**Eurobonds – Key Considerations for Russian Corporate Issuers**

***Introduction***

Last year saw the revitalisation of the international debt capital markets for Russian issuers. In 2016 there were over 30 issues from Russia (more than in 2014 and 2015 combined). While the market is still not back to pre-sanctions levels, there has clearly been a resurgence of demand for Russian debt from international investors.

As the centre of focus has been on private corporates (as opposed to banks or sovereign related entities) we have highlighted below the key considerations in the context of Eurobond transactions for Russian corporate issuers (further referred to as "**companies**" or "**company**") in particular.

***Why issue Eurobonds?***

Eurobonds are generally available to reputable companies that are able to satisfy listing criteria (see "*Listing*"below). Eurobonds offer such companies an opportunity to diversify their funding base and to raise larger amounts of debt from a wide range of international investors, with a view to issuing at lower interest rates than typical bank loans. Except for certain categories of Eurobonds referred to as "high-yield" bonds, Eurobonds are more flexible instruments than bank loans in terms of amount, maturity, currency and interest rate options. In addition, Eurobonds can be used as a handy tool to create public credit history and raise companies' profile, which may be particularly important for companies contemplating an equity offering in the short to medium-term.

***Eurobond structures***

For tax and regulatory reasons, direct issues of notes by Russian companies remain economically inefficient and time-consuming. As a result, two basic offshore structures have been developed in the market for Russian companies, a guaranteed structure (the "**Guaranteed Structure**") and a loan participation note structure (the "**LPN Structure**").

*Guaranteed Structure*

The Guaranteed Structure is regularly used by Russian companies, regardless of whether the credit behind the issue is a collection of companies within the group (the "**Group**") or a single guarantor, each a "**Guarantor**". It involves an issuer, which can be either an orphan special purpose vehicle that is not related to the group ("**A**") or, more frequently, a subsidiary of the group located in a tax-friendly jurisdiction such as Ireland or the Netherlands (the "**Subsidiary Issuer**", and together with A, the "**Issuers**", and the "**Issuer**" means any of them). The Issuer issues notes to investors, which are guaranteed by Guarantor(s). The investors have the benefit of each guarantee and, therefore, focus on the credit support offered by the Guarantor(s). As part of the Guaranteed Structure the flow of funds between the Issuer and the Group is not documented.

The diagram below sets out an example of a conventional Guaranteed Structure:

Guarantee(s)

Intercompany distribution of note proceeds

Notes

Principal + interest on Notes

Note proceeds

Noteholders

Issuer  
(A or Subsidiary Issuer)

Parent / Material Subsidiaries of the Group

*LPN Structure*

The LPN Structure involves A located in a tax friendly jurisdiction (commonly Ireland or the Netherlands), issuing notes to investors. A then lends the proceeds of the offer of the notes by advancing a loan to the Russian company in its capacity as borrower (the "**Borrower**"). The loan is the contractual nexus to the Borrower, so this contains the pertinent enforcement triggers (such as the covenants, payment obligations and the events of default).

Buying the notes from A, investors effectively buy a participation in the loan advanced to the Borrower. The payment obligations under the notes mirror the corresponding payments under the loan, so when A has an obligation to pay under the notes it should already have received the corresponding amount from the Borrower under the loan. This enables the notes to be issued on a 'limited recourse' basis; i.e A is only liable to make payment to the extent that it has received payment under the loan.

This structure requires a trustee to represent the interests of the noteholders. A assigns its rights as lender under the loan to the trustee. In the event that there is a failure by the Borrower to meet any of its obligations under the loan, then the trustee is able to step in (on behalf of the noteholders) and enforce the loan as if it were the lender.

In order to further reduce the risk of having A in the middle of the LPN Structure the Borrower is obliged to repay the loan into a specified account, which is then charged in favour of the trustee (on behalf of the noteholders). In this way, any payments under the loan must be made to a specific account from which funds may only be paid out to the noteholders.

If the Borrower needs further credit support, then it is possible to add guarantor(s) to the structure. In this case the guarantee would be of the obligations of the Borrower under the loan.

The diagram below sets out an example of a conventional LPN Structure:

Security interests

Guarantee(s)

Principal + interest on Loan

Loan

Notes

Principal + interest on Notes

Note proceeds

Noteholders

Issuer  
(A)

Borrower

Guarantor(s)

Trustee

Optional

***Regulation S and Rule 144A transactions***

Depending on the target investor base, two safe harbour exemptions under the U.S. Securities Act of 1933 (the "**Securities Act**") are typically used by companies and managers to issue notes without the need to register them with the U.S. Securities and Exchange Commission. Notes issued under the exemption provided by Regulation S under the Securities Act may generally be sold only to non-U.S. investors while notes issued in reliance on Rule 144A under the Securities Act may also be offered and sold in the United States to "qualified institutional buyers" or "QIBs" as defined under Rule 144A, i.e. U.S. entities that satisfy certain qualitative and quantitative criteria.

