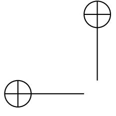
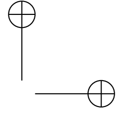
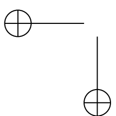
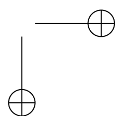
In from the Cold: The Rise of Russian Capitalism

In from the Cold:
The Rise of Russian Capitalism

Edited by Peter Westin

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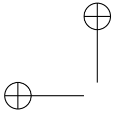
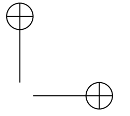
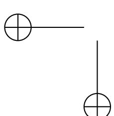
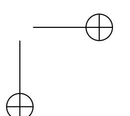
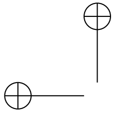
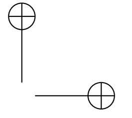
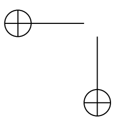
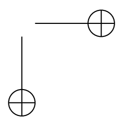




To Monika, my wife, and my beloved little Olivia.
Thank you for being in my life.

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Preface

Over the last 20 years, Russia has made remarkable progress. On the economic front, GDP has grown from USD 66bn in 1992 to almost USD 1.8trn in 2011. In per capita terms, GDP has risen from USD 443 to USD 12,900 over the same period, while the standard of living for the average Russian has improved dramatically, poverty has been significantly reduced and a thriving middle class has taken root.

Russia has also successfully developed one of the largest stock markets in the emerging universe. In December 2011, the Russian Trading System, Russia's original trading platform, included 260 listed companies with a combined market capitalization of almost USD 800bn. Russia has a weighting of 6.5% in the MSCI Emerging Market Index, or the seventh highest weighting of the 21 countries included in the index. The average daily trading volume of equities on MICEX, the more liquid of Russia's two exchanges, has grown from USD 500mn in 2005 to USD 5.3bn in 2011.

Since its inception in September 1995, the RTS Index has appreciated by 1,400%, and Russia has been the world's top-performing emerging market over the period.

In the early days of the market's existence, company information and financial statements were difficult to come by and transparency was extremely poor; investors barely knew what they were buying. Today, most listed blue chip companies publish financial results in accordance with international accounting standards and equity analysts can apply modern financial analytical methods in examining company accounts and financial performance.

Russia has also experienced two major financial and economic crises since its transformation to a market economy, a Russia-specific crisis in 1998 and the global crisis of 2008–9. On each occasion, the economy

plunged into recession and the stock market suffered significant losses. In 1997–98, the RTS index plummeted by 93%, while in 2008–9 the index fell by 80%. However, in the year following each crisis Russia rebounded to become the top-performing market in the emerging market universe (measured in local currency) and economic recovery was swift, although admittedly a strong increase in the oil price contributed significantly in both instances.

While it cannot be disputed that Russia has made enormous strides, both the economy and the capital markets still have a long road to traverse before reaching parity with developed market countries. Corruption remains a persistent problem in an economy that has become increasingly dependent on the global market oil price. Both domestic and foreign investment remain low by any international comparison, and this highlights the need for swift and decisive action to improve the investment climate. While much progress has been made, corporate governance is still a low priority for many companies and minority shareholder rights are often violated.

Although these challenges remain, it is clear to us that the Russian economy has settled on a steady upward trajectory, and the country's recent accession to the WTO provides another long-term foothold for economic development. Politically too the country has stabilized over the past decade, with the government strongly supporting initiatives and amending legislation aimed at addressing weaknesses in the structure of the country's investment climate and capital markets. For example, the adoption of the law on a Central Securities Depository confirms the government's interest in creating the conditions to support investment, and Russian law is becoming increasingly consistent with international standards. On a similar note, the government has expressed a very strong commitment to establishing Moscow as an International Financial Center in order to attract foreign investors and additional capital to the market. In mid-December 2011 the RTS and MICEX completed their merger, creating a single exchange with increased liquidity, as well as more secure and efficient settlement, which should make the Russian equity market accessible to a much broader universe of investors.

Today, the domestic retail segment of the market is just beginning to develop, and I am sure that over the next 10 years or so, we will see dramatic changes in the population's approach to personal finance and, consequently, higher demand for investment and insurance products as

well as retirement savings vehicles. Given the underdeveloped culture of investing in equity and debt securities among Russians, the potential for growth is vast. The Russian population continues to be a net creditor of the banks with an estimated USD 2 of bank deposits for every USD 1 in retail loans. At the same time, the structure of savings is fairly straightforward, with the most popular investments including physical cash, bank deposits and real estate. As a result, there is a huge dormant pool of capital of USD 339bn in retail bank deposits (excluding physical cash) translating into approximately USD 182bn in net household cash assets. Mutual funds and brokerage accounts, however, constitute no more than 0.6% of GDP and only 6–7% of net household financial assets. Consequently, bank deposits exceed total investments in mutual funds by 40 times and only a fraction of the population has invested in stocks, with brokerage accounts totaling USD 4–5bn or around USD 60 per capita of equity investments. This contrasts with Europe, where between 12% and 70% of net household assets is invested in stock and other securities. For example, the Polish mutual funds industry, with nearly USD 1,000 of investment per capita exceeds the Russian asset management sector by more than a factor of 16.

ATON has been active in Russia's capital markets since the earliest days. Established in 1991, ATON is Russia's oldest investment group. Successful since our inception, we have enjoyed a level of financial strength that has not only carried us through the upheavals of the past 20 years, but allowed us to expand our business significantly.

The sale of our institutional business to UniCredit Group in 2006 was a very significant milestone in our history. Following the transaction, we retained the retail brokerage and continued to operate successfully in that segment of the market. In 2009, the agreement with UniCredit that restricted our business to the retail segment expired and we returned to a multiproduct business model, introducing alternative brokerage solutions, mutual funds and trust management. Later that same year, we began once again to build a unique and independent investment bank committed to maintaining international standards of management and service.

In only two years, ATON transformed itself from a retail broker to into a fully fledged investment bank with ambitious targets and a highly professional team. Today, we have more than 40,000 retail clients, operate in 69 of Russia's regions, and have embarked upon a program of

international expansion: in 2010, ATON opened offices in London and Almaty and in Geneva in 2011.

We occupy a unique niche in the Russian capital markets and do not aim to compete with the industry leaders. We offer foreign institutional investors access to compelling investment ideas that major banks frequently miss; we also offer long-term financial planning services to retail clients. In every segment, there is always room for an active, hands-on independent player with a stable capital base and broadly recognized professional credibility. As a result of its reputation for integrity, ATON has received numerous awards, including Best Client Service Award (Finance 2011), The Best Brand (Effie 2010), and Best Start-up (Spears 2010). In 2010, ATON was also voted one of Russia's top five Russian brokerage firms by Thomson Extel.

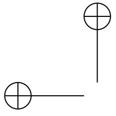
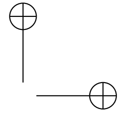
This book is intended to offer the investment community, both domestic and international, a balanced picture of Russia's progress over the past 20 years, with particular emphasis on the development of the capital markets. The authors contributing to this book have been chosen based on their longstanding involvement with Russia. While all of our contributors have been professionally involved in Russia's capital markets in one way or another since the early to mid-1990s, they have also lived in Russia. The majority of our authors speak the language, and offer insights that can only come from considerable time on the ground. Each has made a personal and professional commitment to the country and its people. Many of our contributors offer a very personal account of their love affair with Russia.

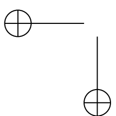
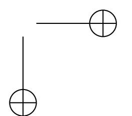
The collection of essays covers the early years of investing in Russia, how investors survived two major economic and financial crises, the subsequent huge stock market returns, as well as the benefits and risks associated with investing in Russia. At the same time, other chapters deal with the progress Russia has made in terms of economic development but also in terms of improving corporate governance, while at the same time discussing the great challenges ahead.

I hope this book will appeal to readers new to Russia, who are only now discovering Russia's tremendous progress over the past two decades, as well as to those familiar with this country's path. These readers will likely enjoy reflecting on the phenomenal changes that have taken place. Today's complex environment presents many challenges for the international financial markets, but with Russia's strong potential for

continuing healthy economic performance and a powerful commitment to becoming a financial center on a global scale, I sincerely believe that we have seen only the first steps in the rise of Russian capitalism.

Andrey Shemetov
CEO, ATON

Author Biographies

Ben Aris is the editor/publisher of *Business New Europe* and an Eastern Europe specialist. Among the longest serving foreign correspondents in Eastern Europe, Ben has been covering Russia since 1993, with stints in the Baltics and Central Asia. He is a former Moscow bureau chief for the *Daily Telegraph* and was a contributing editor at *The Banker* and *Euromoney* for a decade, as well as Russia correspondent for *The Business*. He is also a regular contributor to many of the best-known international business publications, including the *Wall Street Journal*, the *Financial Times*, *Institutional Investor* and many others. In 2003, Ben moved to Berlin as acting bureau chief for the *Guardian* before founding *Business New Europe* in 2006 to cover all of CEE. He returned to live in Moscow full time in the summer of 2009.

Rebecca Baldridge is a writer and independent consultant with more than 15 years of experience in the financial services industry. She first came to Moscow in late 1995 to work for ATON Capital, and thereafter joined the Rinaco Plus equity research team. After returning to the United States in 1998, she was a VP at JP Morgan Investment Management from 2000 to 2002, and then worked with The Bank of New York Asset Management as an institutional marketing consultant until 2005. Shortly thereafter she joined CentreInvest Securities in New York as an equity salesperson, and returned to Moscow in 2007 as the firm’s director of equity research. Most recently, she held the position of Director of Investment Research at Concorde Capital in Kyiv. Rebecca has a BA in Russian and an MBA in finance from Purdue University, and is a holder of the Chartered Financial Analyst designation.

Fred Berliner began his career in 1964 as a clerk at Troster Singer in New York, and spent more than 30 years working primarily in the OTC markets as a hedge fund principal with Argot Partners, manager of Tucker

Anthony's OTC department and as a research consultant to OTC market maker Herzog Heine Geduld. From June 1994 to November 1995, Fred was trading "missionary" to the USAID project to establish a viable equity marketplace in Russia via the Russian Trading System. From late 1995 until 1999, he ran Troika Dialog's equity trading desk, and since 1999 he has been living outside New York and trading his personal account. Fred graduated from the Hackley School and attended Ithaca College.

Arnab Das is managing director of market research and strategy at Roubini Global Economics. Before joining Roubini Global Economics, Arnab was responsible for emerging markets research and strategy and global foreign-exchange research and strategy at Dresdner Kleinwort, the investment banking arm of the Dresdner Bank Group, where he served as co-head of global economics and strategy. Prior to Dresdner, Arnab worked at JP Morgan as a strategist in emerging markets research focused on Latin America, and headed up the Eastern Europe, Middle East and Africa strategy efforts. He led teams to repeated No. 1 rankings in emerging markets and foreign-exchange strategy as recognized by *Euromoney*, *Credit Magazine*, *Global Investor* and *FX Weekly*. He continues to have a strong following among asset managers, hedge funds, and sovereign wealth funds, particularly in the field of emerging markets. Arnab studied at Princeton University and the London School of Economics, and is based in London and New York.

Steven Dashevsky founded Dashevsky & Partners investment boutique in August 2009. Previously, he was a Managing Director and Head of Equities at UniCredit Securities, where he was responsible for all UniCredit Group equity sales, trading, research and derivative activities in Russia. Dashevsky joined ATON Capital in 1998 as an analyst and was appointed head of research in 2002.

In 2007, Steven was voted the best Russian oil and gas analyst in the influential *Institutional Investor* survey. Between 2002 and 2008, he was consistently recognized as one of the top three Russian oil and gas analysts by *Institutional Investor* and Thomson Extel surveys. He serves as an advisor to the Dean of the Skolkovo School of Management, a leading Russian business school. Steven graduated Cum Laude from Baruch College of the City University of New York, and is a holder of the Chartered Financial Analyst designation.

Peter Elam Håkansson is the founder and chairman of East Capital. He also employs his expertise in Eastern Europe as a member of the Boards of the Swedish–Russian Chamber of Commerce and Bonnier Business Press International, as well as on the Advisory Board of Stena Long Term Equity and on the Investment Committee of India's second largest bank, ICICI.

Peter has been awarded the Golden Star for Best Fund Manager five times by Morningstar and Sweden's largest financial daily, *Dagens Industri*. The East Capital Russian Fund was named by Morningstar as the best onshore regulated fund in the world (among 94,000 funds) for the first decade of the new millennium with a total return of 1,565% in USD.

Prior to founding East Capital, Peter held a series of senior positions at Enskilda Securities in London, Paris and Stockholm. When he left to establish East Capital in 1997, he held the position of Head of Equities Stockholm and Global Head of Research. He is a graduate of the Stockholm School of Economics, and also studied at EDHEC, France.

Johan Elmquist is equity portfolio manager and co-founder of Tundra Fonder, a fund manager specializing in emerging markets. Johan joined Alfred Berg, a leading Nordic Investment Bank, in 1991, where he worked as an equity analyst. In 1995 he was involved in launching Alfred Berg's operations in Russia and moved to Moscow, where he launched the first onshore Russia funds in 1997. Johan has also worked at KPMG, T. Rowe Price and HQ Bank. Most recently he was managing the Russia Funds at Swedbank Robur amounting to USD 2bn.

Natalia Gurushina is director of emerging markets strategy at Roubini Global Economics. Previously, Natalia worked for Pantera Capital Management, a global macro hedge fund, where she developed investment strategies for both emerging and developed European markets. Prior to that, Natalia was in charge of macroeconomic research for select economies in Europe, the Middle East, Africa and Russia at Deutsche Bank and Bankers Trust. Before joining the private sector, Natalia analyzed economic and political developments in Russia and the former Soviet Union for the Open Society Institute in Prague. Natalia has a Ph.D. in economic history from Christ Church, University of Oxford, and a bachelor's degree in economics from Moscow State University.

Peter M. Halloran is the CEO of Pharos Financial Group, a specialist emerging markets investment firm. He has been investing in the markets

of Russia and the former Soviet Union since their inception in the early 1990s. In 1995, he moved to Moscow to build the brokerage business for CS First Boston while bringing more than USD 8bn to the Russian capital markets through debt, equity and private placements. During his tenure, CSFB became the top-rated broker as measured by research rankings, market share and profitability. From 2000 to 2002, he took an ownership stake in ATON Capital and subsequently transformed it into a leading local investment bank in Russia.

Peter serves as Chairman of the Board of Orenburg Energy Ltd., an oil exploration company active in Russia. Additionally, he has served as Adviser to Soros Fund Management. Prior to his move to Moscow, he worked for 10 years in New York with CS First Boston, Salomon Brothers and Morgan Grenfell. Peter is a graduate of Yale University.

Andrew Risk joined ATON in 2009 and currently works as an equity strategist covering the Russian market. Previously, Andrew worked in equity research departments of the Russian investment banks IFC Metropol and AK Bars Finance. Andrew has lived and worked in Moscow since 2007. Andrew holds a B.A. honors degree in modern languages from the University of Bristol, having spent part of his university career in St. Petersburg, Russia and Quito, Ecuador.

Andrey Shemetov has been involved in the Russian stock market and related activities since 1995, and is the CEO of ATON, Russia's oldest investment bank. Prior to joining ATON as CEO in July 2008, Andrey served as an advisor to ATON Group.

Andrey is a member of the Board of MICEX-RTS stock exchange. He was named "Person of the Year 2009" by the Russian government in the category "Investment Banker of the Year" for his role in developing ATON's investment business. He is a graduate of the State Management University, where he received a degree in production management. He also holds an Anti-Crisis Management Qualification Certificate from the Federal Service for Insolvency and Financial Rehabilitation.

Bernie Sucher is a non-executive director responsible for strategic development at ATON, Russia's oldest independent investment bank. He also serves on the board of directors of the PBN Company, the region's leading international specialist in strategic communications. In the spring of 2011, he was elected to the board of Eastern Property Holdings, and to the board and audit committee of Magnitogorsk Iron and Steel Works.

Bernie began his career in finance in New York in 1984 with EF Hutton, thereafter holding various sales and management positions with Cresvale and Goldman Sachs, working in London, Hong Kong and Tokyo. In 1993, Bernie moved to Russia. He co-founded and helped to build Troika Dialog. From 2002, Bernie oversaw the restructuring and relaunch of Alfa Capital. From 2007 to 2010, he helped reestablish Merrill Lynch's office in Moscow, becoming Country Head following the firm's acquisition by Bank of America.

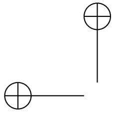
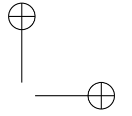
Bernie is also an active entrepreneur, activist and financier. The best known of his start-ups is Moscow's Starlite Diner, founded in 1995. Bernie holds a B.A. from the University of Michigan and is a graduate of Columbia University's Senior Executive Program.

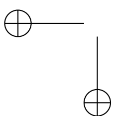
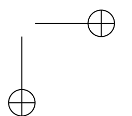
Peter Westin is ATON's Chief Equity Strategist and Economist. Before joining ATON, Peter was Head of Equity Strategy for Russia and Turkey at J.P. Morgan. Previously, he held the Chief Economist position at MDM Bank and prior to that at ATON Capital. From 1998 to 2001, he worked in Moscow for the Stockholm Institute for Transition Economics (SITE) and the Russian–European Centre for Economic Policy (RECEP), where he edited *Russian Economic Trends*, at the time the leading publication on the Russian economy. Concurrently, he also acted as an advisor to the Russian and Swedish governments.

Prior to RECEP, Peter was a lecturer in transition economics at University College London, from which he also has a Ph.D. In 2005, he was voted No. 1 EMEA economist by Thomson Extel, and is also the author of *The Wild East: Negotiating the Russian Financial Frontier*, published in 2001.

Mattias Westman is the Founding Partner of Prosperity Capital Management. He has been investing in Russia since 1993 and was a co-founder and Deputy Chairman of Russia's Investor Protection Association. He has also served on the board of numerous Russian companies, including Lenenergo and Magnit.

Prior to founding PCM in 1996, Mattias was Director of Alfred Berg/ABN AMRO's Russia department, having been a stockbroker with the Swedish firm H&Q. Before that he served on the Russian desk of the Swedish Ministry of Foreign Affairs, having learned Russian with the Swedish Armed Forces. Mattias has a Master of Science in Business Administration and Economics from the Stockholm School of Economics.

Acknowledgments

In early 2011, as I surveyed the aftermath of the 2008–9 economic contraction and ensuing stock market volatility, I began to ask, in broader terms, what stage had Russia reached in its capitalist development. It also dawned on me that a decade had passed since the publication of my last book, *The Wild East: Negotiating the Russian Financial Frontier*, which evaluated the progress of capital markets in Russia since the end of the Soviet Union. Since those early days of the new millennium, notwithstanding a severe stock market crash and economic recession, Russia has experienced something close to an economic miracle and the stock market has surged sevenfold, aided by an environment of rising commodity prices. I felt very strongly that Russia's investment adventure of the past 10 years must be told, and that the people most suited to broadening our understanding of this period are prominent figures from Russia's financial services industry.

I would like to express my deepest gratitude to the professionals who contributed to this book. Their willingness to dedicate significant time and effort, with no financial compensation, share their valuable experience, and detail their special love affair with Russia, means that their insights into this always exciting market will benefit a broader audience.

A special thanks goes to Rebecca Baldridge, not only for contributing a chapter but also for her excellent editing skills, the benefits of which are felt throughout the book. I would also like to thank my friends and colleagues at ATON, in particular my colleagues in the research department. Their valuable inputs helped shape my own two chapters. Finally, I am highly grateful to my employer, ATON, for offering me the time, unconditional support, and sponsorship to realize this project.

It should be noted that the authors' contributions were written during the summer and autumn of 2011, and hence prior to Russia's parliamentary election in late 2011 and the presidential election in March 2012.

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The views expressed in this publication are those of the individual authors and not necessarily those of either myself or ATON.

Peter Westin

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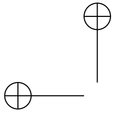
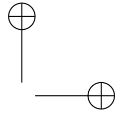
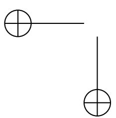
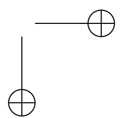
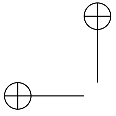
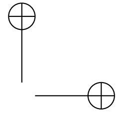
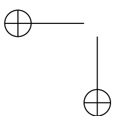
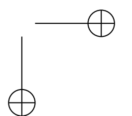



Part 1

MAPPING RUSSIA'S ROAD TO CAPITALISM

CHAPTER ONE

Russian Growing Pains

By Ben Aris

The first time I entered Russia was to get some money. It was May 1993 and I was working in Ukraine, writing my first in a series of reports about the newly independent countries of the former Soviet Union. Getting hold of cash in Kyiv was impossible; the local banks weren't connected to the international financial system and Ukraine didn't even have a proper currency; it had replaced the Soviet ruble with the *karbovanets*, a temporary coupon used until the hryvna could be issued. The only place in the Commonwealth of Independent States our office could find that would accept international wire transfers and issue dollars was in Moscow.

The Iron Curtain had fallen two years earlier, but little had changed. The two-hour flight from Kyiv to Moscow cost USD 10 (if you could get a ticket) and foreigners were still shepherded through the Intourist entrance, a special channel from the old days designed to keep track of foreign nationals attempting to travel around what had been the "evil empire."

The plane arrived at Domodedovo airport and we were driven to the "terminal" in what looked like a cattle car hitched to the back of a truck, suffocating in clouds of black diesel smoke. Domodedovo was the main terminus for flights to and from Central Asia and the building was full of Uzbeks, Tajiks, Kyrgyz and various other Asians sitting on piles of enormous plastic bags and quietly eating sunflower seeds. Collecting our luggage and passing through immigration was relatively easy as my Ukrainian visa allowed me into Russia for a few days and we emerged onto the street to find a car. The local taxi mafia swooped on what they hoped were unsuspecting tourists.

"How much to the center?" I asked in my broken Russian.

"100," came the gruff reply.

"100,000 rubles?" (which was about USD 20).

"No. USD 100."

Walk away and look for someone else.

A short walk from the terminal to the start of the feed road and you could avoid the "taxi mafia" that demanded an extortionate USD 100 for the one hour ride into town. As the mafia ruled the forecourt, gypsy cabs bringing fares from the city had to ride home empty and would be happy to pick you up and accept a knockdown price; you just had to walk away from the main tourist killing fields.

The roads were all but empty in those days. The main danger was the forearm-deep potholes that could take a wheel off and were hard to spot if it had been raining. It was only years later, after Yuri Luzhkov was elected mayor, that anything was done about the state of the roads. For all his faults (he and his wife made billions of dollars during their tenure), at least he fixed the roads.

Finally, we arrived at the Radisson Slavyanskaya hotel on the banks of the river Moskva, just along from the Russian White House, the seat of the Duma at the time. The hotel was opened in 1991 by the American entrepreneur Paul Tatum, who supplied President Boris Yeltsin with a satellite uplink to the outside world during the coup that brought the Soviet Union down that same year. The hotel was an oasis of services and Western-style shops, and for years much of Moscow's expat community would go to the hotel's Dom Kino on Saturdays, the only place in town where you could watch movies in English.

However, like many of the early entries into Russia, Tatum fell afoul of greed and was gunned down on November 3, 1996, at the entrance to the Kievskaya metro, a few hundred yards from the hotel. I bumped into his secretary years later, who told me that toward the end Tatum became so paranoid that he would wear a Kevlar vest to work under his shirt. He was hit 11 times in the head and neck and died instantly. His bodyguards did nothing to protect their boss and the killer escaped unchallenged.

The posh lobby of the Radisson was populated with what the press liked to call the Russian mafia, but in reality most were traders of some sort; the really successful ones had got their hands on state-owned goods that still bore Soviet-era prices. About six months earlier Roman Abramovich, later Russia's richest man, had managed somehow to divert a train carrying crude oil across the border to Latvia and made the first fortune that set him up. This was the time when ruthless and quick action could make a mint and provide the initial capital to pay the bribes that allowed you to build an empire.

In the corner Troika Dialog had a booth. One of Russia’s first successful commercial banks and a pioneer of the stock market, Troika was also founded in 1991 by American Peter Derby and his barrel-chested local partner Ruben Vardanyan, who sounds like thunder when he speaks and is now Russia’s leading investment banker. I joined the queue of heavily muscled men wearing garish tracksuits.

“Good day sir, how can I help you?” said the assistant in passable English. Russians could invariably spot the foreigners in 1993, usually because of your shoes; good shoes were only starting to become widely available.

“I’m here to pick up a transfer for USD 10,000,” I said, handing over my passport and transfer documents.

“Ah, I am sorry sir. We have run out of dollars. Please come back on Tuesday in the morning and we will probably have some more.”

Moscow in Motion

Moscow in the early 1990s was exciting. The dark silhouette of the monumental buildings that line Tverskaya, Moscow’s main shopping thoroughfare, came to life before my eyes, lit up by the first adverts and posh storefronts on what is today one of the highest grossing retail drags in the world in terms of dollars spent per meter. By the autumn of 1993, I had moved permanently to the Russian capital and walked into what nearly ended as a civil war.

Apart from the goons in the Radisson, life was extremely hard for the average Russian. The ruble was in free fall and inflation was running at over 1,400%. There were no shops to speak of, apart from the almost empty *produkty*, where you could buy tea, sugar, pasta, smoked fish, sausage, and of course vodka. However, small kiosks started popping up all over the city to sell the slowly growing stream of imported goods, especially foreign-made cigarettes and beer.

Living in the midst of hyperinflation made everything very complicated. To buy a can of the ubiquitous “Bavaria” beer, you started by haggling over the advertised price; you needed to mentally calculate how much the price should have risen in the past 24 hours, roughly 4% a day. If you were feeling really mercenary, once the ruble price was agreed you started all over again by offering to pay in dollars and haggling over the exchange rate.

But hyperinflation also made most of the oligarchs their first fortunes. The early 1990s was the era of “wild cat banking” and anyone with a pocket full of change could register a bank: more than 4,000 appeared in the first few years of capitalism. The game then became to grab some sort of revenue stream—the payroll of a state-owned company was best—by becoming an “authorized bank.”

The bank would take in deposits, convert them to dollars and then delay payments as long as possible. When it was finally forced to pay up, months later, the bank changed some of the dollars back into rubles to pay its local currency debt—which remained the same amount—but in the meantime hyperinflation had massively reduced the value of that debt in dollar terms. The workers got the same pay in rubles, but the bank pocketed the difference (which it held in dollars).

Banks became money-making machines and by the mid-1990s they had accumulated hundreds of millions of dollars, some of which they lent to the government in the infamous loans-for-shares scam in 1995–96 that allowed the oligarchs to move from banking into industry. Yeltsin allowed the state to effectively sell off its industrial crown jewels for a fraction of their value.

Times were good if you owned a bank. It was less fun for everyone else. Down by TsUM, Moscow’s “Central Universal Store,” one of which can be found in every Soviet city, I met a middle-aged woman selling a painting box. I offered the lady USD 20 for it.

She took the money and burst into tears. “What is this?” she said staring at the USD 20 note. She had never seen dollars before. It came out that she was a pensioner—Russian women retire at 55—and couldn’t survive on the USD 10 a month the state paid. He husband had died, probably from drink, and her son had been killed in Afghanistan in the 1980s. Hyperinflation had reduced her life savings to a handful of dollars in the space of a year and as a last resort she was selling off her dead son’s belongings to get some money to feed herself.

“Calm down granny. It’s USD 20. It’s a lot.” A passerby stopped to comfort her and reassure her that my offer was more than generous. She took the money and left looking crushed. Hyperinflation condemned an entire generation to poverty. Their savings turned into dust and with the state a smoking ruin older people were desperate.

I had to reappraise my view of Russia: it didn’t matter what system was adopted. The point was that something needed to happen and happen

fast. Even today, when the state pension now covers all the basics—but nothing more—most Russians expect little from retirement. A survey at the start of 2011 found that 80% of those polled intended to stay in their jobs until they die.

At the White House

As my first winter in Russia closed in, tension in the capital was rising fast. Yeltsin was in a showdown with the Communist-dominated Duma, which refused to cooperate with the president. The Duma was led by Russian vice president, Alexander Rutskoy, and the parliamentary speaker, Chechen economist Ruslan Khasbulatov.

Things came to a head on September 21, 1993, when Yeltsin unconstitutionally dissolved parliament and Rutskoy rushed to the White House where he was proclaimed the acting president of Russia. A standoff began as the Duma deputies locked themselves in the building that symbolized democracy and where Yeltsin himself had famously stood on a tank in 1991 to rally his supporters. Ironically, Yeltsin was holed up at the other end of Novy Arbat, a 15 minute walk away, in the Kremlin—the seat of the Communist Party since Lenin had taken control in 1917.

I was living in the middle of Novy Arbat, behind Dom Knigi (the House of Books) and walked down to the White House every day to see what was going on. To begin with there was a festive feeling amongst the crowd, the spirit of 1991, where the people were acting to protect their rights, watched over by a token police presence.

But as the week wore on the police presence grew and Yeltsin began to turn the screws. First the phones were cut off, then the power and water. The building was then encircled by police, who prevented anyone from going in or out (although the press was allowed through the cordon). Finally, the city sent all its water trucks, which parked toe-to-tail to form a solid barricade around the building.

Inside the courtyard communists marched chanting slogans and veterans with chests full of medals peppered the crowd; most of the people there were older, or at least middle aged—the generation that had lost everything in the fall of the Soviet Union. General Albert Makashov, a nationalist-communist officer and politician, was in charge of the White House defences and took a swipe at me with his baton for trying to take his picture. The press was tolerated, but as foreigners we also personified everything that had gone wrong with the Socialist paradise.

Bizarrely, in the middle of this siege, the famous cellist and conductor Mstislav Rostropovich, much beloved by the Russians, turned up at Sheremetyevo airport without a visa (he was by then a U.S. citizen) and shouted at the border guards until they let him in.

Within days he had organized a recital of the 1812 Overture (which celebrates the victory of Russian general Mikhail Kutuzov over Napoleon) on Red Square. I stood in the VIP compound near the stage, just a few yards from Rostropovich, and behind me the square was packed to capacity. Suddenly there was stirring to the right and cheers went up from the crowd. In typical impetuous style, Yeltsin had suddenly appeared through the Spaski Tower in the corner of the Kremlin and came out to glad hand with the crowd before the music started.

Things came to a head on October 3. A mass demonstration on Novy Arbat swept the police and the water truck cordon away. I woke late that day with a raging hangover as most of the international press corps had been at the Penta hotel on Olympeisky Prospekt the night before, where the owner of *The Moscow Times*, Dutchman Dirk Sauer, had thrown a huge party to celebrate the English language newspaper's first birthday. A one-time communist, Sauer used to chain himself to embassy railings in the name of Marxism, but his Independent Media publishing house went on to become the powerhouse of Russian print media, scooping up the rights to *Cosmopolitan*, *Men's Health* and *Playboy* among others, transforming Sauer into a multimillionaire in the process. That evening Sauer gave me a *Moscow Times* coffee cup as a memento, which I still have.

I arrived at the White House courtyard the next day in time to see Rutskoy appear on the balcony to give a speech. One of his bodyguards held up a transparent bullet proof shield that folded out of an attaché case to protect him from snipers' pot shots, as he called on the crowd to form battalions, and seize the mayor's office and the national television center at Ostankino. The people in the crowd swirled into action. Men started climbing into the back of Kamaz trucks and handing up Kalashnikov rifles that appeared out of the White House from somewhere.

We found a car and followed the convoy through central Moscow and swept up Prospekt Mira toward Ostankino, where Russia's national television studios are located under the famous TV tower. However, the crack Vityaz Special Forces, under Yeltsin's control, beat the communists to the building by a matter of minutes. Led by General Makashov,

the communists had been hoping to take control of the TV Tower and broadcast a message that the government in Moscow had fallen. If they had been successful, fighting could have broken out across the country and Russia could have turned into a Yugoslavia. At the very least, the fighting would have been a lot bloodier and protracted than it was.

By the time I arrived at Ostankino, a trolley bus had been overturned and thrown across the road. We rushed for cover as tracer bullets flew overhead, making white steaks through the darkening sky. The tracers were clearly intended more to stop people entering the fray than they were actually aimed at the crowd, but we stayed close to the body of the bus. Still, more and more people were coming up the road, but few were going beyond the bus. A crowd was building up in between the protective arms of the bus tires. A fierce firefight raged between the communists and Vityaz forces just out of sight in the darkness under the horse chestnut trees.

Then the first causalities began to arrive. Men sprinted out of the trees carrying between them their unconscious comrades soaked in blood as the first ambulances raced up the access road. The next day it was reported that Rory Peck, a British cameraman working for the German station ZDF, had been shot and killed that night (I later became a founding member of the Frontline Club in London, which is dedicated to the memory of Rory and half a dozen other journalists killed on the job). In all, 62 people died in the fighting at Ostankino that night.

We stayed until we started to hear a quiet "zip" in the air around us. It took me a moment to work out what the sound was. Then I realized it was bullets: snipers had obviously moved round to the side of the bus and were shooting lower, and it was starting to get really dangerous. I was a young freelancer and there was a strong desire to get closer and to see what was going on. The adrenaline rush of being under fire means you don't feel the fear you should. Your senses are pumped to the maximum as you try and become conscious of all 360° around you. But the sound of bullets flying through the air brought me up with a slap and we decided to leave. A friend and colleague at the *Daily Telegraph* once warned me: "In war zones it is always the freelancers that get killed; they have to go further than the staffers to get the better story." Frustrating as it was, I thought I had done enough that day.

We walked down to the main road, where we stopped a gypsy cab to take us to the *Bely Tarakan* (the White Cockroach), a bar set up by

a theater troupe as a private drinking club for the actors—one of the first of Moscow's clubs that later spawned an entire family of cool bars (Propaganda and Kitisky Letchik are two of those still going 17 years later).

That night the time horizon of Muscovites came down to less than six hours. At the bar, rumors were rife. Some said the government had fallen. Some said that the army was marching into Moscow. Others said that the borders had been closed. We went to bed that night not knowing what the morning would bring.

As the sun came up the next day, Kutuzovsky Prospekt was shaken by the rumbling of tanks as they drove down this spoke road to park on the bridge by the Hotel Ukraine and open fire on the White House. The tanks were commanded by Alexander Lebed, a gravelly-voiced general and paratrooper with a love of aphorisms, who later was to run for president in the 1996 election.

Lebed's tank battalion was the closest to the city and during the night of October 3 both sides courted him furiously. Lebed had already won fame by ignoring an order in 1991 to move against the people at the earlier White House protests, and this time shortly after midnight he came down on Yeltsin's side. A feisty nationalist, Lebed was always true to himself, saying that he spat on popularist politics and was contemptuous of the government: "Those who profit are the ones at the top. They keep the doughnut for themselves and give the hole to the people."

The tanks settled the fight. The upper floors of the White House quickly caught fire, blackening the top of the building, and the deputies holed up inside surrendered. However, snipers moved out and onto the roofs of the surrounding buildings, starting to take pot shots at anyone on the street. Akhim Luther, a young German industrialist with a plastics factory in the regions, was living in the apartment block next to the White House and went onto his balcony to take some pictures. He was forced to leap back inside as a hail of bullets poured through his window after soldiers on the bridge mistook him for a communist sniper.

For the next three days, the area around the White House was a no-go zone. According to government estimates, 187 people were killed and 437 wounded, while sources close to Russian communists put the death toll as high as 2,000. Oddly, a 10 minute taxi ride across town, life went on pretty much as normal on Tverskaya, with people out shopping or hanging out in cafes.

The fighting quickly came to an end and, after a few weeks of curfew, life returned to normal. Rutskoy, Khasbalotov and the other coup plotters were arrested (but given amnesty a year later by the new Duma) and Yeltsin rammed through a new constitution, giving increased powers to the president. What is forgotten now is that despite significantly increasing his own power, Yeltsin spent much of his remaining seven years in office battling the communist-controlled Duma. It wasn't until Putin's arrival in 2000 that the president was fully in control of the political life of the country.

The Trading Years

The next five years was a good period in Russia. Although the economy was still stagnant and the government was in perennial crisis, running an 8% budget deficit funded by the now-notorious GKO short-term treasury bills and whatever they could get out of Gazprom in taxes, it was at least quiet and young people began to rebuild their lives.

This was the era of traders, of fast money and ostentatious spending. "I have three million dollars, how much do you have?" boasted one of these young traders in all seriousness as a conversational gambit over single malt whiskeys at a party.

Simon Dunlop was sent to Russia in 1992 by British entrepreneur Tiny Roland with a container of Marlboro cigarettes—legally imported. After a week, the London office rang to see how he was settling in. "Oh fine, thanks," said Dunlop. The office then asked him when he thought he would be ready to start work. "The cigarettes? Ah, I have been meaning to call. I have already sold them. Do you think you could send me 60 more containers?"

Eventually, Dunlop moved to Philip Morris once Russia became its fastest growing market. After Yeltsin introduced tax breaks for the church and charities, Dunlop's biggest customer became the Russian Orthodox Church, which bought over USD 1bn of cigarettes a year.

The money began to flow and Moscow became a party town. The first ever raves in Russia occurred in an abandoned palace on the Fontanka river in St. Petersburg—the residents of Russia's tsarist capital have always been more cultured than the mercantile Muscovites. But Moscow was where the money was and Ivan Salmaksov, the son of the city's KGB boss, brought techno music to the capital in 1992, with the Gagarin First

rave. For USD 5,000 he hired out the Cosmos pavilion, where Sputnik and various Russian space rockets were kept, and threw a party.

"Nobody knew this music. I told them it was a party, a recital, a political rally—anything. And they came and had a good time," Salmaksov told me.

In 1993, the clubs were mainly full of small-time hoods with their tarty girlfriends—places for them to show off their money. Salmaksov and other members of the *tusovka* (literally, the wandering ones, but what would be called the "in crowd" in the West) started organizing parties on the off nights, Tuesdays and Wednesdays. But these upmarket raves attracted so many people and were so wild that within six months the tusovka had taken over Saturday nights at all the venues in town.

And then there was the Hungry Duck. An amphitheater shaped room with seats rising around an oval bar space in the middle, only girls were allowed in between 7 p.m. and 9 p.m. and allowed to drink as much as they liked for free. For two hours they were whipped into a sexual frenzy by male strippers, often ending up on the bar dancing naked. And then the men were let in...

Part of what drove these debauches was the new freedom; locked behind the Iron Curtain in the 1960s, Russia was going through its sexual revolution in 1996 and 1997. And part of it was the drugs. Marijuana was widespread even in Soviet times, but in the mid-1990s ecstasy arrived and by 1997 this had turned into a heroin epidemic that took out the top tier of DJs that had started the scene.

The young Russians were totally innocent when it came to drugs, as there were no public health programs or education of any kind. I once watched a DJ doing speedballs (a line of coke followed by a line of heroin), and asked him why he was messing about with heroin. "Ecstasy is bad for your liver," he replied with a USD 100 bill protruding from his nose.

Posh Shops

By the late 1990s, the first generation of oligarchs was well established. Editors in London were crazy for the "women who like to shop" story—the drop-dead-gorgeous twenty-somethings that were girlfriends to the Novi Russky and dropped USD 5,000 a week on clothes. Looking for a fresh take on what quickly became a very tired story, I went to Christian Dior on Stoleshnikov Lane, an exclusive shopping street, just round the corner from where I had bought my paint box a few years earlier.

The Christian Dior shop was the latest addition to the thirty shops run by JamilCo. The shop was owned by Khaled Jamil, the son of a Syrian trader who exported perfume from Damascus to Soviet Russia in the 1960s; Syria was one of the few countries in the world that had already established trade ties with Russia and its traders flourished in the early years. Jamil himself came to Moscow in 1987 and opened the first Levis store, also on Stoleshnikov Lane.

"At the time we were not retailers and no one wanted to open a shop that carried only one brand," says Jamil. "But of course it was a huge success with queues outside running around the corner for more than a year. We even had touts selling places in the queue."

A young, beautiful woman cruised into the shop while I was interviewing and started to make a commotion: "Can't you get some more?" She was on the point of tears and pleading with the shop assistant.

The woman's problem was that she'd missed "the Truck," which had arrived a week before. The boots were part of the exclusive winter collection and cost a cool USD 1,500 in a country where the average income was still less than USD 50 a month.

"We only ordered a few pairs. The problem with luxury goods is that you have to order six months in advance. The companies only make enough to fill the orders. If something sells well you can't get any more," Jamil explained.

Russians were actually quite well off in 1991, compared with the other emerging markets, with a per-capita income of over USD 14,000 a year on a purchasing power parity basis, compared with China and India at under USD 4,000 in the same year. But the lucky few with access to state-owned assets became multimillionaires almost overnight. A stone's throw from where I bought my paint box from the impoverished pensioner, the Moscow branches of Gucci, Donna Karen and Versace became the top 10 grossing stores in the world, earning up to USD 150,000 per square meter by some estimates—10 times more than a normal shop.

Christian Dior's business in the mid-1990s was based on a group of about 10,000 people that spent millions a year on clothes. Around this time, the shop decided to do some market research and the survey showed that more than half the customers described themselves as "unemployed." Jonny Bayntun, the store manager, said that the shop only carried stockings in sizes 6 and 12.

"It's because we largely sell to the wives or the girlfriends," he explained wryly. "If you were an alien and tried to work out what Russians were like based on just our stocking sales statistics, then you would conclude all Russian women are about 6 feet tall with long skinny legs, or short and fat."

Crash

I interviewed Salmaksov again in the summer of 1998 for *The Face*, a British fashion magazine, for a piece about the eight coolest people in Russia. He was full of plans. Life was settling down and he had been offered a deal by ORT, Russia's biggest TV station, to produce youth programming, but was toying with the idea of going to New York for a while to see how things were done in the United States.

"Things are getting better here. Can you imagine the ruble has been six to the dollar for about a year now? There are lots of things to do, but I haven't made up my mind yet," he said sitting in his apartment across the road from 106.8 FM, a commercial dance music radio station that he had helped found.

But the first sign of the brewing storm clouds was a call I got a few weeks later asking if I knew where Salmaksov was. The door to his apartment had been forced, there was some blood on the wall, and he had disappeared. It wasn't until years later that Vladic Munroe, a famous drag artist who impersonated Marilyn Monroe, told me he had been killed by the partners of a banker friend and his body had been discovered in a shallow grave in the woods outside Moscow. It seems the partners were angry at the banker (who was also killed), who spent too much time clubbing and not enough time working, and blamed Salmaksov.

The trading years came to abrupt end on August 17, 1998. At the time I was in Lenina, a small beach town on the Sea of Azov in the Ukraine. The Sea of Azov is a small gob of a sea that is connected to the north of the Black Sea. I had traveled two days by train from Moscow in a second-class carriage with bunk beds stacked three high. The air was fetid and the floor littered with eggshells as we tried to wile away the trip by playing cards and drinking. I had come down to Kazantip, a rave in the disused RMBK nuclear reactor just inland from the sandy beach.

The rave was set up by Nikita Morshunok, Russia's first ever beach bum, with money he made from working in an "almost legal" gold mine

in the Urals. He smuggled the first-ever windsurfer into the USSR and Kazantip began as a windsurfing holiday in the 1980s for his friends. Despite having the longest coastline in the world, both Russia and the Soviet Union were starved of nice beaches, and by 1995 more than 4,000 people were making the trip to the Sea of Azov—so they started to organize parties. The high point of the month-long party was the Reaktor party, a 10,000-strong rave held in the shell of a disused nuclear power station. (After Chernobyl blew up, the fuel rods were never delivered.)

The festival (for want of a better word) brought together promoters and nightclub owners from across the former Soviet Union and partygoers had traveled the length and breadth of the 15 republics to attend. Even the Moscow chapter of the Night Wolves, Russia’s Hells Angels, led by the “Surgeon” (a qualified doctor turned biker, who rode with Putin in a 2011 pre-election PR stunt), had made the trip and the bikers raced up and down the beach on their huge motorcycles.

At the party a sound system was set up at the end of the main workshop hall and ravers danced next to huge holes several meters deep in the partly finished concrete floor. Most were off their heads from smoking the marijuana that grows in the surrounding fields or amphetamines smuggled in from China (complete with instructions in Chinese); it was amazing that no one died. By 4 a.m. the crowd was in a frenzy and dancers climbed up 50 feet of superstructure to dance on the massive water pipes that were supposed to cool the reactor core.

Kazantip also marked the start of Russia’s recovery. This was the second time the Moscow promoters had gotten involved in the party, and this year they arrived with serious corporate sponsorship. The beach was spotted with huts with straw roofs put up by most of the main alcohol companies and pretty girls in short-skirted corporate uniforms were handing out cigarettes to the sunbathers, incongruously mixing with the local *babushki* who were selling *pirozhki* to hungry ravers from buckets draped with tea towels to stop the sand getting in.

There were no hotels and I found an apartment by hanging out in the market where another babushka offered to rent me her apartment for USD 10 a night and move out to stay with her sister for the next few days. It was from her that I heard sketchy details that the government had defaulted on its debt and devalued the ruble by 75%, but she wasn’t sure what it meant. I had agreed to pay USD 50 up front in rubles, but

offered her dollars instead after I heard the news. The *Evening Standard* (now owned by Russian oligarch Alexander Lebedev) loved the story: they ran a double-page spread the next day under the banner headline: “Forget the ruble, the rave’s gone nuclear.”

Bankers’ War

Between 1996 and 1998, Yeltsin was very sick, recovering from a quadruple bypass operation, and the oligarchs had taken almost full control of the economy. First, the best of Russia’s companies were effectively stolen from the state in a series of rigged auctions, dubbed the loans-for-shares scam. Then the oligarchs cynically clubbed together under the lead of Boris Berezovsky, who hired “young reformer” and Kremlin insider Anatoly Chubais to organize Yeltsin’s re-election campaign in 1996.

But once the elections were over the truce didn’t last long. The clever Chubais was hired by Yeltsin as Russia’s Sherpa to the IMF, and he had a knack for getting cash out of international financial institutions that kept the boat afloat. By 1997, Chubais put his foot down and refused to hand over fixed telephone line monopolist Svyazinvest to the oligarchs at a knockdown price. Berezovsky was incensed. A closed auction was held and oligarch Vladimir Potanin, who had control of metals giant Norilsk Nickel and Uneximbank, the biggest commercial bank in the country, won. Berezovsky went on the attack in his various media outlets, which included ORT, kicking off what came to be called the Bankers’ War.

I asked Potanin a few years later how Berezovsky, a former maths professor, became so powerful. “All the instruments of power were lying around in 1996 and Berezovsky picked them up,” Potanin told me in his faux English study on Masha Perovayava Street, formerly home to Gosbank, the Central Planning Committee’s bank. “No one was sure how much power he had, but he pretended he had a lot and because everyone believed him, he ended up with a lot.”

When I finally interviewed Berezovsky himself after he had fled to London to live in political exile, he wouldn’t talk about those years. But it was clear that he is a master of manipulation; his Ph.D. is in the mathematics of system management.

Potanin eventually bought a 25% minus one share stake in Svyazinvest together with international financier George Soros, who famously called it “the worst deal of my life.” But in the process he screwed over Alfa Bank founder Mikhail Fridman, for which he paid dearly a few years later.

Both Fridman and Pitor Aven, co-owner of the bank, told me separately that they bankrupted Potanin's oil company in 2000 and took it over as revenge for being pushed out of the Svyazinvest deal. But the 1998 crisis ended the Bankers' War and put all the oligarchs on the back foot.

However, all these machinations were not visible at street level, other than in the 1996 elections. The strategy of delay and hyperinflate your way to riches meant that no one had any cash. The entire economy was run on barter, what academics Barry Ickes and Clifford Gaddy dubbed the "virtual economy." In one of the few public protests at this time, a group of miners from the Donbass basin came up to Moscow and set up camp in the back garden of the White House to protest the fact that they had not been paid for months, or if they were paid at all, they were paid with packed lunches.

"Where is our money," one angry miner's wife demanded as she sat in her tent looking out on the courtyard where the communists paraded during the 1993 siege. "I'll tell you where it is: it's all in Switzerland in the bank accounts of the oligarchs and government officials."

Oligarchs are not businessmen. They are opportunists. They got so rich so fast because they saw how the collapse of the Soviet Union could be turned to their advantage. And the lithest of them all was Mikhail Khodorkovsky, who first founded Menatep Bank and then took over what became the Yukos oil company during the loans-for-shares deal in 1996.

The trouble was that the three main production subsidiaries responsible for all Yukos's oil—Yuganskneftegaz, Samaraneftegaz and Tomskneft—already had a foreign minority shareholder, the American container king Kenneth Dart, who was insisting on dividends and good corporate governance. Khodorkovsky attacked, determined to drive Dart out of the company, and it got ugly: in the late 1990s Russia was at rock bottom in the global rankings for corporate governance, and Yukos was ranked at the bottom among Russian companies on that list.

By this time I was writing more and more about business as the financial-industrial groups (FIGs) became increasingly prominent. The Dart people, expecting foul play, invited me to attend an extraordinary shareholders' meeting called by the Yuganskneftegaz production subsidiary in March 1999.

It was a sunny day as I walked down to the Yukos clubhouse in the Lepekhinsky Perulok cul de sac where the meeting was to be held. A

group of men in expensive suits were loitering on the pavement in front of the elegant building, smoking and talking on phones as we all waited to be ushered into the small office in the building opposite to register for the meeting.

John Papesh, who represented Dart and lived in Cyprus, was there waiting for me, looking tanned and nervous. Dart was afraid that the shareholders' meeting was going to massively dilute his stake in the company and had arranged a power of attorney for me to attend the meeting as Dart's proxy.

The girl who was processing the shareholder documents took one look at my papers and gestured to the burly security officer wearing blue fatigues in the corner. He marched over: "Out," was all he said. I didn't move but gestured to Papesh. The guard moved his hand onto the butt of submachine gun as Dart's lawyers rushed over. "Mr Aris has a legal right to attend this meeting under Russian law. All his paperwork is in order!" they said waving the papers around. The security guard took hold of the butt of his gun and pointed it into my face and said again: "Out." So we left.

It emerged later that a Russian court had frozen Dart's shares so he and his proxies were ineligible to vote at the meeting. Over the next few hours, the shareholders (those who got in) voted to triple the number of shares in Yukos, leaving Dart with an insignificant stake. To add insult to injury, the new shares were to be paid for with veksels, or promissory notes, that wouldn't mature for three years. And finally the shareholders decided it was in the best interests of the company to sell its oil to an "independent" oil trader for USD 1.50/bbl, when the price of oil was already on its way to USD 30.

Papesh tried to keep his cool and said that in the long term Dart's interests would be protected, but couldn't contain himself completely: "This brazen asset grab takes the violation of Russian law and international standards of corporate governance to a new low."

The Yuganskneftegaz EGM marked for me the bottom of the crash and the start of what turned into an almost decade-long boom. At the time, the 1998 default on Russia's debt and the devaluation felt like a disaster. The leading stock market index, the RTS, had collapsed from an all-time high of just over 500 to a low of just 37 in October of that year and the top tier of Russia's banking sector, including Menatep and Uneximbank, went bust.

The crash also hit the traders even harder. They had been making money hand over fist, but all their cash was tied up in inventory. As soon as the crisis hit, sales froze and their cash disappeared. Riding about in Moscow everyone was depressed. "This country is shit. It has all gone to hell. I need to take my kids and leave," ranted one taxi driver. The wild party was over and even the Hungry Duck was nearly empty.

About Face

The devaluation that cut the value of the ruble to 25 cents on the dollar overnight turned out to be a blessing in disguise, although it took several years for this to become obvious.

Oil companies that paid their workers in rubles but earned their revenue in dollars became fantastically profitable. As oil prices recovered from the low of USD 10/bbl in 1998, which had caused the crash, to USD 25, newly installed president Vladimir Putin was granted a boon. Oil money primed the pump—LUKOIL invested more into production in 2000 than was invested by the entire sector the year before—and after a decade of negative GDP numbers in the 1990s the economy grew by 10% in 2000 alone. More importantly, both incomes and household spending, which had been falling for 10 years, reversed and began to rise strongly. People had cash in their pockets as the virtual economy got real for the first time.

Oddly enough, it was Khodorkovsky who personified the turnaround. In December 1999, Khodorkovsky bought off Dart for a reported USD 120–160mn. Then in the spring he launched the most ambitious corporate governance program Russia had ever seen. Yukos's share price began a relentless climb from 20 cents in 1999 to a peak at over USD 15 a little over three years later. I interviewed him again just after Yukos's market cap topped USD 30bn, making him the richest man in the world under 40, and accused him of stealing the company in 1996 in the fixed auctions.

"We didn't steal anything. I paid several hundred million dollars in the auction and at the time it was a lot of money. Just because the company is worth billions now doesn't mean it was worth billions then. We paid a fair price at the time," he told me sitting in the same clubhouse where the Yuganskneftegaz EGM had been held. "You have to understand that I am three generations of the Rockefellers in one: the first generation was

robber baron, the second built the business and the last is royalty. What took 100 years to happen in America is taking 10 years here."

He had a point and the other oil companies I interviewed at the time were also all talking about corporate governance; Harvard Business School dubbed it the "the Khodorkovsky effect," and it made all the top businesses revise their ideas about how to get rich.

The Sushi Years

From about 2000 the game changed. The boast in the 1990s was to count your millions in public, but after the financial crisis, thanks to the appearance of cash, it became possible to make money from simply running a good business.

"The guys I talk to boast: 'I invested USD 10m last year and turned it into USD 50m; how much did you make?' They all have more money than they can spend. So now it is all about the multiple you can make on the money you already have," Troika's Vardanyan told me in his rumbling voice in an interview at the time.

By now Troika was a huge investment bank worth billions of dollars and Vardanyan had set up the 2015 Club, a group of independent businessmen that had made their money honestly and were lobbying the government for reforms to create a real market economy. The "2015" in the name of the club was the year that Vardanyan's son would leave university and Vardanyan's hope was to have a Russia where his son would want to live, work and raise a family.

