



## BRIC Spotlight Report

### Oligarchs: The First Russian Capitalists

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**T**he story of the oligarchs – Greek for “the few who rule” – is, in fact, the story of the birth of Russian capitalism. The triumphs and failures of these aspiring businessmen marked the emergence of an unruly brand of Russian capitalism, born out of the embers of Soviet Communism. These men lived very ordinary lives in the Soviet Union of the 80s. But what set them apart was the ability to adapt and manipulate the system to achieve their goals. The oligarchs rose to prominence during the Yeltsin era, becoming owners of big raw materials and energy companies, only to find their wings clipped during Putin’s presidency. Some of them are known for their ostentatious displays of wealth, owning baseball and soccer clubs, luxury

#### Fast Facts

- The emergence of Russian oligarchs marked the birth of Russian capitalism after the collapse of the Soviet planned economy.
- The oligarchs rose to prominence during the Yeltsin era by becoming owners of some of Russia’s biggest raw materials and oil companies.
- The oligarchs soon became unpopular as they began to undermine shareholder interests and manipulate the system to achieve their goals.
- When Putin came to power, he clipped the wings of some of the prominent oligarchs such as Yukos owner Mikhail Khodorkovsky. However, Putin has had his favorites among the oligarchs.
- Oligarch-run companies are not the best examples of corporate governance, with episodes such as the TNK-BP tussle and the Telenor-Alfa Group stand-off vitiating the business climate in the country.
- Many oligarchs lost much of their fortune when the financial crisis struck in the second half of 2008. Thanks to improving commodity prices, some of them have bounced back, now among the top billionaires in the country.
- Of late, the Russian administration has begun promoting state-run companies in crucial sectors such as energy.

villas, and yachts. Badly hit by the recession when the value of their collateral for bank loans eroded sharply, the recovery in energy and commodity prices has helped many of them turn around.

### **The Emergence of the Oligarchs**

Mikhail Gorbachev presided over the disintegration of the Union of Soviet Socialist Republics toward the end of the 80s, introducing some political and economic reforms which were christened *Glasnost* (openness) and *Perestroika* (restructuring). Gorbachev was not a big fan of the authoritarian use of state power, which had characterized the Soviet-era governance. At the same time, he was neither an advocate of private ownership nor a proponent of free market enterprise. And Gorbachev did not succeed in reconciling these two opposed points of view, which resulted in the collapse of the centrally-planned economy with no private enterprise to replace it.

The liberalization of the Russian economy in the late 1980s and 1990s helped the higher-ups in the Communist Party, KGB, and Soviet Youth League to cash in on their clout, which they had acquired during the Soviet days. Some sold off their capital assets and parked the money in bank accounts abroad, while some managed to bag government contracts and licenses through their influential contacts. Some of these people managed to secure loans and government supplies at subsidized rates and made a fortune by selling them at prevailing market rates.

Around the same time, a few young entrepreneurs, without much of a *locus standi*, thought they could take advantage of this chaotic transition period. During 1987-1992, these pioneering entrepreneurs would amass considerable wealth from natural resources trading and foreign exchange transactions. They filled their coffers by importing consumer goods to cater to the huge domestic demand and then turned around to locally produce copy-cat substitutes. Some of them established banks to lend dollars at very high interest rates to businessmen who wanted to import foreign goods.

By the mid-1990s, the formerly well-connected accumulated considerable financial resources, while the newly emerged clique of entrepreneurs developed a rapport with government officials and politicians.

After Gorbachev resigned in 1991, Boris Yeltsin, who became the first president of the Russian Federation, initiated privatization of state enterprises toward the mid-90s. This was an opportunity for those who had amassed wealth in the early 90s to convert their cache into shares of privatized enterprises.

