Valuing Russian Assets

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INTRODUCTION

Following the commencement of the war in Ukraine, many countries – including the US, the UK, and several countries in the EU – have introduced sanctions against Russia. The Russian Federation, in turn, has responded with countersanctions against companies from "unfriendly" states.

The countersanctions have imposed currency restrictions and capital controls that limited, or even eliminated, companies' ability to repatriate dividends. One recent article estimated that around $18 billion in profits were stuck in Russia for 2022 alone.[1] Among other measures, companies from "unfriendly" countries seeking to exit Russia face obligatory contributions to the government's budget.[2] Foreign investors have in effect divested at steep discounts to fair value.

As a result, several investors have already initiated arbitration proceedings, which require the valuation of assets allegedly expropriated or damaged by Russia. Other proceedings seek the recovery of property either expropriated or damaged within occupied areas of Ukraine.

In this paper, we discuss the complexities of valuing foreign assets located in Russia and Brattle's experience addressing such issues.

Valuing the Russian assets of investors from "unfriendly" countries presents several complex valuation issues, which may involve the effect of countersanctions, country risk, exchange rates, and commodity and energy prices.

Effect of Countersanctions

Russia's actions may form part of the disputed conduct that gives rise to damages. In those cases, the valuation analysis considers a counterfactual scenario without the disputed measures and an actual scenario that values the asset under the disputed measures. In commercial disputes where Russia is not the respondent, the analysis may have to consider the extent to which countersanctions drive any wedge between the fair market value and any damages in dispute. We have undertaken valuations considering the effects of sanctions and countersanctions, and modelled alternative 'but for' cases that value the assets absent sanctions.

1 Stognei, Anastasia, "Billions of dollars in western profits trapped in Russia," *Financial Times* (September 18, 2023)

2 At the time of writing, Russia requires a contribution of 15% of the sale price and a discount of 50% to the fair value to be appraised by an independent valuation report.

Country Risk

Country risk is the additional financial risk associated with operating in a foreign country – like Russia – where the political, economic, and/or social situation may adversely affect investments. Country risk includes threats such as armed conflict, strikes, expropriation, and country-specific economic risks.

Many valuation practitioners often approximate the effect of country risk by reference to the sovereign spread – the yield at which the host state's bonds trade above the yield of a 'risk-free' country like Germany or the United States. However, sanctions that limiting Russian bond trading could compromise the reliability of Russian sovereign bond yields as an accurate measure of country risk.

Even absent these sanctions, approximating country risk through the use of sovereign spreads is also incorrect from a theoretical standpoint, as sovereign spreads often overstate the country risk facing assets, and significantly understate their value. At a minimum, Brattle's experts would apply a more sophisticated approach that analyses bond yields to infer the risk of a significant adverse event confronting the business in question. Risk can vary significantly between companies that rely primarily on exports and companies focused on the domestic Russian market.[3] Rather than use the sovereign spread approach, our economists use more bespoke tools developed in the academic literature.[4]

Exchange Rates

Expectations on future exchange rates are a critical input for the valuation of businesses in Russia. The Russian ruble has fluctuated significantly following the imposition of sanctions and countersanctions, requiring the Central Bank of the Russian Federation to intervene in foreign exchange markets and raise interest rates.

Asset valuation typically involves forecasting exchange rates and considering currency risk. Some forecasting methodologies rely on data derived from sovereign bonds or hedging instruments, which may no longer be reliable given international sanctions. Again, academic literature proposes various tools to deal with these issues, and Brattle experts have gained extensive experience in applying them. Regardless of the specific tool, we apply two fundamental principles.

3 Of course, if sanctions also affected Russian exports and we were instructed to consider the effect of the sanctions, then we would account for this risk for exporting companies in our valuation.

4 For example, a study by Geert Bekaert and coauthors develops a methodology to measure the part of the sovereign spread attributable to country risks. See Geert Bekaert, Campbell R Harvey, Christian T Lundblad and Stephan Siegel, "Political risk and international valuation," *Journal of Corporate Finance,* Vol. 37, Issue C, 2016.