Banks and oil companies gave way to supermarkets, restaurants and consumer electronic chains as the front line for change in the 2000s. Getting food in the early 1990s wasn't a problem, but getting nice food was. Very early on the Irish Supermarket chain opened and stocked things like expensive cornflakes and Brie.

Shopping was mostly done in the various markets dotted about the city. My favorite was the Central Market on Tsvetnoi Boulevard next to the Moscow City Circus. Housed in a dilapidated but extremely grand Tsarist-era hall, the place was lined with trestle tables manned by swarthy men from the Caucuses, selling fresh fruit and vegetables brought from places like Uzbekistan and Moldova, delicious honeydew melons and huge sides of smoked sturgeon thicker than your thigh from the northern shores of the Caspian. And caviar was ubiquitous. The vendors in the market had open kilo-cans of the three main types—beluga,

osetra and sevruga—and pestered you to taste some on little plastic coffee spoons. A kilo cost USD 250 but would have been worth thousands of pounds back in London.

From 2000, retail slowly became more organized and real companies catering to the consumer began to come to the fore. The cigarette market at Kievskaya was closed and the glitzy Europa shopping mall went up, which cost tens of millions of dollars to develop.

Wimm-Bill-Dann was well ahead of its time and began selling J-7 juices in 1992, complete with a modern marketing campaign that presented the juice as a high quality product with a foreign feel; there is no "j" in the Cyrillic alphabet. Car dealership Rolf also chose a foreign sounding name for the same reasons. However, while goods with a foreign image were popular in the 1990s, there was a backlash after the 1998 crisis and companies began to emphasize their Russianness in the following decade. After 2000, Wimm-Bill-Dann expanded into dairy, where the real money is, before eventually selling to PepsiCo in 2011 for USD 3.8bn.

Wimm-Bill-Dann's founder, David Iakobachvili, told me part of the company's success was that they stole employees from Mars and other foreign, fast-moving consumer goods companies and, as the company was not their "first born," they let these managers get on with it. Indeed, Mars produced a whole generation of managers for Russian manufacturers while Alfa Bank produced a crop of bankers as it was the only bank to bother training its staff in the 1990s.

The car business similarly made good money in the 1990s, but really only took off after 2000. Sergei Petrov is the founder of Rolf, Russia's most successful car dealership, which turned over USD 4bn in 2010 (back to its pre-crisis sales levels), but you wouldn't have guessed it from meeting him. There is a class of Russian entrepreneur that is serious and modest and hugely successful. Dmitri Zimin, the founder of mobile phone company VimpelCom, which went into profit on its first day of operation in 1994, is another one.

Petrov had exceptional entrepreneurial flare and organized his fellow taxi drivers into a company providing drivers to foreign companies arriving in Russia in 1991. He got on particularly well with the boss of Mitsubishi, who gave him a soft loan to import 40 cars from Finland and by 1992, despite having no experience at all, Petrov won a tender to open the first official Mitsubishi dealership. By 1997, Mitsubishis were

the most common foreign car on the road in Russia and Petrov was a multimillionaire.

"Luxury goods was the only stable market then. The fish were there—mainly high government officials or oligarchs and the mafia. The rest of society, about 80% of the population, had nothing," Petrov told me.

Like Philip Morris, Petrov made a killing on importing cars through a charity dedicated to helping the deaf. But his business really took off in the 2000s after consumer credit arrived. Car sales quickly went mass market, and Petrov had by this time built up a diversified business with 28 dealerships selling most of the leading foreign brands. More surprisingly, unlike many of his peers, Petrov pushed from the start to make the business legal.

"It was a battle of greed versus fear and greed won in the 1990s. When we started selling Audis, my sales staff were de-motivated," says Petrov. "Other dealers, who were in effect smuggling their Audis into the country and avoiding the import duties, could instantly offer a USD 2,000 discount on any car that Rolf sold."

Petrov was lucky because, after Khodorkovsky fell foul of the Kremlin and was jailed in October 2003, it became clear that businesses had to pay their taxes or face the same fate. Rolf could have faded away if the corruption had continued, but instead the rest of the industry fell into line and left Rolf as the market leader. Fear finally overcame greed.

Rustam Tariko did more than anyone else in Russia to introduce debt to Russian shoppers that accelerated the growth into an economic boom in the second half of the 2000s. During a holiday in the Czech Republic, he stumbled across Home Credit Finance, a local express credit operation run by the Czech billionaire Petr Keller, and decided to set up the same business in Russia.

Tariko had already made a fortune in alcohol. He got his start importing and selling Kinder Surprise eggs. Then a chance meeting between the boss of Kinder Surprise, who sat next to the boss of Martini on a domestic flight in Italy, led to an import franchise. Nearly a decade later Martini was one of the most popular posh drinks among Russia's youth (it had sponsored one of the bars at Kazantip). Tariko followed through by launching Russky Standart, a premium vodka that blew the competition out of the water. I first met Tariko when he had just launched his consumer finance operation of the same name.

Tariko was different from his Russian peers in almost every way. His office was a case study in tasteful minimalistic glass and chrome. There was a desk that contained a computer and little else. The only other pieces of furniture were a big leather sofa, a glass coffee table, and a Bang & Olfusen stereo on the wall. Tariko himself was dressed in a smart suit, designer shirt, no tie and spoke immaculate English.

Most of Russia's banks have been founded on the revenues of some Soviet-era company, but Tariko simply hired McKinsey & Company, asked them what to do and did it.

The one snag was naming the new bank: Tariko wanted to call it Russky Standart after his famous vodka; the McKinsey consultants cringed: "You can't name a bank after a vodka; banks are supposed to be solid and conservative." But Tariko insisted, and so the consultants went out, held some focus groups and came back a month later with their tails between their legs.

"Most of the big banks in Russia are backed by either state money or oil revenues," Tariko said. "The Russian public understands that both are volatile and unpredictable. However, this is Russia and Russians will always drink vodka no matter what happens to the economy, so our bank's image ends up being one of the most reliable in the country."

Launched in 2001, the bank flourished. Originally considered a flash in the pan, within five years all the leading banks in the country were scrambling to catch up.

The advent of consumer credit transformed the Russian economy. The average incomes in Russia were rising quickly, but credit multiplied spending power manyfold. Moreover, as the average Russian has no debt to speak of and overheads, for example utilities, are low, almost all of their income is disposable; IKEA discovered when it opened its first store in Moscow in 2000 that the average Russian has the same spending power as the average Swede. The upshot is that Russians can load themselves up with a lot of debt before it starts to pinch.

By 2008, a Russian's time horizon had stretched out to at least two decades. Everyone in Moscow had jobs and most were making good money. A flood of babies arrived as couples that had been putting off having children finally felt their future was secure enough to start a family: in 2008 the falling birth rate reversed for the first time in almost two decades. People were investing in their companies, studying for MBAs, learning foreign languages and taking out mortgages on new homes.

Where Next?

The 2008 global credit crisis has set Russia back. The economy went from growing by over 7% in 2008 to contracting by 7% in 2009—a 14 point reversal. During the worst of the collapse, the economy literally came to a standstill. The only reason why things didn’t get worse is that companies still relied on their own financial resources for three quarters of their investment needs, so everyone tended to keep a lot of cash on their books.

But this has been the Russian story from the start: one of volatile swings and muddling through in the face of incomplete reforms and chronic corruption that slows progress down.

However, in the 17 years I have lived and worked in Russia, the country has made continuous, if uneven, progress. There have been three big crises in Russia (and several smaller ones) but each one does less and less damage.

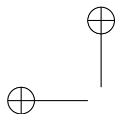
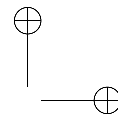
The first was in 1991 with the collapse of the Soviet Union, which completely destroyed everything. However, the 2008 crisis has caused surprisingly little damage. One bank went bust (Kit Finance), but the government bailed it out by lunchtime on the same day it announced its debt default. I interviewed the bank in September 2011 and not only was business flourishing, but it had paid back all its debts three years early.

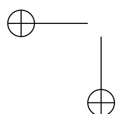
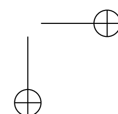
Most of the problems Russia faces today are connected to policy and the government’s efforts to modernize Russia. Retail has flourished as the reforms needed to make it work are essentially apolitical: the state only needed to free prices, which it did in 1992. However, as you go up the industrial weight scale the government’s role becomes increasingly important until you reach the oil sector where the state takes 90% of every dollar over USD 28 a barrel of oil. Reforms are going slowly in these middle-weight sectors—but they are going.

Academics like Professor Sergei Guriev, rector of Russia’s New Economic School, say that in the early stages of transformation the state plays a crucial role as the only economic agent with means. Heavy state spending and support of the state-owned industries can get the economy moving in a Big Push stage of transformation.

However, there comes a point when the state’s involvement in the economy becomes detrimental and the government needs to switch from pushing to nurturing, making it easier for private businesses to operate

and letting commercial, not public, companies take the lead, which is where Russia is today. Despite the chaotic ride so far, there is no reason to believe that the country won't continue to make progress, even if that progress so far as been wild, volatile and unpredictable.

CHAPTER TWO

Russia's Economic Transformation: An Unfinished Success Story

By Peter Westin

Welcome to Chaos

I arrived in Russia in July 1998, one month before the country plunged into a financial crisis that was triggered by a 70% devaluation of the ruble and a debt default. Moving to Moscow for a European Union-sponsored project was not an easy decision as I was leaving a permanent job as a lecturer in economics at the School of Slavonic and East European Studies at University College London. However, the opportunity seemed too good to refuse as it offered me a chance to work in the country where my research had been concentrated for the five previous years. As one can imagine, after one month of attempting to settle into some form of "normality," when the crisis hit, my immediate thought was "what have I got myself into?" The images from the Asian crisis a year earlier were fresh in my mind as the ruble fell as much in six weeks as the Indonesian currency had in six months. In Indonesia, the sharp decline in the currency triggered widespread social unrest and violence. As an economist, it was with a mix of morbid excitement and fear that I watched the events unfold.

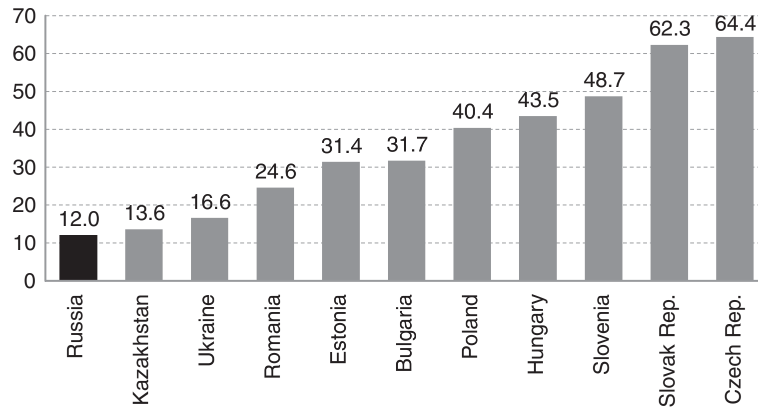
Sure enough, the Russians poured into the streets, but mainly to queue outside banks and withdraw whatever scraps remained of their savings following the devaluation. However, they did so peacefully. While the notion that Russians are more tolerant of hardship may underpin this display of social apathy, the other side of the story was that the social impact of the 1998 crisis, although painful, was less severe than that of the Asian crisis in 1997. In Asia, the crisis triggered rapid job losses and the number of unemployed doubled in Indonesia, Thailand, Malaysia and Hong Kong. In Russia, however, the number of unemployed rose from

8.1mn in July 1998 to 10.5mn in February 1999, a painful yet comparatively minor increase of 30%.

However, the foreign community in Russia was particularly hard hit when it came to layoffs. It was estimated that approximately 70% of the foreigners working in Russia's financial industry lost their jobs, including many of my new friends. One friend was working for a well-known Russian bank (one that still exists today). On the day of the crisis, a large number of investment banking staff were told to report to human resources with their signed letters of resignation. As the employees refused, they were basically told to leave and expect no severance. As the news hit their email inboxes, one employee in the bank's research department began to compose an email intended for clients. In just five minutes, security arrived and physically threw him out the front door. At another bank, even as the owners were assuring employees that everything was fine and there was no need to panic, they were moving their own capital out of the country. The news spread like wildfire and in response the entire staff fled the building, taking whatever they could carry with them, including computers, telephones, chairs and desks. Not surprisingly, this bank went under. My EU project had funding for another two years, and I considered myself lucky to have a job. Since a major portion of our mandate was to advise the Russian government on economic issues, we suddenly found ourselves very busy.

In this chapter I aim to give an overview of Russia's economic development during my time living in this fascinating country. Part of the story I will tell is based on reflections from personal experience and interpretation of events, while partly I will base the analysis on hard data. The tale will be one of a successful revival of an economy close to being in ruins in 1998 where, with the help of a rising oil price, economic growth surged and living standards for the population improved dramatically. At the same time, I will argue that after the second major economic and financial crisis in 2008–9 the structural weaknesses—many of them known for years—have come to the surface, restricting Russia's growth potential. The country is now significantly more dependent on external factors, especially the oil price, and the foundation for successfully diversifying away from oil dependence and modernizing the economy has weakened substantially. Therefore, Russia's leadership is facing great challenges ahead.

Figure 2.1. Money supply in 1999 (M2/GDP).



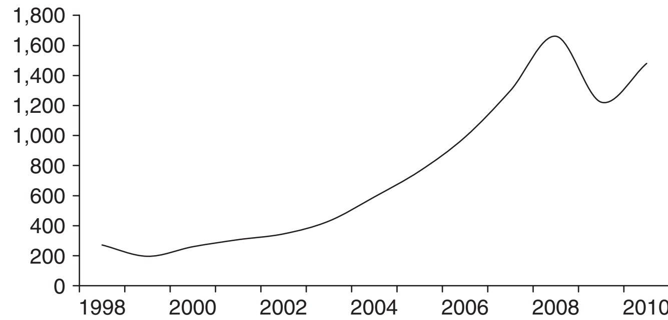
Source: Central Bank of Russia, Rosstat, EBRD.

From Crisis to Recovery

It's a well-traveled path, the discussion of how well Russia has done over the last 10 years or so. But it's easy to forget just how bad things were before 2000, and how dramatically Russia's situation has improved since then. This is especially true when examining the average Russian's quality of life. The 1990s was a time when inflation was reaching extreme levels, workers went unpaid for months at a time (managers often used wage funds to invest in high-yielding short-term bonds), and barter and non-payments ruled an economy that was heavily dependent on the dollar, with the ruble money supply, measured by M2, amounting to a mere 12% of GDP in 1999, low by any standard. The population, distrustful of banks following repeated disasters, held limited bank deposits and preferred to keep dollars stuffed under their mattresses (it was believed that by the late 1990s Russia was the biggest holder of dollars outside the United States).

During the 1990s it was common for companies to pay salaries and bonuses in cash. As the crisis hit and foreigners were forced to pack their bags and leave Mother Russia, they were faced with a dilemma. In an uncanny echo of Russians' own habits, many foreign bankers, as least the successful ones, had stockpiled cash in their flats (whether it was under the mattresses I do not know). In 1998, you could leave Russia with approximately USD 1,000 without making a declaration. For a

Figure 2.2. Russian GDP (USD bn).

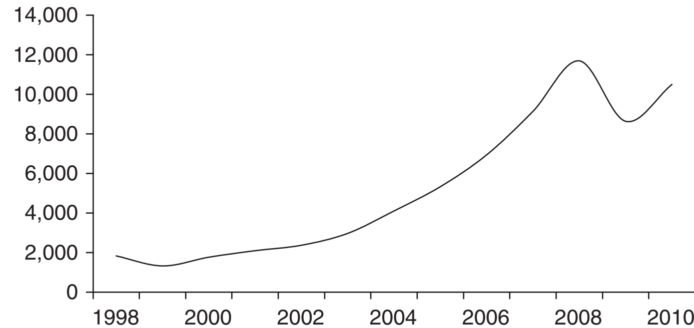


Source: Rosstat.

larger sum, a customs declaration proving that you had brought this sum with you when you entered Russia was required. The bankers were a wily bunch, however (as one may expect of anyone who had placed their careers in the hands of the chaotic opening years of Russia's financial markets), and a solution was soon found: buy traveler's cheques with the cash and then destroy them. Traveler's cheques have the advantage that they can be replaced if lost or stolen as long as the holder retains the purchase receipt showing the serial numbers allocated. Within a week after the crisis hit, you could add traveler's cheques to the list of goods no longer in supply. After the 1998 crash the economy and financial system seemed to lie in ruins and the consensus among economists anticipated a long and drawn-out recession and a severe step backwards following the achievements of the 1990s. For example, in May 1999 the IMF predicted that the Russian economy would contract by 7% in real terms for the year, a shuddering thought in light of the 5.3% slump in 1998. In actual fact, the economy recovered sharply and GDP grew by 6.4% in 1999 on the back of a low base effect, a surge in import substitution following the devaluation of the ruble, and last but not least a 130% jump in the oil price. In October of that year, the IMF's outlook for 2000 projected moderate growth of 2%, the argument being that Russia had too many structural deficiencies to sustain the growth achieved in 1999. The IMF had again underestimated Russia and she achieved GDP growth of 10% for 2000. That year marked the beginning of a great turnaround in the Russian economy.

The post-1998-crisis period was a golden age for Russia in many aspects, especially compared with the years of 1991–98. The Russian

Figure 2.3. Russian GDP per capita (USD).

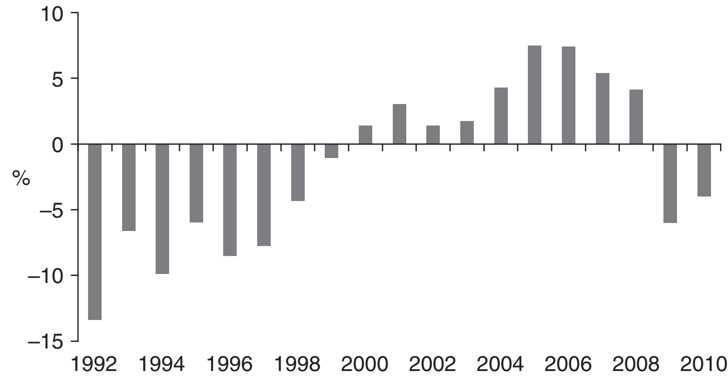


Source: Rosstat.

economy began to advance at a very impressive pace. After the lost years spanning Russia's emergence from the dissolving of the Soviet Union to the crash of 1998, during which a small number of individuals in politics and business essentially robbed the country, Russia's GDP made significant strides. In 1999, Russia's nominal GDP equalled USD 196bn, which was close to the GDP of Austria. However, Austria had a population of 8.1mn in 1999 while Russia's population was 147mn. Eleven years later, Russia's GDP had grown to USD 1.5trn, or four times that of Austria. Over the same period, GDP per capita rose from USD 1,330 to USD 10,500 or by a multiple of nearly eight (although still far below Austria's GDP per capita of USD 54,900). It is, however, worth mentioning that between 1999 and 2010, Russia's population shrank by a catastrophic 6mn people and I will touch upon the role of demography in Russia's economic outlook later in this chapter.

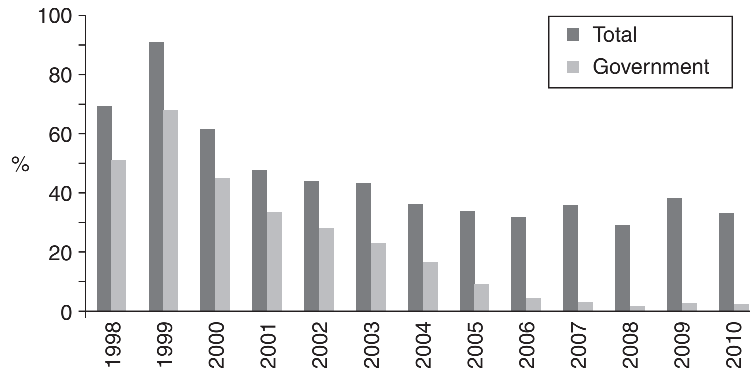
Russia's fiscal balance underwent something of a revolution around the turn of the millennium as the 1998 turmoil became the trigger for the government to clamp down on tax disobedience, forcing companies to pay their taxes on time and in cash. Moreover, it wasn't all just a case of better policing. Tax reforms provided additional incentives for companies and individuals by introducing a flat corporate profit tax of 20% and a personal income tax rate of 13% (a key topic of our advice to the Russian government in 1998–99 was for the introduction of flat tax rates). Thus, having struggled with massive fiscal deficits during the 1990s, which averaged 8.1% of GDP between 1992 and 1998, the budget deficit quickly became a surplus, which averaged 4.4% of GDP over 2001–8.

Figure 2.4. Russian federal fiscal balance (%/GDP).



Source: Rosstat, Russian Ministry of Finance.

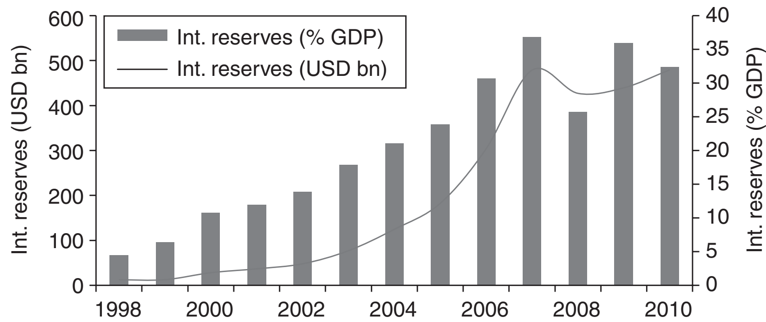
Figure 2.5. Russian external debt (%/GDP).



Source: Central Bank of Russia, Rosstat.

The ballooning in the oil price was also instrumental in Russia's success in significantly improving its balance sheet by paying off external debt and accumulating international reserves. In 1999, Russia's total external debt equalled 91% of GDP, while government external debt stood at 68% of GDP. Eleven years later the total debt burden had fallen to 33% of GDP and government external debt to a mere 2% of GDP. As for international reserves, in 1999 the total was USD 12.5bn (6.4% of GDP). By 2010, the figure had increased to a war chest of USD 480bn (32.4% of GDP).

Figure 2.6. Russian international reserves.



Source: Central Bank of Russia, Rosstat.

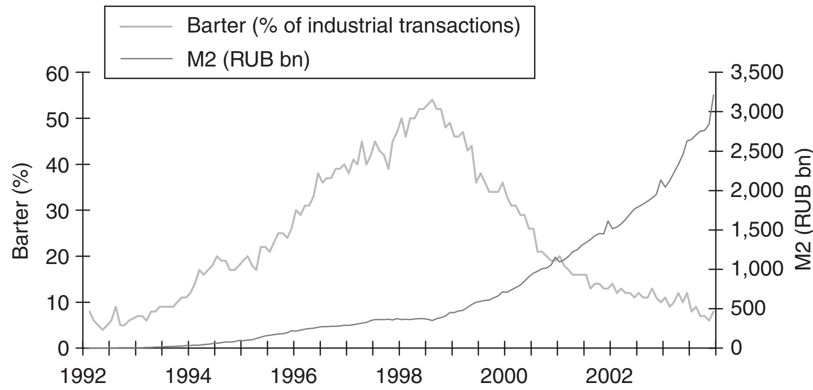
What is more, it was not merely a period of piecing together the rubble of the government's finances from the shattering 1998 crisis as, simultaneously, the wealth of the Russian consumer was also to undergo an immense change for the better.

Not only are workers now getting paid, but wages have risen substantially. In 1999, the official average wage was USD 64 per month while in 2010 the figure had risen to almost USD 700 per month. Salaries are also not being eaten away by inflation to the same degree, as inflation has moderated over the past 13 years, though remains high by Western standards. Furthermore, with the advent of greater enforcement of corporate tax payments in cash, companies followed suit and began to request cash payments from their customers. The overwhelmingly positive result was a move away from barter transactions, triggering a process of remonetization of the economy. By the end of 2003 barter transactions had almost been eradicated, according to data from the Russian Economic Barometer.

The eye-popping explosion in wages has naturally given birth to a thriving middle class and so I would like to offer a few statistics which I feel largely speak for themselves.

For example, the number of privately owned cars numbered 231 per 1,000 people in 2010 (still less than half the number in Western Europe but five times more than in China). Ten years ago, car ownership was 126 cars per 1,000 people and 20 years ago it was 64 cars. In 1998, the majority of cars on the roads were Russian while today most are foreign models (at least in Moscow).

Figure 2.7. Russian barter and money supply (January 1992–December 2003).



Source: Rosstat, The Russian Economic Barometer.

A major offshoot of this race to get behind the wheel has been an escalation of Moscow's famously infuriating traffic jams. The city's traffic was already notorious 13 years ago. In 1998, bad traffic could turn the drive to Sheremetyevo airport from the center of Moscow from a 30 minute journey into a one-and-a-half-hour trudge. Now it can be a four-hour slog. While I will not hide the fact that I mention this issue here in the faint hope that it will help in shaking the authorities into tackling the issue with greater urgency, the huge expansion in Moscow's rush hour, thanks to the increase in car ownership, is still testament to how fast changes took place (and arguably how significantly the country's infrastructure was unprepared).

Another new-found love of the Russians is undoubtedly the cellular phone. Perhaps in a similar vein to cars, the cell phone also occupied the position of status symbol in a society that was deprived of materials goods for so long and then sought to demonstrate new wealth. In 1999, mobile phone penetration was a mere 1% (not aided by the absurd bureaucratic requirement to have a license in order to carry a mobile phone) against levels of around 90% in developed economies. Nevertheless, rising disposable income and a Russia-specific factor that the population often owns more than one sim card generated a mobile phone penetration level of 151% by 2010. Moreover, low broadband penetration (31% in 2010, up from 3% five years earlier) means that mobile phones are an important tool for accessing the internet.

Non-Russian readers of this chapter will, however, likely be more familiar with the influence of Russia's middle and upper classes beyond Russia's borders, as this developing segment of the population have scattered across the globe. In 2010, there were 12.6mn registered departures by Russian residents to non-CIS countries. In 1999 this figure was a mere 2.6mn. It is now not uncommon to find restaurants in Europe with menus in Russian.

The Russian elite has also actively invested in the overseas property markets for years, demonstrating a particular fondness for prime real estate in London. Although exact data on how much money has been directed into real estate is unknown, Knight Frank estate agents reported that in the 12 months up to February 2011 Russians paid an average of USD 8.8mn per property in London. Despite citizens of China, Malaysia and Hong Kong paying a higher average price, Russians are the dominant foreign investors in the London market, buying 5.9% of all properties with price tags above USD 3.3mn over the aforementioned period (second after U.K. citizens, who comprised 48.4%). In addition, Russians accounted for 5% of prime property purchases in Monaco and a full 10% in Paris during the same 12 months.

Any assessment of this phenomenal reversal in Russia's fortunes from the depths of the 1998 turmoil naturally returns to the single most important driver of this transformation: the oil price. On my arrival in Russia in 1998, the oil price stood at just over USD 10/bbl and the oil bears were roaming the streets. In November 1998, Kuwaiti Oil Minister Sheikh Saud Al-Sabah said he feared prices could plunge to USD 5/bbl, a view shared by the influential *Economist* magazine. Instead, the oil price, after reaching a bottom of about USD 9/bbl in December 1998, began a steady climb. For Russia it was a blessing in an (albeit very weak) disguise.

By 2005 I found myself part of the new wave of investment banking employees trying their hand at Russia's growing capital markets as the economy continued its climb out of the abyss. I was working in the research department of a local Russian brokerage with a remit to forecast Russia's economic path. In October 2005, with the oil price at USD 55/bbl, and our in-house long-term base case assumption of USD 32.5/bbl, I published a report in which I outlined a "what-if scenario" for Russia's economy at an oil price of USD 100/bbl.

The majority of the bank's clients appreciated the approach (perhaps dreaming of the fabulous impact a USD 100/bbl oil price would have on

their investments). Others, including journalists, banking competition and selected clients questioned which planet I happened to be living on. Two and a half years later it turned out our worlds were not so far apart after all, and we remain on the same planet.

Finally, while the economic boom years were undeniably oil-fired, some credit must be accorded to the transfer of power in 2000. Vladimir Putin became acting president on New Year’s Eve 1999 when President Boris Yeltsin resigned in a surprising move. Putin then won the 2000 election and went on to a second term in 2004 as the good fortune of rising oil prices persisted.

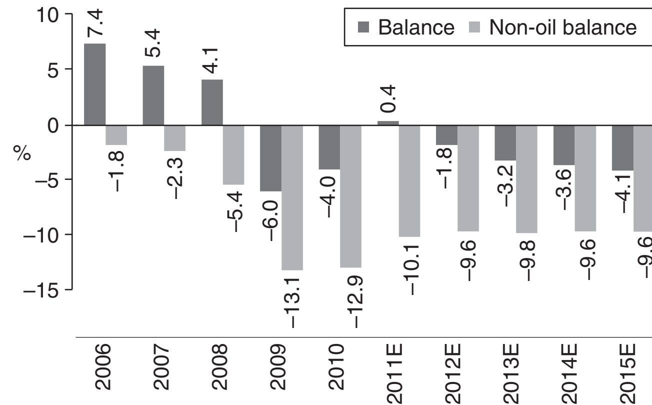
Equally important, the country has not completely squandered its bulging revenue, for which the overwhelming credit must go to former finance minister Alexei Kudrin. For instance, net private capital outflows, which over the 1994–2000 period amounted to USD 128bn, or an average of 6.5% of GDP annually, diminished sharply from 2001 and turned into net inflows in 2006 and 2007. Also, from 2004 the government began to set aside oil-related revenues into a stabilization fund, later split into the Reserve Fund and the so-called National Wellbeing Fund, with a combined value of USD 118bn (October 2011). At the peak in December 2008 the two funds held a combined value of USD 225bn, but it was drained as it was used to prop up the budget after the oil price drop in 2008 led to revenue shortfalls.

That said, there remains an underlying fragility in Russians’ confidence in the economy’s capacity to withstand external shocks and a fear of losing assets earned, as witnessed by the renewal of capital outflows since the 2008 global financial crisis erupted. Over 2008–10 USD 230bn (or 5% of GDP) has left the country (the figures on Russian activity in international property markets may offer some clues as to the destination of this money). Moreover, the 2008–9 crisis has exposed serious structural weaknesses in the Russian economy, which brings into question the ability of Russia to achieve a similar economic performance as seen prior to that crisis.

Economic Progress on Hold

In the aftermath of the 2008–9 global economic crisis, and the ensuing instability across financial markets, economists and government officials alike are, once again, considering how to generate economic growth after a painful contraction in GDP. In terms of starting points, there is no

Figure 2.8. General and non-oil federal fiscal balance (%/GDP).



Source: Central Bank of Russia, Russian Ministry of Finance, Rosstat, ATON forecast.

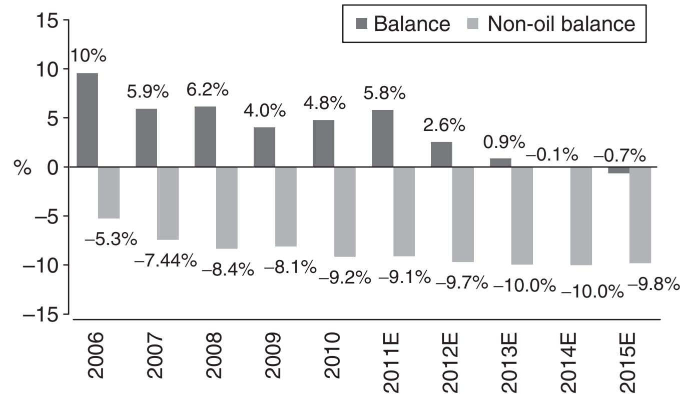
question that if you take a snapshot of the Russian economy you will see that the country will end 2011 with one of the strongest balance sheets globally. The budget and current account will be in surplus, it will proudly demonstrate the world’s fourth largest foreign exchange reserves, a negligible external debt position, one of the lowest level of inflation rates since reforms began in 1992, and despite a volatile global economic backdrop, the oil price remains at USD 110/bbl (October 2011). I ask therefore, is there anything to be genuinely worried about?

In my view, the answer is yes. Russia’s next president, to be elected in March 2012, in my view, will be facing great challenges, and in this section I outline some of the more pressing ones.

While the Russian economy did recover from a 7.8% decline in real GDP in 2009 to a 4.0% expansion in 2010, an even stronger rebound that should have occurred, purely from a low base effect, did not materialize. Real GDP growth is likely to come in around 4% in 2011, hence far below the galloping growth rates seen in 1999–2008 when economic expansion averaged 6.9%. And all this despite the black gold currently trading around USD 110/bbl.

At the time of writing the world is going through another crisis, or some would argue a continuation of the 2008–9 turmoil. European sovereign debt lies at the heart of the problem, but the world is also witnessing political unrest in North Africa and the Middle East, concerns over U.S. economic growth, as well as worries over the sustainability

Figure 2.9. General and non-oil current account balance (%/GDP).



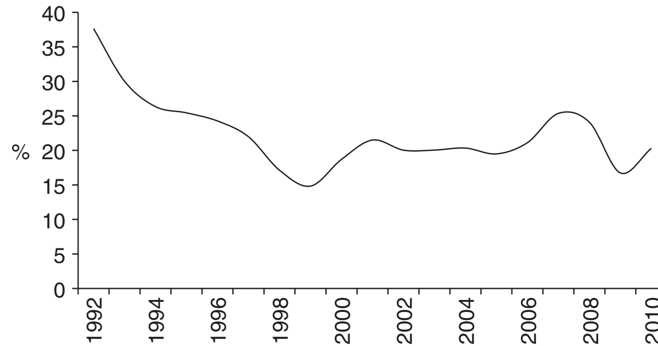
Source: Central Bank of Russia, Russian Ministry of Finance, Rosstat, ATON forecast.

of the Chinese economic growth story. A high degree of integration into the world economy means Russia cannot withstand a global growth slowdown. The main impact would be felt through lower commodity prices—not surprising given that more than 85% of total exports is commodity related.

However, there are also major structural issues within Russia to take into consideration. The output gap has narrowed which has pushed the potential growth rate lower. Currently, the potential real GDP growth rate lies around 4% while during the years 2001–8 it was above 6%, according to an ATON forecast. Russia has missed the opportunity to reduce dependence on the oil price, which quite to the contrary has grown in recent years. The best illustration of this is the non-oil fiscal deficit (the budget deficit after the exclusion of oil-related revenues), which is currently over 10% of GDP. During 2004–8 the non-oil deficit averaged about 2% of GDP. Since 1995 Russia has also enjoyed a current account surplus (with the exception of 1997 when the country recorded a modest deficit). However, as with the budget, when excluding revenues from oil exports, the current account balance has also been negative.

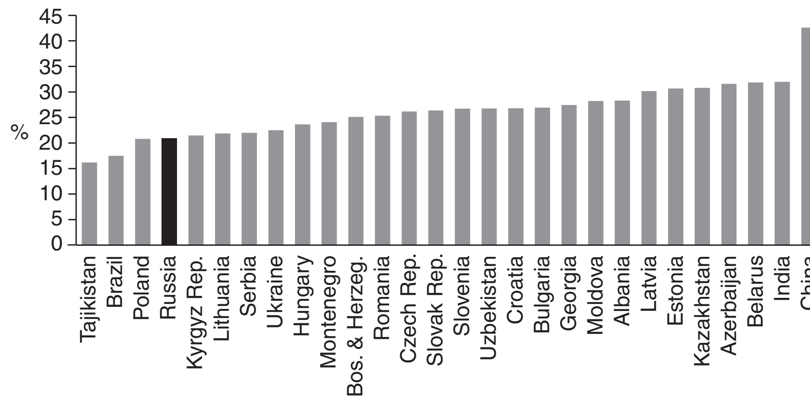
The quality of Russia's economic growth is also questionable given that domestic investment remains low and Russia is in great need of upgrading and replacing a large proportion of its capital structure. Gross capital formation (including change in inventories) stands at around 20% of GDP. This is low by any international standard, as illustrated in figure 2.11,

Figure 2.10. Russia: fixed investment (%/GDP).



Source: Rosstat, IMF.

Figure 2.11. Fixed investment (10 year average %/GDP).



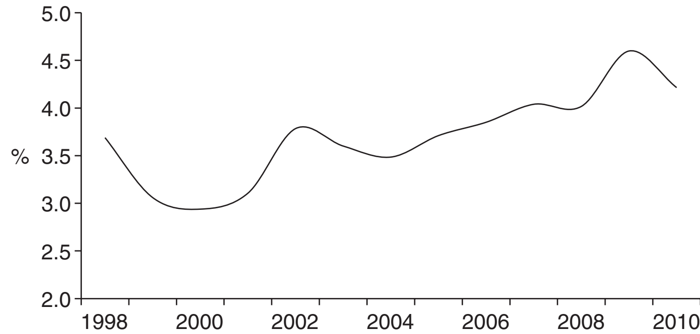
Source: Rosstat, IMF.

where within a group of countries including the other BRIC countries as well as former communist economies, we see that Russia's 10 year average investment level of 20% of GDP is superior to only three other countries (Tajikistan, Brazil and Poland).

The solution lies in modernizing and diversifying the economy, which has been flagged by the Russian leadership as a key policy objective for several years now, though with questionable tangible results.

This challenge will not disappear, however, and will merely grow in stature and complexity. In my own doctoral thesis I analyzed the potential for Russia to diversify its economy. In short, the conclusion

Figure 2.12. Russian budgetary spending on education (%/GDP).



Source: Russian Ministry of Finance.

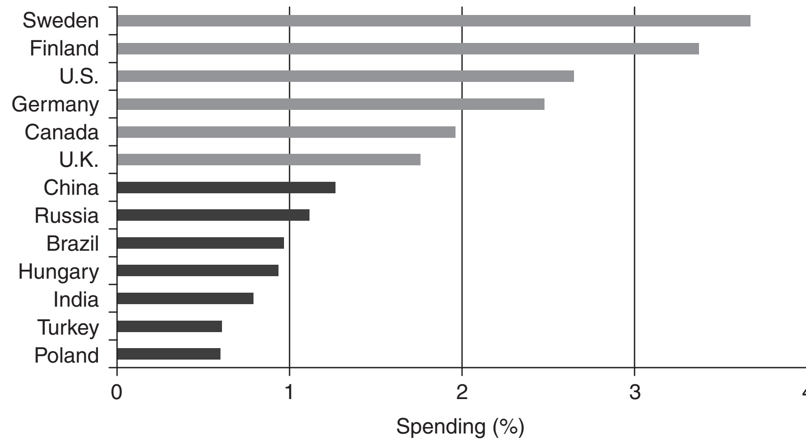
was that without serious structural reforms, a higher oil price would lead to an increase in the dependency on oil, and subsequently, the harder it would be to achieve economic diversification. As history reveals, only a handful of countries have managed to diversify away from dependency on a natural resource (not necessarily oil) to more high-tech/high-value-added economies, namely Sweden, Finland, Canada and to a certain degree Australia.

As a vast body of economic research has demonstrated, the key components for successfully diversifying an economy have been spending both on education and on research and development, coupled with foreign direct investment. Russia's track record in all three areas has so far not been supportive of a success story.

1. Spending on Education

While budgetary spending on education has been rising since 2000, the 10 year average of 3.8% of GDP is low compared with levels of more than 5% in Central European countries or an average of 4.6% in the OECD. In Sweden, a prime example of a country that since World War II has diversified away from natural resource dependency, public spending on education over 1965–80 averaged more than 7% of GDP. For Finland the average expenditure over the same period was around 5% of GDP. To this day, Sweden and Finland continue to top the league table of public spending on education within the European Union.

Figure 2.13. R&D spending (10 year average %/GDP).



Source: Rosstat, World Bank, Global R&D Funding Forecast.

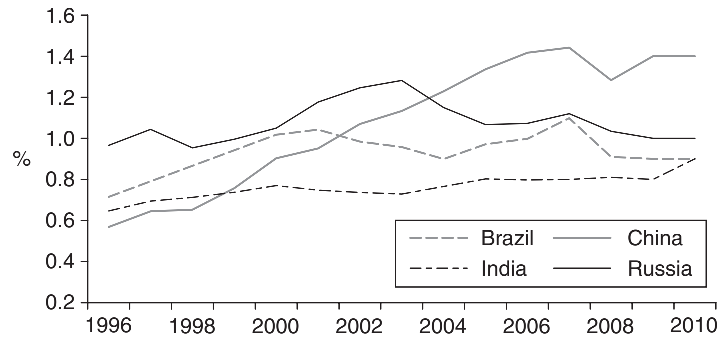
2. Spending on Research and Development

In terms of spending on R&D Russia has a more commendable position within the emerging market universe. Figure 2.13 shows that over the last 10 years R&D spending (public and private combined) in Russia has averaged 1.2% of GDP, only marginally trailing China's 1.3% of GDP. That said, the rather steady growth in R&D starting in 1999 stalled in 2003, and in 2009–10 R&D spending amounted to a mere 1% of GDP. In addition, it is worth noting that Sweden and Finland continue to display some of the highest R&D levels in the world. In 2010 they were the only two countries to meet the EU goal of 3% of GDP, set in 2002 in order to integrate EU members states into a European Knowledge Area (the goal was to achieve this by 2010 so the deadline has passed).

3. Foreign Direct Investment

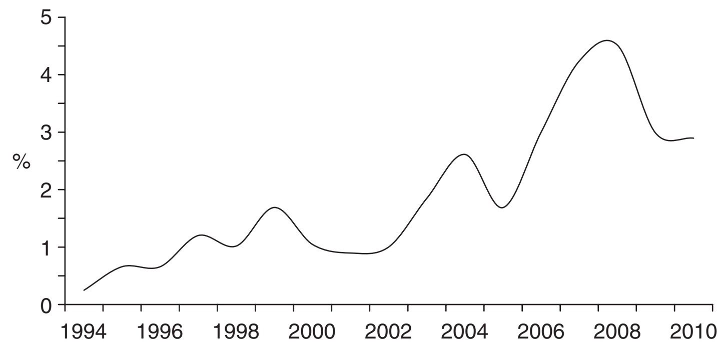
Since records began in 1994, Russia has attracted a pitifully small amount of foreign direct investment and thus has received one of the lowest levels of gross FDI of all post-communist countries. On a positive note, the level of FDI as a share of GDP rose fairly steadily from 2002, peaking at 4.5% of GDP in 2007. Since then, however, the level of FDI dropped to below 3% of GDP in 2010. The average for 1994–2010 was 1.9% of GDP, well below the average for post-communist countries and

Figure 2.14. R&D and the BRICs (%/GDP).



Source: Rosstat, World Bank, Global R&D Funding Forecast.

Figure 2.15. Foreign direct investment into Russia (%/GDP).

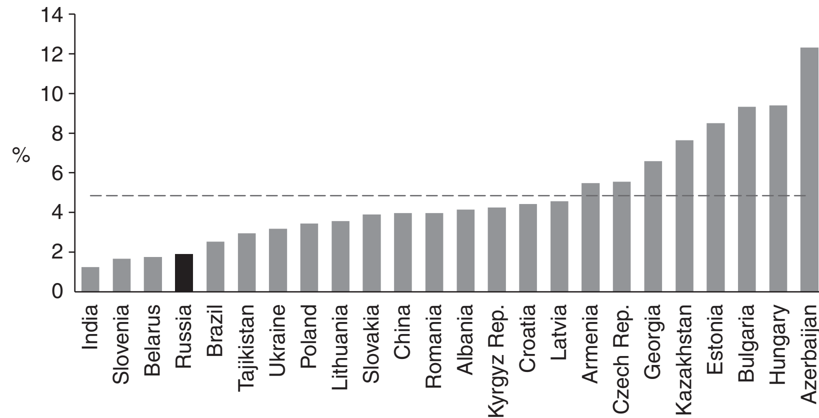


Source: Central Bank of Russia, CEIC Data.

the BRICs, and in fact is the fourth lowest of the 24 countries displayed in figure 2.16. Combining this reality with the earlier mentioned statistics on domestic investment clearly emphasizes that the government must address huge failings in its efforts to attract investment, both by domestic as well as foreign corporations. Deterrents to investment frequently cited by investors have included an untrustworthy investment climate due to an unpredictable legal system and corruption.

Finally, moving the discussion to other weak spots in the economy, it is important to recognize that small businesses have tended to be an engine for growth in most economies. However, in Russia, bureaucracy and corruption have been discouraging small business development. While data

Figure 2.16. Gross foreign direct investment (average %/GDP 1994–2010).



Source: Central Bank of Russia, CEIC Data.

are lacking for 2010, the output produced by small businesses amounted to 12.4% of GDP in 2009 (the EU average is close to 20%). I would expect only a slight recovery in 2010 and a further deterioration in 2011 as anecdotal evidence suggests that small businesses were particularly harshly impacted by a hike in the social security tax in January 2011 from 26% to 34%.

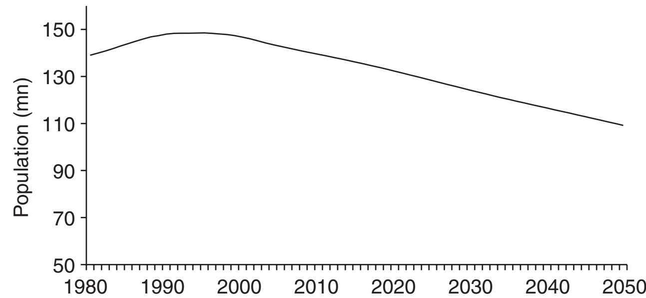
Small and micro businesses are additionally an important factor for labor creation. In Russia, in 2010 employment in small businesses accounted for 8.6% of total employment compared with the EU average of 21%, and micro businesses employed 6.8% with the EU average close to 30%.

Poor Demographics Is an Additional Burden

Russia is also struggling with negative demographic dynamics. Over the period 1993–2009 Russia's population shrank by almost 400,000 per year. Looking to the future, according to the U.S. Census Bureau Russia's population could collapse to 110mn by 2050 from 143mn currently. I should underline the glimmer of good news that the number of births has been on the rise since 2000 while registered deaths have been on the decline since 2003.

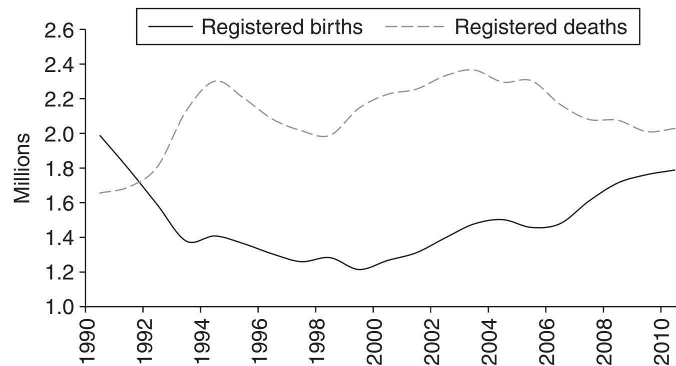
Adding to the good news, in 2010 Russia registered its first population increase since 1992, showing growth of 1mn. This increase was

Figure 2.17. Russia's shrinking population (mn).



Source: U.S. Census Bureau.

Figure 2.18. Number of births and deaths (mn).

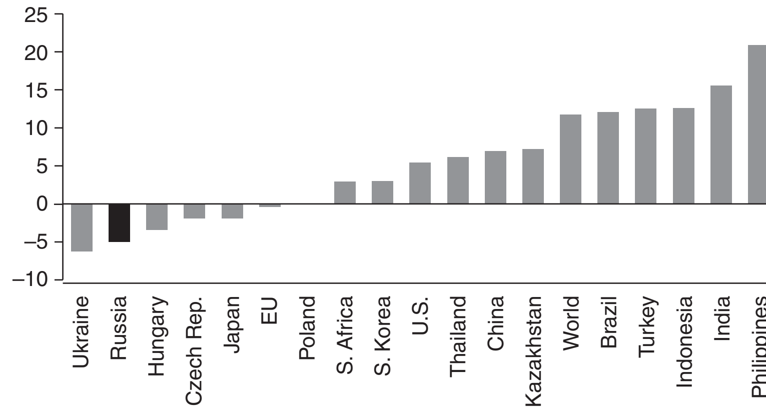


Source: Rosstat.

supported by a slight uptick in the birth rate, but was mainly driven by a surge in immigration. Given that Russia's immigration policy is rather restrictive, with the exception of efforts to reach out to the Russian diaspora, we are not yet confident that 2010 was the start of a reversal of the trend. That said, the rate of decline will likely diminish dramatically and therefore the forecast from the U.S. Census Bureau is probably too pessimistic.

Nevertheless, in an international setting Russia's demographic structure looks appalling. Taking the difference between the number of births and deaths (per thousand people) Russia stands out with a net decline (see figure 2.19). In addition, the average life expectancy for men is still just 63 years while for women it is 75. Russia remains one of seven

Figure 2.19. Birth rate minus death rate 2009 (per thousand people).



Source: CIA World Factbook.

countries in the world where the difference between men and women dying is more than 10 years.

Perhaps more worrying is that the labor force peaked in 2009 and is now in decline, and given low birth rates in earlier years the labor force will continue to shrink for some time. While clearly a declining labor force is serious, the impact on the economy is not straightforward. A falling labor force in a labor-intensive country like India or Bangladesh would clearly have a negative impact on output. However, Russia, I would argue, is capital intensive. The problem, though, is that a large part of the capital stock is outdated, and in need of upgrading or replacement. The alternative is what is known as the t-factor in a production function, namely technological advancement. This means that technological advancement and innovations can help Russia to cushion the negative impact of a declining population and labor force. However, as I have illustrated, the prospects for capitalizing on the t-factor remains low given low domestic and foreign investment, as well as low spending on R&D and education.

Furthermore, a recent survey (May 2011) from the Levada Center (a Russian independent research organization with a focus on social issues) found that 22% of Russia's adult population wants to leave the country. This is the highest number recorded since the fall of the Soviet Union. If we speak purely of students and entrepreneurs, this figure rises to 50%. A study by the World Bank found that 77% of Russian science and

engineering students, studying in the United States will not return to Russia. While I am sure that a similar situation may be found in many other countries during this time of crushing youth unemployment globally, I am particularly perturbed by the number of educated Russians seeking to apply their talents elsewhere. The inference is that we are witnessing a return to a similar sentiment observed in the 1990s.

This, in my view, highlights another fundamental problem: Russians already leaving the country tend to be highly educated or skilled workers. As for immigrants, 90% are from the former Soviet republics, and the vast majority can be classified as blue collar workers. This means that through migration Russia remains a net exporter of talent.

The Government Needs to Take Responsibility

The government has an important role in guiding Russia onto the path of modernization and diversification. Therefore, the prioritization of fiscal spending needs to be addressed, and, in addition, this is especially urgent given the budget's increased dependency on the oil price. As shown above, R&D spending has been on the decline, and although spending on education is currently higher than 10 years ago it is very low for a country where economic modernization is critical. On the federal level, spending on military and security accounts for more than 20% of spending, and increasing every year. With a need to cut expenditures, efforts to refocus and reallocate spending in favor of education and R&D must be adopted. The largest item in the federal budget is financial aid to the regions, which in 2010 accounted for 32% of the federal budget or 7% of GDP. This means Russia's regional governments (given that a large share of spending on, for example, education comes from the regional budgets) have a vital role to play in adopting a modernization-accommodating fiscal regime. The main question, however, is to what extent regional governments have an incentive to comply given that (1) they have been stripped of some of the powers by the central government and (2) given the year-end transfer of regional aid from the federal budget, there may be an issue of moral hazard.

While it may sound like a cliché, improving the general business climate for both domestic and foreign investors is paramount. The figures on FDI and fixed investment presented above speak for themselves. Moreover, the investment climate remains very uneven across Russia. Not surprisingly, Moscow has attracted the largest number of

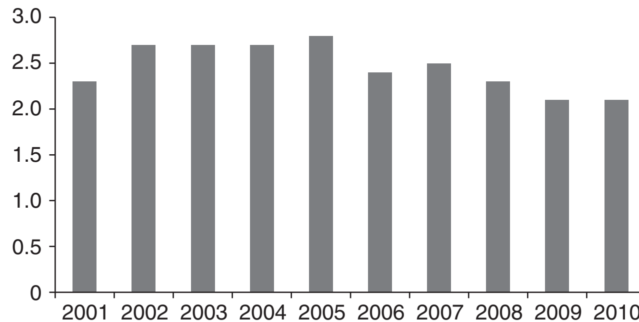
FDI projects. However, under the previous city government, led by former Mayor Yuri Luzhkov, corruption was widespread, and in the process probably deterred larger FDI projects from choosing Moscow as the base for their investment. According to a study by Ernst & Young Moscow, during 2006–10 Russia's capital attracted 272 FDI projects, creating 6,954 jobs. However, the region of Kaluga, generally considered to have the most favorable business and investment climate of Russia's regions, over the same period created 8,858 jobs out of just 39 FDI projects—a sign that Kaluga managed to attract larger foreign projects. The average salary in Kaluga is more than 2.5 times the average salary for the country as a whole and the region is suffering from labor shortages while the nationwide unemployment rate currently stands at 6%.

After 18 years of negotiations Russia is finally set to join the WTO in 2012. WTO membership should eventually bring positives to the Russian consumer through increased competition, and could also have positive implications for further liberalization of sectors such as banking, insurance and telecommunication. Also, there is a belief that membership of the trade club could bring in more FDI. I would, however, argue that the big caveat is that this is strongly related to politics, which will determine how committed the establishment is to allowing WTO membership to benefit the country. If the government pushes ahead with improving the business climate, then the net impact from WTO membership could be huge, mainly in attracting investments. However, if the status quo is maintained, the benefits from WTO membership will be limited, in my view.