In a move intended to drum up popular support for his reforms, Yeltsin decided to distribute

ownership of shares in state companies to Russian citizens. The government introduced a system of free vouchers to kick-start the process. Apart from issuing free vouchers, people were also allowed cash purchases of shares. The system of issuing free vouchers to the general public proved to be a complete failure, as individuals who had the cash to buy them out snapped these shares up within months.

When cash privatization eventually replaced the failing voucher privatization phase, the government came up with a scheme to leverage the privatization process and quickly raise money for its cash-strapped operations. Under the “loans for shares” program, the administration sold off majority stakes in some of its prized companies in the energy, telecommunications, and metallurgical sectors in exchange for loans taken from the new private sector banks owned by rich businessmen. According to the terms of the loan, the lender could stake equity ownership in the company if the government failed to repay the loans by September 1996.

Auctions conducted under the “loans for shares” program were executed in such a way that only the few businessmen who owned these banks were allowed to partake in auctions. Following these bogus auctions, the majority stakes in some of the biggest Russian companies were acquired by a small number of major banks at abysmally low prices. These businessmen also bankrolled Yeltsin’s 1996 presidential election victory, exerting their influence over the then president.

While oligarchs such as Mikhail Khodorkovsky could lay their hands on some of Russia's most valuable companies at bargain prices, some other assets were also given away under sham proceedings. For instance, Russia's second largest oil company, Yukos, was purchased by Menatep, the bank owned by Khodorkovskysy, for \$300 million. Norilsk Nickel, one of the world's biggest raw materials companies, was bought out by Vladimir Potanin.

The influence of this crop of neo-rich businessmen extended to the mass media as well. Boris Berezovsky, who had significant stakes in several banks and companies, acquired control over state television. The likes of Vagit Alekperov, Roman Abramovich, Vladimir Potanin, Vladimir Bogdanov, Rem Viakhirev, Viktor Chernomyrdin, Viktor Vekselberg, and Mikhail Fridman soon appeared on the list of country’s prominent oligarchs. Alexander Lebedev, who recently acquired London’s premium newspaper, *The Evening Standard*, also figures among the prominent oligarchs, with stakes in national carrier Aeroflot, Sberbank, Gazprom, and Unified Energy System. He was ranked the 39<sup>th</sup> richest in the country by Forbes in 2009.

However, these well-connected individuals, who managed to appropriate Russia's vast resources, soon were also on the nation’s list of most hated men. The Western world, which had endorsed the quick dismantling of the Soviet planned economy hoping it would usher in free-market reforms, became disillusioned by the corruption and high-handedness of the oligarchs. The newly emerged crop of powerful business tycoons also set a bad example of corporate governance in Russia by not disclosing proper information to investors and abusing minority shareholder rights.

## **A love-hate relationship?**

Vladimir Putin's accession to power marked the beginning of a new phase in the history of the oligarchs. Putin was determined to free the state from the clutches of the oligarchs who had grown so powerful they manipulated the legislative process. The new president began by seizing the assets of some oligarchs such as Boris Berezovsky and Vladimir Gusinsky, forcing them to flee the country. Though Berezovsky helped Putin come to power, the new president targeted the oligarch's television station soon after. Gusinsky antagonized the government when his NTV television station adopted an anti-government stance. After Gusinsky went into exile, his television station was taken over by state-run Gazprom.

However, the Yukos episode marked the most infamous appropriation in Russian corporate history. Michael Khodorkovsky was the owner of Yukos, the then biggest Russian oil company. Apparently, he had political ambitions and used to fund the Russian Opposition parties. Suspicious of Khodorkovsky's growing clout, the Russian administration slapped improbable tax claims and fraud charges on him, leading to his arrest on October 25, 2003. Pushed against the wall, the company ultimately filed for bankruptcy, and most of its production facilities were auctioned off to Rosneft, the state-backed oil firm. However, some European courts have ordered injunctions and have ruled against Rosneft recently.