First, the valuation should ensure consistency between the assumptions with respect to inflation, exchange rates and interest rates. For example, projecting high Russian inflation should imply high interest rates in rubles, as well as a higher depreciation of the ruble over the long term relative to other currencies with lower inflation. Second, a reasonable valuation should provide the same result whether performed in one currency or another. Choice of currency should not move the valuation.

Commodity and Energy Prices

Russia is a major supplier of commodities, including energy. Because of the war in Ukraine, energy prices increased dramatically in reaction to curtailments. Assessing damages requires careful thinking around the treatment of extraordinary energy prices. One argument may be that energy prices would be lower in the absence of disputed measures. Anticipating such an argument, Brattle has recently undertaken a case that modelled what European natural gas prices would have been if Russian gas supplies had remained at their historic pre-2021 levels. Knowledge of local regulations is also important; Russia has recently updated its rules for setting domestic energy prices, which affects the actual value of local assets.

CONCLUDING THOUGHTS

Disputes involving Russian subsidiaries of Western companies will likely continue for several years, with billions of dollars of assets at stake. Regardless of the forums in which these disputes take place, properly valuing Russian assets will involve careful consideration of the complex issues that the Russian market generates. Brattle experts have considered these issues in depth for a number of cases, and expect to apply this experience in the near future.

EXPERTS

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Mr. Harris has nearly 20 years of experience as an expert in valuation and quantification of damages.

He has been retained by major law firms and their clients to testify on damages and quantum in international arbitration proceedings in a variety of forums, including the International Centre for Settlement of Investment Disputes, the International Chamber of Commerce, and the Permanent Court of Arbitration. Mr. Harris has particular expertise in the energy industry and regularly acts as an expert in disputes involving natural gas and LNG in long-term contracts both in Europe and Asia. He has also testified in disputes concerning energy infrastructure, including petroleum distribution assets, power stations, and LNG import terminals. Mr. Harris is listed as one of the world's leading arbitration experts in *Who's Who Legal's* Arbitration Expert Witnesses.

Mr. Harris is a regular speaker at gas and electricity conferences, and he lectures at the Florence School of Regulation. Prior to joining The Brattle Group in 2002, Mr. Harris worked for Shell's upstream oil and gas business in the Netherlands for five years in a variety of roles, including the development of economic models for new oil and gas field developments.

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Mr. Lapuerta is an expert in economic analysis and financial valuation, which he frequently applies to estimate damages in international arbitration proceedings.

Mr. Lapuerta has served as an expert witness in international arbitration proceedings, including many disputes between investors and sovereign states over the alleged breach of bilateral investment treaties. He offers particular experience in the analysis of investments and contracts in the energy sector, and has provided testimony in several arbitration proceedings concerning the prices in long-term energy contracts. Within the energy sector, his work has covered natural gas, coal, electricity and oil.

Mr. Lapuerta also offers extensive experience with the analysis of competition, including the development of competition in markets subject to liberalization and deregulation, allegations of anti-competitive conduct such as price fixing, and the competitive impacts of proposed mergers. His work on competition has been primarily in the energy sector and the financial services sector.

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Mr. Berger has experience conducting complex valuation analyses in investor-state and commercial disputes.

He has performed analyses in various settings, including changes in regulation, breaches of contract, and anticompetitive conduct. Mr. Berger has estimated damages across a range of sectors, with a particular focus on energy and financial markets. He regularly teaches a core corporate finance and valuation course in the Master in Finance program at London Business School, and he has contributed to *Global Arbitration Review (GAR) Know-how Commercial Arbitration.*

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Ms. Tholot specializes in damages and regulatory issues in international arbitration, court litigation, and advisory and competition matters.

Since joining Brattle in 2017, she has worked closely on dozens of energy-related cases across Europe, Asia, and Africa, including damages assessments, competition and state aid cases, and many gas price reviews and other energy pricing disputes. Ms. Tholot has developed knowledge of the regulatory provisions applicable to several energy markets, including in the EU, the UK, and Russia. In particular, she has analyzed the economics of Russian gas exports to Europe. She has assessed damages in several arbitrations following under-deliveries of gas and LNG under long-term contracts.

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