The choice between a Regulation S or Rule 144A transaction would often have an impact on the size and yield of the contemplated transaction, as the expansion of the potential investor base as a result of adding U.S. institutional investors is often viewed as leading to potentially larger deal size and/or better pricing levels. However, the amount of work required for a Rule 144A transaction is typically more extensive than that for a Regulation S transaction, as the former tends to involve a more thorough due diligence effort (in part to enable U.S. counsel to deliver a 10b-5 disclosure letter to the managers, which is customary for a Rule 144A transaction), more detailed disclosure in the prospectus, a different type of comfort letters from the auditors, and additional tax and legal opinions.

Another important consideration when deciding between a Regulation S and Rule 144A transaction is the period of time during which the company would be able to access the market. On Rule 144A transactions, the managers will typically require that the auditors deliver so-called SAS 72 comfort letters. Such letters can generally only cover periods ending not more than 135 days after the date of the most recent financial statements. Consequently, it would generally be difficult for the company to conduct a Rule 144A transaction after the expiry of such 135-day period and before new financial statements become available. In contrast, Regulation S transactions can be marketed beyond this cut-off period so one should be able to access the Regulation S bond market up until a short period of time prior to the release of the next financial statements.

***Standalone issue or programme***

If a company plans to issue regularly into the debt capital markets, then it may be efficient to establish a debt issuance programme. The standards are the same for standalone issues and debt issuance programmes, however, if you establish a programme then you may negotiate the terms on which all issues under the programme will be conducted. This may be more efficient for regular issues as negotiation time on an individual drawdown is reduced, although it will need to be balanced against the additional work involved in negotiating all possible issues that may be undertaken (not just the individual issue of a standalone).

The main factor to bear in mind is that the disclosure in the prospectus relating to the Borrower and/or the Guarantor(s), and the diligence relating to that disclosure, must be fully up to date at the time that the company comes to market. Therefore, whilst a programme may be efficient in establishing the contractual framework, considerable work may still need to be done on an individual drawdown to update the disclosure in the prospectus by incorporating the most recent financial information and any material developments.

***Listing***

The choice of the listing venue depends on a number of factors, including the investment base the company is looking to approach, the availability of IFRS accounts or plans for subsequent secondary listing of the notes at the Moscow Exchange. Over the last ten years, Dublin has become the listing venue of choice for Eurobonds of Russian companies, although we have also seen Eurobonds listed elsewhere.

The EU Prospectus Directive ("**PD**") sets the regulatory standards required for disclosure in the prospectus in order to enable listing on any PD regulated market in the EEA. Full disclosure will be needed on the Issuer and Guarantor(s) in case of the Guaranteed Structure, and on A and the Borrower (plus additional guarantor(s), if any) in case of the LPN Structure.

The PD sets out extensive criteria for disclosure, however, satisfaction of the technical criteria to permit listing is not sufficient. The prospectus must contain all information that an investor may reasonably require to make an informed decision whether or not to invest in the notes. Furthermore, the prospectus is primarily a liability document: if any statement in the prospectus is incorrect, misleading, or if any material information is missing, then there is potential for an action to be brought against the issuer, and/or the Borrower, and/or the Guarantor.

As a result, if there is any reason why it is not possible to be fully open in the prospectus (for example some material corporate action is planned, but has not been disclosed) then it is not the time to come to market. Furthermore, if significant corporate action (such as a merger or disposal of a significant portion of the business) is planned and disclosed, then additional work will be needed to describe not only the current business but also how the business would look if such corporate action had already been completed. This may require the preparation of *pro-forma* accounts (i.e. the historical financial statements adjusted to show the business after such corporate action).

***Covenants package***

Covenants are the only comfort that a debt investor will get regarding the future running of a company and therefore maintaining the ongoing health of their investment.

It is essential to benchmark a covenant package against the industry peers in the negotiation process to see what the investors will be comparing the terms to. The company obviously has to live with the covenants for the life of the notes. On the one hand they will not want the covenant package to be so tight that they are at a competitive disadvantage when looking to grow the company, on the other hand, covenants that are too weak will be perceived by investors as more risky, and they will therefore look for compensation for this in terms of the coupon demanded.

Broadly speaking the covenants look to address two main concerns: what assets will investors have access to if they accelerate the notes; and will the company's financial health be maintained.

*Access to Assets*

The investor will want the company to maintain its asset base. If the company goes insolvent the investor will hopefully be able to recoup something.

Simple terms of the notes rely on the most standard negative pledge covenant to cover this concern. The company promises not to give security over assets to support other debt so that investors are not further down in the pecking order on insolvency. The negative pledge may be limited to cover security for other capital markets instruments or may be in respect of security for any indebtedness.

There may also be further covenants to consider maintenance of the company's assets. These become more of a focus in case of a complicated group structure, or significant related parties. In order to restrict the depletion of assets within the company or group over time the covenants may impose limitations on disposals, or limitations on transactions with affiliates, limits on mergers, or restrictions on payments. These are all looking to ensure that any such transactions are conducted on an arm's length basis on commercial terms and for full market value.

*Staying healthy*

Other covenants will focus on the ongoing health of the company in other ways. Some of which will be very straight forward, such as covenants to maintain key authorisations, licenses or consents. This is a keen focus where any form of external licence or authorisation is essential to the operations of a company.

