, when looking at deal 'success' it is common to look at short-term abnormal performance of the acquirer's shares around the announcement of the acquisition. The advantages of such an approach are that the impact of the deal itself is almost certainly the main driver of the share price in the time period and the independence from accounting vagaries. The obvious weaknesses of such an approach are that it assumes the efficiency of

[15] Hopkins, H.D., International Management Review, 2008)
[16] Hayakawa, K., Kimura, F. and Lee, H., The Developing Economies, 2012
[17] Burger, M. and Ianchovichina, E., Review of World Economics, 2017

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capital markets and ignores the impact on share prices of risk arbitrage.

Practical implications

This paper has implications for foreign investors in Russia, and likely in other countries where 'soft' factors may be holding back corporate investors. While it is important to be aware of host country risk levels, they do not seem to be the key determinant of post-acquisition success. This would suggest that acquirers would obtain better results through a coherent acquisition and integration strategy, and should not overestimate the impact of political risk factors.

Our approach

Three categories of variables were selected for the deals. The first consisted of all twelve components of the ICRG political risk ratings for Russia. Secondly, control variables, including Russian economic and financial ICRG risk ratings, as well as deal specific variables, namely acquirer industry and nation, were added. Thirdly, the acquisition success was measured from 1998 to 2014 by the acquirers' change in return on assets, considered within a 2-year time horizon before and after the acquisition. Two linear regression analyses were conducted (with the two year and four year time horizons) with the IBM SPSS statistical tool.

Political risk variables

Firstly, the independent variables to account for country-specific political risk were defined. This study used Russia's political risk rating components measured by the ICRG as independent variables except where noted. These are:

- Government stability
- Socioeconomic conditions
- Investment profile
- Internal conflict
- External conflict
- Corruption
- Military in politics
- Religious tensions
- Law and order
- Ethnic tensions
- Democratic accountability
- Bureaucracy quality – did not vary over the time period so excluded

The lower the specific risk, the higher the rating. Monthly data were obtained from the Nexis database and subsequently converted to yearly figures by means of a simple 12- month average. The time horizon covered was 1998 to 2016. The specific timeframe was selected to capture potential variations between the period preceding and following Putin's rise to power as Russia's president in May 2000.

Control variables

To account for alternative explanations of variations in post-acquisition performance brought on by specificities of the deal or other macro-economic conditions, a set of control variables was added. Deal-specific variables included:

- Acquirer's nation
- Acquirer's industry
- Relatedness of acquirer and target industries[19]

Macro-economic variables were comprised of economic and financial risk ratings, as measured by the ICRG, to help account for the impact of other risk factors on M&A performance. Financial and economic variables were aggregated in a similar way to the political risk variables, measuring changes in years t-/+1 and t-/+2.

In line with the World Bank's methodology (2017), the data were transformed prior to running the analysis by removing outliers to yield more significant results:

- 10 observations with the lowest ROA were removed from the sample
- 10 observations with the highest ROA were removed from the sample

This left a total sample of 92 observations for each period. Furthermore, the ROA was squared to obtain a more statistically significant model (Elfakhani and Mackie). While it is still possible to obtain directionally significant results through such an approach its interpretation is more complex. However, the focus of our analysis was on what does and what does not drive M&A performance, as opposed to the direction of such changes, and thus is not included.

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[19] Grigorieva, S. and Petrunina, T., Journal of Management Control, 2015 argued that changes in performance may be partially dependent on industry trends

As an initial step to gathering data, a list of deals was obtained from Thomson One Banker and cross-checked with SDC Platinum. The search criteria were the following:

1.   Transactions where the acquirer was not from the Russian Federation, but the target was, to include cross-border deals only.
2.   Date effective / unconditional between 01/01/1998 and 01/01/2015, to allow the gathering of ROA data 2 years after the acquisition.
3.   Friendly or neutral deal attitude, as hostile deals may have a heightened negative effect on performance and may take longer than two years to complete, leading to biased results.
4.   Acquisition of majority interest as the form of the deal, where the acquirer fully takes control of the target.

Figure 5: Construction of sample

Request	Operator	Description	Results
Database	Include	All M&A	n/a
Acquirer nation	Exclude	Russian Federation	593,597
Target nation	Include	Russian Federation	2,244
Date effective/unconditional	Between	01/01/1998 to 01/01/2015	1,867
Deal attitude	Include	Friendly, Neutral	1,816
Form of deal	Include	Acquisition of majority interest	666
SUB-TOTAL			**666**
Acquirers	Exclude	Serial acquirers	438
Acquirers	Exclude	Soviet Union	437
SUB-TOTAL			**437**
Acquirers	Exclude	Missing/incomplete data	112
TOTAL			**112**

Source: Cass Business School

For these search criteria, 666 deals were obtained, with the number of deals observed at each step shown in the figure above. In addition, all observations involving an acquirer who performed more than one acquisition in Russia during the timeframe examined were removed. This was done as serial acquirers tend to perform better than their less experienced equivalents, especially if we consider country-specific knowledge, which could bias results, and also as the performance of these deals may overlap. After removing 229 observations, 437 deals remained.

As a next step, ROA data for the acquirers was gathered from Thomson One, Orbis and Bloomberg. All observations where the ROA data was either missing or incomplete were subsequently removed, leaving a final sample of 112 observations.

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the development of its new building in
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Sir John Cass's Foundation has supported
education in London since the 18th century
and takes its name from its founder, Sir John
Cass, who established a school in Aldgate in
1710. Born in the City of London in 1661, Sir
John served as an MP for the City and was
knighted in 1713.