Along the way, the Russian administration has had its personal favorites and adversaries among the oligarchs. Last year, the prime minister publicly chided UC Rusal owner Oleg Deripaska for closing down a factory. But few knew that the Russian administration had already helped bail out the debt-laden aluminum company and had asked state-owned bank VEB to invest in Rusal's Hong Kong IPO. The bank also extended a \$4.5 billion loan to Rusal for another year.

Apart from Deripaska, the State has helped many other Russian firms, which had accumulated huge foreign debts during the boom years. State-run banks were directed to bail out some of these indebted companies.

Blowing hot and cold, Prime Minister Vladimir Putin recently castigated some of Russia's biggest tycoons in the electricity sector for not investing back into the industry. The premier singled out Vladimir Potanin, who controls OGK-3, Mikhail Prokhorov, the controlling shareholder of TGK-4, Viktor Vekselberg, who owns Complex Energy Systems and Leonid Lebedev, who controls TGK-2, for not upgrading production capacity after the privatization of plants two years ago. Putin threatened to slap huge fines on them and deny their companies access to liberalized electricity markets.

President Dmitry Medvedev has also openly chastised the oligarchs on many occasions, going to the extent to say "they did nothing but sell raw materials."

## Oligarchs' Debt Position

Russian oligarchs, who had gone on a borrowing spree during good times, were hit when the recession struck in the second half of 2008. Some of them are now looking to restructure their debt, which has put the Russian state in a position to increase its control over the economy.

Oleg Deripaska, Russia's aluminum, construction, and car industry magnate, ranked as the country's richest man in 2008. But the debt-laden tycoon lost \$25 billion of his wealth in 2009 as commodity prices tumbled, reducing his net worth to \$3.5 billion. Aided by the Russian government, he managed to restructure a portion of his debt, thanks to more than \$2 billion in proceeds raised from the Hong Kong IPO of his UC Rusal aluminum company.

Oil-to-real estate tycoon Shalva Chigirinsky also lost a substantial portion of his assets during 2008 as the Russian real estate market collapsed. To repay his debt, Chigirinsky had to pledge his stake in his London-listed oil firm Sibir Energy to Sberbank. However, the lender has apparently sought a change of ownership for the oil company.

Mikhail Fridman, German Khan, and Viktor Vekselberg, the oligarchs who own the TNK-BP joint venture, escaped relatively unscathed from the crisis compared to other oligarchs. Fridman's Alfa Bank, however, was availed a \$3-billion state loan to repay debt taken against its stake in telecom firm Vimpelcom.

Among Russia's steel and metal czars, Igor Zyuzin of Mechel and Severstal's Alexei Mordashov have cobbled together a proposal to merge a number of metals firms in an attempt to retain the foreign assets they amassed in the boom years. Some of the smaller players in the sector which received state assistance to repay their foreign debts may lose stakes in their firms to the Russian state if they fail to pay back the loans.

Coming to the country's dominant oil sector, tycoons such as Vagit Alekperov from LUKOIL and Vladimir Bogdanov from Surgut managed to steer clear of any major debt and are on the lookout to acquire companies which have lost much of their market value. For instance, in April 2009, Surgut bought a stake in Hungarian oil company MOL for 1.4 billion euros, the latest in a series of investments backed by the Russian government to acquire European energy assets.

However, some oligarchs managed to escape the crisis by sheer luck. Mikhail Prokhorov, with \$9.5 billion in assets, and Roman Abramovich, who owns the Chelsea soccer club, with \$8.5 billion in assets, cashed out before the financial crisis struck. Being cash-rich in lean times, they have been able to scout for distressed assets which were available on the cheap.

Some of the oligarchs have managed to bounce bank, thanks to the turnaround in the global economy and improving oil and commodity prices, as the table below shows. The number of billionaires living in the country has nearly doubled to 62 in 2010, according to *Forbes* magazine.