Efforts to improve the business and investment climate must involve a crack down on Russia's rampant corruption as it is associated with economic distortions and provides an obstacle for economic flexibility. Consider, for example, that in many countries small businesses provide an engine of growth and labor creation. In Russia, however, corruption remains a key obstacle for small business development, and partly explains why the segment, as described above, remains underdeveloped. Therefore, the distortions created by corruption should not be underestimated, and the same is true for barriers to entry for both domestic as well as foreign companies. Again, a quantitative data approach provides a telling picture.

According to Transparency International's Corruption Index, in 2010 Russia scored 2.1 (on a scale from 0–10, where 10 represents a "clean"

Figure 2.20. Corruption Index for Russia.



Source: Transparency International.

country and 0 indicates total corruption). Russia was one of the lowest-ranked countries, coming in at number 154 out of the 178 countries surveyed. In 1998, Russia scored 2.4 (ranking 76th out of 85 countries surveyed) on the corruption index. Over the past 12 years, according to the index, the situation relating to corruption has actually deteriorated.

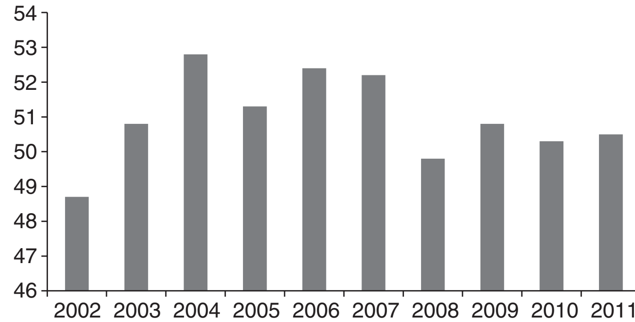
The Economic Freedom Index, produced by the Heritage Foundation, ranges from 0 to 100, with 100 indicating maximum freedom. It evaluates openness, the rule of law and competitiveness, factors which are taken for granted in most well-developed economies, but often lacking in developing and emerging countries. In 2011, Russia scored 50.5 and placed 143 out of 179 countries surveyed. As with the corruption index, this figure represented a decline from 1998 when Russia scored 52.8 and stood at 137 out of the 155 countries surveyed that year.

If one sets the 10 year average Corruption Index and Economic Freedom Index against 10 year average GDP growth (for the Corruption Index figure 2.22 displays the result of 174 countries, and for the Economic Freedom Index figure 2.23 displays the result of 152 countries) the result suggests that a high level of corruption or lack of economic freedom is not necessarily an obstacle for growth.

However, doing the same against GDP per capita reveals a totally different picture, suggesting that in order to develop economically Russia needs to become "free" and less corrupt.

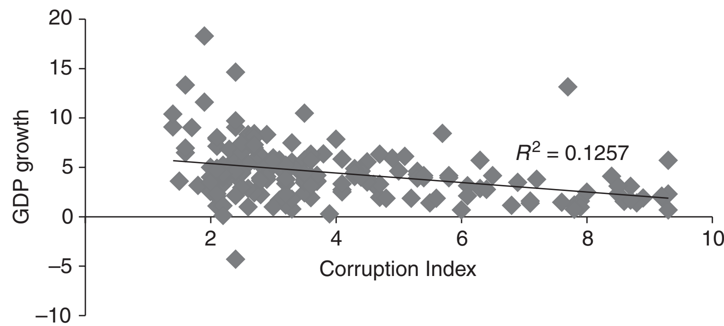
For almost two decades investors have had to consider high corruption levels, poor corporate governance and property rights, and heavy-handed bureaucracy. Throughout this time, the sweetener has been a

Figure 2.21. Economic Freedom Index for Russia.



Source: The Heritage Foundation.

Figure 2.22. Corruption Index and GDP growth (10 year average).



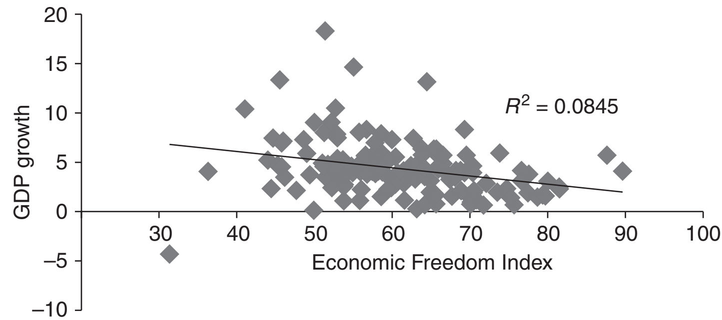
Source: Transparency International, The Heritage Foundation, IMF.

strengthening macroeconomic environment and high commodity prices. Hence, given our view that strong growth is becoming harder to achieve, we believe that in the future these factors will receive more attention and investors may not be willing to show as much tolerance toward Russia's ills.

A Message from China

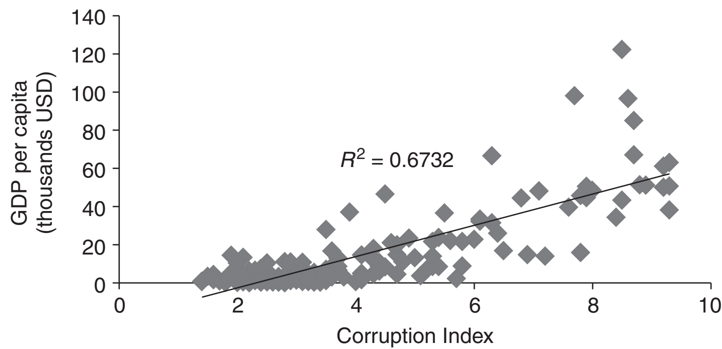
In composing this chapter, and in particular in considering Russia's challenges ahead, I drew on observations from two weeks spent in China visiting Beijing, Shenzhen and Shanghai in September 2011. This admittedly

Figure 2.23. Economic Freedom Index and GDP growth (10 year average).



Source: Transparency International, The Heritage Foundation, IMF.

Figure 2.24. Corruption Index and GDP per capita, 2010.

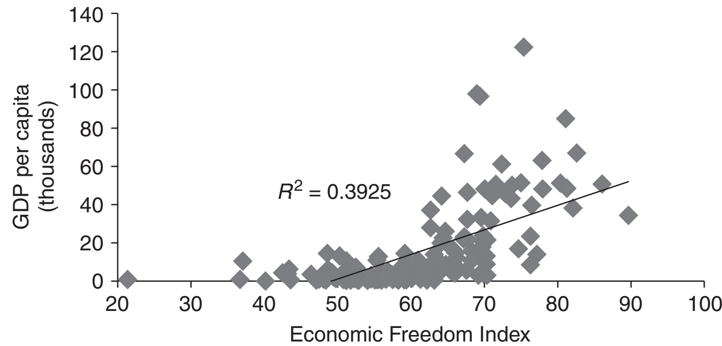


Source: Transparency International, The Heritage Foundation, IMF.

short period nevertheless came to shape my views on Russia's failings in its existing economic model.

There are of course several problems with comparing Russia with China, and the main one being the starting point of reforms, with China moving along a more normal development path, moving from a high degree of labor intensity, and a large share of agriculture, then adding capital, freeing up labor that could then move into other, higher-value-added industries. Russia, on the other hand, in 1992 could be considered a capital intensive nation, but, moreover, a large share of that capital was in dire need of upgrading or replacement. Also, the Chinese economy is heavily dependent on manufacturing while Russia is resource

Figure 2.25. Economic Freedom Index 2011 and GDP per capita 2010.



Source: Transparency International, The Heritage Foundation, IMF.

dependent, and apart from raw materials exports there is little else to write home about.

Nevertheless, China has invested in the population. The infrastructure network, such as roads and public transport systems are some of the best I have observed, at least in the major cities that I visited. Over the last 20–30 years new cities have been created from scratch. Thirty years ago the region of Shenzhen had a population of 300,000—today it is a city of 12mn.

However, a stark difference is the attitude toward foreign investments. If a foreign company set up a headquarters in Shanghai, the local government will give land for the construction of the headquarters, senior management will be given housing, and the company is provided with significant tax breaks for several years. The concept of special economic zones has truly been a success in China. In Russia, the notion of welcoming foreign workers is still alien, and even the basic procedures of moving to the country are exploited by the authorities. For example, it is the case that foreigners moving to Russia have to pay an import duty of USD 5.40 per kilo on household goods. In other words, a foreign worker wanting to bring his 150 kilo sofa must fork out an additional USD 810 on top of his shipping costs.

In terms of the attitude toward foreign investments, apart from the Kaluga region, and a few other places in Russia, there is little to be desired. Foreign companies, as well as domestic, continue to have to deal with red tape, corrupted officials, frequent inspections from different authorities (police, fire department, health & safety, and so on).

Ultimately, I realized that Russia's potential for improvement is far greater than I had previously presumed, and importantly I acquired a greater understanding that discernible change must, at its root, come from a desire for economic development from all levels of government.

Concluding Remarks

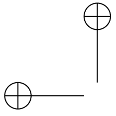
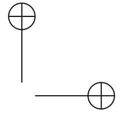
In this chapter I have tried to give an overview of Russia's economic development during the time I have lived in Moscow. The 1998 crisis, in my view, can be described as what the economist Joseph Schumpeter coined "creative destruction," resulting in a new start for the Russian economy, and a clear break from the disastrous period of 1992–98. Thanks in part to some reforms, and a strong helping hand from a strengthening oil price, the economy began to flourish, and more importantly, the living standards of the Russian population started to improve.

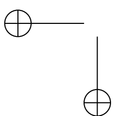
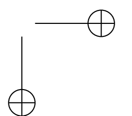
However, the blossoming of opportunities to improve the standard of living was accompanied by rise in corruption, and the rising oil price meant that politicians lost the sense of urgency to reform. Unfortunately, it is this factor which likely has exacerbated problems after the 2008–9 crisis, which in fact had little resemblance to the 1998 crisis. It is true that on both occasions, little social unrest among the population was observed and the economy and the consumer recovered very quickly. However, the last crisis, rather than pushing economic reforms further, has exposed the structural weaknesses of the Russian economy, in my view, such as greater dependence on the oil price. As a result the Russian leadership will need to urgently focus their effort on structural and institutional reforms, in order to avoid further disruptions to economic progress.

A real challenge for any economy where radical reforms are needed, and in particular in a period of crisis, is that the negative impact is normally immediate whereas the effect of most solutions of a structural reform nature will only be felt over time. The mindset of politicians tends to be short term, normally a function of the election cycle. This often leads to governments focusing on quick-fix solutions that tend to have only short-term impact, and rather than solving the problem such measures tend to postpone them. Russia in particular is at severe risk of falling into such a trap in the wake of the 2008–9 recession, given that the state is under huge pressure to improve, or at least maintain the

consumers' standard of living, which has undergone a massive improvement over the past decade.

And finally, I feel the legacy of the Soviet Union, which in the 1960s and 1970s grew stronger and was considered a superpower, may also, at times, stand in the way of Russia's development. In 1993 I spent five weeks in Argentina on a scholarship from the Swedish Development Authorities, conducting a study of the Argentine debt crisis and the Brady Plan. I interviewed Javier Gonzalez Fraga, a former president of the Central Bank of Argentina, who said something that has stuck with me since, because it may also be applied to Russia. He said, "In the 1930s Argentina was one of the richest countries in the world. The problem for Argentina's development today, is that we still think we are."

CHAPTER THREE

Corporate Governance in Russia: Dark Clouds with a Silver Lining

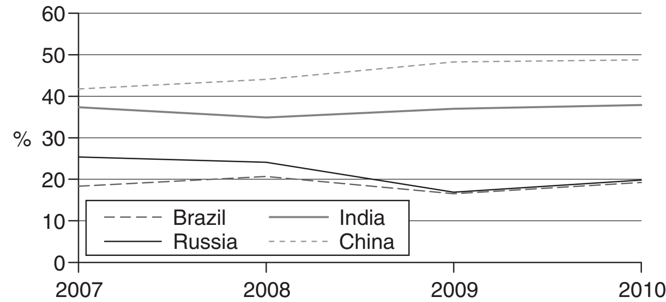
By Rebecca Baldridge

Myriad examples from markets around the world demonstrate that poor corporate governance is destructive of value. Moreover, without reliable information regarding the quality of governance at individual companies, investors cannot assess the level of non-financial risk associated with an investment. This inability to accurately assess risk gives rise to substantial discounts in company valuations. Today Russia trades at an approximate 40% discount to GEMs on a P/E basis, and many market participants believe that this discount is in significant measure due to the widespread perception of poor corporate governance. Perception is indeed the driver that distorts Russia's valuation, as the legacy of corporate malfeasance from the early days of the country's transition continues to overshadow the very real progress that has been made. In this chapter, we look at the strides Russia has made over the past twenty years and the changing nature of the governance landscape. In our view, a more realistic and nuanced view of Russia's progress in corporate governance should lead to the narrowing of a discount we consider unjustified.

Russia's Need for Capital Will Drive Continued Improvement in Corporate Governance Practices

Across emerging market economies, the necessity to attract foreign capital makes corporate governance a compelling issue for consideration by companies and governments alike. Since the inception of the Russian equity market with large-scale voucher privatization in the early 1990s, the need to satisfy the demands of international investors has driven the development of the corporate governance framework in Russia. Russian companies have a steadily rising need for capital that domestic capital

Figure 3.1. Gross domestic investment as a percentage of GDP.



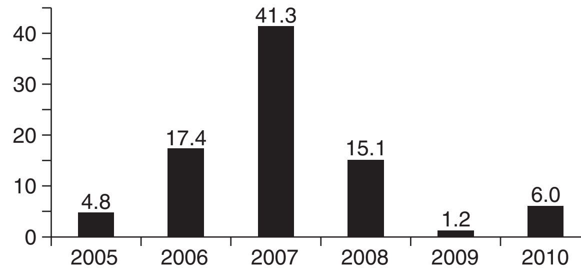
Source: IMF.

markets are unable to meet. At the same time, there is growing recognition of the value of integration into the global economy and the attendant benefits of knowledge and technology transfer. These factors, taken together with Russia's valuation discount, are increasing appreciation for the significant role that stronger corporate governance plays in encouraging the formation and flow of capital.

It is widely understood that Russia has endured a protracted period of underinvestment. Since the late Soviet period, infrastructure and fixed assets across industrial sectors have been falling into obsolescence. Yet, following the economic crisis of 2008–9, gross domestic investment declined sharply. From a low of 16.9% of GDP in 2009, the figure recovered to some degree in the post-crisis period, reaching a still-modest 19.8% in 2010. But compare domestic investment in Russia with the 48.8% of GDP witnessed in China or the 37.9% invested in India. With domestic investment failing to act as a sufficient driver for growth, Russian companies have little choice other than to look for international sources of financing.

Following VimpelCom's debut on the New York Stock Exchange in 1997, Russian companies have sought capital internationally by listing on foreign exchanges via IPOs and SPOs. Activity peaked in 2007 when Russian issuers raised more than USD 41bn. While IPO activity dropped off sharply following the 2008 crisis, as would be expected, 2010 witnessed disappointing performance by, or the cancelation of, a number of placements despite ongoing economic recovery. This disappointing performance in the international capital markets indicates that global investors may be raising their expectations for Russian

Figure 3.2. Russian IPO and SPO activity, 2005–10 (USD bn).



Source: Bloomberg, ATON estimates.

companies, demanding greater clarity in both business models and governance structures. As Russian companies are forced to increasingly look to the international markets to raise capital, the need to improve corporate governance standards will become more acute.

Finally, the Russian government's highly publicized desire to establish Moscow as an international financial center will also spur many changes. Moscow is unlikely to achieve this goal without greater participation of domestic capital in the equity market. The country has an abundance of liquidity, but little in the way of institutionalized third-party management of pensions and savings. The perception of corporate governance risk (not to mention the innate Russian distrust of institutions of any sort) is one of the most significant factors inhibiting the formation of long-term domestic capital, which is necessary to build the institutional framework that would promote better behavior and a stronger rule of law.

Potentially the greatest obstacle to achieving the goal of making Moscow an international financial center, existing structural limitations aside, will be overcoming Russia's negative reputation among international investors. Issues such as the weak rule of law, persistent corruption, poor protection for property rights and the perceived lack of a strong corporate governance culture and support for investor rights continue to be the primary concerns of the international investment community. There is no doubt that these concerns are legitimate, but nonetheless perception may be worse than reality, particularly given the sensationalistic treatment of Russia by the international press. Although it is imperative that the government continue taking significant

measures to address all of these issues, inroads have nonetheless been made, particularly in the area of corporate governance.

Relative to Other Emerging Markets, Russia Appears to Be Unjustly Penalized

In our view, compared with other emerging markets, Russia's standards of corporate governance are not significantly lower and therefore neither the market's sharp discount nor extremely negative reputation is justified. In certain areas, standards are superior to those in other markets, particularly in terms of the legislative infrastructure. According to a recent Standard & Poor's survey, Russia has, along with a comparatively robust body of law, the most well-defined minority shareholder rights among BRICs. The ownership threshold for nominating board candidates is low, while the law stipulates annual board elections (as opposed, for example, to the three-year tenure for directors in China) and universal cumulative voting for directors. Governance Metrics International (GMI) is a ratings organization that provides a bottom-up review of the quality of company management across markets, measuring corporate governance standards at the board level and looking at factors such as accountability, financial disclosure, internal controls, minority rights, the market for control and other corporate behavior. According to GMI's ratings methodology, 10 is the highest rating possible. The United Kingdom is the global leader in GMI's ranking with a score of 7.6. Given Russia's reputation, one might expect to find Russia at the bottom of the scale. Although certainly not a world leader with a score of 3.9, Russia is barely edged out by Brazil with 3.91. China scores a significantly lower 3.37, and Russia still beats countries including Israel, Turkey, Indonesia and Japan. Of the BRICs, only India shows a significantly higher score of 4.54.

Looking at historical P/E ratios, Russia has consistently traded at a discount to other BRIC markets. Ten years ago, in July 2001, Russia traded at a whopping 76% discount to GEMs, while China traded at an 84% premium and India traded at a 26% premium. Brazil's discount was a more modest 26%. By July 2008 Russia's discount had narrowed to 25%, while the other BRICs traded at premiums in the teens. Post-crisis in July 2010 Russia's discount rose to 47%, before returning to the low 40s, where it has ranged throughout 2011. India and China have reversed positions, with India now trading at a higher premium of 34% in mid-July 2011

Table 3.1. Corporate governance ratings, 2010.

Country	Value
U.K.	7.60
U.S.	7.16
Germany	5.80
Poland	5.11
India	4.54
Malaysia	4.21
Thailand	4.20
EM average	3.94
South Korea	3.93
Brazil	3.91
Russia	3.90
Taiwan	3.84
Israel	3.79
Turkey	3.62
China	3.37
Japan	3.30
Indonesia	3.14
Mexico	2.43
Chile	2.13

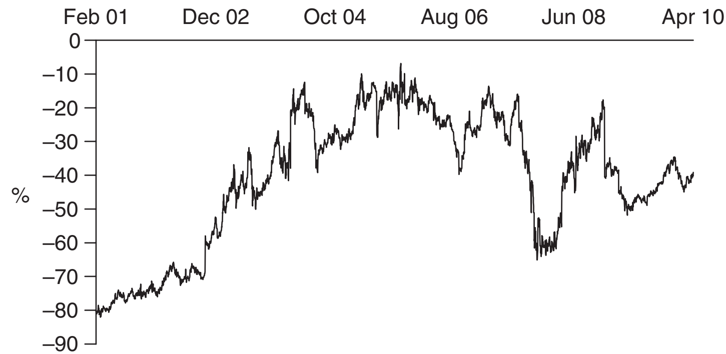
Source: Governance Metrics International.

while China hovers around the GEM average. Brazil was trading at a 24% discount to the GEM average in mid-July 2011. Certainly based on GMI Metrics, as well as relatively robust legislation and consistent progress in improving standards, Russia does not merit this level of discount.

The Rapid Transition to a Market Economy Laid the Groundwork for a Culture of Abuse

In order for international investors to fully grasp the reality of today’s corporate governance landscape and make informed investment decisions, it is helpful to view the current environment within a historical context. In the early 1990s, Russia was just emerging from 70 years of socialism and taking the first steps along the path to developing a market economy. The Russian government adopted elements of a course of Western-advocated shock therapy, which included the rapid decontrol of prices, freeing of markets and the privatization of industry by transferring the assets of state-owned enterprises (SOEs) into private

Figure 3.3. Current P/E: MSCI Russia discount to MSCI EM.



Source: MSCI (www.msci.com).

hands. The theory was that private ownership would enhance economic performance.

Between 1992 and 1994, a voucher scheme for mass privatization saw 147,000,000 vouchers distributed to private citizens. These vouchers could be exchanged for shares in privatized companies, which were the SOEs that had been re-registered as joint stock companies through the Russian Privatization Agency. However, managers and employees were given subsidized or free shares in these privatized companies. Since vouchers were freely transferable and tradable, conditions existed to facilitate the concentration of ownership. Insiders were able to buy more vouchers and exchange them for additional shares, thus passing company ownership predominantly into the hands of insiders. By the end of voucher privatization in the summer of 1994, the typical company ownership structure included 60–65% management and employees, 20% individuals and investment funds, and 15–20% state ownership. The dominance of insiders at the initial stage of post-privatization development became a critical feature of corporate ownership and governance in Russia.

During the late Soviet period, there was little or no investment in infrastructure, plants or equipment. Moreover, during privatization the new joint stock companies received no capital infusions when their shares were created and distributed, as any funds raised went directly to the state. The new joint stock companies, with ownership resting predominantly in the hands of insiders, were strapped for cash and saddled with low quality assets. From the point of view of the shareholder managers,

new external shareholders made no constructive contribution, providing neither desperately needed cash nor other tangible benefits. Instead, these shareholders were unknown quantities making bets on pieces of paper, whose significance was poorly understood. Nor was there any legal framework to support investment or protect the ownership rights of these new shareholders. The conflicts arising from the manner in which these companies were privatized set the stage for the inevitable and predictable violations of shareholder rights that were witnessed throughout the 1990s.

With a centuries-old history of autocracy followed by seven decades of Soviet rule, Russia never developed the institutions underpinning a strong rule of law. The collapse of socialism resulted in an anarchic free-for-all in which the strongest players ended up with the assets and power was concentrated in the hands of a few, namely the state, its bureaucrats, and a number of oligarchs and related financial-industrial groups. In 1995 came the second wave of privatization, the so called loans-for-shares scheme, which saw the crown jewels of Russian industry end up in the hands of select oligarchs, creating a concentrated ownership class. The consequence was increased concentration of ownership and greater insider control, which ultimately led to asset stripping, violation of minority rights, and a variety of other abuses.

Concentration of Ownership Is One of the Most Persistent Legacies of Russia's Economic Transition

According to a report from the CFA Institute Center for Financial Market Integrity, 71% of Russian companies had a controlling shareholder as of May 2008. As defined in the report, a controlling shareholder could be an individual or family, the government or other majority stakeholder. In any case, widely dispersed ownership is relatively infrequent in Russia for assets that were formulated during the Soviet era, and this is a direct legacy of the transition described in the previous section. Following the economic crisis of 2008–9, concentration of ownership increased rather than decreased, supporting the contention that winners remain winners no matter what the circumstances.

Standard & Poor's 2010 transparency and disclosure report shows that 54 of Russia's 90 largest public companies are majority owned, while an additional 24 have blocking shareholders who hold more than 25% of voting shares. In practice, concentration of ownership ensures that

minority shareholders and financial markets have limited influence on management and there is minimal opportunity for market-driven challenges to control.

Moreover, the participation of the state in the economy is growing, particularly in light of the classification of some industrial sectors as strategically significant. According to Standard & Poor's research, 30 of the 90 largest companies were majority owned by the government, while the market value of these state holdings totaled slightly more than 50% of the aggregate market cap of the sample.

When the government is a company's principal shareholder, particular issues in governance arise. For example, state control often means that state-owned enterprises are managed not to maximize shareholder value, but rather to promote specific social or strategic objectives, often at the expense of shareholder value. Patronage too is a significant issue, and often results in plum management roles being doled out as consideration, or as favors to the well-connected. Moreover, the management decision-making process at state-owned companies can be onerous and bureaucratic, with decisions requiring sign off by multiple officials and bureaucrats. In the case of industries classified as strategically important, certain types of decisions can even require approval from the prime minister. The delays involved and the multiple layers of oversight and management actively inhibit value creation.

Independent Directors Can Offer a Counterbalance to the Concentration of Ownership

One counterweight to the concentration of ownership is the independent director, a role which is mandated by the Law on Joint Stock Companies. According to CFA Institute research, 32% of directors on the boards of publicly owned Russian companies are independent directors. However, when ownership is concentrated and a company is majority owned by the state or a private entity, there is a reasonable concern that the independence of any director is less than full and in some way the independent director is compromised. The most compelling question regards to whom the independent director is ultimately responsible.

Early in 2011, new legislation directed that by the end of July high-ranking government officials representing the state on company boards should be replaced by government-appointed independent directors. The legislation is part of President Dmitri Medvedev's recent drive to

Table 3.2. Concentration of ownership, 90 largest Russian companies, 2010.

Companies	Number of companies	Companies in sample (%)	Companies in AMC (%)[a]	Stakes in AMC (%)[b]
Widely held (largest stake < 25%)	12 (13)	13.3 (14.4)	13.4 (17.2)	6.4 (10.4)
With at least one blockholder (>25%)	78 (77)	86.7 (85.6)	86.6 (82.8)	52.9 (50.8)
Of which: majority-owned (>50%)	54 (55)	60 (60.1)	64 (64.7)	43.5 (43.3)
With large stakes (>25%) directly or indirectly owned by government	39 (40)	43.3 (44.4)	53.5 (56.1)	34.5 (36.1)
Of which: with direct government stake > 25%	13 (11)	14.4 (12.2)	34.1 (34.6)	17.4 (15.6)
With controlling stakes (>50%) directly or indirectly owned by government	30 (29)	33.3 (32.2)	50.2 (53.2)	33.4 (35.1)
Of which: with direct government stake > 50%	8 (6)	8.9 (6.7)	15.4 (8.9)	10.4 (5.8)
With large (>25%) private stakes	46 (47)	51.1 (52.2)	34.8 (28.4)	20.8 (19.1)
With private stakes >50%	24 (26)	26.7 (28.9)	13.8 (11.5)	10.1 (8.2)

[a]Share of combined market cap of the relevant companies in aggregate market cap of the 90 largest companies. [b]Share of the corresponding stakes in aggregate market cap of the 90 largest companies. AMC stands for aggregate market cap of 90 companies included in the survey. 2009 figures are in parentheses.

Source: Standard & Poor's, Transparency and Disclosure by Russian Companies 2010: Moderate Improvement in Transparency Led by Power Utilities, 2010.

improve Russia's investment climate, but the extent to which these directors will be truly independent remains to be seen. While the spirit of the law is laudable, the role of independent director could become yet another prize to be awarded within the patronage system.

Russia Has a Relatively Robust Legislative Framework to Support Corporate Governance

While substance has lagged form in terms of corporate governance, both the federal government and market participants have made concerted efforts over the past twenty years to establish a legal framework for managing the relationship between companies and shareholders. As early as 2004, the European Bank for Reconstruction and Development (EBRD) concluded that Russian corporate governance legislation was in "high compliance" with Organization for Economic Cooperation and Development (OECD) Principles of Corporate Governance, and this assessment was reiterated in the EBRD's 2009 Country Strategy report on Russia. Moreover, in the past year a number of new laws addressing corporate governance issues have been promulgated, which demonstrates that the Russian government is ramping up its emphasis on the issue given the desire to be more fully integrated into the global economy and gain status as an international financial center.

But Weak Regulation and Enforcement Undermine Legislative Advances

Despite recognition that the legal structure in place is consistent with international norms and provides a solid foundation for progress in corporate governance, mechanisms for regulation and enforcement remain weak. Both the courts and the regulatory bodies face significant challenges in handling complex corporate governance issues. The main regulatory body overseeing securities related issues is the Federal Financial Markets Service (FFMS), which in 2004 replaced the Federal Securities Commission as the principal supervisory and regulatory authority for financial markets and exchanges. Although under the jurisdiction of the federal government, the FFMS enjoys a broader regulatory mandate and greater independence from the government than did the Federal Securities Commission.

As the principal regulator dealing with the enforcement of corporate governance rules, the FFMS has power over issuers, registrars and professional securities market participants. The regulator enjoys powers to investigate violations, levy sanctions, initiate court proceedings in the interest of protecting shareholder rights and, in the case of criminal offenses, submit findings to the prosecutor for further action. However, in actual fact a dearth of resources acts as a persistent impediment to enforcement activity. Moreover, the FFMS lacks the level of discretionary authority necessary to take corrective action in situations where vague or poorly written legislation allows companies to obey the letter of the law while flagrantly violating the spirit. To ensure a higher level of regulatory integrity, it is imperative that the government grant the FFMS the discretionary authority necessary to provide remedies in legally ambiguous situations.

A strong and predictable judicial system is one of the most important prerequisites in protecting shareholder rights and settling company disputes in any market. In Russia, arbitration courts typically have the responsibility of enforcing shareholder rights, although in some cases, particularly in the regions, courts of general jurisdiction may occasionally hear cases. The Russian court system is vastly overburdened and judges are under pressure to clear cases quickly. Judges are also poorly compensated, and particularly in shareholder disputes where vast sums of money are involved, the judicial process can be vulnerable to subversion. However, the factor that may be most detrimental to protecting shareholder rights is the lack of training and specialized knowledge necessary to adjudicate complex commercial cases. Russian judges often apply a very strict interpretation of the language of legislation, and may have difficulty in applying broad legal concepts such as "acting with due care or in good faith" or "acting in the best interests of shareholders." This often results in cases where the courts apply the letter of the law in a manner that might be less than logical while disregarding the spirit of the law, as we see in the recent case of TGK-2.

When a Domestic Company Is Declared a Foreign Investor: The Paradox of Kores Invest and TGK-2

Although large-scale and blatant abuses of minority shareholder rights are far less frequent than in the 1990s, one recent case highlights the continuing weakness of the legal system and regulators in providing

remedies to violations. In March 2008, Kores Invest, which is directly owned by Federation Council member Leonid Lebedev, obtained majority control of TGK-2, a power generation utility. According to the Law on Joint Stock Companies, upon acquiring a majority stake in TGK-2, Kores was obligated to make a mandatory repurchase offer to minority shareholders at the price at which it obtained the controlling stake. Kores's obligations under the offer were secured by a bank guarantee from Sberbank.

A number of minority shareholders accepted the offer and tendered their shares. Subsequently, amidst the general rout of asset valuations prevailing in 2008, TGK-2's share price declined precipitously. With the tender price at a significant premium to the then-current market price and USD 300 million owed to minorities, Kores sought injunctive relief through the courts. It argued that due to the existence of an offshore affiliate, Kores should be considered a *foreign* company (although directly owned by a Russian senator!) and thus ineligible to hold a majority stake in a company designated as strategically important by the government. Kores would thus be relieved of the obligation to complete the mandatory repurchase. Sberbank would also be prohibited from paying the TGK-2 minority shareholders under the bank guarantee, as a payout would indicate that Kores had defaulted on a legal mandatory repurchase obligation. The Moscow Arbitrazh Court, the Ninth Arbitrazh Court of Appeal, and the Federal Arbitrazh Court of the Moscow Circuit all sided with Kores, deeming the company a foreign investor.

Meanwhile, litigation continued. Approximately 30% of TGK-2's voting shares owned by minorities were being held in the accounts of persons unknown following the tender. Kores, with its overwhelming majority, undertook in September 2009 to increase the company's authorized equity and dilute minority shareholder interests. Given that the tendered shares were held in unknown accounts, minority shareholders were unable to exercise their preferential rights under the new share issue. In 2010, Kores authorized another 1.9 trillion shares intended for issue in favor of third parties. Individuals familiar with the company believe the third parties to be affiliates of Kores Invest or acting in the interest of Kores Invest.

In June 2011, the TGK-2 AGM resolved to undertake yet another dilutive issue. Although minority shareholders have filed suit claiming that TGK-2 board and AGM resolutions should be invalidated given the failure

to complete the mandatory repurchase offer, arbitration courts have dismissed the claims regarding the 2009 share issues. Suits invalidating the 2010 and 2011 AGM resolutions regarding dilutive issues are still pending.

Moreover, TGK-2 refused to include minority shareholder board of directors candidates on the voting list for the June 2011 AGM. Despite the minorities' extensive efforts to file the nomination documents by courier, fax and email, the company appeared to obstruct every attempt at delivery, even resorting at one point to a so-called "quarantine" of the TGK-2 office to keep out the DHL courier. Documents were also personally handed to the chairman of the board of directors, who returned the documents reportedly saying that "he was not authorized" to receive correspondence addressed to TGK-2.

At this point, a minority shareholder filed a complaint with the FFMS asking the regulator to hold TGK-2 officers administratively liable for obstructing minority shareholders' attempts to exercise their rights and order TGK-2 to include minority candidates on the voting list for the board election. In May, the FFMS issued a ruling in favor of the minorities stating that exclusion of the candidates was illegal, as were TGK-2's attempts to obstruct delivery of proposal documents. At the end of the month, minority candidates were included on the voting list.

Kores subsequently filed a claim against TGK-2 to invalidate the board of directors' resolution by which the candidates were included on the voting list and was granted an injunction prohibiting minority shareholders from voting for their candidates. Inexplicably, at the end of June the FFMS reversed its position and terminated proceedings against TGK-2. At the beginning of July, minority shareholders filed another complaint against TGK-2 with the FFMS, but were notified that there were no apparent grounds for actions against TGK-2. No mention was made of the so-called quarantine or the delivery to the board's chairman.

The implications of the judgments on tender offer cases give the observer pause; leading domestic companies such as Gazprom, Rosneft and Novatek all have foreign affiliates included in their ownership structures and between 2008 and 2011 have all purchased stakes in companies deemed strategic entities. By the logic of the arbitrazh court, all of these transactions could be nullified. Of course, they have not been. The arbitrazh court rulings are illogical in the extreme. Even more interesting is the fact that state authorities appear to be divided on the question.

While the courts may have ruled that Kores is a foreign investor, the Federal Antimonopoly service and a special government commission on foreign investment headed by Prime Minister Putin himself have both stated that Kores is a domestic company. Indeed, in August 2010 the Federal Antimonopoly Service and the Government Commission on Foreign Investments both resolved that Russian companies affiliated with foreign investors but not controlled by foreign investors do not fall within the scope of the federal law governing investment in strategic entities. Moreover, the FAS specifically concluded that Kores Invest is not bound by the federal law on investment in strategic companies. It remains to be seen how the situation will ultimately be resolved.

But in a Second Prominent Dispute, a Regional Court Supports Minority Rights

While the Kores debacle highlights a notable failure on the part of the judicial system and the regulators to protect minority rights, another dispute demonstrates that minorities can and do prevail in many situations. In 2008, GAZ opted to pay dividends only to majority shareholders, claiming that financial problems related to the global economic crisis prevented the company from paying the full amount of the declared dividend.

Six foreign shareholders who were denied their dividend payout filed suit in the Nizhegorodskaya region Commercial Court. The court ruled in favor the plaintiffs, even assessing a penalty on top of the dividend payment, and an appellate commercial court upheld the decision. Most significant, however, was the fact that the Nizhegorodskaya regional Federal Bailiff Service instituted enforcement proceedings and the minority shareholders were paid in full.

2010 Witnesses Renewed Focus on Improving Corporate Governance and a Spate of Legislative Activity

Recently, the emphasis on strengthening the legal framework to support corporate governance has gained ground, reflecting the government's previously mentioned growing interest in integrating with the global economy and establishing Moscow as a global financial center.

Although there have been a number of issues related to this move, one of the most significant was promulgation of the Law on Consolidated

Financial Statements, which mandates the adoption of International Financial Reporting Standards (IFRS). Given persistent weaknesses in information disclosure and the unsuitability of Russian Accounting Standards (RAS) for investment analysis, this measure is aimed at correcting one of the most significant deficiencies in this market. The government has also passed legislation making insider trading illegal, and made several other amendments to the Law on Joint Stock Companies and the Law on Securities Markets, the principal legislation relating to corporate governance standards, to address issues surrounding the payment of dividends and increase transparency in ownership.

The Law on Consolidated Financial Statements is one of the most important legal initiatives related to corporate governance in recent history and addresses the issue of transparency in Russian companies. Any company issuing securities that trade on a domestic Russian exchange will be required to maintain and make publicly available IFRS financial statements, as well as submit IFRS statements to the regulatory authorities. Although the dearth of disclosure and enforcement of previously existing requirements has made poor transparency a serious issue for investors in Russian companies, one of the most serious drawbacks in disclosure throughout the history of the market has been the use of Russian Accounting Standards by many companies.

Financial statements produced in accordance with RAS do not provide the type of information necessary for investors to make informed decisions. Historically, RAS figures were compiled with the objective of reducing a company's tax liability rather than accurately reporting financial performance to shareholders and potential investors, and thus incentivized the under-reporting or obfuscation of income. Moreover, RAS results differ significantly from IFRS in terms of recognizing revenue, valuing fixed assets, accounting for inventories and reserves, and booking certain types of expenses. A widespread transition to IFRS reporting would make it possible for international investors to value Russian companies more accurately and more easily compare results across markets

However, optimism regarding the impact of the law on disclosure could be slightly premature, as the new reporting requirements are set to take effect only after recognition by the government and the Central Bank, the procedure for which is described in a decree issued in February 2011. A panel of experts consisting of representatives from the Ministry

of Finance, the FFMS and the Central Bank must review each individual standard to determine its applicability to Russian companies. Such a review process promises to be inordinately time consuming, and the panel has the authority to reject or amend any standard it considers inappropriate for Russian companies. With such carte blanche to amend IFRS rules, this provision gives rise to the risk that a new "Russian" variant of IFRS could be created, and such an outcome would significantly diminish the value of the legislation.

Despite the weakened import of the legislation, a strongly mitigating factor for investors is that many Russian companies are fully aware of the impact that poor disclosure has on their ability to raise capital. Consequently, a considerable number of Russian companies have voluntarily made the switch to IFRS or GAAP statements, often releasing IFRS in conjunction with RAS statements. According to Standard & Poor's, in 2010 84% of large companies surveyed released audited IFRS or GAAP statements, compared with 52% in 2004 and 36% in 2002. Many Russian financial institutions may also require IFRS financials as a condition for corporate borrowers.

The significant proportion of Russian companies voluntarily reporting in accordance with IFRS strongly implies that the need for access to capital is an extremely compelling incentive to increase transparency. Given that more and more companies are demonstrating an understanding of this fact, it seems likely that they will continue to emphasize adherence to international standards rather than any hybrid Russian variant of IFRS that would act to reduce transparency for international investors.

The Law on Preventing Misuse of Insider Information and Market Manipulation was also promulgated in 2010, and is intended to strengthen the integrity of the financial markets by introducing the concept of criminal liability for insider trading. Although the law is to come into force at the end of July 2011, a number of issues remain unclear. Sticking points including the definition of insider information and whether a minority shareholder should be considered an insider remain to be resolved. Moreover, mechanisms for enforcement have not been clarified. While criminal penalties including fines and prison sentences were included in the original draft legislation, NAUFOR, the industry's foremost self-regulatory organization, worked with legislators to formulate a new draft reducing the severity of penalties. NAUFOR's goal was to prevent potential misuse of the law by the authorities, and based on their

efforts prison sentences for insider trading will begin to be imposed only three years after the law goes into effect. Given that the concept of insider trading did not even exist in the Russian market until very recently, it is likely to take several years for the law to gain traction. Nonetheless, it should have a salutary effect on market participants and encourage the continued strengthening of the market's ethical underpinnings.

In April 2011, further amendments to the Law on Joint Stock Companies and Law on Securities Markets were passed. These amendments are intended to improve disclosure of beneficial ownership of securities, with holders of more than 5% of voting shares required to identify themselves to the company. Further notifications are required with each incremental increase of 5% up to 30%, and then at 50%, 75%, and 95%. While the law does represent progress, as with many examples of Russian legislation loopholes remain. The law requires the disclosure of beneficial owners only in the event of a *change* in ownership, but if ownership remains constant the beneficial owner can remain anonymous. Further legislative work will be necessary to promulgate laws that fully achieve the goal they set out to accomplish.

The Kremlin Steps In to Support Minority Shareholder Interests

With President Dmitri Medvedev increasingly vocal about improving Russia's investment climate and stimulating foreign investment, the government in May 2011 submitted a draft law to the Duma which seeks to guarantee more transparency in corporate governance by giving minority shareholders access to complete corporate information, including records from affiliated companies. The law would be an enormous step forward, since many Russian companies transfer core activities to affiliates in order to deny shareholders access to complete information about the company's activities and financial position.

Prior to submission of the draft law, VTB, Rosneft and other large companies lobbied heavily for restrictions on the rights of minority shareholders to company information, complaining that shareholders could request burdensome amounts of information that would be expensive to produce. Moreover, companies fear that minority shareholders could use the information for personal goals that would be harmful to the company. More than likely, companies fear that minority shareholders could take a page from the playbook of activist Alexei Navalny, who

takes minority positions in companies and requests information for the purpose of uncovering and publicizing corporate malfeasance. Current legislation stipulates that a shareholder must own 1% or more to request a list of shareholders and 25% or more to have access to management board meeting minutes or accounting documents. This rule is already equal or superior to similar legislation in the United States or Europe, although the lack of information on affiliates offers companies a loophole. Given the strong presidential support for the new legislation, passage seems likely although continuing negotiations over non-disclosure agreements and liability for disclosure of confidential information are likely to keep the law under discussion for some time to come.

Today's Corporate Governance Landscape Favors Increased Shareholder Activism

Throughout the market's twenty year history, the publicity created by shareholder activists has had a very marked influence on corporate behavior. One of the most notable cases is Bill Browder's success in spotlighting the value-destroying practices of Gazprom's original management. However, in the period following Browder's expulsion from Russia, activists have taken care to resolve disputes with a minimum of publicity. This type of self-censorship is counterproductive and does not contribute to improving the overall atmosphere. Moreover, when market participants think of activism in the corporate space, they can't help but recall the ultimate fate of Hermitage and the apparent murder of Hermitage lawyer Sergei Magnitsky in police custody. Indisputably, this is a terrifying story. However, there are different types of activism, and foreign firms such as Prosperity and Firebird have been very successful in addressing poor corporate governance in specific cases.

Given the government's increasing emphasis on improving the investment climate and transparency, the corporate governance landscape offers fertile ground for activist efforts. One of the most outspoken activists is the previously mentioned blogger Alexei Navalny. Since 2008 he has become one of Russia's most well-known critics of corruption and corporate malfeasance and a trusted public figure. Using the stock market to aid his efforts in uncovering corruption, Navalny buys shares in large state-owned companies and then exercises his right to information as a minority shareholder.

In one highly publicized case, he obtained results from an Accounts Chamber audit that revealed Transneft seemingly misappropriated more than EUR 3bn in taxpayer money while building the East Siberia–Pacific pipeline. Although the supporting evidence was published, no comment was ever forthcoming from the government. In April, Navalny won a short-lived victory after the Ninth Arbitration Appellate Court ordered state-run oil company Rosneft to provide minutes from board meetings held in 2009. As of late July 2011, the Federal Arbitration Court had overturned the lower court's decision.

Despite setbacks, the fact that Navalny continues to be a vocal and public opponent of corporate malfeasance and corruption while avoiding any serious personal repercussions suggests that the climate may be changing for the better in Russia. However, the government continues to fall short of consistently acting in accordance with its professed commitment to improving governance. Nonetheless, increased activism by investors, as well as more attention from shareholders and board members, and the willingness of these constituencies and other activists to speak out in cases of abuse, should support hopes that Russia will see continuing improvement in corporate governance.

Strengthening the Corporate Governance Model in Russia

Russia is striving to create an environment welcoming to investment and conducive to economic growth, but much work remains to be done. Two of the most important steps toward this end include improving the judicial system and increasing the power and professionalism of the regulators.

Good corporate governance is not just a matter of the law, and requires more than a legal framework. It requires a court system with the capacity and expertise to adjudicate complex cases, and a well-trained and appropriately compensated judiciary. As previously mentioned, Russian courts are overloaded, typically hearing thirty or more cases per day.

Several proposals have been made to improve the adjudication of complex commercial and shareholder disputes. First, arbitration and other non-judicial processes should be used more actively, as highly complex disputes are often beyond the competence of a judiciary without advanced training or knowledge of highly complex securities law. Second, as recently proposed by President Medvedev in a meeting with

state court justices, the creation of a financial arbitration and patent court would lead to the establishment of a highly trained cadre of judges knowledgeable in business law. In addition, more power must be granted to the federal bailiffs and other enforcement bodies to ensure that enforcement action is taken once court rulings have been issued.

Regulatory bodies, in particular the FFMS, must be granted the authority and financial resources necessary to do their jobs. Capital markets are sophisticated and dynamic and the regulation of such complex markets is extremely demanding. Effective regulation requires highly qualified professionals, sophisticated technology and a willingness to actively adopt global market practices. The resources that the Russian government has historically put into this area, financially and otherwise, have been inadequate to this task.

One measure that could provide a solution to the resource drought is to require security market participants to contribute a meaningful percentage of the financing necessary to raise regulatory standards and increase the effectiveness of enforcement. Such a proposal would likely meet objections. First of all, no one wants to pay additional taxes or fees. Secondly, from the regulator's perspective, the concept of the industry providing financial support might engender the belief that the regulator would be captured by the industry, or be in some way beholden. However, market participants have enjoyed considerable profits from the equity market despite the volatility, and despite the obviously very painful slumps that occasionally occur in the Russian market. Given this level of success, it does not seem to be unreasonable to ask market participants to support a higher standard of regulation that would lead to gains across the board. An improved regulatory environment would increase the level of security for all market participants.

Market Participants Must Contribute to Improving Corporate Governance

Contributing financially to support the FFMS is only one way that market participants can bolster corporate governance standards. All participants in the Russian market, foreign and domestic, have a vested interest in creating an environment that will both attract foreign capital and lead to the formation of domestic capital and an equity culture in Russia. If market participants increase their involvement in every aspect of the corporate governance environment, from promoting legislation that

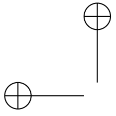
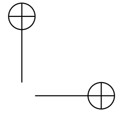
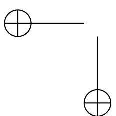
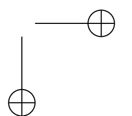
supports high governance standards to increasing their participation in self-regulatory organizations and speaking out against abuses when they occur, the resultant benefit should be significant.

Separating Perception from Reality

After almost twenty years, Russia has a vibrantly growing economy, companies listed on the London, New York and Hong Kong Stock exchanges, and a market that, while still small by international standards, sees average daily trading volume of more than USD 6bn (MICEX average daily trading volume for 1Q11 was USD 6.2bn). By any stretch of the imagination, Russia has made tremendous progress since the dissolution of the Soviet Union. While many shortcomings remain in the standard of corporate governance and the level of protection for shareholder rights, international market participants should not lose sight of the enormous strides that have been made in the Russian market. There are many companies in Russia that place a strong emphasis on good governance and transparency. Unfortunately, these companies frequently do not enjoy the recognition they deserve for taking a proactive approach to protecting shareholder rights and dealing fairly with the investment community.

In the author's view, the international investment community overstates the risk to investors in Russia for several reasons, including lingering biases that are a legacy of the Cold War period coupled with the spectacular and extraordinarily volatile nature of Russia's transition from a planned economy and the attendant failures during the transitional period. Certainly, there were many outrageous corporate governance abuses during the 1990s and the memory has yet to fade.

But investors cannot continue to rely on information that is outdated and inaccurate. Persistent and overly negative perceptions reflect the experience of the 1990s rather than the significant progress that has been made. As a consequence of these continuing misapprehensions, investors apply unjustifiably conservative discounts to the Russian market. Fears regarding corporate governance in Russia, while not unfounded, are exaggerated. As the Russian government, Russian companies, and market participants continue to strive for improvement in the field of corporate governance, a wholesale rejection of the market will lead investors to miss out on one of the world's most attractive and dynamic emerging markets.

CHAPTER FOUR

The Future of Russia’s Membership of the BRIC Club

By Arnab Das and Natalia Gurushina

> You will not grasp her with your mind
> Or cover with a common label,
> For Russia is one of a kind –
> Believe in her, if you are able…
>
> F. Tyutchev

Introduction

Russia’s social, political and macroeconomic transition over the past two decades has been nothing short of spectacular. Russia’s starting point was a centralized planned economy with no embryonic civic society and an annual consumption of less than USD 1,000 per capita. In the 20 years that followed, Russia started putting together the building blocks of a market economy and its institutions, shifted the growth model from the military-industrial complex to a more consumer-oriented society, and began to create its own middle class. Russia was not the only country to experience a major transformation. India, China and Brazil—which together with Russia are combined into the BRIC collective—shared many similar experiences. The possibilities to “dissect” the BRIC bloc analytically and discuss the future of Russia’s BRIC membership are infinite. In this discussion we focus on four issues:

1. BRIC growth models. We look at key growth drivers, evaluate the longer-term sustainability of individual countries’ growth models and analyze Russia’s longer-term growth potential in this context.
2. The impact of demographic trends in BRIC countries on potential output. This is one of the most overlooked topics in BRIC economic

research. We look at the longer-term demographic trends in individual countries and their likely impact on potential growth and the structure of growth.

3. BRIC's exposure to changes in commodity prices. Another key issue, given the presence of the world's fastest-growing commodity importers (China and India) and major commodity exporters (Russia and Brazil) in the group.
4. Longer-term sources of FX appreciation pressures within the BRIC bloc. The BRIC's penchant for dollar-pegging is well-documented. We look at the sources and size of the appreciation pressures in individual countries, measure central banks "fear of floating" and evaluate the currencies' prospects over a longer-term horizon.

But before we start the discussion, we would like to look at the market perception of the BRIC countries and assets and how this perception has changed over time.

Trading Evolution: From Intra-BRIC Divergence to "Investment Clones"

In *Dreaming with BRICs*, Goldman Sachs conceived a whole new era that spawned an asset class, led to the creation of real and financial instruments, gave rise to a plethora of research and forecast clones and gestated global summitry aimed at geopolitical plate tectonics. The group has now begun sui generis evolution with the BRIC collective already expanding to absorb South Africa, with talk of Mexico, South Korea or United Korea and perhaps Indonesia and Nigeria joining up. There are signs that the BRICs have already moved into legacy mode, positing the Next 11 (N-11) to take over as global-growth poles.

It is therefore hardly surprising that intra-BRIC correlations in most asset classes—with the exception of interest rates—continued to climb steadily over the past 10 years. Average correlations between BRIC equities rose from 0.14 in 2000–2004 to 0.48 after the crisis. Correlations between BRIC sovereign credit rose from 0.42 to 0.62 during the same period and between BRIC FX from 0.08 to 0.6. Of course, this in part is a reflection of the general tendency toward rising correlations between risky assets across the globe—especially during and after the 2008 crisis—as the rising wall of liquidity was chasing a limited number of investment assets. The proliferation of similar trading strategies is also

Table 4.1. Intra-BRIC correlations with S&P 500.

	Equities				FX		
	Apr 09–Jun 11				Apr 09–Jun 11		
	Brazil	China	Russia		Brazil	China	Russia
China	0.44			China	0.60		
Russia	0.63	0.39		Russia	0.56	0.54	
India	0.58	0.27	0.56	India	0.61	0.66	0.61
	Aug 08–Mar 09				Aug 08–Mar 09		
	Brazil	China	Russia		Brazil	China	Russia
China	0.12			China	0.67		
Russia	0.69	0.02		Russia	0.24	0.33	
India	0.73	0.07	0.68	India	0.47	0.43	0.15
	Jan 05–Jul 08				Jan 05–Jul 08		
	Brazil	China	Russia		Brazil	China	Russia
China	0.16			China	0.17		
Russia	0.57	0.10		Russia	0.14	0.35	
India	0.47	0.24	0.41	India	0.20	0.20	0.29
	Jan 00–Dec 04				Jan 00–Dec 04		
	Brazil	China	Russia		Brazil	China	Russia
China	0.02			China	0.08		
Russia	0.30	0.04		Russia	−0.01	−0.09	
India	0.22	0.06	0.19	India	0.16	0.14	0.20

Source: RGE, Bloomberg.

“to blame.” The fact that intra-asset class correlations between interest rates and local currency debt—as well as their correlations with other risky assets—remained low (0.04–0.05 both in 2000–2004 and after the crisis in the case of BRIC) can be explained by the following. First, these asset classes are relatively less liquid. Second, the existence of a significant local investment base acts as a stabilizing force during major sell-offs.

A key question to ponder at this point in time is whether a proliferation of specialized BRIC funds and strategies reflects a genuine process of intra-BRIC conversion or poses systemic risk. On the one hand, structural, economic and political divergences are obvious. On the other hand, one can also argue that the BRIC countries’ successes are flip sides of each other’s coins, and of the USD. Chindia, especially China, drives

Table 4.2. Intra-BRIC Correlations with S&P 500.

	Interest rates BRIC 2y IRS				Sovereign credit BRIC 5y CDS		
	Apr 09–Jun 11				Apr 09–Jun 11		
	Brazil	China	Russia		Brazil	China	Russia
China	0.16			China	0.74		
Russia	0.03	0.06		Russia	0.79	0.76	
India	0.14	0.08	−0.23	India	0.51	0.48	0.47
	Aug 08–Mar 09				Aug 08–Mar 09		
	Brazil	China	Russia		Brazil	China	Russia
China	−0.02			China	0.88		
Russia	0.49	0.00		Russia	0.86	0.85	
India	−0.07	0.33	−0.27	India	−0.11	−0.17	−0.21
	May 06–Jul 08				Jan 05–Jul 08		
	Brazil	China	Russia		Brazil	China	Russia
China	−0.02			China	0.30		
Russia	−0.04	0.10		Russia	0.80	0.45	
India	0.12	0.17	−0.04	India	0.28	0.30	0.36

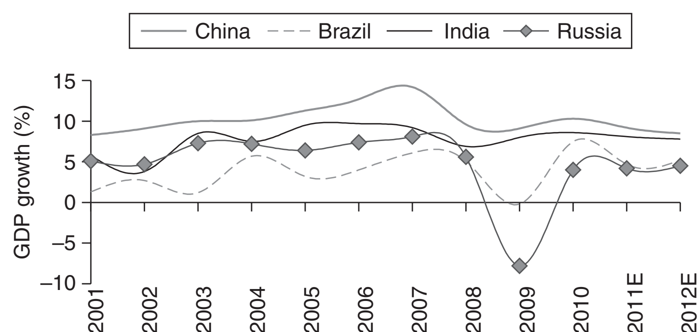
Source: RGE, Bloomberg.

