CLIENT UPDATE

MINING CAPITAL RESOURCES – AN OVERVIEW OF RUSSIAN EUROBONDS

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Over the course of the past ten years, the Eurobond markets have become an increasingly important source of funding for Russia's leading companies. In April 2013 alone, Russian corporate issuers, with metals and mining companies to the forefront, took advantage of historically low interest rates to raise in excess of U.S. $11 billion. While market conditions have changed since May 2013 against a background of capital outflows from emerging markets in response to indications of a reduction of quantitative easing by the U.S. Federal Reserve, the Russian Eurobond market is firmly established and likely to continue to be of interest to corporate borrowers. This article summarises some of the key considerations for a Russian company in planning a Eurobond issue.

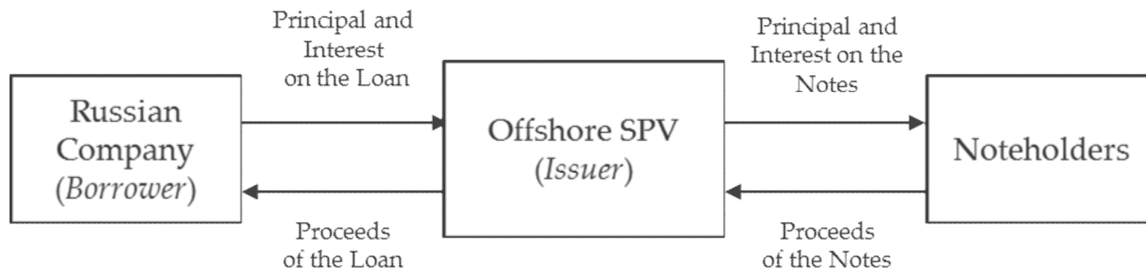
STRUCTURING THE ISSUE

Since it is not currently practicable for tax and regulatory reasons for a Russian company itself to issue Eurobonds,[1] two structures have evolved for Eurobond offerings by Russian companies which both involve the issuance of the Eurobonds by an offshore issuer rather than the Russian company which forms the underlying credit.

[1] In particular, interest payments to overseas noteholders on Eurobonds issued directly by a Russian company would be subject to a 20% withholding tax.

LPN Structure

Under the "Loan Participation Note" (LPN) structure, the notes are issued by a Special Purpose Vehicle (SPV), which is typically an "orphan" which is not owned or controlled by the Russian company, established in a jurisdiction which has concluded a double tax treaty with the Russian Federation. Ireland has become the most popular choice of jurisdiction for the SPV in a Russian Eurobond issue. As shown in the chart below, the proceeds of the issue of the notes are lent by the SPV issuer to the Russian company under a loan agreement, with the SPV issuer using the payments received under the loan to fund payments of interest and principal due on the notes.



Since the issuer SPV is usually unaffiliated with the Russian company, the use of this structure should not require the Russian company to obtain corporate approvals relating to interested party transactions, in contrast to the guarantee structure outlined below. In terms of comparative disadvantages, it is more complicated to issue notes at a premium or discount using this structure and, since the proceeds of the notes must be lent directly to the Russian company as borrower under the loan, it offers less flexibility in terms of the initial use of proceeds.

Guarantee Structure

The second commonly used structure involves the direct issuance of the Eurobonds by an offshore entity (typically a finance subsidiary of the Russian company or an offshore parent company), and the guarantee of the issuer's obligations by the Russian company which forms the underlying credit. Depending on the structure of the Russian corporate group, it may also be necessary or desirable to obtain a guarantee from other significant operating subsidiaries in the group.

The guarantee structure provides greater flexibility in relation to issuance of Eurobonds at a premium or discount and use of proceeds. It will, however, require the Russian company to consider the need for interested party transaction approvals, which may be time

consuming if it requires a shareholder vote. In addition, it may be necessary to include separate financial and business disclosure for each guarantor in the disclosure document prepared in connection with the offering and listing of the Eurobonds, although the precise disclosure requirements and the availability of exemptions may vary depending on the choice of listing venue.

LISTING THE EUROBONDS AND DISCLOSURE CONSIDERATIONS

Although there is no legal requirement to list the Eurobonds, a listing is invariably sought in practice both to widen the pool of potential investors and for withholding tax purposes. The three most widely-used exchanges for Russian Eurobonds have historically been the Irish Stock Exchange, the London Stock Exchange and the Luxembourg Stock Exchange. The Irish Stock Exchange has become the venue of choice in recent years, based on the familiarity of both the local regulatory bodies and listing agents with Eurobond issuances by Russian companies.

