NEW VOICES IN PUBLIC POLICY

Volume II
Fall 2007

Investment in Russia: Three Rules of the Game

Paul Fengler

Introduction by Professor John Petersen

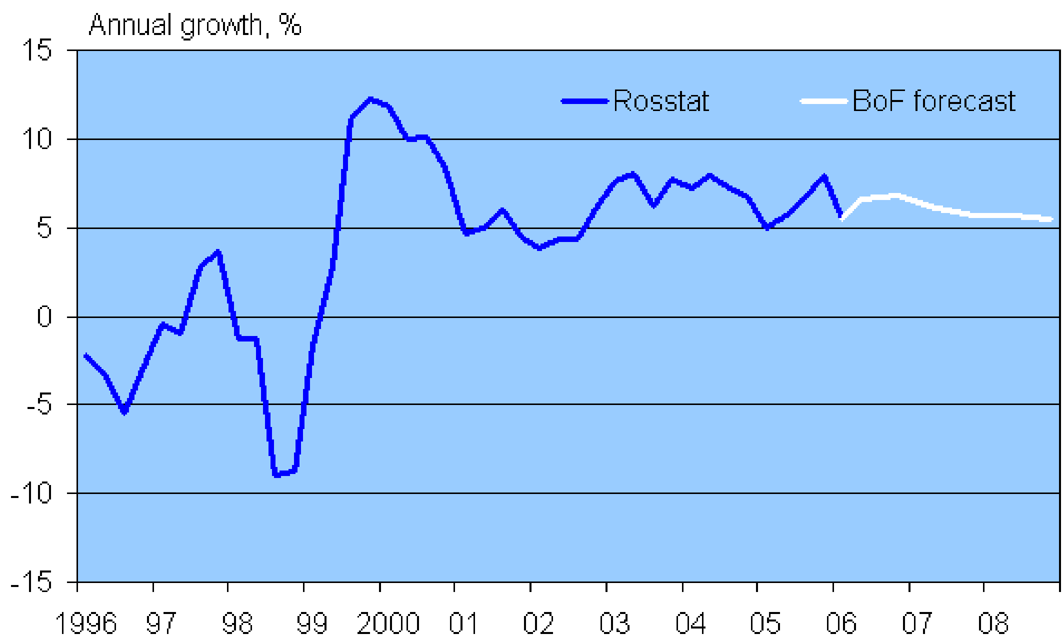
This paper was submitted for my ITRN 602 Class (Globalization and Financial Markets and Institutions). The assignment was for a brief paper (not to exceed 10 pages) dealing with developments in international finance that addresses a problem and discusses solutions. Fengler's paper neatly analyzes the issue of foreign investment in Russia, presenting three rules for such investors to follow if they want to avoid trouble. Each point is well documented and concise. Overall, the paper combines both good research and a lively presentation of useful information in a compact, disciplined space.

George Mason University | School of Public Policy

"**Russia is a bit of a rollercoaster. You don't know exactly what will happen tomorrow**." – Per Kauffman, IKEA, Russian Regional President[1]

Following the collapse of Communism, life became more difficult for most Russians. The rapid transition to a market economy led to economic havoc and social chaos, the policy of "shock therapy," delivered more "shock" than "therapy." In the wake, the emerging middle class and nascent democracy were superseded by mafia capitalism, a weak legal system and a shaky economic infrastructure. In the rush to privatize and democratize the country, large state-run monopolies became profit-driven, privately-run monopolies complete with oligarchs.[2] Matters were made worse by a wave of hyperinflation during the early 90's, which effectively wiped out many Russians' life savings. The result of these economic hardships was a country too poor to take advantage of its new capitalist system. The type of entrepreneurship that existed under the communist system involved circumventing the legal system, a practice that helped a few to profit like bandits during Russia's sudden swing into capitalism. Rapid and careless privatization further exacerbated Russia's fragile macroeconomic situation and the compounding weaknesses culminated in Russia's financial crisis of 1998.