Brazilian, Russian and South African commodity exports, all based on USD-pegging to maintain export- and investment-led growth. Systematic risk would be a high price to pay when/if the United States fails to recover as a sustainable source of export growth, or USD pegs prove the weakest link in the chain, requiring major realignments to prevent runaway inflation and causing asset bubbles and the export/investment growth model to burst.

Russia's Growth Model: The Good, the Bad or the Ugly?

History shows that most high-growth models have ended in tears. Most countries attempting to implement high-growth models suffered severe political, economic and financial disruption at one point or another. The BRIC concept is underpinned by an extrapolation of trends—including growth trends—which can be powerful, but it also ignores, or at least under-emphasizes, institutional and political factors relative to macro, micro and financial development, understating the risk of policy mistakes and financial crises. In Brazil, past crashes owed much to macro

Figure 4.1. Real GDP growth (%).



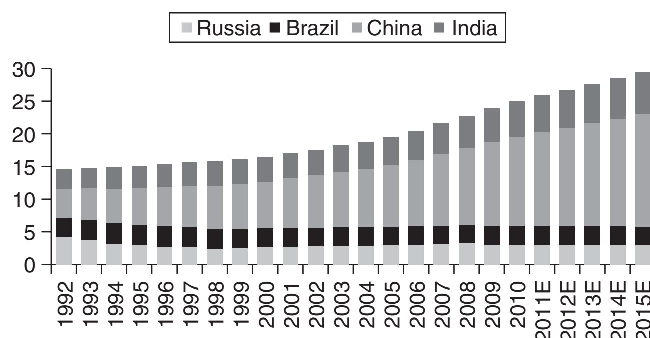
Source: Moody's.

imbalances and inflation, and both risks are now re-emerging. In India, major crashes have hitherto been localized but economic reopening may change that. In China, the unbalanced growth model is at increasing risk of a crash landing. In Russia, past crashes revolutionized its political/economic model repeatedly, and the question is whether Russia's inability to fully restart its growth engine after the 2008 crisis will eventually lead to another one.

After spending most of the past decade growing at more than 5% a year, Russia was the only BRIC economy whose real GDP growth in 2010 remained below the pre-crisis highs—despite the far-reaching and sizeable fiscal and monetary stimulus package and the normalization of the international capital markets. Our estimates suggest that Russia's real growth is likely to remain below 5% in the next two years. According to the IMF, Russia's share in global GDP (on the PPP-basis) stalled at around 3% in the past decade and is unlikely to go up in the years to come. By contrast, China's share in global output rose from 7.1% in 2000 to 13.4% in 2010, and the IMF expects it to reach 17.2% by 2015. India showed a similar dynamic. Its share in world GDP rose from 3.7% to 5.4% in the past 10 years and the IMF expects it to rise to 6.4% by 2015. Is Russia destined to stay at the bottom of the BRIC pack in terms of growth? A look at the BRIC growth models and their changes over time can provide useful clues whether this might indeed be the case.

China's growth model is investment/export oriented, state-led and, in our view, already broken. China is growing largely because of a strong, centralized and efficient state, where the main players are foreign

Figure 4.2. BRIC share in world GDP (PPP-based) (%).

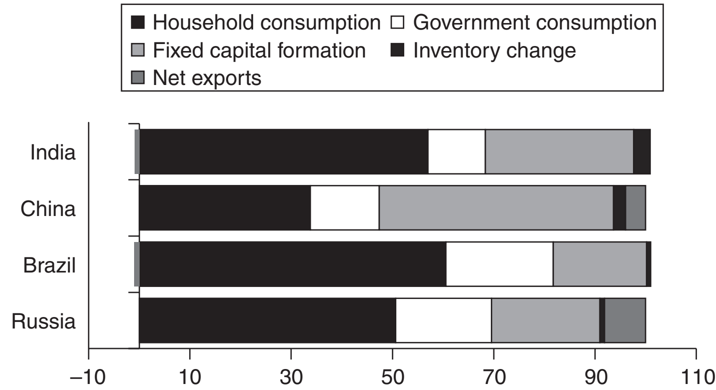


Source: IMF.

companies or parastatal organizations. As China chose to embark on a state-led, industrial revolution "catch-up" growth path, the share of investments ballooned from 34% of nominal GDP in 2000 to a whopping 46% in 2010. In the meantime, the share of private consumption in China collapsed from 46% to 34% of GDP. Even though formally the share of government consumption in GDP is not that big (13–14%), the government owns the banking sector, the bulk of the industrial sector, and about half of local government revenue/outlays are not included on their balance sheets. Even though China's growth model has been successful in generating high growth rates and keeping the population employed, its longer-term validity is highly questionable because the state companies in China get their "life support" from access to cheap labor, cheap capital (low interest rates), subsidized commodity prices and an undervalued currency (the dollar peg). The elimination of one or more of these four prongs (for example, via a floating exchange rate or liberalization of the capital account) would pose serious risks to corporate profits, employment and trend growth, and ultimately to the state's legitimacy.

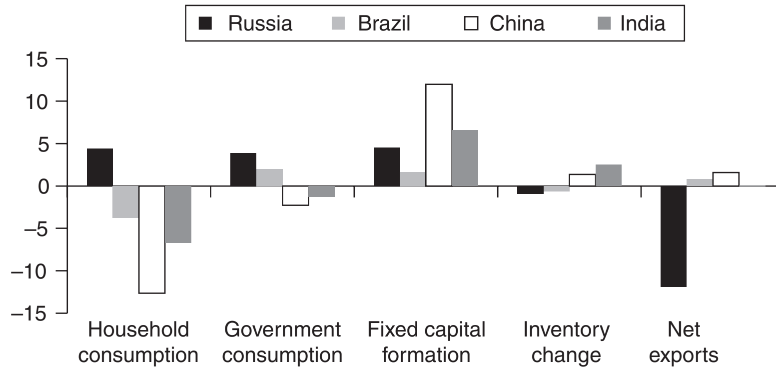
India's growth model is in our view the most balanced—in regard to longer-term sustainability—within BRIC with the share of private consumption broadly in line with that of the developed world. India's growth surge has been led by the private sector and is taking place despite a weak and corrupt government, oversized bureaucracy and the remnants of central planning. A large share of India's output growth comes from the new sectors that benefit from a large pool of English speakers who are well educated but demand relatively low wages (IT, internationally

Figure 4.3. Nominal GDP structure in 2010 (%).



Source: IMF, IBGE (Brazil).

Figure 4.4. Changes in nominal GDP structure in 2000–2011 (%/GDP).

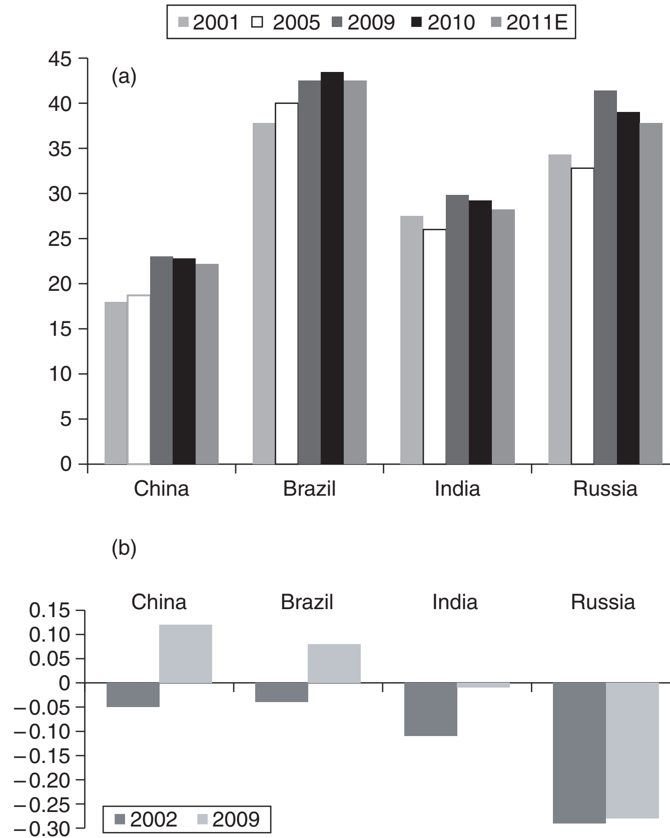


Source: IMF, IBGE (Brazil).

traded services). A key issue that can create medium-term problems for India's trend growth is the infrastructure deficit, which is partly due to a lack of investment and partly reflects corruption/infighting at the local level. This drives the cost of transportation and, along with skill shortages, contributes to high structural inflation.

Brazil's growth model is a combination of a China beta (commodity exports), domestic market consumption (led by maturation of credit markets and, therefore, credit expansion) and considerable government involvement. General government expenditures in Brazil account for the

Figure 4.5. (a) Government expenditure as %/GDP and (b) Moody's Government Effectiveness Index.



Source: Moody's.

largest share of nominal GDP (over 40%) among the BRIC countries. Still, private consumption is booming and domestic credit is currently expanding at 13% year-on-year in real terms. This process reflects changes to credit and bankruptcy laws, as well as the deepening of the domestic credit market. Key medium-term challenges for Brazil's growth model include the wage/costs spiral and the infrastructure bottlenecks that keep structural inflation elevated. The need to streamline the government's fiscal accounts and reform the entitlements system is also key. A few months ago, the government embarked on well-received fiscal tightening, but implementation risks are still high.

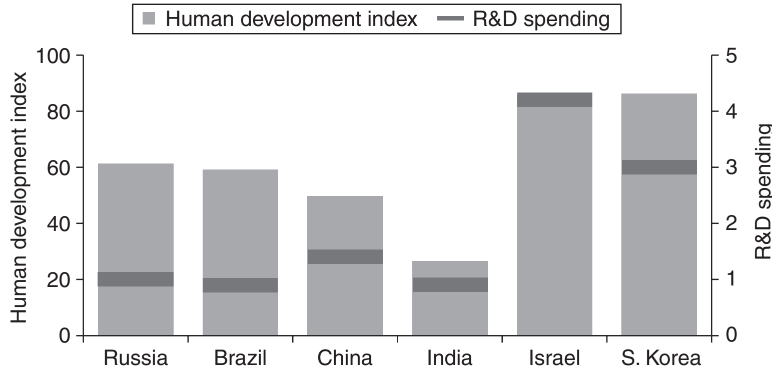
Russia's growth model is still to a large extent government led and export oriented, despite the noticeable rebalancing toward private consumption over the past decade. Russia's growth structure has become slightly more balanced in the past 10 years. The share of net exports—which was exorbitantly high at 20% of GDP in 2000—declined to a more manageable 8% of GDP, while the share of private consumption rose from 46% to 51% of GDP and that of investment from 17% to 21% of GDP. Even though the share of consumption in Russia remains relatively low by international standards, Russia's GDP structure is far less lopsided in this respect compared with that of China. Russia, however, is not realizing its potential for growth because of the large, pervasive and inefficient state. The share of government consumption in final expenditure expanded at the fastest pace in the BRIC universe between 2000 and 2010 (by almost 4% of GDP) and now ranks second following Brazil. The main problem with such rapid expansion is that the Russian government is notoriously inefficient—even by EM standards. According to Moody's, the government efficiency index in Russia remains firmly in the negative territory, oscillating between −0.3 and −0.25.

While Russia's rapid expansion in the first half of the 2000s reflected bold and far-reaching reforms, including a major reform effort at the grassroots level, the growing *chaebolization* of the economy—we use this term to describe the economic role of large conglomerates with strong ties to the government—may already be pulling Russia's trend growth down. A related issue is the government's ongoing focus on social spending (which can help to somewhat reduce the inequality gap and boost consumption) at the expense of investment in technology and rapidly ageing infrastructure. At the same time, uncertainty in the political and business climate stifles private sector green- and brown-field investment. The simple truth is that in order to grow and pull up its trend growth, Russia needs to boost investment (currently only 21% of GDP). And the window of opportunity for Russia to address these problems is getting smaller because of the immense demographic challenges it will face in the coming years.

Demographic Challenges: Is Russia Getting Closer to the Point of No Return?

Until now, most of Russia's human capital indicators looked reasonably bright—in fact, in many respects Russia was significantly ahead of its

Figure 4.6. Human development index and R&D spending as %/GDP (2009).



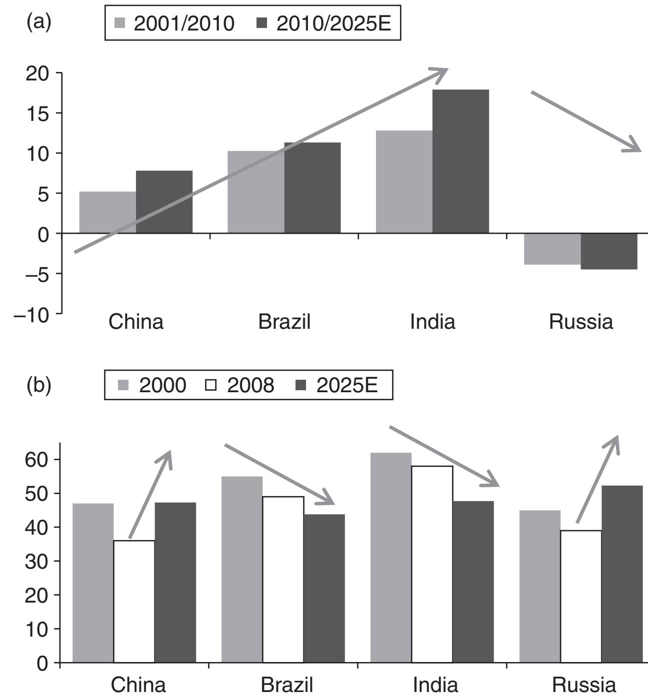
Source: Fitch, Wiki.

BRIC peers. The share of the population demonstrating middle-class spending patterns increased from under 20% in the 1990s to 50–55% at the end of the 2000s. According to Moody's, Russia's PPP-based per capita GDP rose from 21% of the U.S. level (USD 7,362) in 2001 to 41% (USD 18,945) in 2009. In contrast, Brazil's PPP-based per capita GDP was 22% of the U.S. level in 2009, China's was 15% and India's was a mere 7%. Russia also continued to benefit from the Soviet-era emphasis on education and the remnants of the universal healthcare system, which helped to place the overall level of Russia's human capital indicator at 62 points versus 50 points in China and 27 points in India.

The formation of the middle class and the overall increase in the population's well-being helped Russia to make a successful transition toward a more consumer-oriented economy, pushing up its actual and trend growth over the past decade. However, Russia will arguably face the toughest demographic challenge within the BRIC bloc over the next 10–15 years and this could have far-reaching implications for its medium-term growth outlook and social/political stability.

The first warning signs had already started to appear in the 1990s when Russia's population began to fall and its share of global population also started to decline. The process continued in the 2000s when Russia's population shrank by nearly 4% compared with the respective 5%, 10% and 13% increases in China, Brazil and India. U.S. Census Bureau estimates suggest that there will be no change in this trend over the next 10–15 years, when Russia is expected to lose another 5% of its population

Figure 4.7. BRIC's (a) population growth (%) and (b) age dependency ratio (%).



Source: World Bank, U.S. Census Bureau.

and at least a similar proportion of its working-age population (15–64 years). The overall loss of Russia's working-age population in the first quarter of the twenty-first century could be as large as 12.3%, with the expected loss of the younger working-age cohort (15–44 years) as high as 21%. As a result, after falling for most of the 2000s (from 45% to 39%), Russia's dependency ratio will start climbing again between now and 2025, reaching the highest level within BRIC by that time (52%). This process will have several political and economic implications.

First, labor shortages are likely to result in ongoing pressure on wages, which will outpace productivity growth. On the one hand, this can boost consumption and lead to further rebalancing of the economy. On the other, it implies a higher structural inflation rate and loss of competitiveness in the manufacturing sector. Second, Russia's economic rebalancing and trend growth may face serious headwinds because the rising dependency ratio is likely to require a combination of higher savings

and an increase in government spending on healthcare and social programs. Third, Russia will have to increasingly rely on immigration to fill vacant jobs, especially in the unskilled segment of the market, which can worsen income inequality in the coming years. Fourth, the extent of Russia's labor supply constraints suggest that in order to continue growing at a healthy rate, the economy will have to move up the value-added chain and reverse the recent decline in R&D spending as a percentage of GDP. Russia's investment in science and technology rose from 1% to 1.3% of GDP between the mid-1990s and 2003, but retreated to 1% by the end of the decade. Russia's R&D spending dynamic is in stark contrast to BRIC peers. China has demonstrated the most impressive results so far, boosting R&D spending from 0.5% of GDP in the mid-1990s to 1.4% currently. Brazil's investment in science rose from 0.7% to 1.1% of GDP over the same period and the government intends to double this figure by 2020. Even India managed to maintain an upward trajectory, albeit moving at a "snail's pace" with R&D rising from 0.65% to 0.8% of GDP in the past 15 years.

Russia is not the only BRIC country facing serious demographic problems and the associated policy challenges. In China, the overall population will continue to expand at least until 2026—perhaps by as much as 8% in total. However, the working-age population will begin to decline in 2015. China's dependency ratio will also be on the V-shaped path, bottoming out in the next several years and rising from 36% to 47% by 2025. Even though the current five-year plan envisions larger transfers to lower-income households, this is unlikely to have much impact on income inequality until later in the decade. As in Russia, wages in China will soon begin to outpace productivity. This should strengthen private consumption, but will also likely result in higher structural inflation down the road.

The "demographic dividend" looks much higher in India and Brazil. The population and labor force in India and Brazil will continue to expand well through 2025, resulting in much lower dependency ratios—44% for Brazil (vs. 52% in 2000 and 49% in 2008) and 48% for India (vs. 62% in 2000 and 58% in 2008). Still, it remains to be seen whether the two countries will be able to fully capitalize on these positive trends. In Brazil, one of the key obstacles is that the social entitlements system is far too generous given its growth and demographic outlooks (Brazil's state pension system runs a deficit to the tune of 6% of GDP a year),

but reforms—especially regarding private sector involvement—are progressing at a slow pace. In India, the private sector's role in providing education, labor training and healthcare is increasing but is constrained by affordability issues, whereas the state's provisions are seriously lagging behind the increasing demand. Insufficient investment in human capital will continue to contribute to skill shortages, wage spirals and structural inflation, as well as increasing income inequality.

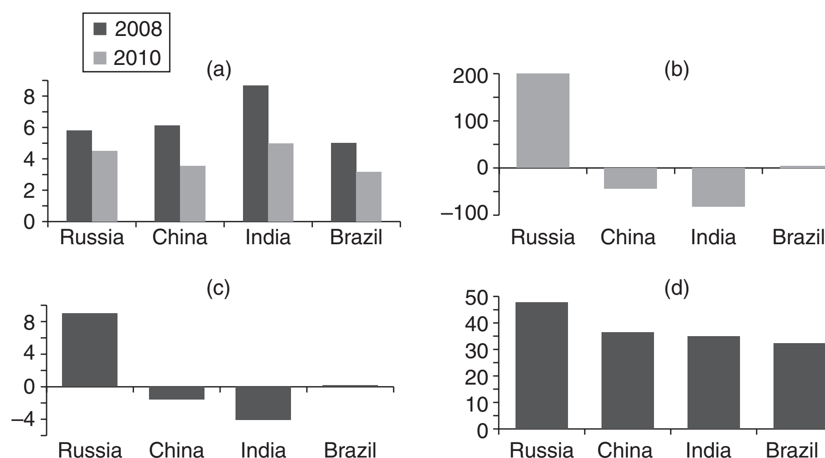
BRIC's Oil Dependency: Two Sides of the Same Coin?

The events of 2011 raised the degree of uncertainty regarding the outlook for commodity prices, especially oil. The situation is likely to remain complicated in the medium-to-longer term due to the presence of opposing forces in the global oil market—including potential supply bottlenecks in the main oil-producing regions (Middle East and North Africa) and the "commodity hunger" in the faster-growing emerging economies. On balance, structural factors point to longer-term upward pressure on the price of oil. It is therefore important to understand the sensitivity of individual BRIC countries to changes in oil prices and the impact this might have on growth, exchange rates and the outlook for structural reforms.

There are different ways to gauge the potential impact of oil on BRICs. At the most general level, a good way to start is by looking at spending on oil as a percentage of nominal GDP. The level varies significantly within the BRIC bloc—from as low as 3% in the case of post-crisis Brazil (close to the global average) to as high as 5% in the case of India. Russia has the second highest spending/nominal GDP ratio. Such divergence most likely reflects the manufacturing and industrial sectors' weights in total output (such as steel-making in the case of India), as well as local energy spending inefficiencies and different weather conditions. The ratios that we saw in 2008 came relatively close to the threshold beyond which higher oil prices start contributing to demand destruction. For Russia and China, this level is around 6% of GDP, for Brazil around 5% of GDP and for India around 8.5% of GDP.

One level down is the exposure of BRIC external sectors to oil. In order to estimate such an impact, one might look at the share of net crude oil exports in nominal GDP and the share of exports in domestic crude oil consumption. The intra-BRIC "demarcation" line is very clear here—Brazil's sensitivity is close to neutral, Russia is a major beneficiary of

Figure 4.8. BRIC dependency on oil: (a) spending on oil, %/nominal GDP; (b) net oil exports, %/domestic consumption (2009); (c) net oil exports, %/GDP (2009); (d) food, fuel and energy, %/CPI (2009).



Source: RGE, Bloomberg, EIA, Moody's.

higher oil prices, whereas China and especially India are the most vulnerable (the opposite is true when oil prices go down, of course). India has to import 85% of domestically consumed oil and shell out as much as 4% of nominal GDP in the process, which can put a lot of pressure on external accounts and currency when oil prices spike. In contrast, Russia's net oil export revenue can be as high as 9% of nominal GDP.

Another useful ratio is the share of fuel and energy—as well as food—in BRIC CPIs. There are two reasons why we prefer to look at energy and food in conjunction. First, there are distortions resulting from widespread use of fuel subsidies. Second, we need to take into account energy prices' feed-through to food prices. Even though the situation differs from country to country, global averages point to a 34% pass-through from fuel and energy to food. In regard to this parameter, Russia has the dubious honor of heading the list with food and energy accounting for some 45% of the average consumer basket, despite the widespread use of subsidies. Brazil has the lowest CPI sensitivity to oil within BRIC—although it is still high by international standards.

When we look at the countries' sensitivity to oil, there are a few other indicators we like to use as well, including the share of net oil exports and imports as percentages of current account receipts and payments and

per-capita GDP. A combination of all these variables allows us to pretty accurately rank the countries by their exposure to oil. Russia and India are at the opposite ends of the spectrum, not just within the BRIC bloc but among most emerging and developed markets. China and Brazil are right in the middle—with overall oil sensitivities that take into account the whole set of factors relatively close to neutral (Brazil benefits from higher oil prices slightly more than China).

These findings have important trading and investment implications, especially in the case of large movements in oil prices, with Russia and India—rather than China or Brazil—more susceptible across all asset classes: equities, FX, credit and rates. They also point to a unique risk in the case of Russia if oil/commodity prices continue to drift higher. The risk is that sizeable oil-related inflows are likely to continue encouraging rent-seeking behavior on the part of the government, reducing the appetite for far-reaching structural change and making the economy even more dependent on the "oil needle." This perpetuates another risk—the risk that Russia will become increasingly nothing more than an "oil derivative" in the minds of investors, capping Russian assets' potential performance when oil prices go up and leading to disproportionately strong sell-offs when oil prices go down.

Dealing with Appreciation Pressures in BRICs

The analysis of the countries' sensitivity to oil—especially in extreme cases such as Russia or India—naturally leads to a discussion about potential implications for exchange rates. But before we can proceed with this set of issues, we would like to express the BRIC FX appreciation pressures in a numerical way that would make cross-country comparisons possible. The most straightforward way to do this is to use a version of the Girton–Roper model that measures appreciation pressures (EMP) by combining changes in the exchange rate with changes in the valuation-adjusted FX reserves of the central bank as a percentage of the monetary base. Positive EMP values indicate appreciation pressures on the currency, and negative values indicate depreciation pressures. Another useful analytical tool that we use extensively at RGE is the intervention propensity coefficient (IPC), which measures a portion of the total EMP for each country that is not absorbed by changes in the exchange rate, effectively showing the amount of free floating (in either direction) that the monetary authorities are comfortable with at any given time.

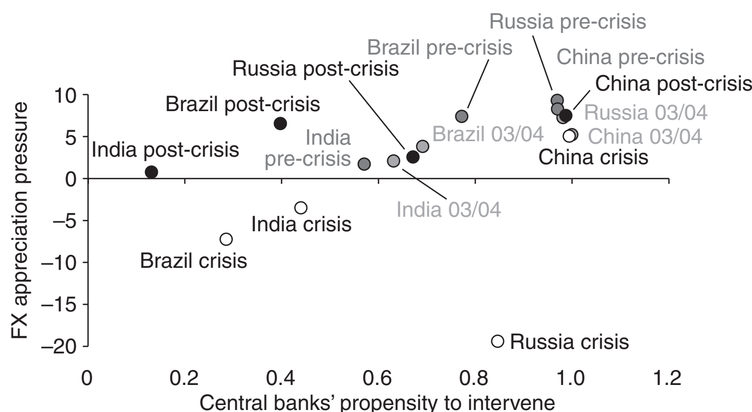
A combination of these analytical tools show a very interesting pattern of intertemporal changes in appreciation pressures and the extent of interventions by central banks within the BRIC bloc.

In the few years before the 2008 crisis, all BRIC currencies were under appreciation pressure but the Indian rupee (INR) hovered at the bottom of the pack with the lowest EMP scores, while the Russian ruble (RUB), Chinese yuan (CNY) and the Brazilian real (BRL) ended up with the highest EMP scores. During this period, central banks in China and Russia allowed almost no free float (IPC scores were close to 1, which means that almost all appreciation pressure was directed toward reserve accumulation rather than FX moves), whereas in Brazil and India between 20% and 40% of the appreciation pressure was allowed to go through the FX channel (rather than toward reserve accumulation).

The 2008 crisis threw everything into disarray with the RUB coming under the most stress and the CNY still under pressure to appreciate. The strength of the depreciation pressures in the RUB's case was in part a reflection of collapsing oil prices, and in part a reflection of Russia's more liberal capital account regime. The high IPC scores indicate that both the CBR and the PBoC kept a strong grip on the currencies during the crisis. In the case of Russia, the CBR was using international reserves to prop up the RUB and maintain stability. Two other BRIC currencies—the INR and BRL—also came under stress during the crisis, although to a lesser degree. One notable feature is that central banks in both India and Brazil became more flexible in regard to free floating, allowing the BRL and INR to depreciate rather than spend reserves to defend them.

Even though post-crisis EMPs in all BRIC countries returned to positive territory, there is much more divergence within the group—both in regard to the magnitude of the appreciation pressures and the extent of free floating. The PBoC still shows the highest propensity to intervene and the least tolerance of floating, while the CNY experiences the strongest appreciation pressure in the group. The overall appreciation pressure on the RUB eased, whereas the CBR made further moves toward greater RUB flexibility. The BRL and INR experienced the most significant shift toward greater floating, but the appreciation pressures on the BRL were as strong as on the CNY, whereas the INR is much closer to the RUB in this respect.

Figure 4.9. BRIC FX appreciation pressures and central banks' propensity to intervene.



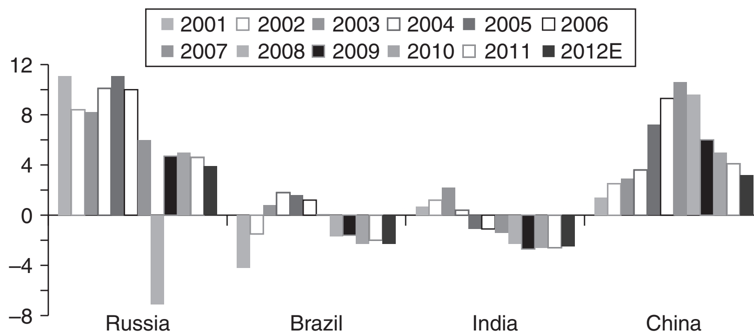
Source: RGE, Bloomberg.

The intra-BRIC differentiation raises an important question about the sources of appreciation pressures: current account/trade balances versus capital account flows. China's large current account surpluses are the backbone of the CNY appreciation pressures. They also provide an important cushion for the currency when other capital flows dry out, which is exactly what happened during the 2008 crisis. The latest report by the Institute of International Finance argues that private capital flows to China are likely to remain very strong in the coming years (around 3.0–3.5% of China's nominal GDP). The combination of large current and capital account inflows indicates that the appreciation pressure on the CNY is likely to remain the highest among BRICS in the medium term.

The outlooks for Russia, Brazil and India are less certain. All three countries experienced deterioration in their current account balances and India and Brazil are likely to run deficits from now on. So far, Brazil has been able to attract sizeable private capital flows, a key factor behind BRL appreciation pressures during the post-crisis period. It remains to be seen, however, whether this outperformance will continue in the medium term: Brazil's structural imbalances and political risks—which can affect private capital flows—should not be underestimated.

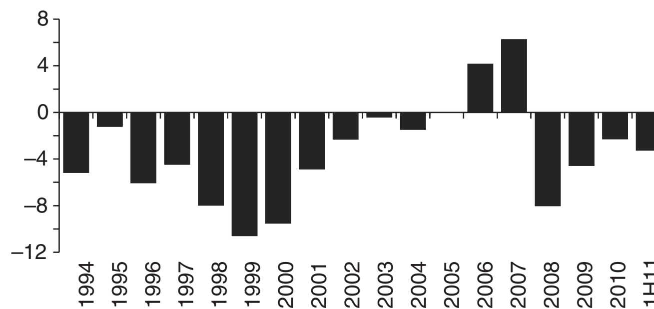
Meanwhile, private capital flows to Russia might be facing longer-term headwinds because of the structural problems that we discussed elsewhere in this report. At the same time, stronger private consumption

Figure 4.10. Current account balances (%/GDP).



Source: Moody's.

Figure 4.11. Russia's net private capital flows (%/GDP).



Source: Central Bank of Russia.

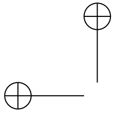
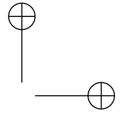
and potentially investment demand in Russia will weigh on the current account balance going forward even though export revenue will continue to benefit from high commodity prices. As such, strong appreciation pressures on the RUB might well be a thing of the past.

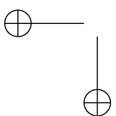
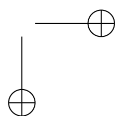
Concluding Remarks

So, does Russia belong in the BRIC bloc? Well, perhaps this is not the question that we should be asking. In our view, structural, economic and political divergences within BRIC are obvious—even though they are routinely ignored by the markets—and questions about Russia's BRIC membership are just as valid as questions about China or India, or South Africa for that matter. Some of the challenges that Russia will have to

face in the coming years are uniquely difficult (demographics), but all BRIC nations sooner or later will be forced to address the issue of their growth models' sustainability.

Similar to the economic challenges, BRIC geopolitical issues are also complex at best, summitry notwithstanding. Fault lines divide them as commodity exporters and importers, with China and India being obvious labor-surplus trading nations. All vie for influence in Africa. Brazil and India desire top-table seats in the Security Council, which would dilute China and Russia's seats. Potential rivals China and India have border disputes, while China and Russia may experience such disputes in the future. Such diverging national interests will hinder geopolitical alignment and may facilitate divide-and-conquer tactics by the West, the United States in particular.

CHAPTER FIVE

Russian Oil Stocks: The Great Pretenders

By Peter Westin and Andrew Risk

In any discussion on Russia and its economy or stock market, it is usually sooner rather than later that "oil and gas" is named as the principal source of both Russia's positive and negative characteristics, with seemingly few other factors coming into play. This is hardly surprising when 45% of federal budget revenue is collected from the energy sector and "oil and gas" accounts for more than 60% of exports.

When it comes to the energy sector's proportion of GDP, however, the picture is a bit murkier. Mineral extraction, which is part of industrial production and includes oil extraction, amounted to a mere 10% of GDP in 2010. However, this is measured in value added in domestic prices, which are lower than world market prices. Moreover, this figure does not reveal the full extent of the oil and gas contribution to GDP given that services to the energy industry comprise a significant proportion of several other economic sectors (notably transportation and trading), a fact that is not reflected in extraction figures alone. Estimates by the World Bank and the Organization for Economic Cooperation and Development (OECD) put energy as a share of GDP closer to 25%.

As a result, there is no question that the oil price plays an important role in the Russian economy. Setting a number of macroeconomic indicators against the average oil price over the last 10 years shows a very strong correlation. A direct correlation can easily be explained between the oil price and the RUB/USD exchange rate, budget revenues, exports, and international reserves. However, the oil price also correlates strongly with income, wages and imports as oil-related export revenue trickles through the economy, contributing to rising income and hence facilitating growing domestic consumption, as well as higher demand for imports.

The oil price also seems able to explain a number of other relationships in Russia. According to *Forbes Magazine*, in the year 2000 there

Table 5.1. Correlation between oil price and selected macroeconomic variables (based on monthly data January 2001–September 2011).

Oil price correlation with	Correlation coefficient
Exports	0.97
Imports	0.91
Budget revenues	0.93
International reserves	0.92
RUB/USD exchange rate[a]	0.50
Average wage	0.91
Average income	0.90
Retail sales	0.90

[a]The correlation between the ruble exchange rate and the oil price has weakened in recent years, largely due to sharper movements in the currency over a period of several months at the end of 2008 to the beginning of 2009, as well as at the end of 2010. For the period 2001–7, the correlation coefficient was above 0.9.

Source: Rosstat, Central Bank of Russia, Bloomberg, ATON estimates.

were no billionaires in Russia (although that might have been due to a lack of disclosure). Since then, however, the number of super-rich has skyrocketed and as of 2011 Russia had 101 billionaires.

From a stock market perspective, there appears to be little dispute over the dominance of oil and gas stocks, which currently comprise 49% and 58% of the Russian Trading System (RTS) and Morgan Stanley Capital International (MSCI) Russia indexes, respectively.[1]

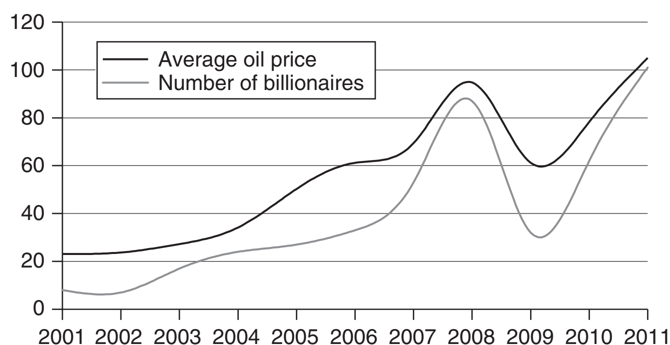
And so from an investment perspective, one might expect that those who had invested in Russia's hydrocarbon behemoths such as Rosneft, LUKOIL and Gazprom over the 10 year period from 2001–11 would have reaped pleasing returns. Let us recall that growth in the oil price, from approximately USD 17/bbl in 1999 to currently around USD 110/bbl helped propel Russia's nominal GDP (in USD terms) up sevenfold over the 1999–2010 period. However, we argue in this chapter that the most profitable strategy on the Russian stock market over the past decade has been, arguably, to invest in almost anything but oil.

Energy: A Longstanding Underperformer

The Russian equity market has been one of the best-performing markets worldwide over the last decade (in domestic currency, it has been the top

[1]The end date for all data is October 24, 2011, unless otherwise specified.

Figure 5.1. The oil price (USD/bbl) and number of Russian billionaires.



Source: Bloomberg, *Forbes Magazine*.

performer in the emerging market (EM) universe). Since May 3, 2001 (the starting date is based on available data for the RTS Index and a wider range of RTS-listed energy names), the RTS Index has provided a 720% return. If, however, you had focused solely on Russian energy names, you would have earned a still very agreeable yet clearly weaker return of 450%. Investing in the non-energy segment of the RTS Index would have generated a return of close to 920%.

Many global investors rely on MSCI indexes as portfolio benchmarks. However, investors who relied on MSCI Russia for guidance on portfolio allocations would probably now be very disappointed. While the RTS Index has returned 720% since May 3, 2001, the MSCI Russia Index has "only" returned 330%—one reason being that the latter is more heavily weighted toward oil and gas. At the same time, holding an underweight position in energy stocks while benchmarking against MSCI Russia would have made it easy for fund managers to demonstrate outperformance.

Setting the relative performance of MSCI Russia Energy against MSCI Russia shows that energy stocks have significantly outperformed the market on four occasions over the past decade (we are using the MSCI indexes due to better data availability with regard to sector indexes). The first instance was in April–May 2000, when the oil price rallied by 80%; the second from March to October 2002, when the oil price gained almost 70%. It is also worth emphasizing that from 2000 to 2004 Russian companies saw significant growth in crude oil output (on average 8.5% per annum), which provided additional support for oil stocks in periods of rapidly rising oil prices. The third occasion, from May 2005 to May

Table 5.2. Energy as a share of MSCI Russia and the RTS Index (% average).

	MSCI Russia (%)	RTS index (%)
January 2004–December 2005	76	56
January 2006–January 2009	64	63
February 2009–October 24, 2011	59	55

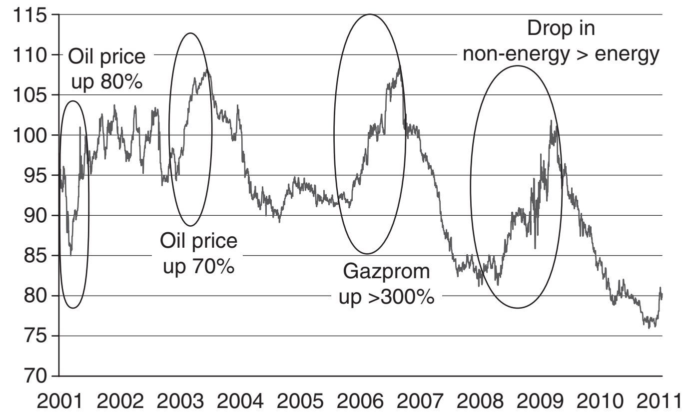
Source: MSCI (www.msci.com), ATON estimates.

2006, was in the run-up to removal of the Gazprom ring-fence,[2] during which time Gazprom gained more than 300%, i.e. the sector was driven by a company-specific factor. The final period, from February 2008 to February 2009, includes a brief period of outperformance as oil shot up above USD 140/bbl in July 2008. However, the bulk of the outperformance occurred during the 2008 market meltdown and was characterized by a sharper decline in non-energy stocks than in energy names. We would highlight that the oil price has really only been a strong catalyst for oil and gas names twice (in 2000 and 2002), and the key difference from today is that the oil sector at that time operated under a much more favorable tax regime. In this regard, it is worth highlighting that the oil price gained more than 70% between August 24, 2010, and April 8, 2011, as fears of a slowdown in the global economic recovery subsided, followed by concerns over potential supply disruptions from civil unrest in the Middle East and North Africa. The energy sector only outperformed the overall index for the two-month period of January 10–March 17, 2011.

Interestingly, in an international context we see that Russian oil and gas stocks have not only underperformed other domestic sectors, but have also lagged international peers. Comparing the performance of the MSCI Russia Energy Index to that of the MSCI EM Energy Index shows that Russian Energy significantly outperformed during only two periods over the past 10 years. For the most part, however, MSCI Russia Energy has underperformed MSCI EM Energy, suggesting that non-Russian emerging-market oil stocks have benefited from the growth in oil prices and investors would have been better off buying Chinese and Brazilian energy names.

[2]At the beginning of January 2006, the Russian government lifted the ban on foreign investors buying shares in Gazprom. Anticipation of the removal of this so-called ring-fence and its implementation resulted in significant growth in Gazprom's stock price.

Figure 5.2. Energy stocks outperformed the overall market on four occasions (MSCI Russia Energy/MSCI Russia).



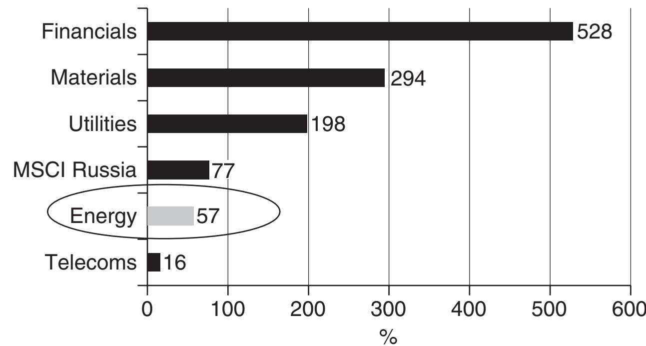
Source: MSCI (www.msci.com).

Figure 5.3. Relative performance: MSCI Russia Energy vs. MSCI EM Energy.

Source: MSCI (www.msci.com).

If oil and gas have lagged behind, which Russian sectors have boosted investor portfolios? Given the availability of MSCI sector data, we focus on the period from June 1, 2004, to October 24, 2011, in order to include MSCI Russia Financials. The latter has been the best-performing sector, up by 528% over the last seven years, followed by MSCI Russia Materials (+294%). Tellingly, MSCI Russia Energy has been the second-to-worst-performing sector.

Figure 5.4. MSCI Russia sector index returns, June 1, 2004, to October 24, 2011.



Source: MSCI (www.msci.com).

Analyzing the performance of different Russian sectors during periods of sharp movement, up or down, in the oil price confirms that investing in oil stocks during an upward move has historically not been the most attractive proposition. Since the beginning of 2005, we identify 19 periods with sharp movements in the oil price and look at the respective performances of MSCI Russia sector indexes over the same periods. We have not looked further back than 2005 as market performance was skewed by the Yukos affair in 2003–4.

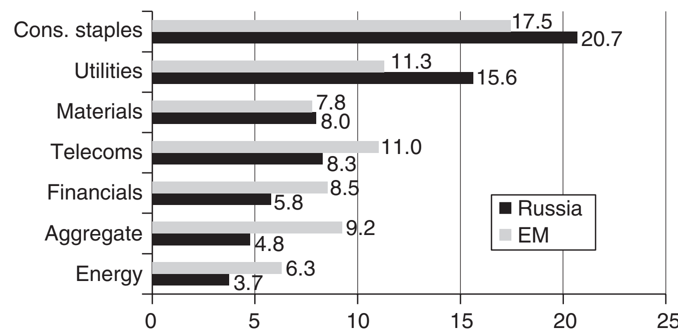
Not surprisingly, we find that an acute rise or fall in the oil price tends to pull the MSCI Russia Index in the same direction. In 10 of the 11 periods when the oil price has risen, the market has also advanced, and during six of the eight periods when the oil price has declined the market has also retreated.

It is crucial to note that the energy sector within the MSCI Russia universe has been the best-performing sector in just one of the 11 periods of significant oil price growth. On that occasion, the oil price climbed for a relatively short period of around three months.

In terms of other sectors, financials, materials and consumer staples have tended to outperform when the oil price is moving higher. Financials have generally outperformed during shorter periods of oil price strength, while stocks in the materials segment appear to gain support over longer periods.

Somewhat surprising, perhaps, is that the energy sector has been the main underperformer only once in the selected periods of oil price

Figure 5.5. 12M forward P/E by sectors: Russia vs. EM.



Source: MSCI (www.msci.com), ATON estimates.

decline. This occurred during an almost six-month period over August 2006–January 2007 when the oil price fell by 36%. This tendency of greater losses in sectors outside oil and gas may partly be explained by the fact that some of the most liquid stocks are part of the energy sector, which might in turn attract investors during periods of broad market decline.

"Attractive" Valuations Have Failed to Inspire

Turning to a forward-looking perspective, as a consequence of the historical return data outlined, we now face the proposition that the Russian market, and especially the energy sector, appears attractive on valuation ratios relative to emerging market peers. MSCI Russia's 12M forward P/E currently stands at 4.8×, or a 48% discount to the emerging market average. We caution, however, that while the majority of Russian sectors are trading at discounts to EM peers, we recognize that the low market average ratio for Russia is very much a product of a low P/E for energy, which is currently 3.7×.

Yet the low Russian energy P/E has an air of familiarity about it: the current 12M forward P/E of 3.7× for MSCI Russia Energy (a 40% discount to MSCI EM Energy) looks, at first glance, rather encouraging when compared with its seven-year historical average of 7.3×. However, the sector's 12M forward P/E has remained below this level for almost two years now. Moreover, Russian Energy has hovered at around a 40% discount to emerging market and developed-market peers since September 2008.

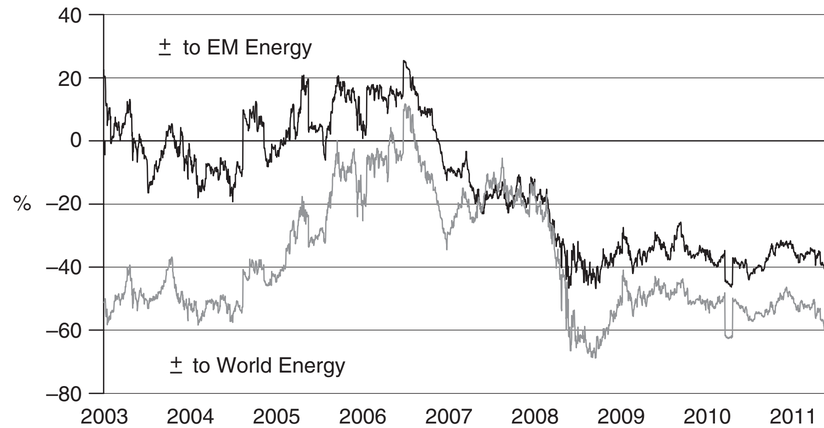
Table 5.3. Performance of MSCI Russia sector indexes during periods of sharp oil price growth or decline.

Period	Duration (days)	Oil price (%)	MSCI Russia (%)	Energy (%)	Banks (%)	Materials (%)	Utilities (%)	Cons stpls (%)	Telcos (%)
February 7, 2005–March 23, 2005	45	26.0	−0.5	0.5	*8.5*	−3.1	−10.5	N/A	−3.6
May 19, 2005–August 12, 2005	86	41.2	22.9	*28.8*	20.0	23.9	5.9	N/A	8.0
September 1, 2005–November 18, 2005	79	−18.5	12.7	14.1	19.4	***10.8***	***12.8***	***9.7***	**5.9**
November 19, 2005–January 20, 2006	63	24.2	27.1	35.4	*44.7*	5.8	18.7	32.0	4.4
January 30, 2006–February 15, 2006	17	−14.3	0.7	−0.3	3.8	0.5	21.8	**−2.7**	***−1.0***
March 22, 2006–April 21, 2006	31	23.6	13.5	16.1	7.0	28.4	15.4	*28.5*	−3.1
August 7, 2006–January 18, 2007	165	−35.6	−0.4	**−10.9**	*77.1*	8.3	35.8	33.1	48.3
January 18, 2007–July 13, 2007	177	64.0	13.8	6.3	18.5	36.1	38.6	*88.0*	32.9
July 15, 2007–August 21, 2007	38	−13.5	−12.5	−12.0	**−16.5**	−11.6	−9.7	***−15.5***	−11.1
August 22, 2007–July 3, 2008	317	111.6	20.9	30.5	−16.9	*45.0*	−14.7	−1.1	16.0
July 13, 2008–December 27, 2008	168	−76.9	−70.7	−69.4	−74.2	**−77.6**	N/A	***−73.6***	−62.8
February 18, 2009–June 11, 2009	114	86.1	99.9	86.3	*254.7*	123.8	159.0	113.4	72.0
June 11, 2009–July 12, 2009	32	−16.3	−27.9	−28.9	**−31.9**	−28.3	−24.9	−16.4	−19.2
July 12, 2009–August 5, 2009	25	25.7	31.4	30.6	*38.6*	34.3	19.7	25.9	33.5
September 25, 2009–October 23, 2009	29	20.2	17.4	17.2	21.7	*22.6*	7.9	15.3	12.7
January 8, 2010–February 8, 2010	32	−14.5	−7.2	−8.1	−6.7	−1.5	−1.9	**−14.2**	***−12.0***
February 8, 2010–April 23, 2010	75	24.0	14.8	10.7	11.4	24.2	*38.9*	15.8	17.6
April 23, 2010–May 27, 2010	35	−15.6	−15.7	−14.9	***−19.2***	−16.7	−13.0	**−21.7**	−12.2
August 24, 2010–April 29, 2011	249	70.9	46.1	52.4	44.1	*61.0*	7.2	40.6	2.3

During periods of oil price growth, the best-performing sector is in italics, while all sectors outperforming the energy sector are boxed; bold indicates the worst-performing sector during an oil price decline, with bold italics highlighting sectors that underperformed energy during these periods of oil price weakness.

Source: MSCI (www.msci.com, Bloomberg, ATON estimates).

Figure 5.6. MSCI Russia Energy: premium/discount to MSCI EM Energy and MSCI World Energy on 12M forward P/E.



Source: MSCI (www.mscic.com), ATON estimates.

We believe that compared with the 2003–6 period, the relative valuation has reached a new level and hence it is difficult to compare the current discount of about 40% with the prior period when Russia was trading within a band of ±20% to EM peers. The reason, we would argue, is a general re-rating of Chinese and Brazilian energy names since 2007; and the May 2006 inclusion of Gazprom in the MSCI Russia Index, with its weight further increased in August of the same year. From this point, we note that after Gazprom's shares were made available to international investors in January 2006, the stock's dynamic has arguably been a disappointment, and in turn it has been a drag on the energy sector's performance. We therefore believe there has been a structural derating of the energy sector's P/E. As a separate observation, this assumed de-rating naturally also has negative ramifications for the valuation of overall Russian stock indexes, which are heavily weighted in favor of oil and gas companies. That said, as we have shown earlier in this chapter, a low valuation for Russian energy stocks has not prevented investors from enjoying substantial returns on Russian equities. What is more, MSCI Russia Energy's discount to MSCI World Energy—a proxy for global developed market oil majors—has been in excess of 40% since September 2008, as was the case in 2003–4.

The accuracy of stock market valuations are, however, a notoriously contentious issue and so in order to assess whether the current valuation

of Russian oil companies can be justified we turn to a method presented by Daniel Johnston in his book *International Petroleum Fiscal Systems and Production Sharing Contracts*. In this book, Johnston introduces a useful rule of thumb for estimating the value of proved producing reserves:

$$\frac{\text{Enterprise value (EV)}}{\text{Producing reserves}} = \left(\text{between } \tfrac{1}{3} \text{ and } \tfrac{1}{2}\right) \times \text{company's take} \times \text{wellhead price}$$

The company's take is its upstream free cash flow after all related taxes have been deducted, and the government's take is the total upstream-related taxes collected. Together, the company and government takes are equal to 100%. The wellhead price is the price after deducting all costs to deliver oil to the market (transportation, export duty, etc.).

As figure 5.7 shows, the formula offered by Johnston (but expanded to include total proved reserves) correlates very well with Russian oil majors and their international peers. In essence it shows that the low valuation of Russian oil companies is totally justified, and hence it is difficult to argue that they are undervalued relative to international peers. We take the companies' Statement of Financial Accounting Standards (SFAS) 69 disclosures at the end of 2010, which means that the estimated correlation is not ideal (due to the lower-than-current oil price in the disclosures).

Both the wellhead price and the company take are quite low in Russia. And importantly, the latter for Russian companies is somewhat overstated in SFAS 69,[3] as the export duty is not included in the government take. However, even with the company takes overstated, the fair value of proved reserves is significantly below that of international peers.

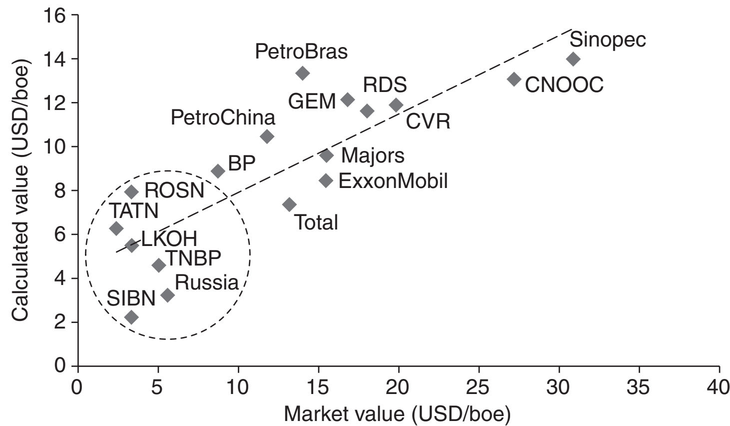
Blame the Tax Man

Having demonstrated the Russian energy sector's past underperformance and shown that low current valuations are not necessarily encouraging, we now assess how Russian oil stocks have arrived at this juncture.

In light of low tax compliance by both Russian companies and the population, set against rising fiscal spending, the government in 2002

[3]SFAS 69 is the Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) required "Disclosure about Oil and Gas Producing Activities," which is supposed to report the underlying economic value of a company's assets, based on historical costs accounting and be comparable with other companies.

Figure 5.7. The discount of Russian oils vs. peers is justified on EV/reserves.



Source: Company data, ATON estimates.