## Back Among Riches

| Rank | Name              | 2010  | 2009 | Company           |
|------|-------------------|-------|------|-------------------|
| 1    | Vladimir Lisin    | *15.8 | 5.2  | Novolipetsk Steel |
| 2    | Mikhail Prokhorov | 13.4  | 9.5  | Onexim            |
| 3    | Mikhail Fridman   | 12.7  | 6.3  | Alfa-Group        |
| 4    | Roman Abramovich  | 11.2  | 8.5  | Millhouse         |
| 5    | Oleg Deripaska    | 10.7  | 3.5  | UC Rusal          |
| 6    | Vagit Alekperov   | 10.6  | 7.8  | LUKOIL            |
| 7    | Vladimir Potanin  | 10.3  | 2.1  | Interros          |
| 8    | Alexei Mordashov  | 9.9   | 4.3  | Severstal         |
| 9    | Viktor Rashnikov  | 9.8   | 2.5  | Magnitogorsk      |
| 10   | Dmitry Rybolovlev | 8.6   | 3.1  | Uralkali          |

\*Fortune (in US\$ billion) Source: Forbes magazine

## Oligarchs undermining foreign investment in Russia

Some of the oligarch-run companies have tie-ups with foreign partners to expand the scope of their businesses and help harness foreign capital. While the Russian State claims it remains impartial regarding the way businesses are run in the country, it is a fact that some oligarch led partnerships have gone sour, making potential foreign investors wary. For example, TNK-BP, the joint venture between BP and Alfa Group, has run into rough weather over differences of opinion. After the BP-backed chief executive left Russia amid regulatory pressure, the British company agreed to give up some influence while maintaining its shareholding.

On a similar note, Norwegian state-owned telecom firm Telenor and its Russian partner Alfa Group, fought a five-year boardroom battle. The high-profile case also resulted in the seizure of most of the company's investments in Russia. Fearing a loss of face, Telenor agreed to terms set by the Alfa Group and combined its Russian and Ukrainian telecom assets with its major partner. Both the companies own stakes in OAO Vimpelcom.

A major dent to foreign investment in Russia, U.S. oil major ConocoPhillips recently decided to halve its 20% stake in third largest Russian oil firm Lukoil, headed by Vagit Alekperov. Conoco's debt would have been the catalyst for the move, but the decision could also have been prompted by the shifting power equation in the Russian energy industry in favor of state-run companies.

## **The Russians are Coming**

After a brief interruption during the financial crisis, some Russian firms are planning \$20 billion of stock sales in the next one year to leverage investor interest in emerging markets.

Although Rusal's Hong Kong IPO managed to raise over \$2 billion, the company's share price has fallen almost 30% over the past three months despite the steady increase in aluminum prices. However, Rusal's poor showing may have more to do with the company's huge debt and outlook. Interestingly, the regulator allowed the listing, but no retail investors were allowed to participate. Undeterred, Deripaska is planning to raise up to \$1 billion in Hong Kong shortly, by listing power firm En+ Power, which operates 14 power stations with a total capacity of 19,500 megawatts.

On a similar note, Russian tycoon Viktor Vekselberg, a prominent shareholder in UC RUSAL, is planning to take his mining firm Kamchatka Gold public in Hong Kong shortly. Some of the oligarchs may find Hong Kong attractive since the conditions for listing there are less restrictive, with the debt-laden RUSAL serving as a case in point. Moreover, Hong Kong is a well-placed link between Russian resource companies and China, the biggest importer of Russian output.

Still, a group of Russian oligarchs are planning multibillion-dollar listings in London, a market appealing to those companies with better fundamentals and governance standards. This may be a clear signal that London remains the favored market for the country's business magnates as they emerge from the crisis. London has some distinct advantages as it has an established investor base, less volatility, and holds the charm for Russians, culturally and geographically. Among the planned London listings are Alisher Usmanov-owned Metalloinvest, SUEK, a coal company owned by Sergey Popov and Andrey Melnichenko, and ProfMedia, controlled by Vladimir Potanin.