Since Putin has taken over Russia's leadership, however, the country's economic future has begun to look encouragingly bright. Many positive trends cause speculators' pulses to race. Russia's oil and natural gas resources have stimulated the economy. Recent GDP growth has hovered between 4 and 10 percent since 1999 (see *Development of Russian GDP* chart on the following page). The country has now paid off much of its debt and can boast of having the third largest cash reserves in the world, topped only by Japan and China.[3] Salaries for the average Russian are rising at a steady rate, and consumer credit is becoming increasingly available. Finally, the ruble is strengthening against the dollar as a reflection of these positive changes. With all these negative and positive trends colliding, how does one make sense of this enigmatic country? In this brief paper, I present three important rules that major investors should follow in order to improve their chances of success in the Russian market. In fashioning these rules, I explore the murky rise of (and the problems associated with) Russia's notorious oligarchs, comment on the delicacy of investing in Russia's natural resources, and note that political dissent has no haven in the new regime.



Three Rules for Investment in Russia

Based on my research, when considering a major investment in Russia there are three rules that investors should follow. The rules can be summarized as follows:

1. **Tread carefully when dealing with industries considered "national champions" by the government (i.e. oil, natural gas and other important resources).**

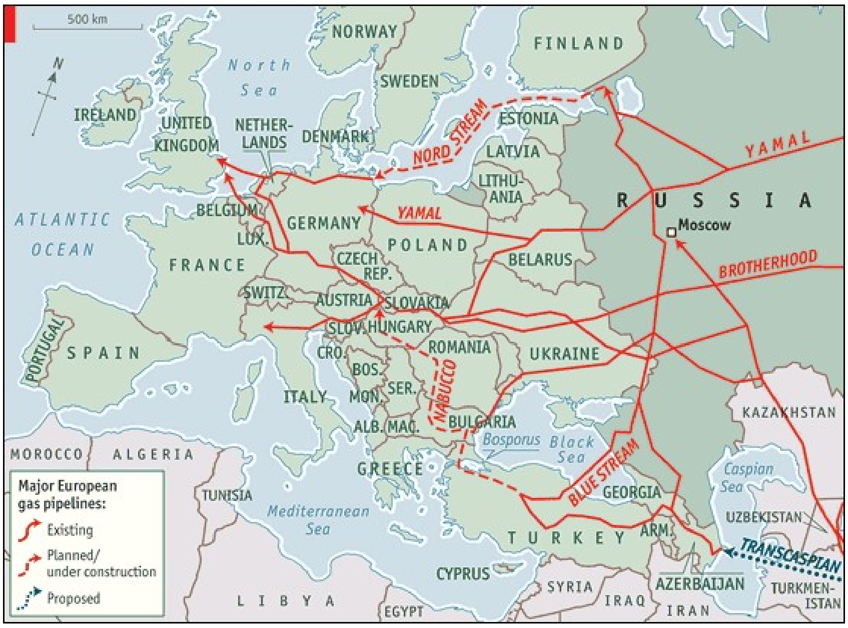
2. **Avoid partnering with a Russian partner who could be classified as an**

oligarch.

3. **Avoid commenting or actively participating in domestic politics.**[5]

Treading Carefully with Russia's Strategic Resources

The major reason behind Russia's recent strong economic growth has been the revenue from its abundant natural wealth of oil and gas. Its natural resources once helped finance Russia's command economy; now President Putin is using them to extend the nation's political influence. Gazprom, the jewel of Russia's energy crown, is a huge player and a government-controlled entity with contracts throughout Europe. Europe is well aware that it is currently too dependent on Russia for its natural gas, but there are few alternatives. Countries that have signed long-term gas-use agreements with Russia include Germany, France, Italy and most Eastern European countries. In addition to supplying natural gas to much of Europe, Gazprom has also begun investing in the strategic distributors of Europe's gas infrastructure. Examples include purchases of 35 percent holdings of the German distribution company, Wingas, in addition to major stakes in all of the Baltic Countries' principal distributors. [6] Gazprom owns large shares of Latvijas Gaze, Eesti Gaas and Lietuvos Dujos, the national gas storage and distribution company for Latvia, Estonia and Lithuania respectively.[7]