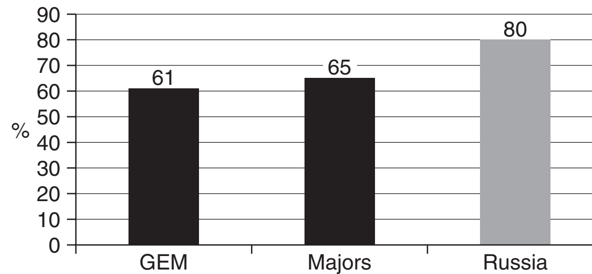
undertook a major overhaul of the oil sector's taxation system, imposing a tax on the top line, a mineral extraction tax (MET) on volume. Then, from August 2004 the government hiked the export duty on crude oil, introducing new rules for the oil export duty's calculation. As a result, in August 2004 the crude oil duty increased to USD 69.9 per tonne from USD 41.6 per tonne in June–July 2004, with a further hike in January 2005. In 2008, the government made some efforts to improve the situation by lowering the MET rate, effective from 2009 (by introducing a higher cutoff rate of USD 15/bbl versus USD 9/bbl previously), and introduced some specific tax breaks for designated Greenfields.

The total government tax take from Russian oil companies' upstream operations is now close to 80%, well above the average for both global majors and EM peers.

We see three fundamental problems with the current oil taxation system:

- The current Russian upstream tax take is too high. We estimate that the state's take from the upstream business is about 80%. This is one of the largest takes among oil exporting countries and means that Russia's budget is overly dependent on oil and gas revenues.
- The Russian oil taxation system is incorrectly structured. Corporate profit tax represents only 10% of total taxes paid by Russian oil companies, with the majority of taxes taken from the top line.

Figure 5.8. Upstream tax take (2010).



Source: Company data, ATON estimates.

Even though some countries (Saudi Arabia, Iran, the United Arab Emirates and Venezuela) take more from their oil companies than Russia, none of them takes the majority of taxes from revenues (or even worse, from volume produced).

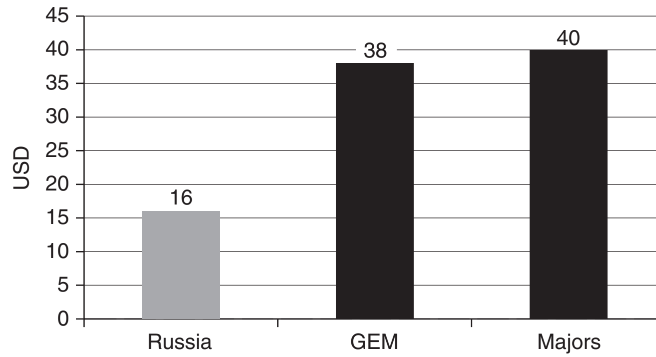
- The tax system is regressive. By taking the majority of taxes from volume produced rather than from income earned, the country gives producers no incentives to invest and therefore develop, or focus on cost control or invest efficiently in capex, for that matter. Not only are risks for developing new fields not shared between the oil company and the state, but the state takes more when profitability deteriorates.

While the high taxation is reflected in the low P/E for MSCI Russia Energy, the fact that Russian companies are taxed on the top line, we believe, continues to be an impediment to the sector's share performance. This taxation system does not encourage attention to cost cutting, and Russian oil companies are far less profitable compared with global majors and other EM oil companies. For instance, in 2010 emerging market oil companies' average EBITDA/bbl was more than double that of the Russian average.

Equally, the present system discourages investment. In 2010, capital expenditures (capex)/bbl in the emerging world was more than three times that of Russia.

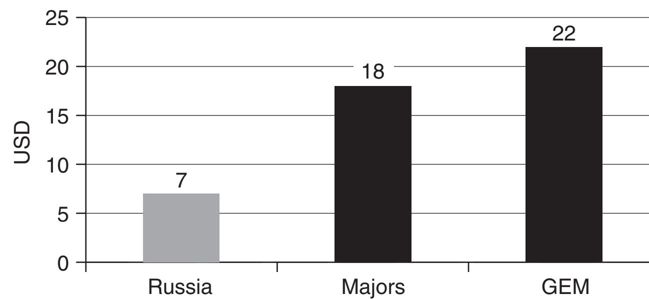
The deterrent to investment from the industry's economics means that the oil sector, we would argue, is largely a no-growth-story (over a standard investment horizon). Underinvestment during the 1990s was an obstacle for geological surveys and exploration work, preventing growth

Figure 5.9. EBITDA/bbl, upstream (USD, 2010).



Source: Company data, ATON estimates.

Figure 5.10. Capex/bbl related upstream (USD, 2010).

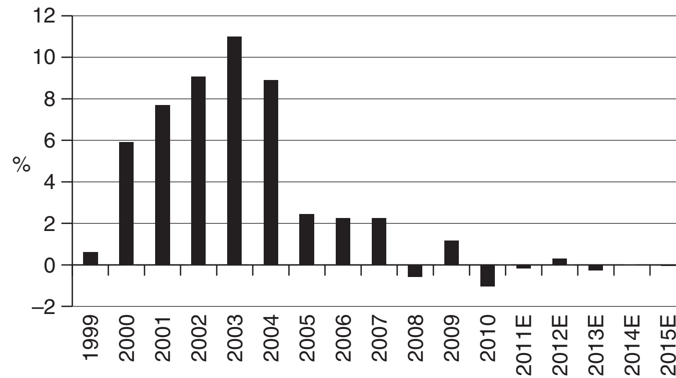


Source: Company data, ATON estimates.

in the reserve base. Crude production then began to grow immediately after the 1998 crisis. However, and as is depicted very clearly in figure 5.11, the current taxation system, with the main tax hike (export duty) introduced in 2004, has discouraged much-needed investment in the sector and negatively impacted future growth prospects. As a result, we anticipate annual growth in Russian oil production fading to around zero over 2011–15.

We struggle to see significant upside potential for oil and gas stocks without a radical overhaul of the sector's tax burden. While the current low valuations shown earlier may provide some support to sector names at times, as was the case following the political and social turmoil in North Africa and the Middle East that erupted at the end of

Figure 5.11. Oil output growth forecast (%).



Source: Company data, ATON estimates.

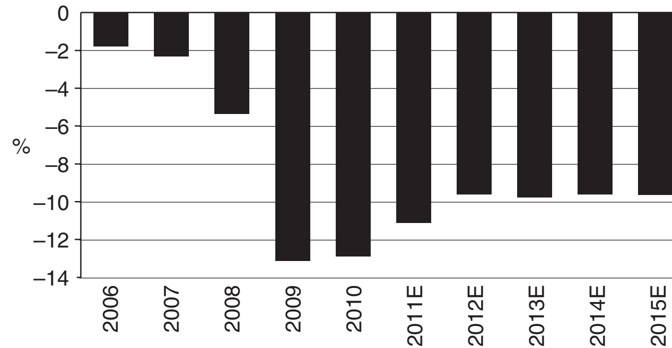
2010, we believe that the most attractive opportunities will continue to lie outside oil, in particular in those sectors benefiting from a recovery in domestic demand over the next couple of years. Therefore we believe that under the current tax regime, Russian energy is likely to continue underperforming.

Taxation Reform Is the Catalyst Energy Stocks Need

While much has been said about how the government should structure any changes to the oil sector's tax system, we feel that the heart of the matter is simply whether the state can afford to cut the industry's tax obligation, given that it constitutes 45% of the total federal budget revenue (2010). The non-oil deficit[4] last year amounted to a full 12.9% of GDP and we expect the deficit to remain at a high 11.1% of GDP in 2011. It is worth pointing out that the share of oil-related taxes should, under a flat oil price and unchanged taxation scenario, naturally decline as a share of total taxes going forward as GDP expansion is likely to outstrip growth in oil output (hardly an optimistic foundation for economic development). That said, our estimate is for a very slow reduction on oil tax dependency, and a non-oil deficit of just below 10% of GDP by 2015, far below the roughly 2% of GDP seen in 2005–7.

[4]The non-oil surplus/deficit is calculated as budget expenditures subtracted from budget revenues excluding revenues from the oil sector, taken as a percentage of GDP.

Figure 5.12. Non-oil federal budget deficit.



Source: Russian Ministry of Finance, ATON estimates.

Progress on Tax Reform

It now appears that all sides admit that changing Russia's tax regime is vital for the oil industry's future. Judging by the *General Plan for Oil Industry Development to 2020* (initially presented to Vladimir Putin in October 2010 by Energy Minister Sergei Shmatko), the government has no illusions about the industry's prospects—under the base-case scenario Russian crude oil production is flat.

The proposals most friendly to the oil industry have, in our view, initially come from the Energy Ministry. That is perhaps to be expected, given that the ministry is responsible for the health of the sector. However, the well-constructed original proposal has been replaced with a plan for a much less efficient two-stage reform:

- Introduction of a tax system called 60-66 (introduced in October 2011). This reform envisages a decline in the crude oil export duty (65% decreased to 60%, which implies a reduction of the marginal export duty rate to 60% from 65%). The reform also calls for unification of export duties on products to 66% of the crude export duty (from 70% for light products and about 40% on heavy products in 2010, and 67% and 46.7%, prior to the introduction of the reform in October 2011). The exception is the export duty on gasoline and naphtha, which is set at 90% of the duty on crude oil.
- Profit-based taxation for Greenfields from 2014. This implies replacement of the MET with an excess profit tax of 27%.

Nevertheless, we forecast that while estimates of the government's tax takes are reduced immediately after the introduction of the 60-66 reform, the tax payment scenario in 2013, just a year later, then returns to levels seen before the reform, according to our estimates. The reason for that is growth in the MET marginal rate, which is set to rise to 23% in 2012 and 25% in 2013 from 22% now.

We estimate that in 2012, under our USD 90/bbl oil price assumption, 60-66 will add about USD 4.6/bbl to the respective companies' free cash flows. The company take would increase to 24% from 20% in 2011 and from 16% if the reform is not introduced. Valuation-wise, introduction of the reform would add only USD 0.016/bbl or 0.5% to the Russian oils' valuation on EV/proved reserves.

In 2013, the company take declines to 18% (even lower than in 2011) under the 60-66 regime. The average company upstream free cash flow dips to USD 8.9/bbl from USD 12.1/bbl in 2012 if the reform is introduced.

Consequently, we believe that a much more serious reform is needed to remedy the situation, and 60-66 is unlikely to improve investors' stance on the Russia oil sector, given the short-term positive effect. As for the second part of the reform—the introduction of the profit-based taxes for Greenfield projects, the proposed reform has yet to be finalized and formally introduced. The government recently said that it will consider only offshore Greenfield projects subject to the reform, leaving out a chunk of onshore projects. Moreover, it has taken the government at least three years to reach some consensus on oil-taxation reform and the likelihood of dramatic change appears slim.

Spreading the Load

Another question worth exploring is to what extent the government could hike conventional taxes and in such a way alleviate the tax burden for the oil sector. Should the government decide to finance a reduction in oil companies' tax by raising other taxes, we believe the obvious choice would be to raise the valued added tax (VAT), which is currently 18%. It is the most important tax in terms of federal revenue, contributing 30% of total revenues in 2010.

Based on the 2011 budget, we estimate that for every 1 ppt hike in the VAT rate, the government would collect an additional RUB 139bn,

or USD 4.9bn at the current exchange rate (equal to 1.7% of total federal revenues in 2010).

However, in recent years the government has spoken more of lowering VAT rather than raising it. Additionally, in our view, obliging the Russian consumer to facilitate lower taxes for oil companies is likely to raise strong social objections.

Increasing the profit tax also has its drawbacks. We see two primary factors that could prevent the government from upping the corporate profit tax rate (currently 20%). First, from 2011 the government increased the Unified Social Tax from 26% to 34%, which has already added to the tax burden of Russian companies in general.

Secondly, the bulk of the profit tax (18% of the 20%) goes to the regional budget with the remainder directed to the federal budget. In our view, reallocating more of the tax income to the federal budget under the current tax rate is an unlikely option as the federal budget is already subsidizing regional budgets (and at an increasing pace). In 2010, federal aid to regional budgets amounted to 8% of GDP (or 30% of federal expenditures). Hence, a reallocation of profit tax would put additional pressure on regional budgets, most likely resulting in the need for additional federal aid.

The 13% flat rate personal income tax is currently split so that 70% goes to regional budgets and 30% to local budgets, with nothing contributed to the federal budget. Redirecting income tax revenue to the federal budget would deprive the regional and/or local budgets of much needed revenue. Alternatively, hiking the tax rate (with the increase going to the federal budget) would again be unlikely to meet a positive reception from the Russian public.

Finally, looking at the option to tax other sectors more heavily, we believe that the government equally faces a challenge. The most common view raised is that the government could hike taxes for metals and mining companies. While some taxes for the sector have been increased, we would argue that given the dire need for upgrading infrastructure and technology to facilitate the vision of modernizing the Russian economy, the metals and mining sector is actually more strategically valuable than the oil sector, and therefore a significant increase in the tax burden for metals and mining companies could jeopardize the prospects for much needed infrastructure investment and modernization. This is especially the case when contemplating the potential negative impact on growth in

heavily taxed sectors, judging by the experience of the drop in crude oil output post-tax hikes, illustrated above.

Keep It Simple: Focus on Good Corporate Governance

As a final addition, in light of the major long-term underperformance by oil and gas equities, we would like to draw readers' attention to a rather straightforward strategy for investors with a long-term investment horizon which has previously reaped substantial rewards: concentrate on firms with solid corporate governance.

We have created a "high-scoring corporate governance" portfolio[5] and a "low-scoring corporate governance portfolio,"[6] each consisting of 10 companies weighted by market capitalization. Our portfolios are based on corporate governance scores for more than 100 Russian companies in which the sector analysts in ATON's research department have rated factors such as transparency and minority shareholder rights from 0 to 10 (10 representing complete disclosure, i.e. high protection for minority shareholder rights). In the high-scoring portfolio, we include the highest scoring companies. We have also excluded oil companies given our negative view on the sector. That said, we are more positive on Russian natural gas producers as well as oilfield services companies, and thus they are represented in the high-scoring portfolio. For the low-scoring portfolio, we took the 10 companies with the lowest scores, with an additional requirement of a market capitalization in excess of USD 300mn.

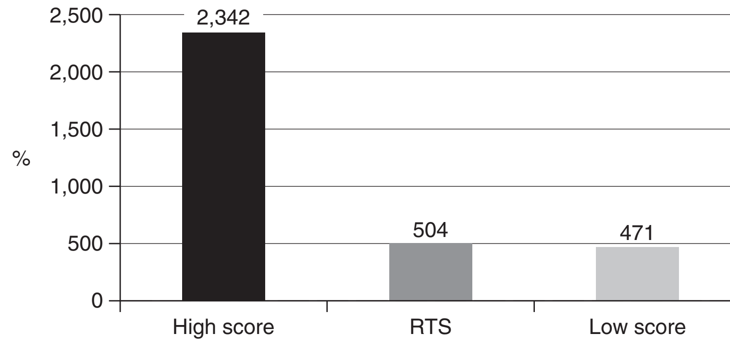
Since January 1, 2002, the high-scoring portfolio has climbed 2,342% vs. a 504% return for the low-scoring portfolio (the RTS Index has risen 471% over the same period). Applying the same strategy over a shorter time horizon renders the same result. Since the beginning of 2009, the high-scoring portfolio is up 339% vs. a 105% gain for the group of low-rated companies (the RTS has added 145% over the same period).

The caveat for both portfolios is that they are based on the current quality of corporate governance, implying that the situation could have been dramatically different several years ago. For example, we consider

[5] The "high-scoring corporate governance portfolio" consists of Wimm-Bill-Dann, Eurasia Drilling, C.A.T. Oil, X5, Novatek, Pharmstandard, Sberbank, Magnit, MTS and Uralkali.

[6] The "low-scoring corporate governance portfolio" consists of VSMPO-Avisma, Open Investment, GAZ, Irkutsk Energo, Razgulay, Seventh Continent, Polyus Gold, Kamaz, OGK-3 and Veropharm.

Figure 5.13. Corporate governance: performance of high- vs. low-scoring companies (January 1, 2002–October 24, 2011).



Source: MICEX, RTS, ATON estimates.

Sberbank to adhere to decent corporate governance standards today, although 10 years ago it was often referred to as a substandard company but a great stock. Nevertheless, the use of current ratings still captures companies where corporate governance has improved over time, which in itself creates a case for investing, in our view. Additionally, readers should note that several of the stocks included in both portfolios have a relatively short trading history. We have therefore included stocks in the portfolios since their time of listing.

Finally, we argue that the performance figures should be of most interest to the companies themselves, as they emphasize the potential growth in shareholder value from striving to maintain high management standards.

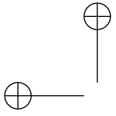
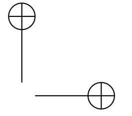
Conclusion

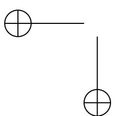
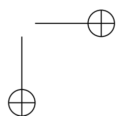
While Russia's oil sector, and hence the oil price, is undoubtedly a vital component for the Russian economy, when it comes to the Russian equity market the oil sector has been characterized by significant underperformance for the greater part of the last 10 years or so. This can largely be explained by excessive taxation on the oil sector and the lack of crude output growth. In periods of high oil prices, investors have been better off investing in sectors like financials, consumer staples and materials. We also note that the government's dependency on the oil sector for fiscal revenue means that any game-changing tax reform to boost

the investment case for the oil sector is unlikely to materialize in the foreseeable future, and therefore we advise Russia-dedicated investors to continue to focus on non-oil stocks. Finally, we show that if history is a good guide, then a wise approach is to invest in companies with good corporate governance standards.

PART 2

PIONEERING RUSSIA: A PERSONAL ACCOUNT

CHAPTER SIX

From Wall Street to Red Square: The Birth of the RTS

By Fred Berliner

Foreword by Bernie Sucher

Anyone who has ever worked on a trading desk knows the morning ritual. Coats flung over the chair, coffee in hand, tapping in the codes and powering up the machines that magically link you to the pulse of the planet. In the first hour, the big room remains dark. The earliest arrivals, traders and salespeople who will soon be flying at each other on an adrenalin high denied mere ordinary office workers are, at this hour, respectful, open-handed, even gentle.

By the spring of 1996, I had enjoyed this routine for over a dozen years, in trading rooms from New York to Hong Kong and Tokyo to London. But the last six months had been something special. Mornings at Troika Dialog were no longer just about plugging in and prepping for the day's joust with Mr. Market. No. Our mornings were now jewels of life's blessings crafted by the canny wisdom and New York wit of Mr. Fred Berliner.

Fred's recollection of his contribution to organizing the Russian equity market follows. The reader not familiar with those days will nonetheless readily recognize that today's institutions are the direct descendants of the remarkable effort Fred led nearly 20 years ago.

Even then, we knew how we lucky were. Alexei Dolguikh, Rufat Askerov, Liz Weiss, Alexei Chistyakov, Peter O'Brien, ... On the desk in our offices behind the notorious bulk of Petrovka 38, those marvelous mornings of learning and laughter. We were all students of a master, the true father of Russia's stock market, Fred Berliner.

In July of 1994, 15 of Moscow's leading brokers were assembled for a meeting at the Radisson and informed that through the benevolence of Uncle Sam and USAID's capital markets project, KPMG had been granted a contract to install an electronic trading system that would greatly enhance their market. Their cooperation was essential for this project to succeed. I remember looking around that large U-shaped table, at mostly young, eager men not yet 30, as they uncomfortably and warily eyed some of their competitors for the first time. They hadn't a clue as to how radically their marketplace was about to change, and none of us could have anticipated or predicted then the rapid emergence of the Russian equities market.

When privatization began, the justifiable conventional wisdom was that companies were priced at a fraction of Western market valuations. For those who knew enough about this embryonic market, even taking the risk into account, the investment opportunities were very attractive. As with all good things, eventually word got out that there was money to be made and the wave started to build. Share prices, which had risen slowly but steadily, started to gain some momentum, publicity soon followed, and by early summer the stampede was on. Articles discussing the efforts of well-known large funds to raise capital for investment in Russia began to appear in the press with increasing frequency. The two main movers of markets, fear and greed, grew ever more powerful, as those who weren't invested dreaded missing the party and threw prudence to the wind while those who were in banked on a rocket-ship ride to Croesus's kingdom.

In August, shortly after the fateful Radisson meeting, I was in a broker's office and overheard a phone call from a Western money manager who was begging to buy an energy stock. The price barely mattered—he just couldn't wait any longer, the train was leaving the station and he wasn't on it. Unfortunately for him, he made it. Stock prices nose-dived in early September when all Western buying suddenly evaporated, which turned out to be a blessing in disguise. Until then, most Russian brokers and traders had only given lip service to the changes necessary in the marketplace. They had all made a ton of money in a market that had gone straight up since early 1993. Educated youngsters, in their mid-twenties to thirties, who a few years prior didn't have a kopeck to their names or know a stock from a latke were now full of recently acquired wisdom and hubris, completely lacking the humility that comes with experience.

Moreover, the monetary situation didn't inspire confidence. The ruble was falling against hard currencies on a daily basis, and in the business world, whether concerning securities, real estate or commodities, Russia's currency was treated like a leper. By early November 1994, there was still plenty of stock for sale but few buyers. Stock prices sagged. Local seers thought the market cheap, but found few believers so the market continued to decline. By the end of November the market was poised for the event that would trigger a mass exodus—the final violent purge that would set the stage for a market bottom.

In mid-April 1994, I was working as a trader when I got a phone call out of the blue asking if I was interested in working and living in Russia. I remember replying that I had never given it an ounce of thought, but agreed to continue the discussion. I had completely forgotten that I had answered an obscure ad in the *Wall Street Journal* months earlier with a note, sans resumé, and now I was caught up in a net cast by KPMG to find candidates who might help fulfill their recently won contract. It was arranged that I would receive a call that weekend from the head of the project, who was in Moscow at the time. I was vaguely familiar with him as he had tried to hire me 10 years earlier to run the trading operation at a medium-sized member of the NYSE. I was offered what was purported to be a six to nine month assignment, and my wife, who was a Russian major in college, and I both agreed it was an adventure we couldn't pass up.

And so I became part of a team assisting the Russian government, Russian security brokers and the financial community in establishing a stock market that would be consistent with international standards. There were several USAID, World Bank and other philanthropic projects underway in Russia at the time, and some operated in conjunction with ours. Our group consisted of men and women with backgrounds in management, telecommunications, logistics, compliance and both American and Russian law (to the extent that there was Russian law). At our first meeting in the spacious Moscow apartment of the project head, I lay flat on the floor as I had thrown my back out on my arrival. I am sure everyone was wondering (a fact later confirmed) who the bozo was lying on the floor during this initial powwow.

Most of the original group scattered after more than a year together, but we all shared a special feeling for each other. We understood that the level of camaraderie we enjoyed during the project was truly a once

in a lifetime professional experience. My main role was that of a live trader, one who had been on the equity market firing line and could relate to the needs of market participants. This was a new role for me, because I have always been a player. Now I was the coach, using my experience to try to impart to the trading community some idea of how the arena would evolve. Before this mission I had never once considered what factors characterized a workable stock market. I never questioned what series of events relied on each other for the successful completion of a transaction, or how vital telecommunication was to the structure of the marketplace. A viable equities market was of utmost importance to Russia since the country desperately needed capital to finance the restructuring of industry from state to private ownership.

Where were we even to begin? The systems in place were barely functional and archaic at best, and every procedure had to be modified. What existed was an extremely elementary bond trading platform totally unusable for equities. The contract agreements between brokers were nightmares. There were so many variables involved in the contractual agreements that it took the patience of Job and Cassandra's vision to sort everything out. In the United States, trades settle (meaning stock is paid for by the buyer and delivered by the seller) in three business days and most are done by "book-entry." This means the transaction is handled electronically, including the transfer of ownership in the company's stock registry. In Russia, there were no standards and every point was negotiated at the time of the trade. These points included when the trade would settle and where, whether the stock would be delivered in the buyer's name before payment was made, where payment would be made and in what currency, and importantly, who would handle the registration of the security with the company's registrar.

Moreover, registration was not an easy task since it required someone hopping on a plane, train or mule to stand in line at the company registrar, which might be open only on the third Tuesday of each month between 11:00 and 11:15 a.m. A month or more could pass between the verbal agreement to buy or sell a security and actual completion of the transaction—and all of the multitudinous variables affected the transaction price to such an extent that it was difficult to quote a firm price for a given stock. The computer technology was there, but there were no systems in place to standardize and track all this information, such as a central clearing organization, and adaptation to Russia's particular way

of doing business would be a long and tedious task. Compliance in the United States generally means playing by the rules established by various industry governing bodies and everyone's favorite watchdog, the SEC. In Russia, the few rules that existed were broadly interpreted and changed frequently, while the watchdog seemed to be relatively toothless.

Another huge problem was taxes. Many transactions took place "offshore" to avoid the authorities. Russian brokers sold to their own offshore accounts for little or no profit and no tax liability, and then, from Cyprus or another agreeable jurisdiction, would sell the stock at a profit to the real buyer. Actual ownership of the said securities was another problem. If trades were made by CS First Boston or another well-known Western brokerage company, the name alone often guaranteed the trade even though the cumbersome process of re-registration had yet to take place. That meant that there was a possibility of a huge short position developing, which was illegal in Russia at the time. Western mutual funds, especially small partnerships and hedge funds, had the leeway to trade stock like this, but industry giants like Fidelity have strict rules about proven ownership of securities; and without these elephants prowling the jungle, the large-scale growth so eagerly anticipated would not be possible.

All these complications, unfortunately, were linked to each other and our project. Virtually giving Russia the infrastructure of a securities market was proving to be very difficult, and the selection of an electronic information and trading system was needlessly delayed for several months by infantile haggling. Two choices were available. One was a Russian-designed system for trading treasury notes that was jury-rigged to accommodate stock trading. As an alternative, we offered the specifications for Portal, a NASDAQ-type trading system, and at the end of 1994 the system was chosen by the brokers. Portal was a system designed by NASDAQ to trade restricted securities in the United States, and basically was a flop gathering moss until it was resurrected by interest from the Russian market. There was no doubt that the system had to be upgraded, modified and customized, but for Russia and its stage of development at the time, the system was ideal. One crucial enhancement was creating a window to negotiate trades in Cyrillic, not easy but doable. There was a spirited debate with Dmitri Vasiliev, the head of the newly formed Russian Securities Commission, regarding symbols using the Latin alphabet and price quotations in dollars. After I patiently explained the investors

came from the United States and Europe, and their initial comfort level was the most important factor in the system's success, Vasiliev reluctantly acquiesced. I was later reprimanded for speaking so directly and forcefully to him, but my modus operandi served the project well.

The problems with telecommunications were mind boggling. Getting through to various brokerage firms in Moscow was frustrating, and the implications for business were obvious. Telephone systems for military use were fine, but in Soviet times the government didn't want to make it easy for the common comrade to exchange ideas, so that part of the country's infrastructure was purposefully neglected. We installed seventeen direct lines, expensive but necessary, to the temporary Portal computer site for the Moscow broker's association. But in two months we needed many more, so the logistics were intricate. Selecting, or rather finding the site for the pad (a communications concentrator that takes in data, sends it on to the computer, and returns the info to the many individual computers) was a major hassle that we should have better anticipated. Locating any site was difficult enough, but the politics involved made the situation even more complicated. The federal government was at complete odds with the city of Moscow and Mayor Yury Luzhkov, who ran his town with an iron hand and had a payoff machine with few rivals anywhere. We wanted to locate the central computer and the pad adjacent to each other at the Moscow Telephone building, where the telephone lines were the best in the city. However, the greatest fear was that the mayor would be able to hold the whole securities market hostage. The notion that the city could end up controlling the securities market nixed that set-up, so the Stratus computer was located two blocks away in the temporary offices of the Russian SEC. We believed that Luzhkov would hesitate messing with the federal government as opposed to a semi-private telephone company. We needed pads in other cities, plus the ability to hook all this to the central computer in Moscow. That meant at least 150 individual contracts had to be written and blessed by the legal beagles from a significant number of organizations. It was like going to bed at 10 o'clock, waking up to a bad dream at eleven, and knowing that before dawn the process would repeat itself many times.

We formed self-regulatory associations in Moscow, St. Petersburg, Yekaterinburg and Novosibirsk to write the rules and regulations for the markets. It was our intention to preempt government legislation that

might be written by bureaucrats with little knowledge or understanding of what a securities market is. A standardized contract with four basic options was blessed by the Moscow and regional broker dealer associations, and it eliminated delays in the actual settlement of transactions and facilitated interregional trading. The stage was now set for one national market with a level of transparency that was previously non-existent.

During the six months before the Moscow brokers went online with the new, upgraded system in June 1995, we had to focus on instilling the rules and trading practices commonplace in the West, but unheard of here. Everybody was so hooked on indicative prices that to have market makers quote prices on a screen and then actually honor them was a novel idea, as well as an extremely difficult sell. The reporting of trades was another major hurdle that had to be overcome. Brokers were afraid that if they reported all their transactions, their customers in the West, and their competitors here would realize, rather than suspect, that the markups and markdowns were huge. The rules they wrote read that only trades between members should be reported, so if you had a trade with any customer, be it a Western fund or broker, or a Russian bank, you were off the hook.

I emphasized that all trades were real transactions with money being exchanged for securities and should therefore be reported, but I temporarily lost that battle. In March of 1995, I participated in a meeting of the newly formed trading committee, where the mood was grim. Volume and activity were at a standstill, and most of the members were convinced that the trading system was a waste of their time and someone else's money. They said, "Why don't we scrap the whole project, it won't work." Three weeks later, the same cast concurred that they were getting many inquiries from known and unknown brokers in Moscow as to how they too could get access to the system. A heated discussion then erupted as to how many terminals each member would be allotted. I knew we had our converts and the Russian Trading System was officially born. By the end of July 1995, the trading system was functioning not only in Moscow, but in St. Petersburg, Novosibirsk and Yekaterinburg as well. In a year's time, a fragmented, indicative priced market had changed to a national market with hundreds of system users displaying real prices, reported transactions, and for many issues, a depth of market makers rare in emerging markets.

So what did the triumph of the RTS do for the equities markets in Russia? First and foremost, the RTS has been the key ingredient in the success and spectacular growth in stock trading. Without it, Russia would have been on the fringe of the equity business. The RTS became the basic, required tool.

A major accomplishment that can be attributed to the RTS, and the broker dealer associations which supported it, was a significant increase in the level of integrity and standards. When I arrived in June of 1994, about 50% of transactions were never completed following an oral agreement—laying down on a trade was a common and expected practice. A year later, based on the threat of being banned from the system and a general elevation of ethical principles, almost all oral agreements were honored. The investing public benefited from narrowing spreads facilitated by the creation of firm and more liquid markets. From the onset, brokers and traders were told that spreads would narrow considerably and competition would intensify. That caused initial resistance to the whole concept of a trading system; but they were also promised a colossal increase in volumes and trading activity that would more than make up for the shrinking margins. Mercifully, this came to pass, as daily reported volume and the number of trades reported increased 10 times from July of 1995. I had immersed myself in an enterprise that would directly benefit others. I put the Russians' interests first and gave frank and non-political opinions. Such counseling garnered the respect and confidence of the brokerage community and slowly opened the avenues of accessibility that were so vital for the success of the project.

The trading system basically spawned the broker dealer associations that have become an integral part of the securities industry today. These associations have written, rewritten and transformed the rules, and are continually upgrading standards and practices. The learning curve was very steep and they did an extraordinary job in two short years, but they have proceeded to govern and regulate their members without the benefit of experienced counsel. The second-year students were teaching the class, and there were some petty rules and regulations created that hindered the development of the marketplace. Because of the trading system's success, the Securities Commission had a much more focused goal of creating plausible, workable, quality regulations that would complement rather than hinder the development of the Russian equities market.

The creation of the Russian Trading System was a marquee success story in the annals of USAID projects in Russia, and perhaps worldwide. We achieved huge, concrete, tangible results relative to the money invested. We had a thriving equities market that couldn't have been created without the young, Russian entrepreneurs seeking a higher standard than that which evolved from the voucher days. Their desire to change, to overcome the fear of the unknown and greet an unsettled future with an enthusiastic spirit, was the wellspring of this success.

What I was engrossed in for 18 months wasn't work. I was myself, virtually unfettered and unmindful of protocol as the spirit and trading experience behind the crucial part of the project, and its success sits at the pinnacle of my career. The most difficult obstacle we had to overcome was the natural resistance to change, and our great challenge was to make the Russian brokerage community believe that the trading system and the inevitable, structural upheavals it would entail were beneficial. The single, most important achievement in this process was convincing market participants to make firm, real markets—and to honor them.

Toward the end of the project, I was enormously gratified when the *New York Times* published a letter to the editor I had written. For too long, I felt, the Russian market had been unfairly portrayed in the Western press and I set out to address these misapprehensions. I had previously sent a similar version of the letter to *Barron's* by email, which was promptly published. However, the editor had butchered its content according to his perceptions, and exorcized the flavor and my intent, which was to showcase Russia's considerable achievements in creating a functioning stock market. And, of course, no one noticed, because I didn't receive one single acknowledgement of my literary achievement. Obviously, I was the only reader of *Barron's* Letters to the Editor section! A pissed puppy, I sent the letter to the *New York Times*, and just to prove that the left hand often hasn't a clue to what the right hand was doing, I sent the exact letter to the *Wall Street Journal* in Europe, the parent of *Barron's*. Complicating matters was my disregard of USAID's strict rules regarding contact with the press, following two unacknowledged attempts to gain official permission. I was also unaware that I was also contractually required to get the Resource Secretariat's (Russian government's) approval prior to any communication with the press. But the die was cast, and when the *Times* called Moscow to inform me of imminent publication, I prepared for the storm. The response to the totally

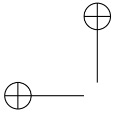
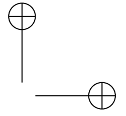
unedited story in the *Times* was unanimous acclaim and appreciation from all parties. My letter was the rare positive spin about Russia—and it was the truth. The *Wall Street Journal Europe* published a slightly edited version a few days later (they couldn't help themselves), but the coup de grace was a translated *Times* version in the popular Russian daily *Sevodnya*.

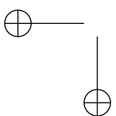
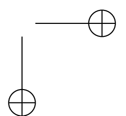
In July of 1994, I met Ruben Vardanyan at one of the initial meetings with the Russian brokerage community. He was the 25-year-old president of Troika Dialog, a small brokerage company that he had started a few years earlier. We hit it off immediately and he implored me to join him at Troika. I told him I had a commitment to the USAID project, but when it was successfully completed, I wouldn't go anywhere else. I joined Troika in November of 1995. Now I had another mountain to climb, and achieving the goals I established for Troika and myself was a challenge, handicapped as I was by a level of Russian on the fair side of pathetic. During my tenure with USAID, I always had at least one interpreter at my side, and often at important meetings I had an interpreter on each side. My role at Troika was trader, teacher, mentor and visionary to a fast growing, young Russian brokerage firm of which I was the senior citizen. I was given free rein over equity trading and its small staff, all young enough to be my children. I vividly recall the first two days on the trading desk. The market was dead, dead. There was virtually no activity and everyone was glum. I asked the traders and sales force what their clients wanted to do and they all said buy, but at lower prices. To me that was like a bell ringing as the market was sold out.

Initially, the sales force consisted entirely of expats, but the traders were and would remain Russians, some with a rudimentary command of the English language. When I was still with USAID, I was responsible for creating all the four letter symbols for securities to be listed on the RTS. Those symbols are still in use today, along with the nicknames created by our desk. SNGS, Surgutneftegaz, became "Snigs," LKOH, LUKOIL, became "Luke," and there are many more. Over the more than three years that I ran the equity desk, my command of the language progressed to learning numbers in Russian and developing the ability to referee squabbles on the trading desk; but my traders learned Western adages and became proficient in English as well as much language painful to the politically correct. But most importantly, Troika evolved into the premier market maker for the burgeoning equity community and eventually became the

top broker in Russia. I also assumed the role as policeman for ethical standards and fair practice among all Moscow market makers. I played an instrumental role, by example, in forcing the market makers to narrow the spread between the bids and offers and to honor those markets if they were called upon. Clearly, my greatest concern was the integrity of the marketplace, which I zealously guarded.

So, an assignment that was supposed to last for less than a year turned into a five-year love affair. I had no expectations in traveling to Moscow, and could not even have speculated that I would be making a serious contribution to establishing a Russian securities market, both with USAID and Troika. But the greatest satisfaction is that I was able to a make a real difference to so many, and I am very proud and honored to have been a part of the community.

CHAPTER SEVEN

The Russian Investment Adventure: A Personal Account

By Peter Elam Håkansson

The Soviets Are Coming

There are events that occur early in life that later come to symbolize important changes in direction. They are the hidden road signs of a career, impossible to spot at the time, disguised as they are by a combination of youth and the murky prism of history. But in retrospect, they emerge as clear pointers toward the way one's life will develop. For me, I believe one such moment came on October 29, 1981. The Soviet submarine *U-137*, a Whisky class submarine of the Baltic Fleet, ran aground on the east coast of Sweden, approximately 10 km from the Karlskrona naval base, and was forced to surface inside Swedish territorial waters. I was 19 years old, serving my time in the Swedish marines and part of a group of soldiers sent out to guard the submarine.

This was not a minor incident. The Soviet Navy sent a rescue task force to the site comprising destroyers and tugs. Sweden's government was understandably determined to safeguard Sweden's territorial integrity. As the Soviet recovery fleet appeared off the coast on the first day, Swedish coastal artillery guns locked onto the ships, indicating to the Soviets that there were active coastal batteries on the islands. Despite the threat, the fleet did not reverse course immediately, and as they came closer to the 12-mile territorial limit the battery was ordered to go to war mode. Finally, the Soviet fleet reacted and the vessels reversed course to remain in international waters.

The Soviet submarine captain, after a guarantee of immunity, was taken off the boat and interrogated in the presence of Soviet officials. The submarine was held in Sweden for nearly 10 days, during which period nuclear arms were discovered on board. Eventually, on November 5, the submarine was hauled off by Swedish tugs and escorted to

international waters, where it was handed over to the Soviet fleet. These were exhilarating events for a 19-year-old marine.

Here, in one incident, was a metaphor for the Cold War—the suspicion, the fear, the imminent threat, the lack of trust, the rapid escalation, the horrendous consequences of a mistake, the need for understanding and, perhaps most tellingly, the tragedy and the farce. Here were two neighboring European nations that should be trading with each other and engaged in developing mutual prosperity instead locked in an ideological battle that had spiralled out of control. With all other options eradicated, they were left to glare at each other across the narrow waters of the Baltic Sea. This pencil thin submarine was in fact a stiletto knife, carefully inserted and moved back and forth to widen the gap between the Soviet Union and the West. What better way was there to illustrate how far away we were from each other?

For me, the messages were conflicting. On one side, I spent two years in the Marines and the Naval Academy, where we were taught about the tactics of the Soviet Union and NATO. We participated in war games to practice methods for thwarting the Soviets. At that time, Sweden had one of the largest air forces in the world and we wanted to make sure that the Soviets would never hit Swedish shores with boats and planes. The tactic was to hit them in the Baltic Sea. In short, I thought the Soviet Union was evil. On the other hand, my grandfather was Swedish but volunteered to fight with the "Whites" against the "Reds" in the former Russian empire in Finland and Estonia. This was in 1918–19, following the Russian revolution. I grew up hearing about a country called Estonia, which no longer existed when I was young. I never met my grandfather, but as a result of his experiences I was always fascinated by what lay on the other side of the Baltic Sea. But, oddly, no one talked about what was happening. In the classroom, the map we had of the Nordic region always had the key printed exactly over the Baltic States. The Soviet Union was another world, almost completely isolated both physically and intellectually. It was known but unknown, ever present but rarely talked about, there and not there. But I did know I was deeply fascinated by that mysterious, enormous and looming land to the east. The ensuing 30 years have no doubt simplified my impressions of that time, but it seems logical to conclude that such a rich experience contributed in ways that are impossible to define to my later decision to set up East Capital. It posed questions that I needed to answer. All I needed was for history to step in

and make this possible. Fortunately, in 1989, that is exactly what it did, in one of the most mysterious events of recent history.

Spotting the Opportunity of a Lifetime

While the benefit of time has served to clarify my personal fascination with Russia, it has been less generous in helping to explain why the Soviet Union collapsed. The finger of blame is often pointed at the drop in oil prices from USD 66 in 1980 to USD 20 in 1986, the financial implications of the Afghanistan invasion, the effects of Ronald Reagan's "Star Wars" program, the independence movements in Poland under Solidarity, and the personal political beliefs of Mikhail Gorbachev. But it is telling that over two decades later, no less a person than George Kennan, one of the prime architects of U.S. strategy in the Cold War and author of the famous "Long Telegram" in 1946 recommending the U.S. policy of containment known as the "Truman Doctrine," wrote that he found it "hard to think of any event more strange and startling and at first glance inexplicable than the sudden and total disintegration and disappearance of the great power known as the Russian Empire and then as the Soviet Union."

As has been pointed out in more recent analysis, and contrary to common opinion, there were few economic clues to suggest a coming collapse. From 1981 to 1985, GDP growth was certainly slowing, but still averaged 1.9% a year. The budget deficit was less than 2% of GDP in 1985. It did rise rapidly, but only to a quite manageable 9% in 1989, well within the range of the tolerable, especially by today's standards. The sharp drop in oil prices undermined Soviet finances, but adjusted for inflation oil was more expensive in 1985 than it was in 1972. Soviet incomes increased by more than 2% in 1985, and inflation-adjusted wages continued to rise over the next five years through 1990 at an average of more than 7%. Afghanistan was also a drain on state finances, but the cost of the war, estimated at between USD 4bn and USD 5bn in 1985, was an insignificant slice of Soviet GDP. One could go on, but suffice to say that the collapse of the Soviet Union remains one of the most intriguing questions of history. As Leon Aron wrote in a recent issue of *Foreign Affairs*, "There were plenty of structural reasons—economic, political, social—*why* the Soviet Union should have collapsed as it did, yet they fail to explain fully *how* it happened *when* it happened. How, that is, between 1985 and 1989, in the absence of sharply worsening economic, political,

demographic, and other structural conditions, did the state and its economic system suddenly begin to be seen as shameful, illegitimate, and intolerable by enough men and women to become doomed?"

This is a heady question, and while I am not seeking to answer it in its entirety, it has always been my strong conviction that one of the fundamental problems with communism is that it does not give the individual sufficient incentive to do anything beyond the bare minimum. It doesn't offer rewards for any kind of initiative. This was an issue that played strongly on my mind at the time. I was living in Paris after the Berlin Wall came down on November 9, 1989, and I took many weekend trips into Eastern Europe to see what was happening. What I saw was great potential. In St. Petersburg, for example, there is an old shopping center, or more precisely a shopping arcade, built in the early part of the nineteenth century called Bolshoi Gostiny Dvor. What struck me was that similar shopping arcades built during the same period in London and Paris were tiny compared with this one. Even by today's standards, it is huge. Just thinking about the fact that this arcade was built such a long time ago made me realize what wealth Russia could create if it was properly managed. It seemed to me that the Russia story was going to be about regaining the past as well as seizing the future.

It became clear to me that the Europe we knew during the Cold War existed within an abnormal situation. If you grew up at that time, as I did, then all we knew was that there was a West Germany and an East Germany, and a division between East and West. That seemed normal, but of course it was not normal at all. The Europe I saw around me was not how Europe should be. I could not understand how these people in the East could have been part of Europe all throughout history, but were part of it no longer. It was my strong conviction that this would change, and change for the better. I had an unrelenting impression of latent potential. I was also convinced, and I remain convinced to this day, that we were going to see a tremendous period of convergence between the Russia of old and the West. The question was what type of people would lead this convergence, and pretty soon I had the answer.

It is of course difficult to summarize the entire range of changes that occurred at that time, so my recollections are more in the form of vignettes. For example, from 1994 to 1998 I was working as the Global Head of Research for Enskilda Securities, part of the Swedish bank SEB, and I remember being called from reception one day during my first year

there to be told that the Vice Chairman of Hansabank, the Baltic institution, was downstairs and wished to meet me. He had been placed in one of our wood-paneled conference rooms. I was of course interested to see him, and expected a gray-haired, middle-aged banker. But he turned out to be a guy slightly more than 20 years old, frankly looking a bit out of place in the old-fashioned paneled room. However, I soon discovered that the young man named Rain Lohmus was a very smart young man indeed. Rain said he needed to raise some capital in order to develop a modern bank. We had a talk, went to visit the bank in Tallinn, and soon Enskilda helped them to raise funds. It seems obvious to say so now, but this incident made it clear to me that the former Soviet states were loaded with young, talented and credible executives eager to re-create the economic success of the West. Casting my mind back to my grandfather who fought the Russians and to the younger version of myself standing guard over that grounded Russian submarine when I was 19, I knew I wanted to be a part of this transformation. Subsequently, it has always been a strong motivation for us at East Capital to participate in Eastern Europe's transformation to a capitalistic society.

The Birth of East Capital

At this time, in the mid-to-late 1990s, the narrative surrounding Russia's transformation began to change markedly with talk of a huge privatization program. My friends in Moscow were talking about privatization, but the message did not really sink in until the summer of 1997 when I was contributing to an article in the Swedish monthly *Aktiespararen* about the best investment ideas. I wrote that Russia was "the buying opportunity of the century" and recommended buying a Russian equity fund. No sooner had I done so than I began to be deluged with phone calls from people all over Sweden who wanted to buy into Russia. I saw there was massive interest in the retail side, but of course when they heard it was a USD 100,000 minimum investment in that particular fund, they were somewhat less motivated. I realized that people do see Russia as a great opportunity, but were only willing to risk about USD 100, not USD 100,000. There was a huge mismatch between the nature of investor interest and the products available. At this point, I started thinking about setting up East Capital to tap into this huge groundswell of retail investor interest in Russia and Eastern Europe. The minimum investment at East Capital was, and still is, USD 30.

Thinking up East Capital was the easy part. Pretty soon more pressing challenges started to present themselves, not least of which were related to the timing of our launch, which was on November 9, 1997, smack in the middle of the Asian economic crisis and, by coincidence, on the eighth anniversary of the fall of the Berlin Wall. We then compounded our bad timing and launched the first Russia fund on May 18, 1998. Three months later, in August 1998, Russia defaulted. Perhaps this is a classic case of post-event rationalization, but I firmly believe that these events really helped crystallize and create East Capital's resilience capability and investment philosophy, and also gave us a clear vision of how we could differentiate ourselves from our competitors. Necessity is indeed the mother of invention. So, what did we learn?

We realized very early on that traditional ways of conducting corporate analysis were basically useless in Russia at the time. Some of the investment banks operating in the region were desperately trying to apply their tried and tested method of working out a price/earnings ratio, which even if you could come up with one was not very useful as the available numbers meant absolutely nothing. We knew we needed to come up with a way to assess the potential of companies that would do more than look at their current profitability. You simply could not trust the accounts. You could have a factory that was running at full capacity with money flowing out left and right, but the accounts were not done properly so the figures did not add up. Nonetheless, you could see the potential that was there.

During the first years when East Capital was investing in Russia, there was also the issue of physical barter going on between companies, which meant that the accounts did not say anything at all. In such a situation, the question was how much you should actually pay. We decided there and then that the only way to make this determination was to actually go and see the companies. We also learned that the best time to see companies was in the winter. Why? If the offices were not heated, the company did not have any cash. If it was warm, they had money. A simple analysis, yes, but nonetheless very efficient. We had many meetings in cold conference rooms that allowed us to avoid some bad investments. Many times after company visits, I would read research reports from other investment banks on a company I had visited. Often, I was unable to recognize anything I was reading. At this very early stage in East Capital's life, we realized that most of the research being conducted on Russia or

Eastern Europe during this period was not really worth the name. This information arbitrage spelled one thing for us—opportunity.

Boots on the Ground

There were other lessons to be learned from having boots on the ground. We were badly hit by the Russian crisis. Assets under management fell. But I remember we went on a business trip to St. Petersburg shortly after the crisis to visit the largest dairy there, a company called Petmol. Frankly, we arrived quite depressed. Much to our surprise, the management was excited. They were delighted because their main competitor was from Finland and no longer able to do business in Russia because of the ruble devaluation. Despite their old-fashioned Russian packaging, people were finally buying their products because there was nothing else to buy. This injected cash into the system and they were able to start investing in new machinery and packaging technology.

This was a very telling example of what was happening at the time. Crisis creates opportunity. We came back from that trip feeling very positive about Russia's potential, whereas our competitors were quite negative. One competing Russian fund manager I met shortly after that trip said that EU rules stated they could not run an equity fund with more than 25% cash, and they were considering going to the local financial authorities to ask for an exemption because things were so bad in Russia. We thought the opposite. We knew it was a time to be fully invested. The confidence to be contra-cyclical can sometimes pay significant dividends in a market like Russia.

What was particularly interesting as a result of the crisis was that we started to see the development of a Russian domestic sector. A lot of the very strong consumer companies that exist now, such as Wimm-Bill-Dann, the juice maker that was sold to Pepsi in early 2011 for USD 5.8bn, really made it big because of the crisis, mainly because all of the competing imports in their sector were gone. The crisis created—for the first time since Russia opened up—a level playing field which allowed Russian companies to develop. The crisis forced Russian companies to rely on themselves. We saw this. Others did not. That is the value of being on the ground.

If I could isolate one core requirement for investing in Russia, it would be having a local presence. If you are not traveling around the country, you are not seeing it. And unfortunately even local analysts in Moscow

have not been traveling much. I can remember many discussions with analysts about a factory somewhere far away, such as in the Urals, and we had been there and they had not. It is impossible to underestimate the value of this type of engagement with local Russian managers, bankers and policy makers across the entire economy. You can derive a completely different viewpoint of the strength and direction of the Russian economy simply by asking the right person the right question in the right place.

Following the consensus view is of little use when investing in complicated emerging markets. You need to develop a methodology that allows you to take an individual view that can be backed up with hard evidence. One way in which we have been able to do that was by becoming a private equity investor. While 80% of our money is in public equity, taking direct stakes in Russian companies taught us a lot about the daily life of running a business and this knowledge fed directly into the asset allocation decisions we made on the fund management side. Having sat in board meetings now for a number of years, I understand that many of these meetings are not just strategy discussions, but are dedicated to ensuring that the multitudinous reports that have to be created for the Russian authorities are done on time. The amount of bureaucracy is stunning. Just knowing this allows one to empathize more effectively with the management of the companies in which you are invested.

There are also unquantifiable benefits to be derived from visiting the company and staying in the company hotel and eating in the canteen with the workers. Such experiences, and we have had many, offer an entirely fresh insight into how a Russian company works from the inside. We also realized that managers were not just managing a company, but in some cases an entire community. Such realizations bring with them a very strong sense of our responsibility as an investor. We are able to demonstrate that owning direct stakes in companies means that we are, quite literally, on board together with the Russians. That has boosted our name and due to our strong track record, the size of the company, and our long-term commitment, we are seen as a credible shareholder by companies that are looking for investment. Hard corporate analysis is one thing, but soft factors such as these play an enormously important role when investing in Russia. It is not an exact science.

This commitment to being local was not just a philosophy. We also put our money where our mouth is by investing in so-called local shares,

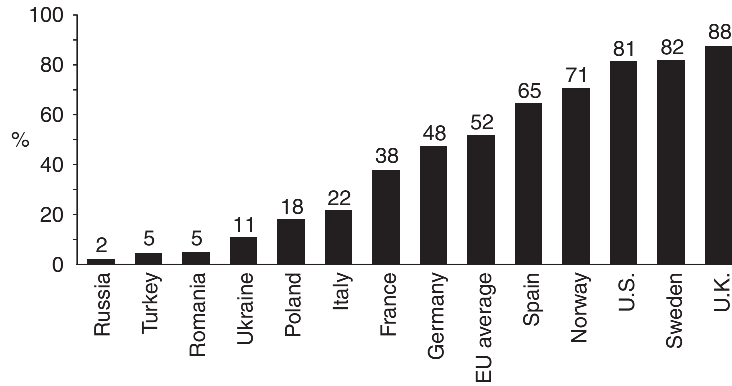
which trade only in Russia and which at the time were trading at a discount of up to 40% compared with the same shares trading in other markets such as London, mainly due to the risks associated with reduced liquidity. This was a risk we were willing to take, as our close analysis of the companies involved meant that we could be as confident in the investments as in investments in any market. We also reasoned that at some point the split between local and international shares would have to disappear, and that this would mean any discount would shrink. This is exactly what is happening, with average discounts now of around 8%. In short, being committed to the local story allows us to position ourselves for change.

Banking on Russia

Generating local knowledge and making room for a high level of elasticity in our decision making process has led us into some extremely interesting areas, such as our direct participation in Russia's banking sector. We tried very early on to buy into Russian banks as we were completely convinced that this was going to be a very attractive sector for investment. The problem was that if you wanted to buy even one share in a Russian bank, you needed to get permission from the Central Bank of Russia. Of course, the central bank followed the law, and the law said you need to know the ultimate owner of the bank. If you are a UCITS regulated fund, as we are, with about 450,000 unit holders, most of whom buy through a bank, we cannot tell the central bank who the ultimate owner is. As a workaround, we set up a Swedish AB (a limited company with a shareholder register run by the Swedish Central Depository) and attracted EUR 500mn from large investors all over the world to invest in Russian banks. Using this type of structure, we were able to provide enough information to the central bank to receive permission to invest. We then started buying up stakes in banks all over Russia, usually of between 5% and 20%.

What did we learn from this process? Obviously, it demonstrated the benefits of flexibility and creative thinking. But in addition, we have been on the boards of these banks all over Russia, Ukraine and Georgia since 2006, and it has been a fantastic source of information about the real state of the Russian economy. We have been able to see where the demand for credit is coming from, and which sectors in which regions are performing well. If anyone knows what the real situation is, it is the

Figure 7.1. Residential debt to GDP ratio.