An application to list Eurobonds on the Irish Stock Exchange or other another regulated market in the European Union requires the preparation of a prospectus which complies with the minimum contents prescribed by the EU Prospectus Directive. The prospectus must include the Russian company's audited consolidated financial statements for the two preceding financial years prepared in accordance with IFRS or another recognised standard such as US GAAP, together with a discussion of the financial results for those periods and a description of the business and the principal risks it faces. The prospectus must also include a statement in which the issuer (which, for these purposes, includes the Russian company) takes express responsibility for the accuracy of the prospectus. For issuances which are classified as non-retail[2] (which, in the context of Russian issuances, is almost invariably the case), it is not mandatory to include a Mineral Expert's Report. Once approved by the regulatory body in the jurisdiction in which listing is sought, the prospectus must then be made available to the public.

Additional Disclosure Considerations

In addition to its technical function as a condition to obtaining a listing, the prospectus in its pre-final form will also serve as an offering document which is provided to investors during the "roadshow" marketing of the Eurobonds which the company undertakes together with the investment bank "lead managers" that it has mandated for the offering.

[2] Issuances are considered non-retail if the minimum denomination per note is at least €100,000.

As such, the level of disclosure will also be influenced by general securities market practice and, if the bonds are to be offered to U.S. investors, U.S disclosure considerations.[3]

The principal additional disclosure requirements for an offering to U.S. investors under Rule 144A typically include the inclusion of audited financial statements for the preceding three years (together with a discussion of financial results for those periods and related operating data), as well the inclusion of a summary of U.S. tax considerations. In addition, as a practical matter, the lead managers will also require a comfort letter from the company's auditors which provides "negative assurance" on the period from the date of the most recent financial statements in the prospectus (which may require the preparation of interim financial statements[4]), as well as a letter from the respective legal counsels to the company and the managers regarding the disclosure in the prospectus (a "10b-5 letter").

As a result, the inclusion of U.S. investors in marketing does add to the initial costs of a Eurobond issuance, as well as widening the potential exposure of the company and its directors and management to disclosure-based claims. However, the difference in terms of the required contribution of management and advisers in an offering including U.S. investors relative to a purely non-U.S transaction should not be over-emphasised; the company will in any event be subject to standards of care and potential liabilities in respect of disclosure in the publicly-available prospectus and all parties will have reputational considerations. In practice, the majority of Russian Eurobond issuers have opted to access the U.S. market in order to benefit from a wider and deeper pool of potential investors.

TERMS OF BORROWING — THE COVENANTS

Covenants are generally less onerous in Eurobond issues as compared with syndicated loans, reflecting the fact that Eurobonds issues were traditionally limited to companies with high credit. The scope of the covenant package continues to be largely influenced by the corporate rating of the underlying credit and market practice. Investment grade issuers[5] benefit from the lightest covenant package, which normally as a minimum contains a negative pledge covenant. In addition, in relation to Russian borrowers, it will often include covenants on mergers, payment of taxes and reporting. Sub-investment grade issuers should be prepared for a longer list of covenants, including restrictions on

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[3] Offers to U.S. investors are typically made to "qualified institutional buyers" pursuant to the exemption under Rule 144A from registration under the U.S. Securities Act of 1933. The principal disclosure considerations arise under Rule 10b-5 promulgated under the U.S. Exchange Act of 1934 (the "Exchange Act"), the general anti-fraud provision of the Exchange Act.

[4] Under applicable guidelines, an audit firm will generally provide negative assurance for a period of up to 135 days from the date of the most recent annual or interim financial statements.

[5] An investment grade rating is a rating of not lower than BBB- (Standard and Poor's and Fitch) and Baa3 (Moody's).

the incurrence of debt, change of business and asset sales, as well as an environmental compliance undertaking. Other covenants may be proposed by the lead managers, based on their assessment of likely investor reaction, depending on market practice for the industry sector in which the company operates. The covenant package can also incorporate the flexibility to reflect an upgrade in the company's credit rating such as a covenant "fall-away" or suspension provision. Under this provision, a sub-investment grade covenant package will be transformed into a lighter investment grade package upon the company obtaining an investment grade rating from at least two internationally recognised rating agencies.

In addition to the comparatively narrow scope of the overall package, specific bond covenants will often be structured to offer more flexibility as compared with equivalent provisions in a syndicated loan. For example, the key negative pledge covenant will typically require the company, in the event of granting security in respect of other indebtedness, to provide equivalent security to the bondholders rather than imposing an absolute prohibition on new security. In addition, if the covenant package includes a restriction on indebtedness, it will generally be structured as a prohibition on the incurrence of new debt unless certain conditions are met, as opposed to the more onerous requirement typically found in syndicated loans to maintain certain financial ratios at all times.

Consequently, while the upfront costs of a Eurobond issuance, particularly a debut offering, are higher as compared with borrowing from the syndicated lending market, in large part due to the potential liabilities arising from any offering of securities, the terms of lending generally offer substantially greater flexibility to the company in terms of operating its business. These attractive borrowing features have combined with the development of well-established issuance structures to establish the Eurobond market as significant source of fund raising for Russian mining companies and other major corporates.

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Please do not hesitate to contact us with any questions.

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