[8]

Russia understands that the main factor behind its economic boom is its natural resources. During the Soviet period these resources were used to provide cheap energy at below market prices to the Soviet Union's residents and finance an arms race with the United States. Now the arms race has been replaced with a race for political leverage and Putin is beginning to flex his country's muscles. Recent criticisms such as Putin's "The United States has overstepped its national borders in every way," are signs of confidence from the Kremlin.[9]

Royal Dutch Shell's venture on the Arctic island of Sakhalin highlights the problems foreign companies can face when investing in Russia's natural resources. The project in question is creatively named Sakhalin-2. So far, Shell has invested $20 billion in a natural gas project that is currently the largest integrated oil and gas scheme in the world. When completed, the project has the potential to meet 8 percent of the world's liquefied natural gas demand.[10] Currently, Russia is seeking to renege on a feasibility study that had allowed the project to proceed in the first place. Gazprom, the major Russian player in the agreement, had originally taken a 25 percent stake in the project in exchange for allowing Shell a 50 percent interest in

Gazprom's Zapolyarnoye gas fields (a separate natural gas project also located in northern Russia). After it was announced that the costs for Sakhalin-2 were much higher than anticipated, Gazprom has been trying to negotiate more favorable terms. If the negotiations break down, it seems the government will get involved to create technical or legal excuses to achieve their demands. In September of 2006 the Russian government did get involved, revoking environmental permits against Shell.

The issue centered on the sea in which the offshore drilling rig stands. The project's construction could potentially interfere with the local salmon population and a rare breed of whale. The move was greeted warmly by environmentalists who didn't understand that the true interests of Moscow were more political than environmental. It will be interesting to see how stringent the environmental examiners will be once Gazprom has a controlling stake in the project. While the consortium of Shell and foreign contractors were subject to public relations concerns and the need to secure loans from multi-lateral companies, Gazprom has no public relations worries.[11] Furthermore, Russian energy firms have hardly been role models for leaving small ecological footprints although they rarely invoke environmental penalties. The Sakhalin-2 example highlights the dangers of investing in natural resources with a government that makes up the rules of the game as it goes along.

Don't Partner with an Oligarch

In 1995, Boris Yeltsin was in a political struggle to keep Russia from returning to a command economy. The Communist Party was becoming increasingly popular and it seemed only a matter of time until Russia's four-year run with democracy would come to an abrupt halt. Yeltsin desperately needed additional funds to finance his campaign and help revitalize his prospects. The needed cash was raised through an infamous privatization scheme known as the loans-for-shares program. In the program, state assets were auctioned off at ridiculously low values to pre-selected bidders. In exchange for the low auction rates, many of these bidders donated or loaned large amounts of money to help finance the publicity and media coverage that secured Yeltsin's election victory. Many current and former Russian oligarchs were benefactors of the loans-for-shares program.[12]

The average Russian believes that these oligarchs cheated Russia out of its formerly state-owned natural resources that should be paying dividends to the country's citizens rather than profiting a handful of private investors and their rich shareholders. Recent tough actions against oligarchs by Putin and the Kremlin have been widely popular throughout Russia. Shortly after Putin's 2000 election victory he sent a sharp warning to the nation's oligarchs in his State of the Nation address stating "Russia can no longer tolerate 'shadowy groups' in the economy that divert money abroad, hire their own 'dubious' security services, and block the development of a liberal market economy."[13] Unfortunately many of these formerly privately owned companies are now in the hands of potentially corrupt government officials. This highlights the massive lack of transparency that exists in Russia's business climate today.

It is therefore advisable that foreign companies bent on investing in Russia make sure they know the people with whom they are making deals. Examples of oligarchs who have come under attack from the Kremlin include Mikhail Khodorkovsky (former top shareholder of Yukos Oil), Roman Abramovich (owner of oil company Sibneft) and Boris Berezovsky (top shareholder of AutoVaz and several large media companies and also involved in Sibneft), to name a few.