Source: European Mortgage Federation.

banks. We also learned a very valuable lesson about perceived risk in Russia compared with actual risk. When you say you are launching a fund to invest EUR 500mn into Russian banks, quite a few people tell you that you are completely mad. But we saw very quickly that the Russian central bank is doing a very good job of getting banks to report. We knew that this process was working very well indeed, and we had a strong conviction that investing in this allegedly highly risky sector was in many ways less risky than buying so called normal companies that are not under the same kind of supervision. Today, banks comprise 16% of the assets under management in our Russia fund, and we continue to leverage the insights we gain from the banks to understand the true state of the development of the Russian economy more deeply.

Russian Risk: A Misconception

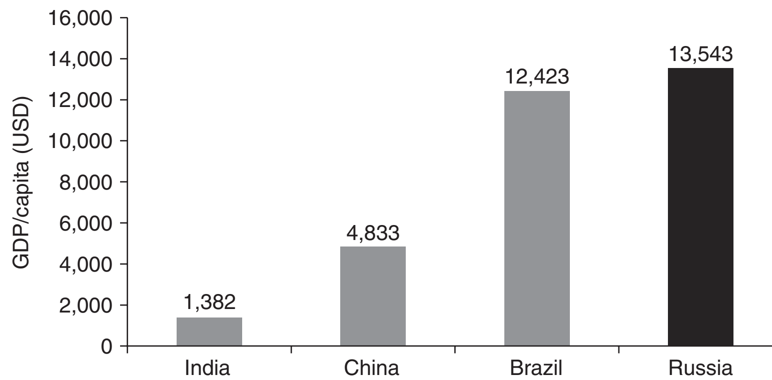
I have just mentioned the misperception of the risks involved in investing in the Russian banking sector, and would like to add that this reality contains a deeper lesson about investing in Russia itself. What I am referring to here is the vexing—or should I say downright mysterious—subject of the risk premium attributed to Russia compared with other large emerging markets. I sometimes wonder whether investors have realized that Russia has changed dramatically. It is a very different country today than it was when we started East Capital in 1997, and yet the market price-to-earnings ratio, and hence the risk premium, remains at the same level as

in 1999, directly after the Russian crisis of 1998. You should never be naive when you are investing in any market and especially in emerging markets. However, many of the risks and worries people have when considering investing in Russia are attributable to other countries as well, but investors are strangely willing to accept much higher valuations, and hence a much lower risk premium, in other countries compared with Russia. It is always mentioned that the reason is corruption. Yes, there is corruption in Russia, but there is also a high level of corruption in other large emerging markets around the world. Another alleged explanation for the risk premium is the often repeated allegation that Russia does not produce anything, but is basically an oil and gas play. One thing we hear constantly is the question: "What does Russia produce?" I believe this is the wrong question—and it is being asked because Russia is to some extent wrongly included in this well-known grouping known as the BRIC economies.

It has of course always been fashionable in the investment world to find and use catchy acronyms for certain investment trends. Such things register well with investors. One such example is the BRIC phenomenon. Certainly there have been some benefits for Russia in being placed alongside other BRIC economies, but there have also been disadvantages. People take a look at the BRICs, especially China, and like to find similarities. But I think it is to some extent unfair as Russia is at a completely different stage in its development than the other BRICs. In terms of GDP per capita, Russia is at around USD 13,500. When you reach this level, you have reached a level where you can consume much more. This makes the Russian economy much more like that of Western Europe than the other BRIC economies in terms of domestic consumption. Rolling Russia in with the other BRICs and expecting it to be comparable in terms of production gives a completely misleading impression.

In my opinion, it is completely ridiculous for Russia to be carrying the same sort of risk premium today as it did a year after its default in 1998. Russia is trading much lower than other comparable emerging markets as a result of the difference between the perceived risk of doing business here and the actual risk. In my view, this gap must close. Let us remember that the Wall came down in 1989. We had a strong conviction then that there was going to be convergence with the West. It will take time before Russia catches up, but it is clear that the growth is going to be tremendous. And yet we are still getting the same questions today as

Figure 7.2. BRIC's GDP per capita (USD).



Source: IMF.

we did when we started going out and doing marketing in 1997. We are still asked about political risk, corruption, oil and gas, and what Russia produces. Many people still believe Russia has significant debt problems. They have completely missed the whole transformation of the Russian economy.

A Thriving Middle Class

So, having excoriated these false perceptions of investing in Russia, what in my opinion is the right perception? I have already mentioned that we have been offered extraordinary insight into the actual dynamics of the Russian economy as a result of our investments in a number of Russian banks. One of the direct consequences of this insight has been to reinforce our conviction that investing Russia is about three words: consumer, consumer, and consumer. It did not take us long to stop looking at Russia as an oil and gas economy and start realizing that it was a consumption play. Our top-down view is that *the* big thing in Russia is the development of a middle class. There is a very strong catch-up effect because people naturally want to reach a standard of living comparable with that in the West. If you add to that the fact that Russians typically do not have mortgages to service and pay a 13% flat tax rate, you have a level of disposable income that is just amazing. When we started to do calculations in the early days and looked at people making between one and two thousand dollars a month, you actually saw a higher disposable

income for a married couple living in Moscow than for most Swedish people living in Stockholm, who are servicing their mortgages and paying very high taxes. People may look rich on paper, but what really counts is disposable income.

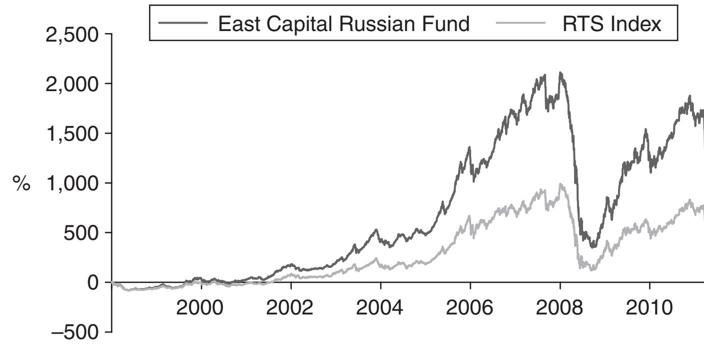
This belief in the rise of the Russian middle class has shaped the East Capital of today. For example, we have a significant investment in Melon Fashion Group. Of course, it is a well-known company these days with around 500 stores across Russia and Ukraine under the brands of Zarina, befree and Love Republic, as well as a team of in-house designers. But when we bought into the name, Melon had only a factory in St. Petersburg, 1,200 employees and about 10 stores. The management was, to some extent, thinking in an old-fashioned way by trying to locate their stores next to metro stations. We pointed out very quickly that they needed to be in shopping centers. We knew that shopping centers were the future. I fought hard over this and they eventually agreed.

But when we opened in the first shopping center it didn't do well at all. In fact, for various reasons, it bombed. I can still remember the looks in the management's eyes when I came to the next board meeting and they showed me the figures. They were looking at me saying: "What have you done?" But we knew we wanted to build a strong brand and take a very strong market position all over Russia. It was an historic opportunity to do this in a major way in a very large market—and it would be completely impossible to do in a rival European market. I am delighted to say that the growth created by the strong management—including in that first shopping center—has been spectacular and Melon is today a company that is benchmarking itself against the best retailers in the world. Moreover, by making this investment we learned a huge amount about the kind of opportunities there were in Russia. We were, for example, a tenant, so we could see the returns available on the real estate side, for example, which led us to investments in shopping centers in both Ukraine and the Baltic States.

The Key to Success

In our business words will only get you so far. What really matters is performance. Since its inception date of May 18, 1998, until June 30, 2011, the East Capital Russian Fund is up 1,603% compared with 738% for the benchmark RTS Index (all returns in USD). The fund was also the top onshore fund in the world during the first decade of the new millennium

Figure 7.3. East Capital Russian Fund: performance since inception.

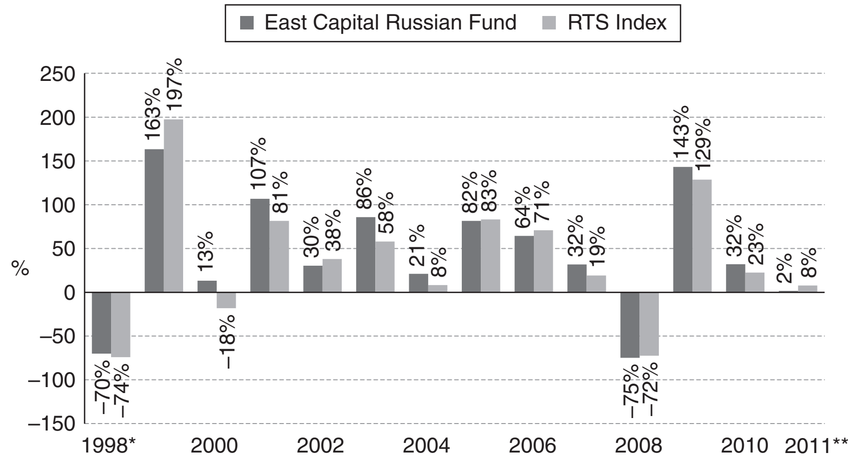


Source: East Capital, RTS.

with a rise of 1,565% compared with 1,380% for the closest competitor (a precious metals fund) and 724% for the RTS Index. This is based on Morningstar data covering 94,000 funds worldwide (again, all returns are in USD). We are convinced that this is attributable to our investment philosophy of specialization, which allows us to understand the market better and identify investment opportunities that are not always evident. We also believe in being long term, secure in our belief that emerging economies such as Russia will outperform developed economies over time. But most importantly, we believe in being local. We doubled the number of company visits we did in 2008 and 2009 from 600 to 1,200. Being on the ground allows us to spot investment opportunities others simply miss.

East Capital today is one of the largest investors in the world investing in Eastern Europe, with more than USD 8bn under management. It is a huge amount of money and with that amount of money come big responsibilities. We have a devoted team of 170 people representing more than 30 countries. We have about half a million clients from more than 60 countries. What has always been important for us is to make sure we can help rectify broadly held misconceptions and prejudice toward Russia and Eastern Europe. One way to do this is by making regular presentations to thousands of investors and potential investors on how we think Eastern Europe is developing. We also bring many hundreds of people a year to Eastern Europe during our summits and investor trips to see things for themselves. Nothing beats being on the ground and seeing the changes yourself.

Figure 7.4. East Capital yearly performance.
*Since inception. **Data for 2011 is for the 1H11.



Source: East Capital, RTS.

We also recognize that our size does bring responsibilities as an investor to work with our portfolio companies, whether helping them resolve the occasional conflicts that arise or aiding them in developing a more mature attitude to their own responsibilities as a company when it comes to issues included under the corporate social responsibility umbrella. For many large international institutional shareholders from outside Russia, CSR issues are becoming increasingly fundamental to their asset allocation decisions, and we will in the future help our companies make themselves more attractive to the investment world by working with them in this area.

Our size helps us in this process. In Russia, East Capital runs USD 4bn in public equity and as a result of our size, we are granted the kind of meetings we want. During these meetings, we do not present East Capital as purely an investor, but also as a manager engaged in working for the benefit of investors in Russia in general, for example, by promoting good corporate governance and working toward higher levels of environmental awareness. More than once we have told management we might be forced to sell our shares unless they take action to deal with the issues that we highlight. This is not a threat, but rather a question of encouraging the standards that are demanded by the international investment community.

Concluding Remarks

Many of the driving forces that led us to Russia in the first place still remain. Although GDP per capita is quite high, it still has a long way to go in order to truly converge with more developed European markets. This convergence will be led by domestic consumption, which will become increasingly advanced as Russians develop a taste for more sophisticated financial products, international travel and fine dining, to name just three examples. There are also going to be opportunities in the Russian logistics sector as all these consumers are serviced. There remains huge under-penetration in these areas.

I started this chapter by recollecting my experiences as a 19-year-old soldier looking down at the hull of a Russian submarine stranded in Swedish territorial waters. At that time I—like many others—viewed Russia through the lens of the Cold War. Ours was a narrative of distrust, fear and opposition. The USSR was the enemy. It is frankly extraordinary to think of the changes that have occurred in Russia since that date in 1981. Today's narrative is one of engagement, opportunity, emancipation and development. It is a sobering reminder to any student of history that we only get to see the world as we perceive it at a particular time, and that to make absolute judgments based on those subjective perceptions is a fool's game. It is the beauty of history that it always surprises us.

CHAPTER EIGHT

Business-Like Investment in Russia

By Mattias Westman

> Investment is most intelligent when it is most business-like.
>
> Benjamin Graham, 1949

Introduction

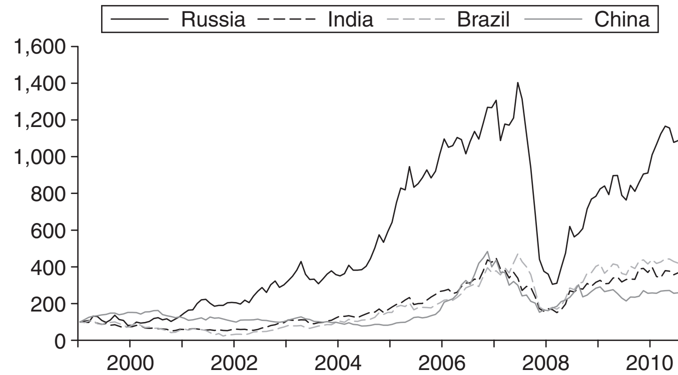
Russia has been, and continues to be, one of the very best investment opportunities of my lifetime. The combination of rapidly growing company earnings on the one hand, and the ongoing determination of so many to view Russia as a "basket case" on the other, means valuations remain extremely attractive. Despite the spectacular gains already made by portfolio investors who've stuck with the Russia story, there is a very long way to go.

Western asset managers who say this country is "un-investible" generally think in clichés, viewing Russia in terms of oligarchs, vodka and Soviet-era decay. Spanning 11 time zones, though, Russia is massively diverse, boasting world-class reserves not only of natural resources, but also human capital. The oil and gas sector, over 40% of GDP as recently as 2005, now accounts for only 17%. Russia's service sector, at around a third of national income, outstrips hydrocarbons in terms of scale and profitability.

Nonetheless, most global investors still dismiss Russia without even bothering to visit, their research not venturing beyond the Western "quality press." Such refuseniks look at this part of the world from an emotional rather than a business perspective, failing to see that the country is diversifying and Russia is a huge market, full of increasingly wealthy consumers and smart, energetic entrepreneurs.

Russophobe investment managers have cost their clients a lot of money. Over the last 10 years, Russia has easily outperformed every other major stock market in the world. Shares have been volatile, but

Figure 8.1. BRIC markets compared (USD terms, Dec 99 = 100).



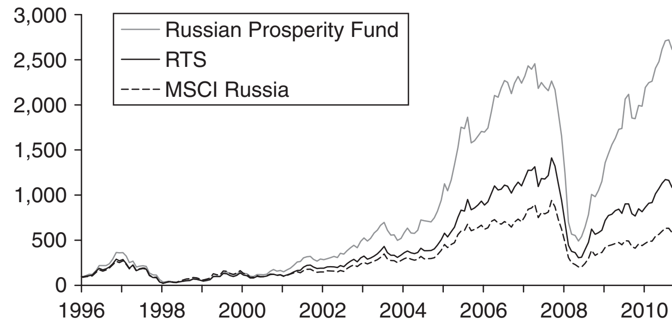
Source: RTS, Bombay Stock Exchange, Sao Paulo Stock Exchange, Shanghai Stock Exchange.

such volatility has been around a very strong upward trend. Since the end of 1999, China's *Shanghai A* share index has risen approximately 2.5 times in dollar terms. The Indian *Bombay Sensex 30* is up 3.5 times, while Brazil's *Bovespa* has risen 4.3 times. The RTS index of leading Russian shares, meanwhile, is up around 11 times as of mid-2011. Over the same period, the S&P 500 lost 10% in dollar terms and the FTSE 100 shed 12%. Emerging markets have trounced Western markets and Russia has outperformed other large emerging markets. When you analyze Russia objectively, this isn't surprising. Improvements at the company level and in the broader economy, while not widely recognized among Western "experts," have in reality been pretty sensational.

While the Russian market has outperformed markets globally, some managers have, in turn, soundly beaten the Russian market. Since its inception in 1996, our flagship Russian Prosperity Fund (RPF) has risen 25% a year in dollar terms and after PCM fees, while offering investors weekly liquidity. That's a 25-fold increase, during which period the RTS rose 10-fold.

Our "event-driven" Prosperity Quest Fund (PQF) has gained 44% a year since its late-1999 inception, while offering monthly liquidity—a 63-fold increase. The Prosperity Cub Fund, like RPF but with a mid-cap bias and monthly liquidity, has also performed extremely well. During the decade from the end of 1999, these PCM funds ranked 1st, 2nd and 3rd in the world among managed funds of any asset class, according to Morningstar data. And these returns were generated without leverage.

Figure 8.2. Russian Prosperity Fund (USD terms, Sep 1996 = 100).



Source: RTS, MSCI (www.msci.com), Prosperity.

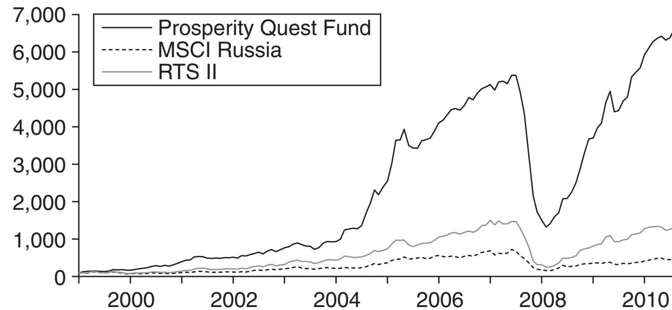
Since PCM was founded, our approach has been "long-only, buy-and-hold," running relatively concentrated portfolios. When allocating the capital entrusted to us, we have above all remained focused on the companies—their fundamentals and management quality. In a market subject to so much top-down noise and judged almost entirely from this perspective by international investors, we've spent the last 15 years being relentlessly bottom-up.

As such, PCM has applied, in a post-Communist environment, the principles of Benjamin Graham's *Intelligent Investor*. This book is required reading at my firm. For it is our experience that Graham's ideas are applicable in Russia, just as they are elsewhere. "Investment is most intelligent," Graham wrote in his 1949 masterpiece,[1] "when it is most business-like. It is amazing to see how many capable businessmen try to operate on Wall Street with complete disregard of all the sound principles through which they have gained success in their own undertakings. Yet every corporate security may best be viewed, in the first instance, as an ownership interest in, or a claim against, a specific business enterprise."

At PCM we always tell ourselves, just as Graham did, that the share certificates we hold aren't just pieces of paper someone may pay more for in the future. They represent our ownership of part of a company—and companies can always be encouraged to improve. As such, we are "activist" investors. Activism can involve raising your voice and seeking legal redress. PCM has a well-deserved reputation for using such

[1]Benjamin Graham, 1949, *Intelligent Investor*, p. 523, New York. Page numbers refer to the fourth revised edition.

Figure 8.3. Prosperity Quest Fund (USD terms, Dec 1999 = 100).



Source: RTS, MSCI (www.msci.com), Prosperity.

tactics, when appropriate. But activism is also often about constructive engagement—building significant stakes, sitting on company boards, helping with corporate finance, bringing in strategic investors and catalyzing value-generating restructurings and consolidations.

PCM's success since 1996, not only surviving the volatility but outperforming our competitors, has come about because we've kept our focus squarely on the companies, on cash-generation, on value triggers, on management and on the potential for future productivity gains. This is a far more effective strategy than trying to "time" a market so often buffeted by "risk-on, risk-off" squalls from abroad. "Investment is most intelligent, when it is most business-like," as the great man said. That's why PCM strives to make "business-like" investments in Russia.

Early Days

My Russian adventure started inadvertently. We have national service in Sweden and one of the options—for students who make the grade—is the "Interpreter School," where a small group spends 15 months studying Russian language, military organization and interrogation techniques. I applied, was accepted and, almost accidently, learned how to extract information from Russians. In a way, that is what my company does to this day.

After national service, I studied at the Stockholm School of Economics. It was the early 1990s and one of my professors, Anders Aslund, was advising the Yeltsin government. As a student, I learned about the early privatizations from the inside. Suitably intrigued, I came to Russia

and, with what little money I could muster, participated in the voucher auctions.

Sweden's proximity to Russia, and our entwined histories, means there has always been enormous interest in our massive Eastern neighbor. Lots of Swedes, including many of my former national service and Stockholm School classmates, became involved in Russia's nascent financial services industry. In the mid-1990s, some of us worked at GKI—or Goskomimouchistvo—which evolved into the Russian Privatization Center. Brunswick Brokerage, one of Russia's first investment banks, was run largely by people from my military academy. Paul Leander-Engström, with whom I founded PCM, was Brunswick's first Head of Research. During those early days, Moscow was practically invaded by a tight-knit group of Russian-speaking Swedes. We trusted each other. And trust was essential to make Russia's fledgling stock market work.

In the initial voucher auctions, when making a bid, you didn't know for sure the price you were submitting or how many shares you would get. Trading was a leap of faith. There were hundreds of registrars so you had to visit the companies, in far-flung regions of the country, to re-register shares. Voucher transactions were conducted in cash, so sacks of money were dragged around and exchanged for sacks of vouchers. It could take weeks to make a trade but, incredibly, the system worked.

The labor-intensive nature of early trading was one reason so many international investors stayed away, but it made prices very attractive. The "margin of safety" in the buyer's favor—one of Graham's favorite concepts—was huge. Some 150mn vouchers were issued, one for each Russian citizen. They were selling for around USD 5 each, or USD 750mn in total, and represented a third of the economy. Russia's entire universe of commercial assets was priced at roughly USD 2bn, which looked like good value to me. After my first investments rose 20-fold in six months, there was no going back.

I started my investment career aged 13, with my small savings and some money borrowed from my father. An early and unknowing disciple of the Peter Lynch School of investment, I bought what I knew, developing an early "overweight" in the shares of a chocolate factory and a bicycle manufacturer. As a young graduate, I worked for the Swedish investment bank Hagströmer & Qviberg, in institutional sales. When I started investing in Russia myself, I talked to some of my company's clients about doing the same. Quite a few did, including the late Adolf Lundin, who

went on to launch Vostok Nafta, which became a major investor in Russia. Another Swedish investment bank, Alfred Berg, then took me up on my offer to start their Russia desk. As more Swedes got involved, and made money in Russia, our business press started to report what was happening and the thing snowballed.

Founding PCM, and doing so with Paul, seemed the natural thing to do. Paul had been in Moscow for a couple of years, working for McKinsey and consulting on the reshaping of Russian industry. I was already investing. We knew each other well and felt we were a good team. Valuations were superbly compelling and there was little competition. We won the support of Enskilda Securities and SEB Group and recruited our first clients. In September 1996, we launched the Russian Prosperity Fund (RPF) with USD 28mn. This wasn't a huge fund but, back then, USD 28mn was a lot of cash to throw at the Russian market.

The West was fixated on Russia's numerous problems, not least the "incompetent" and "rarely sober" president. But we saw very clearly that Yeltsin was a highly courageous man and a figure of deep historical significance. Given his great contribution in destroying the horrendous Soviet system, the world had a lot to thank him for. Growing up relatively close to Russia and having developed lots of contacts, I also recognized the potential of the Russian people. Russians are well-educated, determined and ingenious. They will always find a way.

Our fledgling business faced dangers, of course, not least of which the fear that the Communists would regain power and confiscate our investments. However, once Yeltsin decisively won the July 1996 election, that risk was low. We saw it as a bet worth taking. I figured, anyway, that if PCM failed I would chalk it up to experience and go back to Sweden. But, as it happened, PCM did very well. In 1997, the RTS gained 74% while we were up 119%. *Business Week* published a table of the world's best-performing offshore funds in 1997, and RPF was in first place, in our very first year!

We had another significant success during those early days. A young broker from St. Petersburg read a newspaper report that some Swedes were starting a Russian investment fund. He visited our office, asked if there was anything he could do and made a very good impression. This fresh-faced fellow laid out the case for a few investments and his reasoning was solid, his manner of thinking similar to ours. We decided

we should persuade him to move to Moscow, bringing him into the fold. I'm referring, of course, to Alexander Branis.

Alexander is now PCM's Chief Investment Advisor and a highly respected figure across Russia's financial services industry, not only for his investment acumen but also for his vigorous defense of minority shareholder rights. I remember when, having talked with Alexander several times, we offered him a job. For the first time, his confidence seemed to desert him. "You are aware that I'm only 19 years old?" Alexander remarked. We told him he'd do just fine anyway. That was one of the best investment decisions PCM ever made.

1998 And All That

It was all going so well. Then, in August 1998, Russia suffered what became known as the "ruble crisis," sparked by the previous year's "Asia crisis," which had begun after the Thai government tried to float the baht. Even before this meltdown, Russia's battered economy was still struggling through the trauma of the transition from central planning. The dismantling and near-collapse of the former state-directed system meant that, for almost a decade, real GDP had spiraled downward. By 1997, though, growth had just about turned positive, with Russia's infant market economy expanding by 1.4%. Then the Asia-related sell-off sent oil prices decisively below USD 15/bbl, causing another savage contraction and a run on the ruble. Russia was left with no foreign exchange reserves but still had sizeable Soviet-era debts, which sparked a sovereign default. Local equities went into meltdown. The RTS fell 82% in 1998 and RPF similarly suffered.

PCM's clients were on weekly liquidity terms. However, we had been careful to subscribe mainly institutional investors (mostly from Scandinavia) who understood our 3–5-year investment horizon. During this tough period, we communicated with them regularly and avoided major redemptions. Our lack of leverage meant we weren't in danger of margin calls, so our investors knew we wouldn't become forced sellers and solidify their losses. PCM, at the same time, was still a small team with a tiny cost-base, so our survival wasn't in jeopardy. And, of course, we had the energy and optimism of youth.

We also had our Grahamite attitude. Thinking of our holdings as stakes in underlying businesses helped us rationalize the situation. Our shares may have been trading at next to nothing, but the companies we held

were still generating our electricity, pumping our oil in Siberia and creating telephone networks that we partly owned. Value was being created. Goods and services of demonstrable worth were being produced. It was surely only a matter of time before the market came to its senses.

PCM dug in. Most of our clients kept their nerve. When the last optimists pack up and go home, the saying goes, that's the time to buy. We joked we'd be the last optimists, but then we would stay. Other Russia funds folded. Several big Western financial institutions, having opened their Moscow offices not long before, shut up shop. Yet Russia's spectacular resources remained in place and the economy was improving rapidly. History was still flowing strongly in the direction of a capitalist Russia. Eventually, of course, the market did recover. On New Year's Eve 1999, Yeltsin's final day as president and 15 months after the crisis hit, RPF finally climbed back above its starting point. It had felt like an age, but in the grand scheme of things it wasn't really all that long.

The 1998 crisis made PCM a stronger manager. We survived because we had the right kind of clients, kept in close touch with them and focused on what our portfolio companies were actually doing, not what the rest of the world was saying. These lessons we took to heart. Once the crisis was over, our competition in the Russian market was also much diminished.

It was important, during this first big test, that the PCM team was actually based in Russia. Western media sources were screaming that the economy had "ceased to function" and the Communists were "on the brink" of returning to power. *The Economist*, as ever, was predicting "civil war." Consequently, that is what most investors in London and New York believed. The reality was very different, and we could see that reality every day. There were some weeks during the autumn of 1998 when there were limits on what you could buy in the shops. But pretty soon, domestic life returned to some kind of normality, with people conducting their daily business. Had we been far away, we may have bought the scare stories. But living and working in Russia meant we could make up our own minds, giving us the courage of our convictions. That remains central to PCM's investment philosophy today.

Despite the stresses and strains of business, those early days were a special time for me and my family, and one we cherish. Sonia and I had married in late 1997. We lived in a three-room apartment in one of Moscow's ugliest streets. The windows were draughty, so the place got very cold in winter, and Sonia, as a Mexican, feels the cold. The apartment

was also PCM's first office. Working conditions were somewhat basic. Email connections were patchy and the brokers we visited sat in grim backstreet basements. But we felt strongly that the companies we had invested in were moving in the right direction, as was Russia itself.

During this period, the Westman household expanded. There was probably even more skepticism about bringing up three small children in Russia than there was about investing. Again, we didn't see it that way. Moscow wasn't, and isn't, a bad place for children. Education standards are excellent. The music and art teachers we found were superb. Learning from Russian tutors, our youngsters played very good chess from an early age. Now living back in London, all three are county players and our eldest daughter (proud father moment!) is a junior international.

When our Muscovite kids joined a local gymnastics club, the instructors thought they showed real potential (their mother's genes). One of the coaches was an Olympic gold medalist and she really pushed our children. But she was neither brutal nor insensitive. The club was actually a very loving environment, with an internationally renowned gymnast taking huge trouble to inspire our kids, teaching them the point of training and a deep respect for physical activity.

Another memorable aspect of those early days was that Sonia and I enjoyed a fantastic social life. It was a great time to be in Moscow. The city had attracted lots of smart, interesting people from all over the world. Many highly capable young Russians were also coming to the fore. We were surrounded by energetic, talented friends who could see that history was happening before their eyes and were willing to step up and make a difference. Many of them have gone on to significant achievements in Russia and elsewhere.

In that environment, we all quickly became entrepreneurs. The situation was changing so fast, and the market economy was so young and raw, you could almost instantly see the direct link between the cause and effect of what you did. It was an incredible living and learning experience. So by the time the 1990s madness was over, we had not only built a family and a life in Moscow. We had also built a solid business, a business that had survived.

2000–2007: PCM Philosophy Develops

In mid-2000, the new President Putin appointed Alexei Kudrin as Finance Minister. Kudrin remained in place for more than eleven years and has

surely been one of world's very best finance ministers of recent times. In the aftermath of the 1998 default, Kudrin was adamant that Russia must rebuild its credibility on international markets. At a time when local politicians were screaming for welfare payments and knowledge of global finance was thin on the ground, Kudrin's views weren't popular. But Putin backed him, as he introduced highly punitive tax rates that applied, and still apply, to Russia's vast oil industry.

Under the so-called "Kudrin scissors," Russia's oil companies were compelled to pay taxes equivalent to around 90% of export revenues above USD 25/bbl. When this tax regime began, prices were generally lower. But as they rose, the money started flowing and the oil lobby started resisting. Unabashed, Kudrin parked the proceeds in a stabilization fund, built reserves and paid off the national debt. This provided a stable macroeconomic platform, with Russia running consecutive budget surpluses from the early 2000s, which helped control inflation. Kudrin's insistence on saving for a rainy day was to stand Russia in good stead, not only in the first years of the new millennium, but also in the aftermath of the Lehman Brothers collapse in 2008.

After the 1998 ruble crisis, the Russian economy quickly recovered. Real GDP bounced back by 6.4% in 1999 and 10% in 2000. Between 2001 and 2007, growth averaged over 7% a year. During this period, as a portfolio investor, it was a case of "who bets the most wins." The RTS rose by more than 50% per annum on average. What really drove the economy forward, though, were company-level improvements. It was during those post-crisis years that our team, rather than relying on Russia's strong "beta tail-wind," consolidated PCM's "business-like" investment philosophy.

Many investors look at Russia and see only an oil and gas play. That's understandable given the commodity cycle—a super-cycle, in fact—and related economic growth. This Russian beta has been superb for those who've stayed the course. But "alpha" drivers—sector-specific and company-specific factors—have generated far greater returns. Russia's well-known oil and gas stocks, accounting for over half the RTS index, have posted large price increases over the last decade. However, they've been trounced by the best companies in sectors such as retail, consumer goods and power utilities. For PCM, "going beyond the index" has been a major source of alpha and our funds have benefited handsomely from

our general preference for domestic names, often from the second and third tiers.

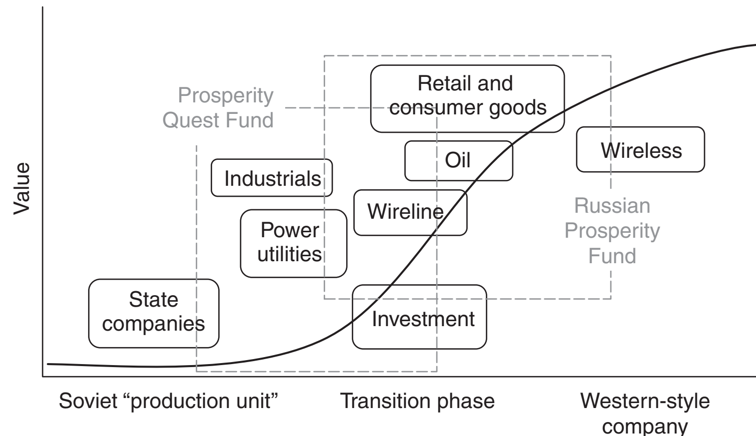
Digging deeper, PCM's outperformance has derived from our focus on building sizeable stakes in a limited number of carefully selected companies, allowing us to capture the value created by the restructuring and consolidation processes at the heart of Russia's transition. Company restructuring and firm- and sector-level consolidation have generated enormous growth in productivity over the last 15 years, driving shareholder value.

As Russia has continued its long march from state planning, many Soviet-era "production units," once they were privatized, began restructuring themselves into real corporations. Most had very substantial fixed assets but weren't run according to market logic. As private investors came in, generally Russian entrepreneurs but also a few foreign pioneers like PCM, many companies started to modernize, sorting out their finances and product lines, while enhancing transparency and corporate governance. Such changes generated, and continue to generate, massive shareholder gains. PCM has deliberately sought out such companies at the very earliest stages of this restructuring process, precisely when they appear completely unattractive to the vast majority of international investors.

At the same time, while Russia's "shop-by-shop, factory-by-factory" voucher privatization program left a highly fragmented economy, there has since been rapid consolidation. After Russia adopted a new tax code in 2002, making it tougher to park profits in offshore subsidiaries, entrepreneurs began bringing together disparate production units into proper corporations and benefiting from economies of scale. They started publishing consolidated IFRS accounts, reporting full profits and paying real dividends. Better transparency and more senior listings meant these companies' market liquidity often improved. As some of the best consolidated companies increased their market share, both organically and via M&A, they began commanding leading positions in their respective sectors. Once again, these processes were, and continue to be, a source of enormous shareholder gains.

Productivity isn't everything. But in the long run, it is almost everything. The strong productivity growth we've seen in Russia has been largely driven by the restructuring and consolidation of Soviet-era assets in sectors such as hydrocarbons, mineral extraction, telecoms,

Figure 8.4. Capturing the value during Russia's transition.



Source: Prosperity.

transportation, manufacturing and power utilities. These gains have gone hand-in-hand with the efficiencies achieved by rapidly expanding *de novo* private sector firms in post-Soviet sectors such as retail and mobile telephony.

Finding lower-tier companies ripe for restructuring and future consolidation stars is difficult and labor-intensive. But it is an area in which PCM, during these post-crisis years, developed considerable expertise. With our highly experienced Moscow-based team, as well as our unrivalled reputation and network across corporate Russia, we've since carved out a comparative advantage in identifying and influencing such firms. We also learned that restructuring and consolidation, while often generating big returns, have the added advantage of not being driven by oil prices. In fact, when commodity prices go off the boil, these restructuring and consolidation processes in which we specialize, and which are ongoing, generally speed up.

PCM's flagship Russian Prosperity Fund offers weekly liquidity. It is a "fundamental value" vehicle, investing mainly in companies already well on their way to becoming "Western-style" operations. Such stocks tend to be traded on the main board of the Russian market, which provides the liquidity to meet RPF's weekly obligations. However, our restructuring and consolidation plays often involve lower-tier names which, while they are listed, may not be widely known and are generally less liquid. That's

why the main open-ended vehicle pursuing our "special situations" strategy, the Prosperity Quest Fund, trades monthly. This longer notice period allows PQF to invest in companies at an earlier stage of their development and gain exposure to the most value-accretive processes.

Companies targeted by PQF tend to have more issues to resolve. While the Quest strategy delivers stronger returns, they can take longer to materialize with a higher variability of outcomes in terms of individual investments. When investing in PQF, the NAVs are generally more volatile than RPF and, because there are more "moving parts," the corporate governance dangers are greater. However, since its inception PQF has generated returns above those of any managed fund in the world, and without leverage. Despite the problems, real value has clearly been created.

During the early 2000s, while pushing for restructuring and consolidation gains, PCM began building significant stakes and sitting on the boards of many of our portfolio companies. This was when our "activism" came into its own. Together with our championing of smaller domestic stocks, this aspect of our investment philosophy has, in my view, been the main source of our outperformance. Activism has allowed us to add value to our portfolio companies in terms of advising on corporate finance and investor relations, bringing in strategic investors and helping with IPO execution. It has also allowed us to address what was then, and remains today, the main hazard of investing in Russia: corporate governance.

Corporate Governance: A Surmountable Danger

When PCM was founded, corporate governance risks in Russia were legion. However, we found that if you did your homework and exercised caution, conditions weren't prohibitively bad. In fact, by backing a company with bad corporate governance, which subsequently showed marked improvement, investors could benefit from the related value trigger. Russian corporate governance has in any case improved significantly since the early days and is now unrecognizably better than it was. PCM would contest the notion that standards are worse than in many other emerging markets. Nonetheless, Russian shares are still generally priced as if they are, which is itself an investment opportunity.

During the immediate post-Communist years, most Russian companies could hardly be described as "companies" at all. They were, in

reality, just collections of assets. We saw enormous value in these assets though, and became heavily involved in efforts to improve corporate governance. PCM helped establish Russia's Investor Protection Association, which is today the country's main minority rights lobby group. Alexander is the current IPA chairman. I also sat on Russia's Corporate Arbitration Panel, the first foreigner ever to do so. PCM, in addition, has pursued shareholder rights in the Russian courts and often pushed for, and achieved, changes in the law. We used a combination of legal means, publicity, lobbying and, as we established ourselves and developed a powerful international client base, financial muscle.

Contrary to perceptions, many of the rules governing Russia's financial markets are more favorable to minority shareholders than in the West. I am often asked how PCM has secured board seats at so many Russian companies. In fact, local regulations require directorships to be determined by proportional representation. If you have enough shares, or the support of enough shareholders, you are voted onto the board. It's as simple as that.

While during the early years there were sometimes conflicts, companies are now increasingly happy to have independent directors. The involvement of an international asset manager signals a company's intent to maximize shareholder value. The fact that PCM is visibly invested can also convince other market participants that a company has a bright future. It is more problematic to become a director of a state-controlled company, but PCM has anyway generally given such companies a wide berth. On the whole, private majority shareholders have the same fundamental goals as we do, to generate profit and create value. That applies in Russia, as anywhere else.

State involvement, though, can sometimes be an opportunity. From 2000 onward, PCM was deeply involved in the policy debate regarding the unbundling of UES, the vertically integrated Soviet-era power monopoly. Western stereotypes, then and now, suggest that the Russian state is overbearing and pro-market policies don't apply in "strategic sectors." Yet we've seen the full privatization and restructuring of the highly strategic power industry, along with the liberalization of wholesale electricity prices. PCM played an important role in this process.

The power sector restructuring was initially set to happen in a manner that wasn't very investor-friendly and would have attracted only limited private capital. PCM was invested in the partially privatized UES, so we set

about promoting more market-driven reforms. Initially, our ideas were resisted. Two years in a row, I missed election to the UES board by just a few votes. This raised suspicions that UES, at the time still majority-owned by the state, perhaps wasn't counting the votes properly. On our third attempt, though, Alexander gained election to the board.

Rallying like-minded minorities, PCM drafted detailed alternative proposals for Russia's power sector. Up against entrenched vested interests, we lobbied hard. Twice, Alexander and I were asked to discuss our ideas with Putin, who listened intently and displayed a firm grasp of complex policy issues. After intense questioning, he ordered the ministers sitting around the table to listen carefully to our views, even though PCM manages entirely foreign money. For good measure, Alexander was also appointed to the UES strategy committee at the tender age of 23, signalling official determination to introduce market-driven incentives to Russia's power sector.

Despite serious corporate governance issues, Russia's power sector restructuring and full privatization turned out to be highly successful. In total, some 100,000 megawatts of generation capacity were sold—among the biggest utility privatizations in history. Leading foreign utilities such as Enel, E.ON and Fortum took the opportunity to enter the world's fourth largest power market, each making multi-billion dollar investments, with Russia allowing overseas ownership of its power sector to a degree unmatched in almost any other large country. This outcome was at least partly due to PCM's efforts.

Over the years, while pursuing our minority rights, PCM has taken on some formidable opponents, including Surgutneftegaz, then Russia's third largest oil producer. Under CEO Vladimir Bogdanov, Surgut was relatively well-run, but still prone to some "Soviet" tendencies. PCM owned mostly preferred Surgut shares and such stock, originally distributed to company employees, has dividend rights linked to net profit. Surgut was calculating net profit in a manner that minimized this payout. After attempting to negotiate, we then sued, and unfortunately lost. Yet this was a pyrrhic victory for Surgut, as PCM had highlighted the lack of an agreed definition of net profit in the law, which undermined the value of preferred shares held by millions of Russian workers. After another year of lobbying, a few lines were added to the Russian statute, imposing a uniform net profit formula. Bogdanov later contacted us, making clear there were no hard feelings and seeking our advice on a number of

other financial issues. PCM remains invested in Surgut to this day, and in recent years we've enjoyed double-digit dividend yields on our preferred shares!

TNK-BP is often cited by international investors as an example of "what can go wrong" when you invest in Russia. I would argue, on the contrary, it shows what can go right. Before the joint-venture was struck in 2003, PCM was an investor in some of TNK-BP's constituent parts, and we've remained invested ever since. For TNK-BP has been, quite simply, the best investment in BP's history. Having spent USD 8bn at the outset, BP has since reaped USD 20bn in dividends and its TNK-BP stake is worth close to USD 40bn.

The "corporate governance" problems BP experienced with AAR (their Russian partner) have been largely of BP's own making, in my view. On most occasions, BP has been wrong and AAR right. Bob Dudley, TNK-BP's CEO until 2008, tried to run the JV as a BP subsidiary, justifiably infuriating not only AAR but many minority shareholders as well. TNK-BP wanted to pursue opportunities in Central Asia, for instance, but Dudley blocked this move as BP had its own Central Asian interests. BP also insisted on transferring "seconded" workers to TNK-BP, then paying them extortionate salaries. When ARR and other shareholders protested, Dudley inevitably backed BP.

From a minority shareholder perspective, AAR's attitude was consistently far more constructive than that of BP. As for Dudley's recent Russian adventure, now he is CEO of BP itself, courts in both London and Stockholm have ruled against his attempt to transgress the TNK-BP shareholder agreement. It's encouraging that a private sector group like AAR was able to block the Rosneft–BP share swap even though the Kremlin clearly supported the deal. Widely presented as "another example of Russian skulduggery," this latest episode actually demonstrates the extent to which corporate governance has improved.

The other major corporate governance dispute during the mid-2000s was the infamous Yukos saga. As an investor in Mikhail Khodorkovsky's oil empire, PCM had a ringside seat. It was a complex case and neither side—Khodorkovsky nor the Russian government—behaved like angels. However, it is simplistic and dishonest to paint Khodorkovsky as a paragon of virtue and to view his incarceration as entirely political. Yet that's how the case is invariably presented in the West.

Khodorkovsky's business practices during the late 1990s were indisputably criminal, not in the least his use of offshore entities to capture oil profits and deprive the Russian budget and minority shareholders of funds. PCM had a protracted struggle with Yukos over this issue, which resulted in our being physically threatened, the only time we've been subjected to such treatment in Russia. Khodorkovsky's notorious "Menatep lobby" of Duma members also tried blocking Kudrin's tax measures which, while onerous to oil producers, did much to stabilize the Russian economy.

The Yukos debate will rumble on. At the time of Khodorkovsky's arrest in late 2003, the government needed to cut the oligarchs down to size. This was vital not only to prevent the business elite from taking over politics completely, but also to bring Russia's tax base back onshore. There was a tangible and wholly understandable public appetite for this to happen. Khodorkovsky complains he was not the only one engaged in massive tax fraud, but that's hardly a defense. He was the oligarch most blatantly flouting the law.

The seizure of Yukos was a one-off in my view, a symptom of the time. PCM doesn't view Khodorkovsky as a "liberal hero" or a "corporate governance champion" as he is often described in the West. That wasn't our experience. Having said that, as we made clear at the time, we believe the government was too heavy-handed. Khodorkovsky was guilty, but Yukos minority shareholders were not. In our view, it was wrong to wipe out the company altogether, penalizing those who had invested in good faith. Had this aspect been handled more carefully, I doubt the Yukos case would have reverberated to the extent it has.

In sum, Russia's business environment has improved enormously since PCM was founded. During the late 1990s, some of our investments could have been characterized as speculative, seeing as company revenues were prone to being shifted to majority shareholders in various offshore companies. Such behavior is now all but non-existent, representing huge progress. The tax code has been streamlined, international accounting standards are widespread, the courts are improving and peer pressure is exerting a powerful influence.

Having said that, some important Russian institutions remain a work in progress and there are still occasional governance flare-ups. PCM continues to concentrate our assets in firms we fully understand and where we may have board representation and/or other methods of influencing

senior management. In our view, this is preferable in the Russian context to a highly diversified approach.

2008 Onward: Slippage, Then Recovery

Despite Yukos and various other thrills and spills on the Russian market in the mid-2000s, shares continued to surge. By the spring of 2008, the RTS was above 2,400 points, some 24 times higher than its autumn 1994 starting point. What's more, while practically every other stock market in the world had succumbed to subprime related fears, Russia stood out as relatively strong, buoyed by its commodity wealth and fiscal strength.

After Lehman collapsed in September 2008, though, global investors engaged in a knee-jerk "rush from risk" and the Russian market was hammered. The extent to which it fell—by 78% in 2008, despite a relatively strong first-half—took us by surprise. Russia's corporate sector, like the state, was servicing relatively low debt, suggesting the market was relatively durable. What became clear, though, as oil prices began falling, was that while most Russian companies weren't highly leveraged, investors in such companies often were. Entrepreneurs had raised money overseas, using their Russian equity as collateral. At the same time, considerable "hot money" had been attracted to the Russian market during the 2004–8 bull run, much of it via heavily levered Western hedge funds. Once the Russian market fell sharply, many investors faced margin calls, turning them into forced sellers. That weakened the market further, sparking even more margin calls. Russian stocks spiralled downward, with RTS valuations falling from a composite P/E of over 10× current earnings to around 2× in little more than six months.

While this was obviously nerve-racking, PCM was once again able to ride out the storm. Drawing on our experience, we communicated regularly with our clients and stressed the lack of leverage in our open-ended funds. With valuations detached from any notion of fundamental value, very few of our investors redeemed. Quite a few actually used the 2008 collapse as a buying opportunity, as did some new clients we managed to attract. During 2008 as a whole, while many other Russia-focused managers suffered near-meltdown, PCM saw net subscriptions. It was also pleasing that while some of our competitors "gated" their funds, we managed to avoid that outcome. PCM, in fact, has never imposed any arbitrary redemption restrictions. The importance of preserving this record

informs our ongoing investment decisions to this day, as we manage the trade-off between liquidity and potential returns.

During the 2008 sell-off itself, PCM "found liquidity" by offloading some of our block stakes. Sizeable positions in lower-tier firms that haven't traded in a while look rather illiquid on paper. However, when a company is in the midst of a consolidation play and is principally owned by a small number of large shareholders, as is often the case with Russian second- and third-tier companies, trading is naturally slow. The reality is that block stakes in the right companies have enormous strategic value and, when they are put up for sale, there are generally willing buyers. As we found during late 2008 and early 2009, such stakes are not only liquid but can often be sold at a premium. This is another reason why, in our view, Russia continues to lend itself to a relatively concentrated investment approach.

The 1998 crisis, essentially a macroeconomic crisis, was followed by macro reforms. The 2008 crisis was different, exposing serious flaws in Russia's microeconomy, including weak financial institutions and a lack of domestic institutional investors, the absence of which allowed valuations to reach absurdly low levels. It is therefore pleasing that the government reacted by catalyzing a serious overhaul of Russia's financial market infrastructure, part of a broader initiative to establish Moscow as an International Financial Center (IFC).

Russia is the world's seventh largest economy. This fast-developing country has enormous capital needs. Moscow itself is now Europe's most populous city and well-placed geographically, between the time zones of Europe and Asia. Its emergence as a major financial capital is, in my view, almost inevitable. PCM has become seriously involved in this initiative, after the government asked Alexander to be Chairman of the official IFC corporate governance committee. Given PCM's campaigning reputation, this appointment shows ministers are serious. There is now real momentum—among political and business leaders alike—to make progress. The upcoming merger of the RTS and MICEX exchanges will enhance visible liquidity and help build investor confidence. Plans are also afoot to establish a single market custodian and "T + 1" trading.

Another important legacy of the 2008 crisis, which should also contribute to the IFC Moscow effort, is that the ruble is now a much more widely used vehicle for domestic savings. Russia is the only large emerging market with an open capital account, its currency having been fully

convertible since July 2006. This was one reason the ruble came under such pressure during late 2008. Thanks to Kudrin, though, Russia had built the world's third-largest forex reserves, and so avoided a one-off devaluation. As a result, the ruble has, in recent years, emerged as a "hard currency within its own borders." Amid Western money-printing, the Russian population is now increasingly saving in local banks, rather than using foreign currency "stuffed in mattresses." Domestic deposits surged by 26% in 2010 and at the same pace during the first half of 2011. This growth of onshore, ruble-denominated savings is crucial to the creation of Russia's pension and mutual-fund industry, in other words, a domestic, institutional investor base. The ongoing development of deep local capital pools, as Russia's vast informal savings are declared, then intermediated through the banking system, will help establish more sophisticated regional capital markets while making Russian stocks less volatile and more "fully valued"—a compelling prospect for long-term investors.

After the drama of 2008, the RTS bounced back with a 129% rise in 2009, placing Russia among the world's top-performing markets. Last year, we saw an additional 23% gain, with the RTS once again beating other large emerging market indexes. These were two of PCM's most successful years ever in terms of outperformance. By the spring of 2011, most PCM funds were at all-time highs, even though the RTS remained 30% below its pre-crisis peak.

Despite the market still lagging previous levels, corporate earnings have generally recovered and, in some cases, surpassed pre-crisis highs. Some of PCM's portfolio companies, as they've grown and grabbed market share, have unveiled 20%, 30% or even 40% annual earnings growth during the first half of 2011. Despite some steep increases in share prices since 2008, Russian stocks are still displaying very low earnings-based valuations. As of mid-2011, the RTS is trading at an average P/E of 6.8× current earnings. The Chinese, Indian and Brazilian equivalents are 14.1×, 16.2× and 11.7×. Russian stocks have a composite multiple not only much lower than other large emerging markets, but less than half that of mid-2007, when the RTS was valued close to the emerging market average.

This low valuation looks even more interesting when you put it in the context of the late 1990s. Since then, the economic transformation has been stunning. Russian GDP, below USD 200bn in 1999, is now almost

Table 8.1. Main PCM funds (USD returns, net of PCM fees).

Fund name	Description	2009 return (%)	2010 return (%)
Prosperity Quest Fund	Open-ended, monthly, spec sits	147	60
Prosperity Cub Fund	Open-ended, monthly liquidity, small/mid-cap	204	52
Russia Prosperity Fund	Open-ended, weekly liquidity, fundamental value	195	48
Russian Prosperity Fund Euro	Open-ended, daily liquidity, UCITS-III	176	48
Prosperity Voskhod Fund	Closed-ended, AIM-listed, spec sits	154	58
Prosperity Russia Domestic Fund	Closed-ended, AIM-listed, non-energy stocks	168	56
RTS Index		129	24

Source: Statestreet, RTS.

Table 8.2. The Russian economy 1999 vs 2011.

Russia in 1999		Russia in 2011	
GDP (USD bn)	196	GDP (USD bn)	1,894
GDP per capita (USD)	1,346	GDP per capita (USD)	13,543
Average wage (USD/month)	64	Average wage (USD/month)	824
Sovereign debt (%/GDP)	162	Sovereign debt (%/GDP)	11
Foreign exchange reserves ex. gold (USD bn)	7	Foreign exchange reserves ex. gold (USD bn)	510
Average oil price (USD/bbl)	17	Average oil price (USD/bbl)	111
Annual inflation (%)	86	Annual inflation (%)	8.5
RTS P/E Ratio (1999)	6.0×	RTS P/E Ratio (2011)	6.8×

Source: Rosstat, Central Bank of Russia, IMF, Prosperity.

USD 2,000bn. Average wages are up 13-fold. The national debt has been vaporized and, despite having practically no reserves at the start of the millennium, Russia's forex haul now lags that only of Japan and China. Annual inflation has dropped from almost 90% to less than 9% and, in terms of corporate governance, the difference between the late 1990s and now is night and day.

Incredibly, though, largely due to an earnings explosion and the determination of most international investors to under-rate Russia, today's average RTS multiple is similar to that of late 1999, even though share prices are roughly 10× higher. Beyond the main indexes, where PCM often seeks exposure, valuations are lower still.

The difference between Russia now and during the late 1990s is difficult to overstate. Living standards are incomparably better for the vast majority. Many adults own their own homes, often with no debt, having been given their state-owned dwellings during the transition. When I moved to Moscow, there was one modern food outlet in the entire country. These days, the food-retailer Magnit, on whose board I'm proud to have served, is opening over 1,000 modern format stores every year. In 2010, more cars were registered in Russia than existed in the entire country the year I arrived.

While barely reported in the West, Russia's renaissance is among the biggest economic stories of our time. Across the country, factories are opening, housing and infrastructure is being built, technology is being developed, crops are being planted and mineral and hydrocarbon extraction is ongoing, all of which create superb opportunities for investors like PCM. The restructuring and consolidation processes to which we seek to gain exposure both have a very long way to go. We are also confident there is huge scope not only to maintain this strategy in Russia, but to extend it across the former Soviet Union.