There may also be financial covenants. These could restrict operations to within certain key ratio limits although this depends very much on the nature of the company and its credit rating. If financial covenants are needed, then certain information will need to be provided to enable monitoring of the company's performance. Therefore, covenants may be included to provide information such as accounts, compliance certificates, or granting right of access for inspection. Financial covenants tend to be lighter than those in the loan market generally.

***A balancing act***

The best way to look at, and negotiate, the covenants and events of default is to see them as a balancing act with significant common interests on both sides. Everyone wants the viability of the company to be maintained (not just the ability to repay its debt on time, but also the ability to grow, take advantage of market opportunities, and to remain competitive and responsive to market change). At the same time, the value of the investment needs to be maintained, including through more difficult market conditions (neither the company nor the noteholder wants the secondary market trading value of any notes to fall significantly during difficult times). Robust and efficient enforcement mechanics will help to maintain confidence in an investment during such times. There is therefore a community of interest in ensuring that the covenant package is properly balanced.

***Russian law matters***

*Regulatory approvals*

Neither the Guaranteed Structure nor the LPN Structure requires the Guarantor(s) or the Borrower to obtain approvals of the Central Bank of the Russian Federation (the "**Central Bank**") or of other government or regulatory bodies in the Russian Federation.

*Corporate approvals*

As a matter of Russian law, transactions entered into by a company which are valued at 25 per cent. or more of the balance sheet value of that company's assets as of the last reporting date must be approved by its board of directors or shareholders, depending on the value of the transaction.

Transactions with related parties (for example, where the notes are guaranteed by a non-wholly owned related party of the Subsidiary Issuer) can also require specific approval as an "interested party" transaction.

Finally, the charter of the company may require that certain transactions (such as borrowing the loan or guaranteeing the notes) be approved by its board of directors or shareholders.

***Russian tax matters***

*Russian withholding tax*

Generally, Russia would impose 20 per cent. withholding tax on interest payments to foreign entities. While historically Russian companies relied on double tax treaties and paid gross on the basis of the tax residency certificates received from the Issuers, in 2011 the Russian Ministry of Finance has expressed a view that the Issuers are not eligible for treaty benefits as they are not beneficial owners of income for tax purposes. As this statement destabilised the market, in order to preserve the ability of Russian companies to raise funds through Eurobonds, a specific Eurobond exemption was introduced into Russian tax legislation.

The Eurobond exemption applies where:

* debt obligations of a Russian company have arisen in connection with the issuance of "traded bonds" by foreign companies (such as the Issuers); and
* the Issuer (another foreign company authorised to receive interest income, or an assignee of rights and obligations in respect of the "traded bonds" issued by a third party) is tax resident in a jurisdiction which has a double tax treaty with Russia and its tax residency is confirmed by the relevant certificate.

The term "traded bonds" includes notes and other debt obligations listed and/or admitted to trading on one or several recognised foreign stock exchanges and/or rights to which are recorded by recognised depository and clearing organisations included in the list approved by the Central Bank. Currently the list includes several dozens of foreign stock exchanges and depository clearing organisations including, *inter alia*, the Irish Stock Exchange, Euroclear, Clearstream [and DTC].

A debt obligation qualifies as being connected with the issuance of "traded bonds" if it is expressly stated as being such in the agreement governing the relevant debt obligation and/or in the terms and conditions and/or the prospectus for the issuance of "traded bonds", or if this fact is confirmed by the actual transfer of funds upon the issuance of "traded bonds". [Eurobonds customary issued by Russian companies qualify as debt obligation connected with the issuance of "traded bonds" for the purposes of the Eurobond exemption.]

The Eurobond exemption applies not only to interest amounts, but also to other payments, including, *inter alia*, payments under guarantee(s) provided with respect to (1) the notes issued under the Guaranteed Structure or (2) the loan advanced under the LPN Structure, provided such payments are contemplated by the terms of the relevant debt obligation, or are made in connection with the terms of the relevant "traded bonds" and/or debt obligation (including the early buy-back or redemption thereof). However, there is still uncertainty as to whether the Eurobond exemption applies to payments under guarantee(s) in the Guaranteed Structure in case the proceeds of issue of notes were not used to provide loans to Russian companies.

*Expenses deductibility*

Generally, interest expenses are fully deductible for Russian corporate profits tax purposes. Certain deductibility limitations, however, may apply where [either] a loan [or a guarantee] is deemed to be a controlled transaction under Russian transfer pricing rules. The latter may apply to the Guaranteed Structure or the LPN Structure, unless interest rates are either set at market level or within "safe harbours" provided by the Tax Code of the Russian Federation.

Starting from January 2017 Russian thin capitalisation rules will not apply to the loans advanced under the LPN Structure. As these are the loans where a connection with issuance of "traded bonds" may be demonstrated, in the absence of such connection (as may be the case with on-lending funds raised through the Guaranteed Structure) application of thin capitalisation rules may limit interest deductibility and affect availability of withholding exemptions for interest payments under double tax treaties.