Avoid Commenting on or Participating in Domestic Politics

The plight of Mikhail Khodorkovsky demonstrates this final point well. Khodorkovsky was formerly the top shareholder of Yukos, the largest oil company in Russia. During Gorbachev's era of *perestroika* and *glasnost* in the late 1980s, Khodorkovsky began an import business of imitation high-class goods such as French brandy and vodka from Switzerland. The products allegedly originated in Poland and other Eastern European countries. The business provided the entrepreneur with enough capital to purchase foreign computers and then sell them back in Russia at incredible profits. Reselling Western goods, coupled with Khodorkovsky's knowledge of how to manipulate the former Soviet bookkeeping system that comprised dual accounts of cash and non-cash transactions, provided him with enough income to establish Bank Menatep by 1989.[14] Menatep, one of Russia's first privately-owned banks, expanded rapidly, allowing Khodorkovsky's import-export business to flourish. By the mid 1990s Khodorkovsky had become a rich man. Eventually he used his wealth to purchase 78 percent of the shares of Yukos Oil. It was through the loans-for-shares program that Khodorkovsky became the main shareholder of Yukos.

Like most of Russia's current oligarchs, Khodorkovsky was a sharp businessman who took advantage of a situation to profit from Russia's abundant natural resources. Khodorkovsky soon became one of the richest men in the world. As his wealth and power grew so did his political appetite. In 2003, Khodorkovsky began donating money for philanthropic causes and financed numerous political parties prior to the federal legislative elections. After several signs of what was to come, such as the arrest of Yukos's second largest shareholder, Khodorkovsky was arrested in October, 2003 on charges of tax evasion.

The case against Khodorkovsky is controversial and has both critics and proponents. The key point to his arrest is, however, that Khodorkovsky was a victim of selective persecution by Moscow. Despite the recent and popular implementation of a 13% flat tax on earnings, tax evasion remains a common practice to certain degrees by almost all Russian businesses. Economic laws are confusing, constantly changing and rampant with corruption.[15] Due to the massive amount of regulation and paperwork demanded by the government, it is relatively easy to persecute those firms that rub them the wrong way. In this case Khodorkovsky seemed to be aiming for the Presidency, coupled with his control of a strategic resource that many Russians feel was snatched up in the notorious loans-for-shares program. It was this combination that led the Kremlin to seek and eventually secure Khodorkovsky's arrest, which proved to be as popular within Russia as it was unpopular in the West.

Boris Berezovsky is another example of an oligarch who decided to interfere in Putin's politics. The decline of Berezovsky is arguably the most surprising of all oligarchs since it was he who helped secure Putin's appointment as acting President for an ailing Boris Yeltsin.[16] Once Putin was secure as Yeltsin's successor, Berezovsky went back to publicizing his opinions on cpolicy issues that often clashed with that of the Kremlin. His views, coupled with his heavy investment in the liberal media, made him a large target for the increasingly influential Putin. Investigations into Berezovsky's shady business practices began, and in late 2000 he fled to London, England, where he officially received political asylum in 2003.[17]

Of course, you don't need to be an oligarch to be persecuted for interference in local politics. Just ask Bill Browder, CEO and co-founder of investment fund Hermitage International. Browder is another example of how Putin does not play favorites. Browder has been a very vocal supporter during Putin's presidency and has often defended some of the leader's strong-arm measures. He had even implied that Khodorkovsky had it coming when he was sentenced by Moscow in 2003.[18] But first and foremost Browder is concerned with his fund and some of his comments finally engendered opposition from the Kremlin. It is widely believed that Browder was denied entry into Russia last year due largely to businessmen bribing local officials in order to blacklist him. The regulations used for indictment were point 1, Article 27 of the 1996 federal immigration law, which states that a foreigner may be denied entry "to safeguard military preparedness, state security and public order of the Russian Federation, or the health and safety of its citizens."[19] .