Corruption, the Mafia and the Future of Russia

The Russian market, in my view, still has tremendous growth potential. There will be volatility, of course, not least due to the parlous economic state of much of the Western world. But the direction of travel is clear. Russia will emerge as an economy with natural resources at its core and a highly educated workforce generating "added value" in a wide variety of other pursuits. The model resembles that of Australia, Canada or

Sweden—three of the most consistently successful economies on Earth—but on a somewhat larger scale. Already Europe's biggest retail market by value, Russia could well become, in my lifetime, Europe's largest economy overall.

One reason I state this with confidence is Russia's growing trade links with China. Sino-Russian trade has gone from USD 20bn per annum in 2005 to an estimated USD 80bn in 2011. By 2015, it could well double again. The ESPO oil pipeline, recently opened and linking Eastern Siberia directly with the world's most populous country, is clearly of major commercial significance. It will soon be joined by a gas pipeline too. In essence, Russia has what China needs, not just hydrocarbons but a whole range of natural resources. As China scours the world for non-dollar assets, its investment in Russia will keep expanding. These two nations will ultimately be each other's largest trading partners, which is one reason for the growing political warmth between Moscow and Beijing.

Beyond natural resources, Russia's other big comparative advantage is human capital, in particular, the population's aptitude for science. With local high-tech companies such as Yandex, VKontakte and Mail.Ru holding their own against the very best in the world, Russia looks set to become a global IT powerhouse. Ultimately, though, as in any modern economy, it is services that will provide the most employment and value-added. Russia's service sector is already twice the size of resource extraction and has attracted many of the country's top entrepreneurs. Then there's construction and infrastructure development, of course. Investment has poured into house building and power generation. High-speed rail links are appearing, along with new roads and airports. These trends will accelerate in the run-up to the Sochi 2014 Winter Olympics and the 2018 World Cup.

For now, Russia remains an "exotic" investment destination. Institutional investors don't yet make routine allocations to Russia. One reason is that, while there have been significant improvements, serious governance concerns remain. PCM is good at avoiding such problems, and mitigating issues when they arise, but we still sometimes become ensnared in situations where we're treated unfairly. Russia's court system, reasonable in parts, remains weak in others. A decade ago, we lost practically every case we contested. These days, most of the time, when we are right, we win. But sometimes we don't, particularly in the regional

courts. Cases can be escalated to Moscow, but that's time-consuming and doesn't always guarantee a fair hearing. The general situation is that quite often, and increasingly so, shareholder rights can be enforced via Russia's courts, when the need arises. Occasionally, though, some people still get away with bad behavior and manage to avoid legal sanction. That clearly needs to change.

Having said that, the relentlessly negative coverage Russia gets in the international business press is wholly unjustified. Bad practices should clearly be reported and PCM strives to make sure they are. Yet, the huge progress post-Communist Russia has made—in terms of economics, political freedom and corporate governance—is barely recognized in the West. Diplomatic relations between Russia and the "advanced nations" are complex, of course, given the memory of the Cold War. But international press coverage remains so jaundiced that when potential investors visit us in Moscow, they are often amazed by the quality of the firms they see and the management teams they meet.

PCM has learned to live with lazy, cliché-ridden Western journalism. As long-term net buyers of Russian assets, such reporting helps us build cheaper stakes. But years of alarmist Russia coverage have skewed portfolio flows. The Nordic media has been more objective and much less "political," conveying Russia's business successes as well as failures. As a result, numerous Scandinavian pension funds and insurance companies, as well as individuals, have made up their own minds, with many investing heavily and doing extremely well.

British and American institutions, conditioned by their media, have for the most part stayed away. Once again, no one at PCM is denying there are problems in Russia. We know all about the problems and tackle them every day. But it's also clear that an incredible economic turnaround is taking place in a country, positioned between Europe and Asia, which has matchless resources and world-class human capital. Serious multinationals are already here in force and portfolio investors should be too. Those who aren't will look myopic in years to come.

"But Russia is corrupt!" I'm often told, when making the case to invest. My quick response, only half in jest, is that if investors want to avoid countries with corruption, they'll have trouble placing their cash. In Russia's case, keep in mind that the Soviet Union was a tough place to live. The economy didn't work and getting practically anything done, whether it was renewing a driving license or visiting the dentist, often involved a

bribe. At the same time, the chaotic transition of the 1990s necessitated the complete destruction of the old system, for it was too entrenched to be dismantled piece-by-piece. This meant that property rights shifted rapidly and assets were sometimes up for grabs.

This recent history means that tackling corruption is now an extremely live political issue in contemporary Russia. The early Kudrin tax reforms were all about reining-in the oligarchs and preventing the theft of oil revenues, which was one reason the public backed these reforms. Now that material living standards have improved, attention has shifted from blatant expropriation to clamping down on graft among Russia's still bloated police apparatus.

The Ministry of the Interior, for instance, previously an untouchable edifice of power, is now under intense political scrutiny. "Re-evaluation" tests—effectively anti-corruption checks—led to the ousting of two dozen high-ranking police officers during the three months from March 2011. The entire force, in fact, having also been subject to such testing, has been scaled back from 1.2m to less than 1m officers in just six months. Rank-and-file officers who survived the re-evaluation will enjoy an enhanced benefits scheme, with their salaries tripling from the start of 2012. The government's reforms in this area are serious, not least because of the weight of popular pressure for change.

Investors need to know where they are, but even more so where they are going. The legacy of central planning and the transition means that Russian corruption won't be solved in a single electoral cycle. In contrast to many other places, though, it is now a major talking point, with opinion polls showing that tackling corruption is among the electorate's highest priorities. Repeated statements from both Putin and Medvedev have kept this issue near the top of the political agenda. As the situation improves, global perceptions will hopefully follow. The likelihood is, though, that whatever progress is made, mainstream Western views are unlikely to change significantly any time soon. So, sophisticated investors should ask themselves, is Russia really more corrupt than China, or India, or other emerging markets deemed "OK" by the Western media? I think not.

It's important to say that PCM has never engaged in any kind of murky deals or paid bribes. Doing so would have posed not only moral problems. Once you go down that path, you are vulnerable and can't speak out about the wrongdoing of others. They then make it their business

to discover what you have been up to, and pressure you in return. PCM has always avoided "gray schemes" and "side deals." Others who have had problems must speak for themselves. But we've been determined to remain beyond reproach, not only as a matter of principle but as the most effective protection against unscrupulous tax officials and others. In the early days, our refusal to "play the game" perhaps cost us in terms of lost opportunities. Some of our rivals called us naive. But, years later, the reputation we've built can help us negotiate favorable terms for an investment, seeing as the market may view our participation as a good sign. Our previous single-mindedness is now reaping commercial benefits. Most importantly, though, it has allowed us to maintain our integrity and our voice.

"But the mafia runs Russia," is another common refrain. The mafia in Russia has been, and no doubt will be, the subject of numerous bad Hollywood movies. As Russia's largest foreign portfolio investor, what has been our experience? Well, PCM has come across the mafia precisely once. They were actually rather polite. In the late 1990s, we bought some shares in a St. Petersburg brewery that looked interesting. We went to see the management and, as usual, asked questions about future sales, margins and strategies. After a while, one of the gentlemen hosting us said: "Hang on, we're not sure if you know, but this company is actually controlled by a group of Chechen businessmen. They've put in a lot of work and the brewery is running quite nicely but they don't want to share the profit." There was an awkward silence. The same gentleman continued: "But since you didn't know this when you bought the shares, we want to be fair. So we'll buy your shares off you, and we'll even give you a small profit." And that was PCM's brush with the mafia. Hardly the stuff to get Tinseltown screenwriters excited, but that's how it was.

Looking Forward: In Ben We Trust

Over the last 15 years, PCM's development has been consistent with that of numerous Russian companies. We started out as a simple "production unit"—determined, but perhaps lacking in sophistication. We've since learned a lot and are now well on our way to becoming a widely respected fund manager, with real systems, recognized risk controls and a much broader team.

Our partnership has grown beyond me, Alexander and Paul (who retired in 2007). Ivan Mazalov, who joined us in 2003, is not only a first-rate

oil and gas analyst but also leads our Quest strategy. Tomas Olsson, another Stockholm School alumnus, joined around the same time, taking over Client Services and helping us build a truly global investor base. Liam Halligan, a founder RPF board member, returned to PCM in 2007 and is our Moscow-based Chief Economist. Alexei Krivoshapko, Russia's top consumer and retail analyst in my view, joined us in 2008. While the average age of our partnership is only 39, which bodes well for the future, PCM's combined experience in the Russian market is unrivalled.

Supporting us we have our in-house sector specialists who know their various companies, and management teams, inside out. PCM's back office, meanwhile, uses self-developed software that has been stress-tested and deemed "world class" by several of our leading institutional investors. Our London-based client service operation generates monthly factsheets for the eight products we currently offer, liaising with our investors in the Americas, Europe, Asia and the Middle East. We also have a permanent office in the Cayman Islands, where our main open-ended funds are domiciled. At around USD 5bn, PCM's asset base is above its pre-crisis high, our investors including family offices, private banks, pension and insurance companies and sovereign wealth funds. We don't chase retail money and we rarely advertise. But PCM has raised its profile in recent years, as the Russian market has become more widely followed.

As allocations to Russia increase, and I strongly believe they will, our presence and track record means PCM is likely to grow. While we recognize the risks of getting "too big" and "losing our edge," PCM controls less than half of one percent of the Russian market. At some point we may decide we have an optimal amount of capital, but I'm not sure we're close to that level yet. It's interesting that over the last two years, as faith in Western markets and institutions has been questioned, we've seen a lot more interest in Russia. Extremely high-quality investors, including some of the world's top pension and sovereign wealth funds, are now seriously considering entering this market, or have already done so.

Going forward, PCM will strengthen its team. In late 2011, we opened our Asia-Pacific office, given growing regional interest in our funds. We have a good position in one of the world's most interesting markets and we believe in what we do. I'm sure there are further improvements we can make and we'll endeavor to make them to the best of our ability. Most fundamentally, though, PCM will continue its "hands-on" company-focused approach to investing. Many will keep insisting Russia is "just a

commodity play." But we'll maintain our strategy of going well beyond the blue-chips, seeking out domestic restructuring and consolidation stories, a strategy that has proved remarkably effective. What really creates value in Russia is the actions that management teams take to turn their young companies—whether they comprise Soviet-era assets, post-Soviet assets or a combination of the two—into efficient corporations. The scope and speed of such company-level improvement is higher in Russia than almost anywhere else in the world. That creates a lot of value, for those with the knowledge, and determination, to gain the exposure.

As investors, PCM can't do much about the oil price, or the macro picture. But we can find the management teams across Russia and the rest of the CIS that are really driving company-level changes. And then we can back them, putting to work the capital entrusted to us. Global equity investors place great importance on assessing company management teams in the United States, United Kingdom, or elsewhere in the West. In a fast-changing environment like Russia, though, the quality of a firm's management has a far greater impact on its relative future success than is the case in the West. Yet, beyond specialized investors like PCM, and a few Moscow-based brokers, such company-level analysis has barely begun.

Russia is a place of great opportunity but genuine risk. Even the most expert bottom-up stock-pickers can't always be right. The key, of course, is to be right more often than wrong. PCM believes our world-beating 5-year, 10-year and now 15-year returns demonstrate we've not only achieved that objective in the past, but are now better equipped than ever to do so in the future.

"Have the courage of your knowledge and experience," wrote Benjamin Graham. "If you've formed a conclusion from the facts and you know your judgment is sound, act on it—even though others may hesitate or differ. You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."[2]

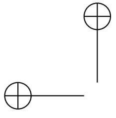
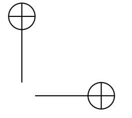
Warren Buffett first read *Intelligent Investor* in 1950, when he was 19 years old. "I thought then it was by far the best book about investing ever written and I still do," Buffet wrote in the preface to the fourth revised edition. "What's needed to invest successfully over a lifetime," he remarked, "is a sound intellectual framework for decision-making and the ability to keep emotions from corroding that framework. This book,

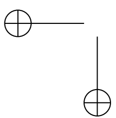
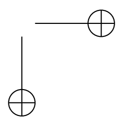
[2]Benjamin Graham, 1949, *Intelligent Investor*, p. 524.

precisely and clearly, prescribes the proper framework. You must supply the emotional discipline."

The returns you generate, Buffet concluded, depend "on the effort and intellect you apply to your investments, as well as on the amplitudes of the stock-market folly that prevails during your investing career. The sillier the market's behavior, the greater the opportunity for the business-like investor."

Well, Russia is a "silly" market. The country's tumultuous "transition," together with the small-minded attitudes of mainstream global investors, have seen to that. "But if you follow Graham," says Buffet, "you will profit from folly rather than participate in it." If that's good enough for the Sage of Omaha, it's good enough for me. Ably supported by the rest of the PCM team, then, I'll stick to "business-like investment" in Russia.

CHAPTER NINE

Searching for Capitalism in the Former Soviet Union

By Peter M. Halloran

Starting in 1991, Russia undertook the greatest peaceful political and economic transformation in history as it moved in a matter of months from communism to democracy and from a command economy to a market economy. This transformation opened the door to significant opportunities, both political and economic.

For Western politicians, the transformation presented a unique opportunity to gain an important ally for nuclear non-proliferation and to contain religious fundamentalism, ensure energy security and corral China's rising global influence. Unfortunately, the moment passed and the opportunity was lost. The club of Western democracies did little to help this transformation. During any given week in 2010, for example, the United States spent more dollars trying to push Afghanistan toward democracy than it spent during the entire first decade of Russia's transformation. While the West celebrated the "peace dividend" that it received from the fall of communism, it did not reinvest that dividend in pursuit of bigger rewards.

For Western investors, however, the story is quite different. The returns on investment available during this economic revolution have dwarfed those of other markets despite two full-fledged financial crises and a handful of corporate governance abuses. Those investors able to read between the lines of Russia's appalling public relations gaffes have been amply rewarded over the years.

My venture into the fledgling capital markets of Russia began in January 1994 as simply an attractive investment opportunity. At that time, few Westerners were aware the market for Russian privatization vouchers even existed. Meanwhile, at CS First Boston, we had exiled some newly minted bankers to a Moscow office to give free advice on privatization to the government. The real opportunity, in fact, turned out to

be organizing the local brokers to source vouchers for Western clients; I provided the clients and investment funds from my position in New York while the Moscow team organized the local brokers. The success of this early voucher activity became the launching point for all that followed.

The mathematics of the voucher privatization trade were quite simple. Every citizen was issued a free voucher as a birthright, with roughly 148 million vouchers issued in total. These vouchers traded in the range of USD 12–18 each, thus valuing a large foothold in the asset base of Russia at between USD 1.8 and 2.7bn. I do remember "research" that we put together for voucher auctions. The meager entries typically included such illuminating facts as: company name, address, number of employees, percentage of shares outstanding to be auctioned and industry category. But with dreams of untold resource riches, not to mention some industrial assets, little additional analysis was needed.

The voucher auctions became a battle of information and misinformation. Often managements looking to buy their own shares would hold the auction in an obscure location with minimal notice. For the larger enterprises, the game among investors was to guess how many vouchers might be bid by others in order to avoid pushing the price too high. A great coup was being able to find an overlooked company where only a few vouchers could buy the entire auction. Thus investors were always careful to keep their true interests as quiet as possible.

Most of the activity took place over a short period in the spring of 1994. The last significant enterprise to be auctioned was Norilsk Nickel on June 30, 1994, for which almost all remaining vouchers were used. So, in fact, the now famous Russian voucher activity actually took place over just a few frenetic months. Yet the market became more frenzied during the summer of 1994 as the dollar flows continued even as the vouchers had expired and very few companies remained available to trade in the market. The result was a bubble that lasted until the Mexican peso was devalued later that year.

In 1998, an even greater mania in the region took place in Azerbaijan, and was largely fueled by those who had missed out on Russia's privatization. Again, free vouchers had been issued to all citizens although very few enterprises were made available for auction. The key asset that drove the market valuation of Azeri vouchers was the state oil company, SOCAR. Azerbaijan owns vast oil reserves sitting beneath the Caspian

Sea, and was one of the world's major oil producers before World War I. Most of these reserves sat under-explored during the twentieth century as the Soviet Union developed more easily defended oil reserves in western Siberia. The potential value of SOCAR was viewed as nearly limitless.

Unlike with Russia, Westerners began buying Azeri vouchers long before plans for privatizing SOCAR were announced. As a result, the mathematics of the trade were much less clear. Without SOCAR, there was very little else worth buying with Azeri vouchers. The market price of a voucher settled around a purely speculative assumption that 5% of SOCAR would be offered through the voucher mechanism; a mechanism from which the state received no proceeds.

The Azeri voucher mania began in earnest when a more aggressive assumption was introduced to the market by a young Czech con artist, Viktor Kozeny, who had hired former U.S. Senator George Mitchell as his front man. I knew Kozeny from an earlier time when he would drop by my office at CS First Boston in Moscow and regularly send me Christmas cards. At the time, he claimed to have teamed up with investor Michael Dingman to look for investments in Russia and throughout the former Soviet Union.

Kozeny's pitch to investors was that fully 50% of SOCAR, rather than 5%, would be handed out for free through a voucher auction. The vouchers, according to this new assumption, were thus undervalued by more than tenfold. As part of the scheme, Kozeny spent about USD 8mn setting up a new Baku-based regional brokerage called Minaret while he was trying to raise USD 400mn for his scheme. It was housed in the fanciest new office building with rows of empty trading stations all waiting to be filled. Kozeny tapped the London headhunters for all the financial talent they could provide in a hurry. Minaret was critical to Kozeny's image as an insider in the local market.

One local trader that Kozeny was never able to hire was a friend of mine who had moved to Baku from Greece to make his fortune. He quickly understood the scam Kozeny was putting together and chose to trade against it rather than participate. Through him I came to understand the workings of the deal and sought to warn some of my former clients from CS First Boston. One of these clients was Clayton Lewis of Omega Advisors. On a trip to Moscow in 1996, Clayton had planned to invest in LUKOIL shares. However, I steered him instead toward local

T-bills, called GKOs, in which we had a created a monopoly on selling to foreign investors. Clayton bought both, but it was the GKOs that became hugely profitable and gave him heroic status at Omega. By the time the Azeri voucher trade came along, Clayton had become desperate for a second act.

I traveled to Baku in April 1998 to participate in the grand opening of Minaret and to see what other investors had been pulled into Kozeny's orbit. To my surprise, Senator George Mitchell took the podium and gave an eloquent speech espousing Kozeny's virtues and confirming Minaret's aspirations to become a world-class investment bank serving the needs of the region; all of it was complete nonsense. As it turns out, Mitchell was a paid performer and board member for Kozeny's front company, Minaret. Mitchell rebuffed my attempt to share my view of matters in Baku as he chose instead to enjoy a view of the city while surrounded by bodyguards.

Clayton could not be convinced of his folly and claimed to be a true believer in the SOCAR trade. His attitude became understandable years later when he pleaded guilty in U.S. federal court to having been an insider to the scam. Viktor Kozeny has spent two years in a Bahamian jail over his role in the Azeri voucher scam while the U.S. government is trying to extradite him so that he can spend even more time in one of their jails. George Mitchell returned to his various political activities without having to explain himself.

The Westerners caught up in the mania had failed to understand that Kozeny was selling them his own marked-up positions, to say nothing of the absurd notion that Azerbaijan would give away so much value to its own people. In the end, none of SOCAR was privatized, meaning that the Azeri vouchers were largely worthless. This example shows that, in comparison, Russia has done some things right along the way.

Such voucher mania never fully reached Ukraine. While a similar voucher system was devised, few meaningful enterprises were made available. As a result, without a diversified shareholder base, the Ukrainian stock market consisted mainly of blocks being horse traded in sizes designed to create either blocking minority stakes (25% plus one share) or controlling majority stakes (50% plus one share). With Russia having already drawn investors to the region, there was clearly an opportunity for Ukraine as these same investors began searching for comparable opportunities in nearby Kiev. The deputy prime minister in 1996,

Viktor Pynznyk, recognized the opportunity. I went to see Pynznyk in Kiev where he offered to sell controlling stakes in two of the four major Ukrainian electricity utilities. We discussed how this transaction was exactly what Ukraine needed to create liquidity and jump-start its equity market.

The idea was to sell the shares on to portfolio investors in the West. I bid him that day in excess of USD 100mn, an amount that was quite reasonable. He promised to get back to me after consulting with his boss, Prime Minister Pavel Lazarenko. Unfortunately, he never called back. Instead, our Kiev office called to say Pynznyk had abruptly resigned from the government—Ukraine had thus shown its true interest in privatization. While I cannot confirm Lazarenko's motives for canceling the privatization, I can confirm that in 2006 the former prime minister was sentenced to a nine-year prison term in a U.S. federal prison for international money laundering and fraud. As it happens, much of the money he was accused of stealing came from trading natural gas, and included proceeds from transactions with the electric utilities.

Russia had its own unique version of such a large-scale transfer of assets for cash. But unlike with Pynznyk, the motivations were not quite honorable. This was the "loans for shares" scheme. Originally, voucher privatization was intended to create a market into which cash privatizations could be sold. The state was to raise revenues during this second stage. It never happened.

Instead, moneyed insiders hatched an idea in early 1995 to co-opt the process. At the time, the Russian equity market was struggling. Moreover, state coffers were low due to inept fiscal planning and an inability to collect taxes. The idea was simple—the pocket banks of select oligarchs would lend money to the state in return for holding controlling stakes in some of Russia's largest enterprises as collateral. The oligarchs would then take management control of the enterprise and its cash flows. Once control was taken, these cash flows were diverted through these pocket banks owned by the oligarchs. There were endless opportunities to make money in such a scheme.

The loans came due a year later as the equity market was booming. Not surprisingly, however, the government allowed the oligarchs to effectively foreclose on the loans by allowing the shares to be sold through rigged auctions organized by the oligarchs themselves. Often the purchase price barely exceeded the windfall already received by

the oligarchs simply from having controlled the enterprise for a year. Even more perversely, the original loans themselves were often simply government funds on deposit with an oligarch acting as clearing agent for the Ministry of Finance. Thus the oligarchs never needed cash, just connections.

One deal that had not been earmarked for such abuse was the sale of an 8.5% stake in Unified Energy Systems (UES), which was to be auctioned for a minimum of USD 325mn in 1997. In November 1996, CSFB announced that it would organize the auction based on convertible bonds to be issued in mid-1997. The market had cooled considerably by year-end 1996, so the prevailing logic was that an auction should wait for market conditions to improve. Moreover, as management was likely to be replaced in the spring and market sentiment expected to improve, waiting would likely result in a better price. These visions of a better auction environment were clouded by realism, which made it apparent that waiting could be even more dangerous as assets seemed to be disappearing from the auction block.

It was already November 1996 and Privatization Minister Alfred Kokh was under pressure as he had failed to meet his revenue target for the year due to the "loans for shares" giveaways. If Kokh could be persuaded to launch an early sale, I knew of a deep-pocketed investor who could quickly commit to the entire purchase. Both parties agreed and the problem became time. According to Russian law, the auction was required to remain open for 30 days. However, if the revenues hit before the end of January 1997, they could be credited to the 1996 budget.

Kokh shocked the market when he announced the auction with a bid deadline of December 20. At first it was dismissed as year-end posturing; the market did not believe there was a buyer for such size. The minimum price for the auction was set 20% above the market at 9.2 cents per share: all or none.

Once the market came to realize that CSFB did have a buyer, the Duma quickly responded with a vote of 270–0 to cancel the auction and prevent a sale to foreigners. But, even worse, Gazprom decided they wanted the stake themselves. Those were the days of massive payment arrears, and UES was a sizeable debtor to its fuel supplier Gazprom. As the endgame was played, National Reserve Bank (NRB), a Gazprom-linked entity, emerged as a second buyer. It was difficult to imagine they had

USD 300mn in cash to spend on UES, but they pushed forward as the only other bidder.

The auction procedure required a refundable deposit of the full bid amount to be deposited several days before the bids were due. We decided to deposit a much larger sum than we actually intended to bid, in hope of dissuading the other bidder. While the process was supposed to be blind, we learned after the deposit deadline that NRB had placed a sum nearly identical to the amount of our deposit. The next step in the "blind" process was the bid itself. At this point we bid the minimum, assuming that the outcome depended only on whether the other bidder was real, rather than on the amount we might choose to bid. True to our expectations NRB won the auction, outbidding us by exactly one ruble per share. A brilliant insight on their part? The saddest part of the tale appears to be that no actual cash made its way to the budget; instead budgetary offsets were allowed to create cash value. This experience confirmed that, at the time, the state was not acting to maximize revenues.

The most infamous cash auction of all was the privatization of Svyazinvest, the state telecom holding company. With a 51% stake in nearly every incumbent provider in Russia, the company represented huge untapped opportunity. Western investors were invited to participate for the first time given the high asking price of USD 1.1bn. At that time telecoms globally were starting to be re-rated by investors who saw them as an all-important link to the consumer; Svyazinvest had access to 148 million consumers. And it was for sale.

As the last of the big cash auctions connected to loans for shares, the eventual winner had been predetermined to be a combination of oligarchs including Mikhail Friedman of Alfa Bank and Vladimir Gusinsky of Media-Most. As the asking price was USD 1.1bn, an amount the oligarchs were unwilling to stake themselves, Alfa was appointed to source the funds from Western investors. For this they turned to CSFB, and ultimately I started the process before leaving for Christmas break in 1996. At that time, as with the UES auction, there was little year-end demand for Russian shares that were already up 123% for the year.

Nonetheless, there were some large, non-traditional buyers who had shown interest in Russia. They were very quick to embrace the idea of effectively financing the oligarch's acquisition of Svyazinvest, and by the time I arrived back in New York for Christmas the money had been raised.

Alfa Bank was puzzled, and decided that perhaps their terms had been too generous. They chose not to accept the financing consortium and instead turned to a competitor for help—on less attractive terms. After several months passed without result, Alfa decided to accept the offer from our financial consortium.

They had waited too long. By this time the stock market was booming again and the regional telecoms in the Svyazinvest structure were the leading gainers. Svyazinvest had also caught the attention of the other oligarchs, specifically Vladimir Potanin. He understood that the last jewel was about to be sold, and decided to break the peace and participate in the auction. Thus began the first real cash auction in Russia.

The implications were numerous and predominantly negative. The CSFB-financed consortium, which included a strategic partner, ultimately had the deepest pockets, yet lost the bid. It remains a subject of heated debate whether this was due simply to a poor bidding strategy or otherwise. Whatever the case, Svyazinvest was the catalyst leading to the destruction of the fragile alliance of oligarchs in Russia.

The result of the auction was a series of open disputes that ultimately tainted the legitimacy of the government. The timing was disastrous as the government was just about to launch reforms under its "dream team" of Boris Nemstov and Anatoly Chubais. With a leaderless state under Yeltsin, and the controlling oligarchs going their separate ways, there was little that the dream team could hope to accomplish. Their downfall launched a series of events culminating in the debt default of 1998.

The August 1998 devaluation, default and moratorium on repayment to foreign creditors came as a shock to the global markets. The devaluation itself was much less of a shock, and already priced into the markets. Many fixed income investors had already arranged the durations of their portfolios to weather a 50% devaluation near term, yet have adequate dollar returns on their longer-dated paper. But the default was the unexpected event. And the moratorium on repayments was a criminal act.

The moratorium confirmed the statelessness of Russia under Yeltsin. Here was a nation exercising its sovereign authority not to protect its own interests but rather to protect those of a chosen elite. Quite simply, the moratorium was designed to benefit the oligarchs, giving them ample time to shift title to assets while leaving behind billions in liabilities, mainly to Westerners and the emerging Russian middle class.

Hardest hit were those who had bought Russian T-bills, called GKOs. The Westerners' GKO adventure really began in earnest in early 1996. At that time the Russian government had embarked upon an expensive pre-election spending spree. As the country was awash in wage and pension arrears from the government, Yeltsin was in need of cash in a hurry to win over the masses. To raise the cash, the T-bill (GKO) market was expanded from USD 8bn outstanding to what would become an eightfold increase over two years. Pre-election yields quickly tripled from 50% to more than 150% during the weekly auctions.

Officially, non-residents were not allowed to participate. Yet, to be successful, the government needed to tap into Western fund flows. In fact, at CSFB we often had sufficient demand to buy the entire weekly auction allotment of more than USD 500mn in bonds. We were allowed to participate on an ad hoc basis, always with special central bank approvals designed to emphasize the temporary nature of the situation. Eventually, the Ministry of Finance understood the inevitability of their needs and created a non-resident investment mechanism called an "S-Account." All dollar flows from the West destined for the GKO market (and flows back out) had to pass through this S-account window.

The idea was that the window could be opened or closed as needed, and all GKO flows could be closely monitored. It was intended to be a clever way of controlling the flows, and of equal importance, controlling CSFB's growing monopoly in bringing investors into the market. Instead, the unintended result was that the S-account became a mechanism for more Western banks to set up their own proprietary accounts to control the client flows they brought into Russia. Ultimately, these accounts were not offered to investors directly as originally intended, but instead Western banks brought flows in through their own proprietary S-accounts.

By 1997, the short-term GKO's were on the way to being replaced by more stable, longer-term dollar financing through the Eurobond market. This transition was well underway at the end of 1997 when a global liquidity crisis put an end to that opportunity. Instead, Russia found itself faced with a classic short-term funding squeeze, a squeeze the IMF was set up to prevent. The problem persisted as it became apparent that no amount of money could offset the oligarchs' lack of confidence in the ruble. They feared their hard-won gains would not survive growing intervention from the West. This fear, coupled with the relative inexperience of the oligarchs and government ministers in the financial markets,

caused them to panic in August 1998, forcing a sweeping cancelation of obligations. It wasn't altogether different than children asking for a do-over when things don't go their way on the playground.

Since those dark days of economic collapse in 1998, Russia has benefited from resurgence in commodity markets while finding the political will to free itself from the oligarchs and corrupt regional administrations. During the first decade of the twenty-first century, Vladimir Putin reasserted the power of the state against the narrow business interests of the oligarchs and the feudal corruption of the regional governors. When measured against the norms of Western democracies, it has been an ugly process at times, and certainly an undemocratic one. Nevertheless, the short-term benefits are evident.

The restrictive economic agenda of the oligarchs was replaced by a Western-leaning, Western-educated liberal economic team that set policy throughout the first decade of the twenty-first century. Their success can be measured by the containment of inflation during the buildup of fiscal and currency surpluses at a time when the Russian economy grew nearly eightfold in dollar terms. Indeed, if you treat oil prices above USD 35/bbl as representing a windfall, then Russia received a USD 750bn windfall in the years leading up to the 2008 crisis; this is roughly equal to the currency reserves built during that period. Such fiscal conservatism is rarely found among export rich nations, and certainly would not have been possible without effective control by the state.

Putin undertook significant structural reforms to accompany the resurgence of commodity prices after 2000. His initial challenge was to force the natural resource sector to pay the bulk of taxes. He was, by definition, going against the most powerful interests in the country. Yet by 2003, his victory was complete with one odd exception: Mikhail Khodorkovsky. The other oligarchs had accepted the demise of their unseemly control of the political process enjoyed during the 1990s under Yeltsin. Khodorkovsky, behaving as a virtual relic from the land that time forgot, actively resisted the liberal reform team's call for higher oil industry taxation. The subsequent imprisonment of Khodorkovsky and ill-considered dismantling of the Yukos oil company appear to have derived predominately from this dispute. Putin, in a rare public acknowledgement of Russian corruption, has accused Khodorkovsky of buying Duma votes in opposition to reform.

Khodorkovsky's imprisonment raises the question whether the end justifies the means. An immature democracy is easily corrupted, given that democracies rely heavily upon effective civil institutions for success. While Alexander de Tocqueville famously observed that democracy risks becoming "mob rule" without such civil institutions, the Russian corollary of the 1990s showed that it can equally become "oligarch rule." Typically, such corrupting impulses are overwhelmed by a larger voice espousing the benefits of democracy that can be shared more broadly. When opposed by privately owned resource wealth, however, these voices never have a chance to develop.

Due to Russia's extraordinary resource wealth, the early days of its democracy require extra care as the temptations for abusing democratic institutions are simply too great. As such, the rise of a dominant party system under Putin seems to have provided Russia with a better chance for success than the pluralistic model under Yeltsin. This has less to do with the Russian spirit, as is sometimes described, than with the burden of creating a system that is not dominated by the voice of the natural resource sector.

The rise of a middle class could, over time, enable Russia's civil institutions to consolidate and move the country toward a more pluralistic model. In the meantime, Russians can find solace in knowing that many countries have prospered under a dominant party model before eventually adopting multiparty democracy, including Japan, Canada, Sweden, India, Norway, Mexico and Taiwan.

During the 1990s, there was a real opportunity for the West to influence the growth of Russia's institutions and political process. By the time the Soviet Union collapsed, most Russians had come to see the West as a utopian model of wealth and happiness. However, without any economic assistance from the West, Russians were left alone to feel the full pain of their decision to transition toward a Western model. They reeled from shock therapy to serial devaluations to IMF-dictated austerity. The result was widespread disillusionment with the notion that democracy and capitalism could assure them this utopia. Instead, by the time rising commodity prices had bailed them out in the 2000s, most Russians had concluded that Western models were not for them.

While Russia will undoubtedly continue to provide great theater and fodder for the world's press as it chooses its destiny, determination of that destiny can still be influenced by a more accommodating West.

Perhaps expanding NATO to the Russian border and deploying missile systems there does not achieve the greater goals of the West, and perhaps Russia could be admitted to WTO even if they resist importing U.S. chicken. There is no doubt China enjoys the counterproductive squabbling between these former Cold War foes.

CHAPTER TEN

My Early Encounter with Russia

By Johan Elmquist

One morning in the early 1990s, I was watching CNN. There had been serious unrest in Moscow for several weeks, and the Swedish media were reporting that more than 50 people had been killed in a battle for control of the Ostankino TV tower in northeast Moscow the night before. This morning CNN had installed a camera atop a building in the city center, next to the Russian White House, where the parliament, led by vice president Alexander Rutskoy, was engaged in a standoff against President Boris Yeltsin. The live feed showed tanks gathering on the bridge between the Hotel Ukraine and the White House, a bridge that many people took on the way to work. The situation was chaotic, violent and confusing from my point of view, given what I knew of the situation, when the tanks began to fire on the White House.

Yeltsin's open conflict with parliament, which was then called the Supreme Soviet, led to a second October revolution and the highest number of casualties in an open conflict in Moscow since 1917. Official police sources later stated that 187 people were killed and nearly 500 injured. Sources connected to the Communist Party claimed that these numbers were significantly underestimated and the true death toll was around 2,000 during those three violent weeks in Moscow.

Yeltsin had dissolved the parliament on September 21, 1993, and the building was now occupied by not only a large number of parliament members, but also by paramilitary forces and other forces linked to the Interior Ministry. The Constitutional Court ruled that President Yeltsin had violated the constitution and should be impeached. During an all-night session led by Ruslan Khasbulatov, the parliament declared the presidential decree dissolving the parliament null and void, and vice president Alexander Rutskoy was proclaimed president and took the oath of office. Following the collapse of the USSR, Khasbulatov had consolidated his control over the Russian parliament and become the second most powerful man in Russia after Yeltsin himself.

Despite the compelling drama of these events, I felt that Russia was a far off place and of no immediate importance to my quiet life in Stockholm, Sweden. The situation in Russia was turbulent in the two years following the dissolution of the Soviet Union. But what I saw live on television was amazing. The Russian White House was under siege by military forces loyal to President Yeltsin, while heavily armed Interior Ministry forces supporting parliament controlled the building. Suddenly several trolley buses appeared on the television screen, rolling over the bridge toward the White House. Even as the shooting between the tanks and White House forces continued, the trolley buses rolled onward. Little did I know in those first days of October 1993 that inside the trolley buses were young men performing their compulsory military service. In Sweden, military service was more or less theoretical, at least in my personal experience. For these young Russian men, military service involved real enemies and real bullets. Their goal was to get as close as possible to the White House, storm the entrance and end the "occupation." Little did I imagine that a few years later, I would have the opportunity to meet one of the young men from the trolley bus in a very different situation. When he told me the story of that day, he said that bullets had started to rain down on the bus even while they were some distance away from the White House. It was unpleasant, but he survived, and went on to have a great impact on my understanding of Russia when we finally met several years later.

The Chance of a Lifetime

The very first time I visited Russia was in 1987, when the Soviet Union still reigned as one of the world's superpowers. As I left the plane, I was met by two men with Kalashnikovs. I wondered if I had somehow mistakenly wandered into a war zone. The two young soldiers glared at me and my fellow passengers with suspicion, as though we might be criminals. The border guard at passport control was no less hostile; the light was very strong and as she scrutinized my passport she stared at me equally suspiciously, as though I was probably hiding something and she intended to find out what. Throughout my visit to St. Petersburg that spring, every interaction with officialdom was permeated with hostility. Given the somewhat off-putting atmosphere, I spent less time meeting people and more time in the city's many museums.

After that experience, it was with mixed feelings that I returned to Russia in March 1995 to visit Moscow and write a report on a privatized power utility called Mosenergo. For several years, I had been an equity analyst in Stockholm and had been named the top-ranked analyst in the utilities sector by a major business journal. I worked for Alfred Berg, the top-ranked broker among Nordic institutions.

If someone had told me I would give up my life in Stockholm, move to Moscow and begin working in the Russian equity market, I would have said they were joking. At Mosenergo, management was engaged in accumulating stock and each day a sign was posted at the main entrance stating the price at which shares would be purchased that day. During my meeting with the CEO, I couldn't help but notice that a bronze bust of Lenin occupied pride of place on his desk.

Later in the evening, following a long dinner and a great steak at Uncle Guilly's, opposite the Moscow Mayor's office, I was convinced. The opportunity to participate in a market so new that stock prices were posted on the company door even as Lenin continued to cast a gimlet eye on the CEO was the chance of a lifetime, never to be repeated. Then and there, I decided to move to Moscow and in late summer 1995 I went to work for Alfred Berg's Russian operation. The first report I published on the Russian stock market, on Mosenergo, was titled *Power to the People*. Mosenergo then was not the same company it is today. It has since been divided into several different companies, but the investor who bought stock in Mosenergo in 1995 profited many times over.

In the summer of 1997, I returned to Stockholm to launch one of the first onshore Russian equity funds. The years since have provided me with a fascinating opportunity to learn more about Russia and follow the country's development. Moreover, moving to Russia changed my life in many ways. I have learned that Russians make extremely loyal friends, and today some of my dearest friends are those I made in this often enigmatic but unforgettable country.

What is easily forgotten now, after 11 years of relative stability in Russia, is the turbulence of the Yeltsin era. The risk that the true hardliners would return was a real possibility. After Yeltsin won the election in 1996, he was very ill and the bypass operation he underwent was serious. He recovered, but it was a very close call and the markets trembled until he was out of the woods. Yeltsin had a clear minority in the Duma during his entire presidency, and went through six different prime

ministers. The environment was sharply delineated. On one side, Western liberals promoted full democracy and a free media, with Harvard professor Jeffrey Sachs and Swedish professor Anders Åslund supporting deregulation and privatization. On the other side, reactionary forces clamored for a return to the command economy. This dichotomy significantly influenced the stock market, and every important vote in the Duma reverberated throughout the markets or caused a crisis in the government.

Looking back, from both a personal perspective and the perspective of an investor, it's somewhat disappointing to see how few entrepreneurs have succeeded in the stock market. Magnit is a clear exception, although there have been successes on a smaller scale. All the major gains in the market have come from investors buying cheap assets, engaging in transactions such as buying local Gazprom shares before removal of the ring fence in the last days of December 2006, or buying "blessed" Sberbank shares before foreigners were openly allowed to invest in Russian banks. Of course, at an even earlier stage investing in subsidiaries of LUKOIL, Langepas, Urai, Kogalym and Permneft also yielded significant benefits when it was possible to buy stock in Russian oil companies valued at a few cents per barrel. Going forward, one hopes that there will be more entrepreneurs like Sergei Galitsky and more growth companies like Magnit to invest in.

Today's political stability has come at a price, which is the bureaucracy and stagnation that arise from the patronage system that still dominates in Russia. For example, according to the Russian Academy of Science, the percentage of *Siloviki* (literally translated as *people of force*, or individuals with FSB and military backgrounds) in senior government positions increased from 25% in 2000 to 40% currently.

The Russian Equity Market 20 Years On

The international media often decries the inefficiency of the Russian market. Liquidity is higher for London-listed depository receipts, and companies receive higher valuations if they are listed in London rather than in Moscow. Indeed, London-listed shares typically trade at a premium to local shares, and the media highlights continuing issues regarding corporate governance. However, what we tend to forget is how young the Russian market really is. Seventy-five years of Communist rule cannot

be transformed into a dynamic market economy overnight. From the perspective of 1995, enormous progress has been made.

In 1995, there were no stock exchanges, no prices were available to investors and all trading was OTC. Spreads were extremely wide, and outside the top five or six names could easily reach 100% or more. There was no central clearing mechanism and settlement could take weeks. Today investors enjoy direct market access (DMA), with stock or cash delivered the same day when trading on MICEX.

There was no information available on companies in 1995. Analysts were forced to rely on Russian accounting standards, which are compiled on a cash rather than accrual basis and can result in misleading reporting of profit. Following the demise of the Soviet Union, a large part of the economy relied on barter, and revenue figures could therefore not be trusted. Sometimes the cash portion of sales could be as low as 10%. Wage and tax arrears were a significant problem for every company, and in some cases businesses were nearly bankrupt. While some companies did provide profit and loss statements, they were relatively theoretical with inflation running as high as 10% per month. Most of the time, we were grateful if we knew a company's number of shares outstanding and production volume so we could make a rough estimate of what we were paying. For example, for oil companies we calculated how many dollars we paid per barrel of production or reserves. For regional telecom companies, we relied on market capitalization per line. These are just a few examples of how rough the estimates were, and yet these types of estimates provided the basis for our investment decisions.

For oil companies we had our own method of calculating profit and loss. We knew the production volume, the quantity of oil sold domestically and the quantity sold for export. Frequently, we noted that the difference between our calculations and reported profit was significant, with reported profit considerably lower than our estimates. We attributed the difference to broad leakage across company structures—at that time vanishing profit was more attributable to graft at every level rather than transfer-pricing schemes from the top.

There are certainly concerns regarding corporate governance, and if anything Russia took a step back in progress following the crash in 2008. But from a long-term perspective, although there has been significant progress from a macro and human perspective, one hoped that progress would have been faster. GDP per capita has improved dramatically since

2000. The private sector as a component of GDP has increased from virtually zero in the early 1990s to more than 60% today. Consumption has risen from approximately USD 1,000 per person in 1995 to USD 6,000 today. Real wages rose by 180% between 1995 and 2011, according to the State Statistics Service. In 1995, I used to take a cab to Paveletskaya and do my weekly shopping at Stockmann rather than visit five or more shops in the area where I lived to get what I needed. As a consumer I therefore appreciate the 25-fold increase in modern retail format selling space since 1991, and hence the appearance of one-stop-shops.

Corruption is the biggest obstacle to further improvement in overall prosperity for the Russian population. According to the Corruption Perception Index published by Transparency International, Russia has continued to deteriorate in terms of corruption, falling from number 76 in the ranking in 1998 to 154 today and lagging behind countries such as Paraguay, Pakistan and Zimbabwe. If there is no change in the level and breadth of corruption, Russia will find it extremely difficult to further increase wealth per capita. The country's low birth rate is another negative factor. While the birth rate has risen to 1.55 today compared with 1.19 in 1999, it still lags the 1.75 recorded in 1991. Life expectancy for men was 57 in 1994 and has risen to 63.5 today, but still remains below the 1991 level. While there is much more room for confidence in the economy, these figures indicate that living conditions in Russia remain difficult.

A Violent Transformation

Many foreign commentators often point to the fact that Russia's transformation from a communist state to a free market economy and fledgling democracy was smooth in relation to its history, with relatively little loss of life. Considering what was at stake, I agree. However, there were deaths in the Baltic States during the liberation, as well as the approximately 200 fatalities in Russia during the constitutional crisis of 1993. But in the overall scheme of things and relative to Russia's turbulent history, little blood was spilled in the transition.

When I have been asked to comment on the changes in Russia and the development of the Russian equity market over the past 15 years, it is difficult to avoid discussing the violence that characterized the transition in the mid-1990s. In those days, it was impossible to avoid the

newspaper stories about people murdered in Moscow, typically in relation to business disputes. Killings often took place in the suburbs, but occasionally in the city center. Shareholder conflicts continued, and in some cases the stakes were very high. One well-known casualty in the 1990s was Paul Tatum, an American entrepreneur who opened the Radisson Hotel in Moscow. Despite the presence of several bodyguards and following a dispute over ownership, Tatum was gunned down execution style in an underpass, not far from the Radisson Slavyanskaya Hotel he had helped develop. His killers were never found.

Metals trading had become very profitable in the mid-1990s, and in 1996 visiting Krasnoyarsk in Siberia was like a trip back in time to the Wild West, but without the horses hitched outside saloons. I have never seen so many weapons in the hands of so many different people in the same place in my life. Many people died as a result of deals gone wrong or fights over valuable assets in and around Krasnoyarsk.

There were even casualties in the brokerage industry. Andrei Orekhov, founder of the brokerage house Grant, which was later acquired by Creditanstalt, was shot and injured in Moscow in April 1995. According to market rumors, he was buying the wrong shares, or possibly preparing to sell them to the wrong people. His six-year-old daughter was killed in the attack. In those days I also met an equity salesman who had earlier been a metals trader. Knowing how profitable metal trading was, I asked why he had switched. His answer: "It was easy, my boss was killed and I was asked to do something else."

In yet another example of the Wild West atmosphere, one of our competitors had concluded a corporate finance agreement with a company based in the Urals. Following handshakes and pleasantries regarding how everyone would work together, the CFO opened his jacket to reveal a gun, loudly announcing, "We know how to deal with people who violate contract terms."

In 1997, it was with some concern that I paid my first visit to Avtovaz, Russia's largest car manufacturer, with production facilities and headquarters in Togliatti. Before flying to Samara and taking a taxi to Togliatti, I had heard that two members of the Avtovaz board had been murdered the week before. The manufacturing plant in Togliatti was huge, as plants always are in Russia. The main offices were located in a mini skyscraper overlooking the vast manufacturing complex. As we took the elevator up to the CEO's office, I couldn't resist asking about

the changes in the board. The CEO's assistant and translator explained that two board members had been "dismissed." It seemed wise to ask no further questions.

During the meeting, I raised the issue of the two-tier market for Ladas—one tier consisted of the official market for new cars while the second market was where "stolen" new Ladas were sold, the implication being that the theft was being perpetrated at the factory. We were told that no such two-tiered market existed, and the management's own security force controlled the production facilities, precluding any possible theft. Management made this pronouncement with great sincerity, despite the fact that the two-tiered market was common knowledge. The same assistant that had escorted us up in the elevator followed us down to the ground floor. Trying my luck again, I told her that I knew the two board members had been murdered. She replied, "Yes, but it was because of private issues."

The area around the Avtovaz factory in Togliatti had been very violent since the early 1990s. Not only had board members and top managers been killed, but journalists and even police officers as well. According to Russiablog (www.russiablog.org) more than 500 people associated with AvtoVAZ have been murdered in contract killings since 1992. The violence was not limited to market participants such as brokers, commodity traders and shareholders engaged in ownership conflicts. Violence was also a part of everyday life. One of my neighbors on Kotelnischkaya had a bomb placed outside his door. He miraculously survived the blast and life in our building returned to normal shortly thereafter, with the explosion accepted as another fact of daily life. Just outside my apartment, a discotheque owner and his 25-year-old driver were killed by a man on a motorcycle stopped next to them at a red light. These were only events in my own neighborhood.

According to *Kommersant*, contract killings peaked between 1994 and 1996 (with 562, 560 and 580 killings, respectively). The homicide clearance rate was very low at only 10%. It is estimated that approximately 50% of those murdered were businessmen. Contract killings still happen in Russia; more than 20 journalists have been killed since 2000. However, such murders have become far rarer than in the mid-1990s when violent conflict was ongoing between businessmen who wanted control over newly privatized assets.

Adventures on the Road in Russia

Traveling in Russia during the mid-1990s is a topic sufficient for a book of its own. I have heard hundreds of remarkable travel stories over the years, and I have some good memories of my own. For example, my boss and I once had an early morning Transaero flight from Irkutsk to Moscow. There were only three passengers booked in business class. Shortly after takeoff, a fourth person suddenly sat down a row ahead of us and began to smoke. He looked extremely tired, possibly hung over, and was smoking compulsively. As our breakfast was about to be served, my boss asked the flight attendant why the man was smoking. "Smoking area will start in front of you," she replied. "He wasn't here at takeoff," replied my boss. The flight attendant answered, "He is the captain." The conversation was over. We had begun to eat our breakfast when another man emerged from the cockpit and began to eat breakfast and smoke as well. I leaned across the aisle to my boss and asked with trepidation, "Who do you suppose is flying the plane?"

One of the vagaries of traveling in Russia was that you could never be sure whether a flight would take off or not. On one occasion, I had planned to go to Naberezhnye Chelny (formerly Brezhnev) to meet the management of Kamaz. The flight was supposed to leave Domodedovo at 8.40 a.m. We were checked in with one of the baby-flots (smaller airlines that competed with Aeroflot on domestic routes). There was no plane at the gate, and the flight was delayed an hour. Another delay was announced, although no reason was given for the delay. At 11 a.m., we were informed that the flight was canceled. When my colleague asked why, she was told that the airline was unable to pay for fuel for the flight. When Kamaz management heard the story, they invited us to take the company jet the following day. Truck production nearly came to a complete halt in the spring of 1997, but the company still had a corporate jet flying between Naberezhnye Chelny and Moscow.

Power struggles within companies also affected travel plans. Two colleagues and I wanted to fly from Domodedovo and became stranded at the airport for hours. The sun was shining and the sky was clear. We took advantage of the delay to rest, given our rather hectic schedule. But nonetheless it was very strange since the entire airport was closed for both arrivals and departures even as the sun continued to shine brightly. We suspected that President Yeltsin or another high-ranking official might be flying in, but that surely wouldn't necessitate a wait of

several hours. We had a full program of company meetings booked, and we weren't prepared to give up easily, but in the end we drove back to Moscow. The next day we read in the newspaper that the deputy CEO of the airport had been shot and the entire airport had been closed down as a precaution.

In early 1996, I went to Irkutsk for the first time. We asked our assistant Inna to book a nice hotel in the city. She told me that the best hotel in Irkutsk was at the famous Fyodorov Eye Microsurgery Scientific and Technical Center. In fact, it proved to be a good hotel, nice and clean. However, there was one problem. The client who had joined us on the trip wanted to buy shares in Irkutsksvyasinform following our meeting. This is before mobile phones existed in Russia, and before the Internet revolution. We had to order a long-distance call to Moscow, and then wait for more than an hour for an available line for the client to call our trader.

Once the call was finished, we were ready for dinner and needed a taxi to take us to the restaurant downtown, but there was no driver to be found. The resourceful receptionist at the hospital proposed a solution. "Take the ambulance to the city; it needs to be there anyway." It was an interesting ride, with four people crowded into the small ambulance. We had dinner at the local Intourist, which was a delight considering it was a Tuesday evening during the Siberian winter. The next morning we breakfasted together with some miserable-looking Fyodorov patients who had recently enjoyed eye surgery. It was not only the hangover that made me feel sick that morning.

From the Planned Economy to a Free Market

In 1995, I moved from Stockholm, one of the most efficient and liquid stock markets in the world (on liquidity to market cap) with 100% electronic trading, to a market where there was no real exchange to buy and sell stocks, no central depositary, no delivery versus payment mechanism, and no intraday price information. Prices on the RTS were indicative. In the evening, the three or four largest brokers gathered price information so that the best bid/ask and last order for the 20 most liquid names were determined and distributed by fax. There was no transparency regarding the names. Prices could move 10–15% intraday, and bid/ask spreads on even larger companies were huge. It was a revolution for price transparency when in 1996 Reuters transmitted bid/ask

prices directly from RTS participants during the day. It was bad for the brokers whose margins shrank, but positive for clients who could deal with Russia from abroad with much lower transaction costs. At the time, transaction costs were extremely high.

Not only did the enormous bid/ask spreads in the market make trading expensive for investors, but the costs of settling a trade were significant. In the worst case, the local registrar charged 50 basis points just to make the change in the shareholder register. In order to record the change of ownership in the register, signed and stamped purchase and sale agreements from each counterparty had to be presented. Many of these registrars were located in far-flung locations, forcing counterparties to dispatch couriers across Russia to deliver the purchase and sale agreements. Once the documents were approved by the registrar, a *vipetska*, or receipt, was issued and the re-registration completed.

After the buyer had received the *vipetska* from the courier, he would then have three days to transfer funds to the seller of the securities. This entire process took at least 10 working days, possibly significantly longer when the registrar was located outside of Moscow. Indeed, the process could stretch to weeks in the worst case scenario.

When we started trading local Russian shares with our clients in 1995, we had to manage the risk arising from re-registration and the lengthy settlement period. We had a special agreement with each client, who was required to sign a disclaimer for "potential cancelation" if the shares were not delivered to us, or if the shares were not re-registered with us. This was a clause we never used, as far as I remember. However, there were several occasions when a counterparty outside the market canceled a trade. When we bought shares in the market for clients, we preferred to avoid revealing that we were buying shares directly from management, which on one occasion did cancel the transaction. In addition to the special agreements that we internally called "the Russia contract," for each client who wanted to buy Russian local shares we issued a preliminary trading confirmation. The preliminary confirmation allowed a 30-day settlement period. When contracts were signed, they were sent to the local registrar for re-registration and the final trade confirmation was issued to the client. If you then add the time necessary for faxing every trade confirmation back and forth between the brokers, you get an idea of the enormous amount of work required for every transaction.