However, many Russian IPOs in overseas stock exchanges, especially London, have displayed dismal returns so far. Despite being the biggest Russian oil producer, oil giant Rosneft's public issue on the London Stock Exchange in 2006 has returned a meager 6.4%, as of March 2010. Other IPOs such as VTB Group and PIK Group were no different. The performance of these stock offerings seems to have been affected by the structure of Russian IPOs themselves. Many, such as the UC Rusal IPO, put restrictions on ownership and most of these firms floated less than 20% of their shares on average.

## **The Making of Russia Inc.**

The Yeltsin-era oligarchs are no longer the dominant force in Russia, increasingly being replaced by Putin's former colleagues in the KGB, who often double up as government ministers or senior Kremlin officials. The new "oligarchs" have conveniently formed a marriage of

economic and political power. For instance, Dmitry Medvedev, who succeeded Putin as President, was the chairman of Gazprom. Igor Sechin, the influential current deputy prime minister, is now the chairman of Rosneft, Russia's largest oil producer.

Most of Russia's industrial production was controlled by some influential business groups when Putin became the Russian President in 2000. Despite the infamous Yukos episode, which saw the state interfering blatantly in business affairs, a group of businessmen close to the Kremlin still continue to manage important state assets to further their own self-interests.

There is only a thin line which separates the bureaucracy and private assets in Russia. The ubiquitous firms, christened state corporations, handle public assets as their own, amass profits and do not disclose information to the public. Sergei Chemezov, a friend and former colleague of Putin in the KGB, for instance, is the man-in-charge of Russian Technologies, the holding company for 500 companies owned by the state.

The Russian administration under Putin made the Yeltsin-era oligarchs fall in line, driving home the message that they held their assets at the Kremlin's pleasure. Putin, over the two terms of his presidency, had deftly followed the policy of using state businesses to re-establish Kremlin control of strategic assets. Rosneft's purchase of Yukos' main production arm in 2004 and Gazprom's acquisition of Sibneft from the U.K.-based oligarch Roman Abramovich are examples of re-nationalization of assets privatized in the loan-for-shares scheme. Similarly, the Russian government recently decided to combine most of the state aviation assets with the flagship carrier Aeroflot to increase its stake in the airline.

The increasing role of the state in business affairs, however, does not reflect a return to the Soviet-era days when all economic decisions were made by the central planners. The Russian administration has acknowledged the influence of the market forces in shaping up businesses. In September 2009, Prime Minister Vladimir Putin announced the launch of a fresh privatization drive in a luncheon meeting, with some of the big sovereign wealth funds and money managers participating. The privatization agenda seems to have been a well thought-out strategy by a Russian government, which desperately needs foreign capital in the aftermath of the financial crisis.

Despite pushing for privatization, Putin was quick to point out that state-run Gazprom will remain the natural gas monopoly for years to come. The Russian finance minister, who said the government shareholding in VTB will be reduced, was quick to add that its stake in the state-controlled bank won't be brought below 50 percent over the next five years. The dichotomy between words and action is evident in the manner in which the administration has gone ahead with consolidation in the strategic oil and natural gas sector, prompting at least one foreign partner to reduce its stake in one of the oil majors.

Yet, the Russian state still holds a 60 percent controlling toehold over the \$1.3 trillion Russian economy, an influence which is likely to hamper economic growth. Russian bureaucrats liken themselves as guardians of public wealth, protectors who have pulled assets away from private “fat cats”. Worse still, judges in Russia think they are doing the right thing by favoring state interests in corporate law suits.

The Russian government may have done the right thing by reining in the 1990s-era oligarchs, who had distorted competition and discarded all business ethics. However, by not separating political and business interests, the move has resulted in the creation of a new class of politically connected business people. It is anybody’s guess to what extent these businessmen will go to cling on to their newfound influence and riches, putting the country’s economic development at risk. 🌐

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