Browder is no average businessman. He happens to be the largest fund investor in Russia. His fund is heavily invested (over 2 billion dollars worth) in Russian stocks, including natural resource giants Gazprom and Surgutneftegaz. While he has defended Putin's practices and agrees with the punishments many of the oligarchs are now receiving for their shady practices he also has done a good job of exposing the corporate corruption in some of the companies in which he is invested. His aim is to improve these firms' behaviors and at the same time further increase their share prices. Some of his criticisms were directly against a national champion - Gazprom. His critique evidently reached the point where he was no longer welcome to invest in Russia.

Conclusion

For better or for worse, Russia seems to be arming itself for political leverage. This race for international influence is, however, fueled by oil and natural gas, rather than anti-ballistic missiles. Through various legislative measures Russia's abundant natural resources are being repatriated by the state from the oligarchs who snatched them up at bargain prices during the loans-for-share program. Recent events are almost a reversal of the rapid, and often reckless, privatization of the 1990s.

The good news for an investor is that there is much opportunity throughout Russia. The macroeconomic climate of Russia is improving each quarter and real wages and credit are becoming increasingly available. Interestingly, Russians have a love of displaying status through gadgetry and fashion, and so as credit increases, so does the potential for increased purchases of the latest cell phones, perfumes and designer jeans. The bad news is that if you are going to invest in the Russian market you had better follow the rules and be prepared to look the other way when corruption manifests itself. If you follow the three investment rules laid out above and are willing to hang on for the Russian rollercoaster ride, you may find yourself smiling at the end.

[1] "Dancing With the Bear: Want to make money in Russia? Here are some ground rules," *The Economist*, February 1, 2007.

[2] Stiglitz, Joseph. *Globalization and Its Discontents*. New York: W.W. Norton & Co., 2002.

[3] Kruger, Daniel and Min Zeng, "Currencies: Dollar Weakens as Russia is Set to Add Yen Reserves," International Herald Tribune, October 17, 2006.

[4] Bank of Finland. "Development of Russian GDP 1996-2008." http://www.bof.fi/NR/rdonlyres/7331A96C-198D-4CEB-9021-6AFCC828229B/0/BOFITforecast_02_06.gif

[5] "Dancing With the Bear: Want to Make Money in Russia? Here Are Some Ground Rules," *The Economist*, February 1, 2007.

[6] "A Bear at the Throat," *Economist*, April 12, 2007.

[7] Collier, Mike. "Baltics: Island in a Storm." Transitions Online. October 30, 2007. http://www.tol.cz/look/TOLrus/article.tpl?IdLanguage=1&IdPublication=4&NrIssue=242&NrSection=4&NrArticle=19115.

[8] "A Bear at the Throat," *Economist*, April 12, 2007.

[9] Ricks, Thomas and Craig Whitlock, "Putin Hits U.S. Over Unilateral Approach", *Washington Post*, February 11, 2007.

[10] Stepek, John, "Royal Dutch Shell's Trouble with Russia," *Money Week*, September 6, 2006.

[11] "After Sakhalin," *Economist*, December 13, 2006.

[12] Hoffman, David. *The Oligarchs: Wealth and Power in the New Russia*. New York: Public Affairs, 2002.

[13] Starobin, Paul and Catherine Belton, "Boris Berezovsky: Tycoon Under Siege," *European Business* (International Edition), July 24, 2000.

[14] Hoffman, David. *The Oligarchs: Wealth and Power in the New Russia*. New York: Public Affairs, 2002.

[15] Mironov, Maxim, "Economics of Spacemen: Estimation of Tax Evasion in Russia," (PhD diss., University of Chicago, unpublished, 2006).

[16] Starobin, Paul and Catherine Belton, "Boris Berezovsky: Tycoon Under Siege," *European Business* (International Edition), July 24, 2000.

[17] "Russia Presses UK on Berezovsky," BBC News, April 16, 2007, http://news.bbc.co.uk/2/hi/europe/6559551.stm

[18] "An Enemy of the People: The Sad Fate of a Loyal Putinista," *The Economist*, March 23, 2006.

[19] Schreck, Carl, "The Businessmen Who Were Barred From Russia," *The St. Petersburg Times*, August 8, 2006.