A Tiny Market

Some people might think that liquidity in the Russian market remains low today, and this is true. About 50% of the market's liquidity, which includes the local Russian market as well as markets in London, New York and Hong Kong, is provided by trading in two stocks, Gazprom and Sberbank. If we include Rosneft, LUKOIL and Norilsk Nickel, we're up to nearly 80% of the market's liquidity. Daily turnover on a typical day in the cash market, excluding extremely liquid RTS futures, is about 70–150 times more then it was in 1995–96. At that time, a single trade of USD 1mn was huge. I remember on one occasion my salesperson at Regent said, "I will take you to Maxim [the most expensive and prestigious restaurant in Moscow at the time, at the National Hotel] after our first USD 1mn trade." Unfortunately, we never made the USD 1mn trade and I never got that dinner. Often a USD 40–50,000 trade could make the offer side disappear.

Company Visits Russian Style

People frequently ask me if there wasn't a lot of drinking in Russia during the time I lived in Moscow. There was, and this was never more evident than on a company visit. A visit could start at 9:30 a.m. with a double shot of brandy. I quickly learned that it was an insult not to drink. A visit to a production site or power plant would sometimes end with the *banya*, which is the sauna that is such an integral part of Russian culture. This is typically a very nice experience usually accompanied by good food, and the communal *banya* encouraged open communication. But the *banya* also included vodka drinking, of course. We Swedes were appreciated for singing along with the vodka as well as our ability to drink. It was also at one of these colorful company meetings where I learned that when a Russian asks if you play chess, he is probably playing at the master level. I am a competent player myself and played very frequently in my youth. But my latent skill was no match for the Grand Master at Mosenergo's power station 17.

Typically, a company meeting in 1995–97 would start with a room full of people—heads of all the operating segments, the board members and a full delegation. We would be given extensive technical information, and often treated to a detailed history of the company stretching back to Soviet times. Of course, the issues that interest an analyst or investor

are topics such as the level of non-payments and the amount of cash revenue; particularly in sectors where barter significantly exceeded cash transactions. Salary arrears was also a major concern, and we always asked how long it had been since salaries had been paid and what was the accumulated wage debt. It was not uncommon to find that salaries had not been paid for seven to nine months.

For power utilities, the non-payment issue was particularly problematic. Cash payments could be as low as 10% and non-payments could reach 30–40% or even higher. A company's obvious reaction would be switching off the electricity to non-paying customers. Sometimes that policy worked out well and the customers paid. Quite often, however, complaints were lodged with the local or federal authorities regarding power cuts. I am sure that managers of utility companies were occasionally threatened. The worst story I heard was in 1997 on a visit to Kolenergo in Murmansk. Kolenergo's corporate office was stormed by the armed forces after management switched off power to the naval base where nuclear submarines were docked. In the words of Kolenergo's CFO, he had no problem switching the power back on after looking down the barrel of a Kalashnikov.

Even as a hotel guest you were affected by the non-payments situation and disruptions in power transmission. I froze in Krasnoyarsk before I learned you should stay at the KrazAls Hotel. During my first trip, my hotel was freezing—the lobby, the restaurant and the corridors were all cold enough to make you keep your coat on. Once I discovered KrazAl's hotel, I was very happy to experience the rare pleasure of a warm rooms.

Yaroslavl was worse, and there I was once again forced to spend the night in an unheated room. I had gone to Yaroslavl to check up on a private equity investment in Yaroslavl Rubber. The rubber suppliers were squeezing us, and the business had almost come to a standstill without raw materials. I arrived in Yaroslavl late at night after driving for several hours from the airport in Moscow. It was so cold in my hotel room that I was forced to take all the blankets and sheets from the second bed and pile them onto my own to keep from freezing. In addition to being extremely cold, I was also hungry. In 1997, the restaurants in Yaroslavl closed early.

In the more Soviet-style hotels, each floor had a dezhurnaya, typically an elderly lady who monitored the comings and goings of guests and handed out room keys in return for a receipt showing that you had paid

for the room. On this cold and unpleasant night, I threw myself on the mercy of the babushka, asking where I could possibly find anything to eat. The only thing she had to sell was some very sweet candy and some imported cake from Germany sealed in plastic. She seemed to recognize the desperation in my face, and offered me a thick slice of dark rye bread from the personal store under her desk. That was neither the first nor the last time that I was to experience the kindness and generosity of Russians who offered to share whatever they had despite their own limited resources. The rye bread was perfect, and I was warmed by the old lady's kindness as well as kept from starvation. In the end, the rubber supplier took over Yaroslavl Rubber for peanuts. We had to give in.

During the first years in the market, we only issued buy recommendations. There was no reason to issue a sell. If an opportunity was less exciting, it was better to move on to something else. There was so much ground to cover, with hundreds of companies. We wrote a brief note on Kolenergo in 1996. Apparently, it had not been covered before. We stated the replacement value of the hydro power assets, and the stock was up over 40% in the first day and more than 100% in a week. That's how under-researched the name was. If we found something doubtful, we wrote about it. Occasionally, this caused some concern. A business associate of Boris Berezovsky, later jailed for large-scale theft, somehow gained access to a colleague's report. He said, "I read your report, I don't like it," and the statement was followed by a pregnant pause. Although the threat was not explicit the meaning was clear, and the experience was unpleasant for my colleague.

Russia is an enormous country, and when you travel you notice this fact very quickly. One problem is that if you want to travel to multiple destinations, you frequently have to fly back to Moscow in order to travel onward to your next stop. Once I had a full day of meetings in Ufa, which is a very beautiful town, by the way. I had been trying to get a meeting with Chelpipe for some time, as we were holding a fairly large position through our Rurik Investment Company. The broker I was traveling with said that I would have a meeting with Alexander Fyodorov in Chelyabinsk the next day. But how was I to get there? Chelyabinsk is 360 km from Ufa, Europe to Asia over the Ural Mountains, but there are no flights and there is no train. It seemed to me that it shouldn't be more than a five-hour drive in good weather. We flagged down a yellow cab in Ufa—what are the chances? You wouldn't even find a yellow cab in Moscow.

The driver was very interested and said the meter price would be too expensive. We agreed on a figure per kilometer. The drive started off nicely, but climbing the Urals in the middle of the night as snow started to fall took some time. We arrived in Chelyabinsk at 2.30 in the morning. Finding the Hotel Viktoria at that time of night when you've never been to Chelyabinsk and there is no one to ask for directions is a challenge. The ride was USD 350 including tip, and the driver immediately took off back to Ufa. I made the meeting.

Alfred Berg's office in Moscow had an excellent driver with some very convenient qualifications; Vasily was a retired policeman. Given his connections, we never once paid a traffic fine. When stopped by the GAI (the road police), Vasily would brandish his identification and off we would go. Illegal U-turns, speeding, no matter the offense, we never paid. But this benefit only worked in the city center, as we discovered on our way to a small airport past Moscow's outer ring road. We were stopped there and given two choices: either Vasily could surrender his driver's license to the police, find a Sberbank to pay the fine, get a receipt, drive back to show proof of payment and retrieve the license, or settle in cash straight away. The twist was that the on-the-spot "fine" was higher than the official fine to be paid at Sberbank, and the policeman would pocket the cash. We paid cash and drove off.

Despite the expedited interaction with the traffic police, we were running late for our flight to Nizhny Novgorod. Back then though, this was not a big issue. The plane was sitting on the runway ready for takeoff, and we asked our driver to head straight for the aircraft. We stepped conveniently from the car onto the plane—no gates, no security, just show the ticket. Seconds later the turboprop took off for Nizhny Novgorod. It was late and dark, and as the pilot accelerated I saw blue flames shoot from both engines. "This is it, I thought, we're going down." Strangely enough, the flames disappeared after a few seconds. Later I learned that small explosions occur when the cylinders in the engine are leaking fuel into the exhaust. It's similar to hearing noise from the exhaust of an old car.

In Nizhny Novgorod we met GAZ and Nizhnovenergo, but also officials from the local administration. We met a young and dynamic man who was very Western in his manner. He told us about the progress that Nizhny Novgorod had made as a town for entrepreneurs. His name was Boris Nemtsov, and one year later he was deputy prime minister and

in charge of reforming the energy sector. That's how it was during the Yeltsin era. One day a man could be an unknown but dynamic politician, and the next part of the national government in Moscow.

Over the years I have traveled extensively in Russia and the former Soviet republics. I have visited Ukraine, Kazakhstan, Estonia, Latvia, Lithuania and Azerbaijan, and I have also visited more than 35 Russian cities in Europe and Asia. The most beautiful trip I made was a flight by helicopter to Elga Ogul. I had never known that Siberia was so green and hilly and full of small lakes. It looked like a lovely place to go hiking and canoeing. In contrast, the toughest trips emotionally were the visits to Norilsk. The combination of pollution, isolation and six weeks of no sun in the winter makes Norilsk a particularly grim place. The average temperature is −10 °C (14 °F). Visiting one of the most polluted cities in the world (one of the top 10 most polluted places, according to the Blacksmith Institute) was distressing. The snow on my hotel's window ledge was black. The trees surrounding the city are dead; indeed, according to CNN all of the trees within 48 km of the Nadezhda ("Hope") nickel smelting facility are dead. Moreover, the isolation is extreme. The closest town is more than 1,100 km away and all efforts to build a rail link to Norilsk stalled when Stalin died. Nonetheless, close to 200,000 people live there. This northernmost town is also home to the world's most northerly mosque, built to attract new workers from the former Soviet republics in Central Asia.

The Young Man from the Trolley Bus

I mentioned a young man at the beginning of this chapter, the young conscript riding into a hail of bullets in 1993. We got to know each other in 1996 when he worked for Nikoil, which later became Uralsib. He had just graduated from the Oil Academy and had done his practical training in Surgut, where conditions in the winter are harsh in the extreme. He had limited knowledge about the international equity markets and how they worked, while I knew little about Russian oil and Russian oil companies. We began to meet regularly to discuss the Russian oil industry and global equity markets. He taught me a great deal about the peculiarities of the Russian oil industry, and much about the history of oil in Russia, its discovery and exploration.

I also learned more about the young man himself. After facing death in 1993 as he rolled toward the White House, he nearly came to an untimely

end once again in the autumn of 1999. Prior to the presidential elections, there were suspicious explosions in several large apartment buildings in Moscow. The perpetrators were never apprehended. The young man lived with his family next door to one of the buildings that had been reduced to a pile of rubble, and it could just as easily have been his own building that was destroyed.

Russia versus Brazil

Russia is my second home; I have not spent more time in any other country. But looking at other emerging market countries raises questions. For example, in Brazil valuations are much higher than in Russia. Why is that? The structure of industry is similar, both countries are highly dependent on oil and gas, and the countries are regularly regarded as peers. The divergence in valuation has existed for some time, and has increased since 2008. While Brazil has a more diversified economy with less dependence on oil and gas compared with Russia, this fails to fully explain the valuation gap.

In the fall of 2010 I had the opportunity to spend two weeks traveling in Brazil, where I visited oil and gas companies, as well as mining, agriculture- and consumer-related companies. After 15 years in the Russian market, it was extremely interesting to make some first-hand observations of another BRIC country. In short, I found that Brazil is less corrupt on all levels. Visit a state-owned company and you will not see any black Mercedes 600s, executives in bespoke suits, or USD 100k watches. It doesn't really matter if Russia has the best educated parliament in the world and 218 Duma delegates of 450 have a Ph.D. (according to *Der Spiegel*) when corruption continues to be rampant.

There is much more legal security in Brazil. For example, I asked the CEO of Petrobraz, José Gabielli, if he believed that the state would increase taxes on post-salt deepwater fields following the company's SPO. He answered, "the Brazilian state has not broken an agreement with a private party in 16 years." Differences between private and/or public organizations are settled in court, and the outcomes of legal proceedings are more predictable than in Russia. Moreover, Brazilian oligarchs have a much stronger belief in the future and profits are reinvested in new projects. Compare that to the aftermath of Russian IPOs, where proceeds are frequently spirited out of the country. Or look at capital outflows in the third quarter of 2010, when people began to worry after

Moscow mayor Yury Luzhkov was fired. Finally, you see joint ventures everywhere you go in Brazil, with Japanese, Chinese, Korean and German companies, as well as firms from many other countries. Brazil has opened up to access capital and technology, and is ready to share the upside. All of these factors are reflected in higher valuations.

I think it's time for Russia to make a firm and final commitment to ending corruption and establishing a credible rule of law. Imagine a day when Russian and foreign investors know that their ownership rights will be protected by the Russian authorities, and that conflicts will be resolved in courts that operate fairly. Strengthening the rule of law, protecting ownership rights and fighting corruption will have an incredibly positive impact on the Russian economy. Capital flight will end and oligarchs will reinvest in Russia, fostering dynamic economic growth. If Russia creates a market environment that is truly friendly to foreign investors, badly needed long-term capital will flow into Russia, making it possible to fund the investments in infrastructure that the country so desperately needs to modernize and achieve higher economic growth.

> Enlightenment is man's release from his self-incurred tutelage. Tutelage is man's inability to make use of his understanding without direction from another. Self-incurred is this tutelage when its cause lies not in lack of reason but in lack of resolution and courage to use it without direction from another. Sapere aude! "Have courage to use your own reason!"
>
> Immanuel Kant 1783–84

CHAPTER ELEVEN

Death of a Russian Salesman

By Steven Dashevsky

> The men in Washington were last to be reached by the panic. They watched, not the news from Minnesota, but the precarious balance of their friendships and commitments; they weighed, *not the fate of the harvest, but the unknowable result of unpredictable emotions in unthinking men of unlimited power.*
>
> *Atlas Shrugged*, Ayn Rand

It was in the summer of 2009 that I decided to leave my job running Unicredit's equities desk in Moscow after a long and productive 11-year career in Russia.

Having arrived in Russia on the verge of the 1998 Russian default-and-devaluation crisis, I started work as a research analyst for ATON, subsequently becoming head of research in 2002. Following ATON's acquisition by Unicredit in 2006, I was appointed head of the Russian equities division the next year, taking responsibility for equity research, sales, trading and derivatives. My career on the Russian sell side was an exciting and educational journey, but after 11 years of service I felt it was time to try something different.

As I was typing away at my farewell email, I briefly thought about the amazing experiences I was lucky enough to have enjoyed and all the good people I had been fortunate enough to meet during my tenure at ATON/Unicredit. But the future was equally bright, for I knew precisely what I would do next: like any self-respecting former sell-sider, I was going to start my own hedge fund.

The timing was almost perfect. The markets had just started to recover after the global meltdown of 2008, office rents were still low and a lot of good people were on the street after the 2008–9 job cuts. The business plan was simple and straightforward. We were to set up an independent boutique focusing on event-driven investing in Russian and former Soviet Union stocks, something that was at the core of our business

model at ATON and later at Unicredit. The simple idea was to capitalize on many years of local market experience, strong company knowledge and good corporate and investor contacts.

Two years later, in 2011, the goals we set out for ourselves had largely been achieved. We managed about USD 90mn in the hedge fund (called the Russia Special Situations Fund) and several large managed accounts, and had delivered strong returns with below-average volatility to our investors. Our firm employed about 10 people and we were discussing various expansion plans.

However, these expansion plans consisted primarily of diversifying our investments and overall business (including moving offices) away from Russia. Why? I will try to explain below.

2008: The Year when Everything Changed

The main reason for our diminished interest is that the Russian investment landscape has changed materially for the worse after the crisis, with the government assuming further commanding heights in the economy.

I believe that future historians will come to view the 2008 credit squeeze as the pivotal event of modern Russian economic history. It was the last straw that broke Russian capitalism's back (if you can call a highly leveraged mix of cronyism, corruption and backroom dealing capitalism, of course) and opened the gates for the state's successful final march on the economy.

In the fall of 2008, with the global credit crisis ravaging markets worldwide, most of the proud members of the Russian Forbes 100 rich list had to crawl to the state for financial support to save their leveraged empires. Large multi-billion dollar Russian conglomerates that were widely thought to be products of the ingenious business strategies of the country's smartest men with few exceptions turned out to be houses of cards, supported by little other than the speculative boom in commodity prices and the flow of cheap, easily accessible credit to emerging markets. When both of these supporting factors disappeared, the music for most Russian oligarchs stopped.

Indeed, the situation had gotten so bad that Josef Ackerman, the head of Deutsche Bank, one of the largest lenders in Russia, had to make a trip to see Russian Prime Minister Vladimir Putin to politely ask for a solution as Deutsche Bank stood to become a major shareholder in

some of the largest Russian companies following de facto loan defaults by their principal owners, who had pledged their controlling stakes as loan collateral.

In another equally illustrative example, Russia's second richest man (according to the 2007 Forbes list), Oleg Deripaska, went from being worth an estimated USD 17bn in 2007 to being de facto bankrupt by the end of 2008 as his liabilities turned out to match his assets, which had rapidly lost value during the crisis. Only with massive support from the state, which provided debt financing and later bought equity during the IPO of Rusal (Deripaska's flagship metals company) did he manage to recover from the crisis.

In keeping with the standard operating procedures of those times, the Russian government duly obliged calls for help, rescuing its captains of industry by providing cheap financing from the coffers of various state-owned banks such as Vnesheconombank, VTB, Sberbank and the like. Multi-billion dollar loans were issued to major companies and their owners, which allowed them to refinance their debts to Western creditors. While the loans were generally granted on market terms, the choice of recipients was highly subjective. Various lists of "systemically important" companies were drawn up, but even being included on such lists didn't guarantee government support as many more bureaucratic hurdles had to be surmounted before accessing the government lifeline.

Naturally, such a complicated and opaque process again became fertile ground for corruption. While at Unicredit at the time, I saw one of our corporate clients, a company recognized as strategically important by the state, spending many months going from one state agency to another to clear the refinancing package until he gave up and refinanced everything on market terms with commercial banks.

The Russian government clearly did the right thing by interfering in 2008 to save its industrial giants and the banking system from collapsing into uncontrollable chaos. However, the rescue came with a large price tag. The state realized it now held a massive bargaining chip over the oligarchs, and, as any good businessman would do, it deployed this leverage to the fullest. Following the 2008 rescue operation, the balance of power in both economics and politics in Russia had firmly shifted in the state's favor. To the winner go the spoils, as the saying goes.

The spoils included the ever-growing share of state-owned businesses in the GDP and Russian equity market capitalization, the meteoric rise of a few businessmen with strong political connections as their main asset, as well as increased (and often arbitrary) regulation of various economic sectors.

Some of the industries that were successfully privatized (such as the power generation sector) were equally successfully consolidated back by the state. State-owned utilities Inter Rao, FSK, RusHydro, as well as Gazprom, now control the overwhelming majority of the country's generation capacity, negating many years of reform and privatization efforts. State-owned Rostelecom has consolidated seven regional telecom operators, thus restoring the nationwide fixed line monopoly. Two state-owned banks, Sberbank and VTB, own more than 50% of banking sector assets, with their market share climbing steadily after the crisis. Their access to low-cost central bank financing provides an important competitive advantage vis-à-vis privately owned banks.

Whatever the state doesn't control directly, it controls or influences indirectly. As one example, the government called on VTB to provide, on very short notice, billions of dollars in loans to finance the acquisition of the two major Russian potash producers, Silvinit and Uralkali, by an approved consortium of Russian investors with good political connections. Without the state's help, this deal would have never gone ahead so quickly and the financing package sealed the victory for the buyers.

Another unfortunate example is Gazprom, where the government allowed stealth privatization of its financial, construction and other assets (including its very valuable 20% stake in Novatek, the largest independent gas producer) to politically favored buyers at laughable valuations (with all such transactions accompanied by equally laughable explanations).

The state also became de facto the buyer of last resort for businessmen seeking exit from their investments. From shipping (Novorossiysk Port) to media (CTC Media) to telecoms (Rostelecom) to construction (Mostotrest) to food processing (Russian Sea), companies owned by the government or people close to various government leaders became virtually the only buyers for various assets and equity stakes offered for sale in Russia. Needless to say, the absence of a competitive deal market means that, if you're a seller you have two options: receive a low

valuation for your asset, or deploy your connections and intermediaries to negotiate a higher price from the state—and then you return the favor in various ways.

It is interesting to note that major global private equity firms are largely absent from Russia as they find it impossible to compete with the small group of local businessmen with unmatched political connections and easy access to financing from state-owned banks.

The reflection of the above trends is visible even in analyst reports, some of which make me just plain sad. One analyst report suggested VTB Bank shares were a good buy as the analyst expected the state to exert pressure on the selling shareholders of Bank of Moscow (which VTB sought to acquire) to negotiate a lower price for VTB.

In another strategy piece, an analyst argued that investors should analyze how the government extracts rent from various industries and then seek investments that would allow participation in these rent flows. Indeed, why should you care about Rosneft's or Novatek's fundamentals and earnings if their value is determined primarily by successful local political intrigues, such as getting a tax break not allowed to competitors or receiving new licenses without a contest?

There is an obvious problem with this line of thinking, of course. Not only is this approach to investing immoral ("Loot the looted" was the famous slogan of the Russian Revolution of 1917), it is also very likely to lose you money. This is because you, as a portfolio shareholder of VTB or Gazprom or Rosneft, stand at the very end of a long line of stakeholders hoping to enjoy the spoils of unjustly obtained profits. In front of you in that line are the majority owners, the government, the managers, the employees and other participants in the process, and only after all of their (often insatiable) appetites are met, will you receive your share of the proceeds. As an approximation of how much this might be, look no further than the dividend yields on the shares of state-owned companies—they proudly offer 1–2% dividend yields even as their earnings reach new records.

To conclude, the state was always heavily represented in the Russian economy and capital markets, but the post-crisis levels of direct and indirect interference have reached new heights.

Weak institutions have gotten even weaker and haphazard industrial regulation has become even more unpredictable, with important issues for industries from steel to power to auto manufacturing being decided

only after direct interference by Prime Minister Vladimir Putin. Clearly, no economy can function properly in such an environment.

To be fair, a large part of the blame for the increasingly state-dominated economy lies with Russian businesspeople themselves. Their ill-thought-out, pre-crisis expansion plans led them into the debt trap, while poor corporate governance and continuing scandals at such leading companies as TNK-BP, Rosneft, VimpelCom and Norilsk Nickel didn't add to their popularity with stakeholders. In any case, apportioning responsibility for the new economic order in Russia is now pointless—it is what it is and is likely to remain so for the foreseeable future.

From a Secular Growth Story to Just Another Derivative on Global Risk

One may say this is an unduly depressing picture of an up-and-coming BRIC star of the future. Maybe I have lived in Russia for too long and am thus sensitive to small shortcomings in the evolving market economy. Maybe so, but let's consider some facts.

Russia has never recovered to its pre-crisis GDP level, averaging only about 4% growth in 2010 compared with the 8–10% growth rates in Brazil, India and China. Economies in all these three BRIC nations have quickly recovered to their pre-2008 levels, whereas Russia's GDP still remains below its 2007 high water mark.

The Russian stock market (as measured by the RTS Index) now consists primarily of 19 state-owned companies (55% of the approximately USD 900bn market cap) and 14 companies owned by the top 10 Russian oligarchs (another 39%). Of the latter figure, 83% are natural resource companies, which are primarily driven by the prices of their respective commodities and not the level of Russia's economic progress (or lack thereof).

Furthermore, Russian capital flight amounted to USD 21bn in the first quarter of 2011 alone, compared with about USD 35bn for all of 2010. As portfolio investors were actively putting money into Russia in the first quarter following soaring oil prices, domestic players were just as rapidly taking money out of the country. Putting it in simple terms, if foreign portfolio investors are buying Russia and domestic businessmen are de facto "selling" Russia by taking their money out, which side of this trade would you like to be on? A large number of my close friends, business partners and former colleagues of Russian citizenship became

Figure 11.1. Gazprom: material valuation de-rating after the 2008 crisis.

Source: Bloomberg.

live illustrations of the numbers above, moving their families and capital out of Russia in recent years.

Another illustration of the changed investor attitude toward Russia is the massive valuation de-rating of Russia's blue chip companies. For an example, one should look no further than the country's premier company, Gazprom. Having traded at a P/E of 10–15 times annual earnings prior to the crisis, its earnings multiple has been firmly stuck in the 3–5 range despite material improvement in its selling prices and earnings over the past two years.

Indeed, Russia boasts what is probably the lowest priced large cap stock in the entire emerging markets world, with the national oil pipeline utility Transneft trading at just 2–3 times steadily rising annual earnings. A closer look at Transneft, however, reveals a state-owned company that intentionally minimizes its statutory net income through intra-company transfers to reduce dividend payments to portfolio investors. When the latter complain, the management openly states that its key priorities are building more new pipelines (of questionable economic value due to steadily ballooning costs) and helping various charities rather than enriching market speculators.

Similarly low absolute and relative valuations are observed across Russia's natural resources and industrial universes, which on the surface makes Russia one of the most attractively valued equity markets in the world.

In my view, however, these low valuation multiples represent a largely fair market assessment of poor capital efficiency and the weak corporate governance practices of many large Russian companies.

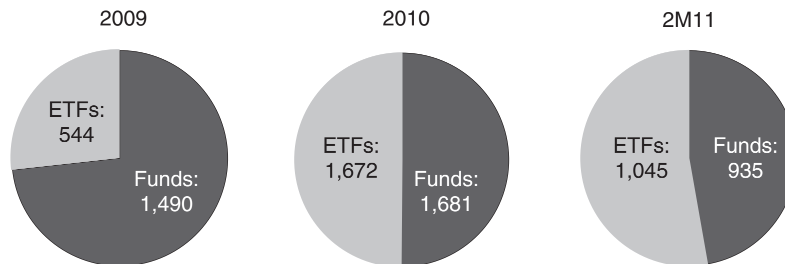
Poor investor perception is not limited to dysfunctional state-owned behemoths. Following numerous IPO flops, investors are increasingly turning away from new Russian equity offerings. Half of the Russian IPOs announced thus far in 2011 have been canceled due to lack of investor interest, with only six deals concluded from the twelve that were marketed. Of the six deals that went through, most were done at the bottom of the offered price range, and three now trade below their placement levels.

Notably, this refers only to placements of foreign-listed shares or depositary receipts of Russian companies. There were no new placements on the Russian exchanges in the first half of 2011, a very weak showing compared even with only three domestic IPOs in the first half of 2010. Lack of proper oversight of new issues by the Russian financial market authorities and ill-prepared deals that were rushed to the market resulted in large losses to investors in domestic IPOs in 2010. As a result, domestic capital markets have all but closed to new issuers, an unfortunate development for a place striving to be a new global financial center.

These Russia-specific developments coincided with significant changes in the global fund management industry, most importantly the rise of the exchange trade fund (ETF). As the Russian investment case petered out and it became just another emerging market to buy when you have a higher appetite for risk or commodity exposure, the importance of diligent company analysis and detailed sector knowledge diminished to the point of being almost irrelevant and the importance of watching portfolio investor flows became paramount.

In fact, since 2009 the value of Russian equities moved almost completely in sync with the direction and magnitude of investor flows in and out of relevant country and regional funds. Using data from the Emerging Portfolio Fund Research fund data website, we have observed the following almost linear relationship: officially reported investor inflows into (or outflows from) Russian equities equal to 1% of the market's total capitalization (the latter stood at approximately USD 900bn in July 2011) cause the Russian stock market to rise (or fall) approximately 10%. The investor flows, in turn, now increasingly depend on the overall global

Figure 11.2. Share of ETFs in Russian equity holdings by portfolio investors (USD mn). Russian funds only, excluding Russian holdings in EMEA, GEM and other funds.



Source: EPFR.

appetite for risk, as well as global commodity price levels. One almost has to wonder what would happen if MSCI were to exclude Russia from its benchmark indexes and investors would no longer have to hold Russian equities simply to avoid large tracking errors in their EMEA or GEM portfolios.

There are two critical implications: (a) such flows by nature tend to be extremely volatile and (b) the market valuation of Russian assets is increasingly being determined by external factors that are almost impossible to analyze or predict and have very little to do with the underlying economic growth rates or corporate earnings.

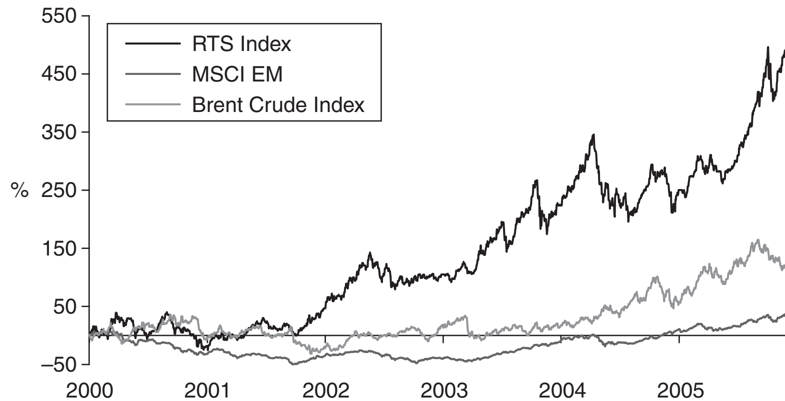
A Tale of Two Five-Year Plans

We thus reach a very unpleasant conclusion. From a secular play on the economic and governance turnaround that Russia represented in 2000–2005 (i.e. during Putin's first presidential term), it appears to have transformed into a second or even third derivative on global commodity prices and equity portfolio flows. Now it's just another "risk on" high-beta trade, exhibiting a very tight correlation with commodity prices and emerging market portfolio inflows.

A brief analysis of Russian stock market performance over the last decade lends support to this thesis.

Over the 2000–2005 period, the Russian market gained 542% compared with a 126% increase in the oil price and a 44% gain in the MSCI Emerging Markets Index. Very substantial value was thus created for investors who bought into the Russian political and corporate

Figure 11.3. From reflecting political and corporate governance improvement 2000–2005.



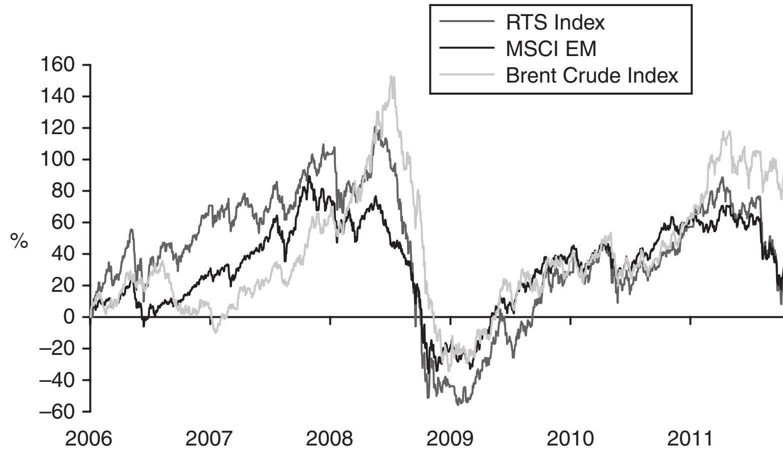
Source: RTS, MSCI (www.msci.com).

turnaround story following the 1998 crash. By way of reminder, during the first Putin presidential term, the country's finances were put in order, tax revenues skyrocketed after the introduction of lower personal and corporate taxes, and the Stabilization and Reserve funds were formed to accumulate excess budget revenues.

Also during that period, major Russian companies restructured and consolidated, subsequently listing their shares in London and New York. Gazprom saw the arrival of new management that at first actively sought to return assets lost under the previous leadership as well as remove the long-standing restrictions on foreign ownership. Sberbank and VTB showed signs of becoming proper commercial banks and Rosneft prepared for an IPO. The global oil super-major BP, having had previously lost nearly all of its investment in Russia, in 2003 struck a landmark deal with a group of Russian billionaires to create TNK-BP, one of Russia's largest and most successful oil companies.

Recovering oil prices during the period were clearly helpful, but represented a supporting side act to the genuine story of corporate and socioeconomic reforms taking place. No wonder that against this positive backdrop even the arrest of Mikhail Khodorkovsky and the demolition of Yukos were seen as one-off events, as exceptions proving the rule that if you stay out of politics, you stand to make a lot of money in Russia, as a strategic or a portfolio investor.

Figure 11.4. To becoming just another volatile "risk on" trade 2006–11.



Source: Bloomberg, RTS, MSCI (www.msci.com).

Fast forward to 2006–11, the joint Putin–Medvedev era. The Russian market equity return of 64% over the period is virtually indistinguishable from that of emerging markets overall (61%) and actually lags behind the 97% increase in the oil price. This translates into an annual return of about 9% with head-spinning volatility—hardly an exciting investment proposition.

Thus, in full spirit with the Ayn Rand classic quoted in the epigraph, investors in Russia have increasingly become subjects to unpredictable actions of unthinking men of unlimited power, be it rapid fire trading ETF and fund managers, or cunning Russian political operators, or both.

Real Deal: Focusing on Special Situations in Russian Stocks

Before we proceed to a conclusion, one thing must be clarified. How is it possible to reconcile my generally negative stance on Russia's medium-term prospects with still significant holdings of Russian securities in the investment portfolios we manage?

The answer lies in our strategy, which in classical hedge fund terminology is called "event driven"; we like to call what we do "special situations."

The main idea is that we invest in Russia not because of its structural macroeconomic potential, forecast earnings growth or expectations of high commodity prices. Rather, we invest in Russian companies or companies operating in Russia that are undergoing specific corporate events, such as mergers, buybacks, restructurings, large dividend distributions, new share listings, spin-offs and so forth.

We thus think of ourselves not as a Russian or EMEA or FSU (former Soviet Union) fund, but rather as an event-driven fund seeking to profit from the opportunities arising in a geographically defined universe of approximately 250 companies that I and my colleagues know fairly well.

The key appeal of this strategy for us is that it focuses on clearly identifiable catalysts and events that should unlock value and provide profitable exits for portfolio investors. Furthermore, as most corporate actions require fulfillment of various Russian and international legal statutes and regulations, in such instances the rights of majority and minority holders are equalized by the law. This allows us to mitigate the biggest risk of investing in Russia and most other emerging markets—the corporate governance risk, the risk of being mistreated by majority shareholders.

Let us consider a few recent examples.

Late in 2010, PepsiCo announced the acquisition of Wimm-Bill-Dann, one of the largest Russian juice and dairy producers, for approximately USD 5.4bn. Wimm-Bill-Dann was listed on the New York Stock Exchange, and PepsiCo immediately announced that upon acquisition of control from the principal owners, it would proceed with making the same offer to all other investors. We viewed the chances of a major global corporation behaving properly in the acquisition of a NYSE-listed company as high, and immediately bought Wimm-Bill-Dann stock that still traded at a 10% discount to the reported offer price. Considering the expected holding period of six months and our target absolute return of 15–20%, we thought this to be a quality defensive trade. In an interesting twist, due to ruble appreciation the locally listed shares of Wimm-Bill-Dann, which we owned, advanced beyond the expected buyout price that was expressed in U.S. dollars. We subsequently sold our position for an approximately 15% gain.

In another instance, after a lengthy legal battle in the middle of 2011, major Russian gold producer Polyus Gold agreed to merge with London-listed Kazakhgold in order to obtain a higher quality listing and change

its domicile from Russia to Jersey. The announced terms called for near mandatory conversion of Polyus Gold shares into Kazakhgold stock on very tight deadlines, with an approximately 7% difference between the price of Kazakhgold at the time of the announcement and the value of the Kazakhgold shares one stood to receive by converting the relevant number of Polyus Gold shares. By going long Kazakhgold and selling short (i.e. borrowing and subsequently selling) Polyus Gold stock, we captured this spread over the period of one month without taking any directional market exposure.

Finally, late in 2010 majority shareholders in TNK-BP Holding, the main Russian subsidiary of BP's joint venture with its Russian partners, decided to list its shares on MICEX, Russia's largest and most liquid exchange. We thought that upgrading the listing of Russia's premier oil company from the over-the-counter trading system (RTS Board) to the country's main exchange would result in materially improved trading liquidity and hence in a higher valuation. TNK-BP Holding's shares advanced approximately 30% following the MICEX listing, at which point we sold our position.

Clearly, not all of the trades work in our favor. Some corporate events end up not taking place or taking longer than expected, resulting in losses. Sometimes it takes much longer for the market to recognize the value in a particular event or company that we see, which may extend our holding period and thus reduce returns.

Our fairly strict investment criteria also limit the opportunity set. You are thus unlikely to see shares of major Russian companies in our portfolio, irrespective of their share in major market indexes, unless they are undergoing or expected to undergo a corporate action. Consequently, we tend to underperform when investors flock en masse to Russia's state-owned blue chips, but we tend to outperform when investor flows stabilize or turn negative. Our particular investment style also means that the maximum capacity of our fund is USD 200mn–250mn; we would likely encounter difficulties trying to deploy larger amounts without deviating from our investment principles.

Still, I firmly believe that the right way of investing in Russia—and in fact in emerging markets in general—is to seek absolute returns from company-specific events, in which your entry and exit points are well-defined, your expected catalysts are clear and visible, and your shareholder rights enjoy additional protection.

The initial results of our strategy are very encouraging. Since launching the Russia Special Situations Fund we have produced positive absolute and relative returns for our investors with below-average volatility. Obviously, a much longer track record is required to make a qualified judgment on our strategy. Yet, I am certain that time will validate our fundamental bottom-up, event-driven approach to investing in Russia and other emerging European markets.

Good Bye and Good Luck

I would like to conclude with the following.

One could say that Russia is hardly unique in respect of weak governance, a state-dominated economy and other socioeconomic issues when compared with its emerging market peers. This is most likely true. Recent corporate governance scandals at foreign-listed Chinese companies, corruption scandals in India and the growing interference of Brazilian authorities in key mining and energy companies may support such a statement. But this logic is clearly flawed: should you want to buy a market whose main appeal is not being worse than others?

Despite all the shortcomings I have highlighted above, I don't think a Russia-specific crisis is inevitable. Moreover, the Russian economy may well grow at 4–5% in the foreseeable future, possibly indeed becoming the fifth largest economy in the world in a few years' time, as some experts suggest.

The main point of my story is that this journey is unlikely to bring many benefits to portfolio investors in Russian equities.

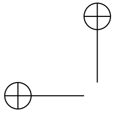
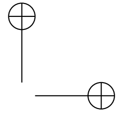
This is because the current Russian political elites have no incentives to change. High commodity prices continue to provide them with windfall cash flows that further entrench their socioeconomic status, while the rigid and centralized political system virtually eliminates any chances of the current leadership being voted out of office. Additionally, the country's gold and currency reserves provide a safety buffer in case of short-term commodity price volatility.

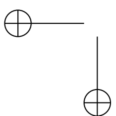
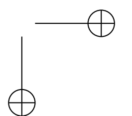
Unless the oil price collapses to USD 40–50/bbl for a prolonged period of time, there is no point in changing the status quo for the rulers, and there is little chance of changing the status quo for the subjects. And without changes, Russia is thus likely to be stuck in this constant quagmire of half-hearted reforms, incompetent industrial policies, bad corporate governance and nation-destroying corruption. In turn, it is hard

for me to see how such an environment is conducive for investing in Russia's major companies. I would love to be proved wrong on this, even if it costs me and my investors some missed profits.

My second point is that many good people and good companies most certainly do exist in Russia, and in some of them we happily own stock. Unfortunately, the universe of such opportunities in Russia is not expanding, but shrinking.

Thus, it is time for us to take at least a part of our business elsewhere. I honestly pitched the Russian investment case for 13 years because I believed in it. Now, the Russian salesman inside of me is dead.

CHAPTER TWELVE

Sing When You're Winning: Two Decades of Corporate Governance in Russia

By Bernie Sucher

I think I first heard the term "corporate governance" in 1997. With the help of American and British investment bankers, the oil company Sidanco was trying to dilute minority investors through a convertible bond issue. One of those threatened, Hermitage Fund's Bill Browder, fought back. That first campaign wasn't as loud or slick as the ones that later made Bill's reputation, but somewhere in the din of the battle, someone added "corporate governance" to Russia's long list of failings.

The formal phrase may have been new to me, but by the time of that particular scandal, the wide, deep crevasse in expectations between Western investors and Russian owner-managers was territory with which I had become painfully familiar. Dilutions, asset stripping, secret EGMs, AGMs held in unmapped villages, the disappearance or murder of significant company officers—well, these things were not uncommon features of our business environment. Humans, perhaps especially humans who happen to be commercially minded, adapt pretty quickly to almost anything.

What I didn't understand even then (and I will admit that I still struggle with it today, years later) is why any investor would have expected anything else. I mean, for Chrissakes, this was *Russia*! Twenty years ago, the USSR was but freshly buried, and not a few people half-imagined its blood-soaked claws might grab at our ankles some night as we stumbled back from Rosie's. The country was broke. You counted up inflation every day. Hardly anything worked. When something did work, like the sole digital phone line at one of the world's largest oil companies, wannabe users queued for hours for a chance to make a call. People, especially older citizens, were dying from neglect and need in numbers that only a raging war should claim. There was hardly any relevant legislation, no enforcement or judicial institutions worthy of the name. You

expect, in such circumstances, that companies are going to govern themselves according to your international standards? Yeah, sure, that'd be *my* top priority, Mister.

To be fair, there was an underlying logic to the beliefs brought to Russia by pioneering representatives of the City of London and Wall Street. These people, first and foremost, thought of themselves as the winners of the Cold War. "The End of History" had just been written and Russia had to learn the rules of our game. Among those rules, like a law of physics, was that capital goes where it wants to. Even the most powerful man in the world struggled with this force. It was at this time that James Carville, a key architect of Bill Clinton's winning campaign to become America's first post-Soviet President, memorably exclaimed that if he could be reincarnated, he'd choose to come back as the bond market: "You can intimidate everybody!" Surely, then, Russia's destitute new corporations would get the joke: behave yourselves, and the West may just give you some money.

The problem, of course, was that Western investors were not putting their cash into anything that, from a Russian perspective, was useful. Book entry claims on a company's shares do not equip factories. Or repair pipelines. Or pump oil. Or feed a worker's family. "What investment are you talking about?" was the quite predictable Russian refrain. "Who are you coming here to tell me about your rights?" Thus Western theory and practice met Russian reality. We designed a stock market for a country without a reliable currency, without savings, without law. Russia was crying out for direct investment. Yet as our vanguard, we sent in portfolio investors, who by 1997, were looking for something that could be called good corporate governance. We could have done better.

A Normal Country?

The Soviet Union had fascinated me since my adolescence in Middle America, a child of families that had fled the Russians in the twentieth century's two great European conflicts. I'd studied the language and visited the USSR twice. Not because I loved the place, let alone ever imagined that I'd live there, but because I was certain that one day, we'd be at war. "Know thy enemy," said Sun Tzu.

Excellent advice, I am sure, but I failed to live up to it. Because, like most people, I was astonished when the Berlin Wall was torn down and amazed again when the Russians overthrew communism. I saw these

shocks as the historic miracles of my lifetime and asked myself, with such things happening, how could I abide an ordinary life? So in the spring of 1993, I gave up a great job at Goldman Sachs and a nine-year career in the financial industry to go to Moscow. I had no real plan beyond wanting to do something, perhaps charity work, to help Russians re-enter the planet's mainstream. The idea that I might be pitching in to start up a new Wall Street franchise on the Moskva never entered my head.

On a Thursday morning, a few weeks after my arrival, I'm sitting in the lobby of the Radisson Hotel. It's a scene that recalls the famous bar sequence from the original *Star Wars*. Except that no purple aliens are required—the locals are naturally outlandish. It's 10:30 a.m. and I am surrounded by gun-toting Mafiosi, drunken Asian suits, massive Texas oilmen. Every other one with what looks like a teenage supermodel in a cocktail dress or a disco outfit dating from the 1970s. In sharp contrast, opposite me, is an earnest young man, conservatively attired. He is trying to persuade me to join his tiny investment bank. Perhaps conscious of the wackiness about us, Ruben Vardanyan shifts forward and says softly, "I know this is not a normal country. Maybe it never will be. But if we build a normal business, and if other people do, too, maybe that's how Russia will become a normal country. Will you help me build a normal business?"

I am in. Just like that. I am more in than I have ever been into anything in my life.

Over the Cuckoo's Nest

In the land of the blind, is the one-eyed man truly king? I mean no disrespect to anyone, but it's quite possible that as vouchers and the first shares began to trade, for a year or more, I may well have been the only person in the local market who actually knew what he was doing. This, alas, was not at all helpful.

The math was simple and if greed is good, then Russia's voucher privatization was surely Mammon's masterpiece. Mr. Yeltsin's government had issued nearly 150 million vouchers and for most of 1993 they traded below USD 20. A whole country (the world's largest country, at that) thus had an implied market cap of less than USD 3bn. Naturally, any person with a speculative gene in their body gets long this trade.

But "trade" implies a deal struck within the context of some kind of system. And until the summer of 1994 when, like Moses bearing the

Tablets, Fred Berliner introduced an antiquated version of America's NASDAQ, there was nothing remotely routine, let alone systematic, about anything we traded. As a market professional with an understanding of the basics, and something of a reputation in the real world, I was frankly overwhelmed with the unknowns, the uncertainties, and the unmanageables. Was it legal for foreign investors to buy vouchers with dollars? Must our clients pay Russian taxes on gains? If they did, would we, as their nominees, be liable for the bill? How could non-Russians securely register ownership in shares from privatization auctions? And dozens more of the same.

Every day we shouldered up duffel bags of cash, our wares for trade at the bazaar in the old Moscow post office on Myasnitskaya. A million U.S. dollars isn't that heavy, but the 50,000 vouchers it typically bought meant 50,000 opportunities to own a forgery and a total of 450,000 digits to enter manually in triplicate into that evening's privatization register with GosImuschestvo. At least those transactions were settled. Physically. But for every moment of every one of those days, and for long months following the end of voucher trading stretching into late 1994, what weighed on my mind like a thousand of those duffel bags, was the anxiety that our investors would get nothing for their money. Or worse (much worse!) that other brokers would deliver 100% on their promises to their clients and that when the accounting was finally done, we would find that we alone had done it all wrong.

This period was my real introduction to corporate governance. I couldn't believe that respectable firms like CS and Solly were marketing this "investment" to their global clientele. Gosh, they couldn't even settle their trades, let alone determine the tax consequences! And the clients themselves? How, I wondered, can it be consistent with the fiduciary duty you owe to your investors to throw money into companies that you haven't researched (there was *no* research) or visited (management refused to see you), and which, in the first instance, the shares you hope to claim were "when issued" according to a policy that has never been tried before? Some of the players saw all of this with crystal clarity. They were veteran speculators, properly in their element. My guess, though, was that most of the suits could do what they were doing because they were either mendacious or clueless. Me? Both of my eyes were wide open. And I was scared to death.

How Dare You Do This To Me!

As history has recorded, the Russian State made good on its commitments—formal and informal—to Western investors in that initial wave of privatization. And given the bureaucracy's idiosyncratic demand for preserving paper-based records, it is likely that surviving in storage somewhere is written evidence that Troika Dialog's customer accounts balanced perfectly at the close of business, December 31, 1994. Conscious, all the same, of how near-run a thing it had all been, and fired even more by our shared commitment to "building a normal country," some of us made a long-term investment of a different kind. The rules of the trading game regularized (Troika campaigned for one precedent-setting law suit under the slogan "A deal is a deal"); RTS and NAUFOR became institutions, against which MICEX's stock market initiative later benchmarked itself; settlements and registration, however awkward the flow chart, stopped being an adventure long before the 1998 economic crisis. Others did much more, but I take pride in remembering how I contributed.

Today, I'll compete confidently with anyone to list Russia's—or the Russian securities' markets'—failings, but I see the industry's birth and development as a remarkable accomplishment upon which much more can be usefully built. Yet, the popular treatment of "corporate governance" in Russia retains its old capacity to get under my skin.

No, the general standard of governance among the country's listed firms is not good. But are Russian managers really behaving worse than those in other economies new to the market? I can't speak from extensive first-hand experience, but my educated guess is that gross violators are common in China, India and in many other countries. Russia, I think it plain, is measured by a yardstick different to the one applied to others. I am sure the reasons for this are very much rooted in the same Cold War mindset in which I was raised. It is not just that the Russians were The Enemy. It is that when the USSR abruptly dissolved itself, we Anglo-Americans let our expectations of Russia's possibilities soar. In the 1970s, Hedrick Smith wrote a wonderful book called *The Russians*. One of the observations he made there has since been repeated time and again. It is that we (the West) have a problem understanding the Russians because they look so much like us. If they were colored differently, or if their eyes were shaped more narrowly, we would not expect their behavior and values and aspirations to be just like ours. But by and large, the

Russians do look like us, and in 1991, free at last from communism, we expected them to want to be *just like us*. That chronic Russia equities discount? I say it is mostly a stubborn hangover from the policies and collective mentality that infused our stumbling embrace of Russian liberty in 1991 to our war with Moscow's last continental ally, Serbia, in 1999. We are still punishing the Russians for disappointing us.

All Together Now

There is of course much that the country can do, without outside reference, to improve governance. Indeed, slipping steadily behind its global competitors on most measures of performance, Russia has little choice but to address governance, in the broadest sense. As concerns corporates and the security market, unlike others, I believe that tangible progress is achievable even without real change in the fundamentals of a profoundly corrupt national elite. Now a decade into conditions of relative prosperity, the authorities have failed to take and persevere in initiative. Thus, among other perennial items on the old list, we can still see important open issues such as: mandating IFRS for all firms; enforcing existing exchange regulations on reporting and transparency; securing the rights of creditors; and substantial upgrading in the status and resourcing of regulators, particularly the Federal Financial Markets Service. None of this is really that hard, or expensive.

Within Russia, it is frustrating that the special interests of a few have stymied reforms that would yield massive benefits to so many. Those 1990s Western portfolio investors and the abstract benefits they were peddling are today, in a more sophisticated and globalized Russia, of much more obvious utility. The Russian equities discount is, in practice, a tremendous impediment to raising needed capital, and a steep tax on the cost of finance for the whole economy.

Perhaps, however, because I am an American, and so forever a guest in Russia, I am more deeply disturbed by international participants whose actions or policies inhibit the development of the Russian securities market. It is naturally too much to expect a portfolio investor in California or Massachusetts to take a hand in improving local trading conditions in countries to which they allocate funds. Nevertheless, could there not be some recognition that, when you buy without discrimination a basket of stocks which happen to be in an index, you are floating the boat of poor corporate governance actors, bad guys who are free-riding on

the rest of the community? Is it a coincidence that when the RTS is on one of its frequent world-beating bull runs, investors don't seem to be all that bothered about the country's allegedly rotten corporate governance? Why does the failure of investors to undertake proper due diligence of a shabby IPO, one led by a syndicate of mostly Western banks, inevitably become yet another "black mark" on Russia's record in capital markets?

With but a few notable exceptions, those same banks have an almost laughable track record in terms of their commitment to clients and staff in the country. Their almost universal failure to contribute meaningful resources to raising standards through the legislative process and their chronic absence in leadership within the industry's self-regulatory organizations is, alas, not the stuff of comedy. And how many respectable global players in the financial industry, along with their professional service firms who are their fellow-travelers, have lent their good names to practices, personalities or transactions that would fail every training class's basic standard, "How would this situation look if it was written up Monday morning in the *Wall Street Journal*"?

To me, the saga of Russia's most vigorous campaigner for better corporate governance, Bill Browder, illustrates harshly the failure of the investment community, particularly its foreign members, to live up to their rhetoric on higher standards. It is to be acknowledged that in highlighting a series of issues that crimped the market capitalization of Russian blue chip companies in his portfolio, Mr. Browder not only pursued his own commercial ends, but did so in a style that many disliked. That said, how many individuals who've given still another speech about Russia's shortcomings in governance can claim to have accomplished even one tangible remedy? Mr. Browder, along with a rare few activists such as Firebird and Prosperity, moved the needle. In fact, he and his team moved it farther than anyone else. What did Mr. Browder's peers do when the government, without explanation, banned him from the country? Well, worse than nothing. For some, Mr. Browder became a pariah, even a hate figure. Bad for business. Nor did the subsequent persecution into exile of the whole of Mr. Browder's Hermitage staff and many attorneys from its law firm—nearly all of whom are educated, aspirational young Russian family people like most of our own colleagues—impress the foreign investment community as a challenge connected to the cause of better governance. The apparent false arrest and murder in jail of Firestone

Duncan attorney Sergei Magnitsky? Well, tragic, but this has nothing to do with me.

Here, we get back to the still-beating heart of the matter. One may define corporate governance narrowly as the process by which a specific firm in which you have an economic interest is managed. I suppose there is some utility in this, even in emerging markets. In Russia, though, to accept this definition as your benchmark is to be, at best, myopic. And since we are talking about a country where listed corporate entities have been and are used as cover for very bad conduct, an arm's-length approach to the issues of governance may well make you a participant, however distant, in something worse. Some years ago, at Troika, I wrote, "As businesspeople, we come to work to make money. But in this country, in this time and place, our obligations to our larger community are unusually strong." This sentiment doubtless strikes many as naive, even stupid. I hold to it, just the same, and urge others to consider that the revolution that brought individual liberty to Russians in 1991 is not some dusty relic of history, but very much a work in progress.[1]

It is perhaps ironic that the most irrepressible actor in Russia's continuing revolution is business. Look about you at the stunning changes wrought in Russia these past two decades. How many were the gift of the Kremlin? Of civil society? Of popular initiatives from the People? By and large, the safer, wealthier, saner Russia we live in today is the way it is thanks to the reintroduction of business into the life of this country.

We are not politicians. We don't all need to be activists. And Russia wants no more martyrs. But as businesspeople, we have the influential power of example. Rendered in the usual way, "corporate governance" is one of the more boring topics imaginable. Yet if we accept the phrase instead as a professional challenge—to higher expectations, greater transparency, stronger standards, more forthright leadership—we acknowledge the responsibilities that society expects are commensurate with the rich rewards our industry often accrues. This country has been very good to most of us. We can do a lot better for Russia.

[1]Editor's note: Bernie's chapter was written in June 2011 and hence well before the Duma election in December 2011, and the subsequent protests over alleged election fraud that broke out in several cities across Russia.