

# Truth and Beauty...

## (and Russian Finance)

### *Of Tempests and Teapots*

#### *Khodorkovsky rides out against the State?*

*A number of our investors have expressed serious concern about the supposed sudden unraveling of the historic truce between the Russian oil companies and the government. Rumours are swirling: bands of rebel oilmen have taken control of outlying Russian regions, the Kremlin is surrounded by oligarchs and their henchmen carrying pikes and siege machinery, angry investors are burning aristocratic homes in Moscow... Unhelpfully, amidst the turmoil, one local brokerage has reminded us that Russia is "still an emerging market"...*

*T&B believes that there is a great deal more smoke than fire...and we believe that some of the supposed provocative remarks made by Mr. Khodorkovsky were misinterpretations arising from problems with translation.*

#### ***THE PROPHET, MISQUOTED***

One wire service carried a report from the Moscow Times essentially stating that in a 3-minute interview on NTV last night, Khodorkovsky had threatened to cut off oil supplies to the Russian regions. Had he said anything of the sort, it would have suggested war! (indeed, to say so publicly would also strongly suggest that the oligarch had gone barking mad...)

Fortunately, having checked, we see no indication that he made any such threat.

In the interview, Khodorkovsky stated that Yukos was the largest energy supplier to much of Russia, and that they had responsibilities - but that the authorities should understand their responsibilities, too.

We believe that “the responsibility” that Khodorkovsky was referring to was in the social sphere. The “social sphere” in Russia refers to all of the benefits which are provided by major companies in their areas of operation. This includes clinics, rest homes, kindergartens, holiday camps, etc. It does not include the provision of energy.

Had Khodorkovsky gone on television directly threatening to cut off energy supplies to Russian regions, this would have been an outright challenge to the legitimacy of the government; it is fair to assume that the Russian press would have noticed! Other than the above-mentioned article, there was no mention of any such threat in any Russian media today. Tired and under pressure, Khodorkovsky is adopting a fairly combative tone, asking Putin to become involved in the fight between himself and the government. Putin, of course, while controlling the process, will publicly abstain (to become openly involved in this fight right now would simply look like he were supporting a rapacious oil company against the interests of justice).

T&B also sees something of a double standard here. What Khodorkovsky did say in his interview was that the behavior of the General Prosecutors office and the FSB was akin to that of bandits! For those who remember, the last time T&B used the b-word about one large Russian oil company (which Yukos has just bought), it created all sort of turmoil, eventually resulting in the opening of some new career perspectives. We wonder if the FSB is going to phone up Khodorkovsky’s boss to try to get him fired, too!

**NOTE: As we go to press, the Yukos press secretariat has used terms not reprintable here to characterize the MT’s interpretation of their boss’s comments. They have reiterated to our analyst that Khodorkovsky did not threaten to cut off the oil to anyone!**

### ***So, THEN WHAT IS REAL, AND WHAT IS NOT?***

“July,” as one journalist friend lamented, “is supposed to be the dead season here.” This July has been anything but!

In the past week we have seen a Duma resolution passed calling for an in-depth tax investigation of the Russian oil majors. T&B remains convinced that a couple of deputies went short the blue chips!

Sibneft, typically, is the most controversial of the bunch, having somehow managed to pay an effective tax-rate of 12%, as opposed to the statutory 24% (we assume by domiciling its trading companies in tax havens.) Sibneft’s President (and new “Chelski” board member) Evgeny Svidler has been called in for questioning by the Prosecutors office (perhaps they are just looking for free tickets to the next Chelsea game!), as has Khodorkovsky himself. Lukoil is on the watch-list, Lebedev is still in jail, the Russian market no longer seems a one-way bet, and yet T&B seems relaxed, bemused and not in the least worried... Why?

We reiterate our recently expressed view that this whole *scandale* is a warning to the oligarchs to get back into line and stop meddling in politics. Perhaps, as a secondary benefit, those whose interpretation of the tax laws has been overly generous (to themselves) will be encouraged to contribute a bit to the Federal Budget. Given the often-repeated idea that natural resources should be taxed more heavily to allow a tax break for smaller business, it is perhaps not such a bad idea to bring their tax payments up to the average...

### ***“GREED IS GOOD” – BUT IN REASONABLE DOSES, PLEASE!***

There is an election coming up, and while Putin himself could probably win against the personal candidate of God the Father, the Duma election is by no means a shoo-in. The oligarchs are playing a dangerous game by supporting anyone in opposition to Putin as a means of pressuring the government. Were they to “succeed”, they would find themselves facing a far, far worse situation than what confronts them today. That is precisely what Mr. Gref was hinting at when, mildly criticizing the government’s heavy-handedness in the Yukos raid, he reassured the oligarchs that they had nothing to fear, **for so long as the current team remains in place...**

The oligarchs are, as is usual for their breed, showing total indifference to the greater good, not only of Russia, but even of their own narrow interests. It is somewhat reminiscent of the 1997 fight over Svyazinvest in which Gusinsky et al were quite happy to destroy the entire edifice of Russian governance as revenge for being deprived of what they felt was their fair share of the booty. By the end of the fight, the “Young Reformers” were history, the Yeltsin government was hopelessly split, and the Communists were resurgent.

The interest of Khodorkovsky and his ilk in “Russian liberalism” seems self-serving at best. They would no doubt support any system of government known to man, provided that it allowed them the prime place at the kill. They are trying to take advantage of the upcoming elections to snatch some prized plums: oil pipelines, gas fields, export contracts, etc. We doubt that Putin feels very much like playing Santa Claus, and some oligarchs may find their stockings stuffed with coal!

### **ONWARD, INTO A SHINING FUTURE**

The market has now dropped a good 10% on the turmoil. Khodorkovsky is trying to put forth a story that the attack on Yukos was lead by a supposed FSB faction within the government, which is trying to renationalize property – this faction is said to include various Putin loyalists, including Viktor Ivanov, Igor Sechin, and Nikolai Patrushev. We remain deeply skeptical; while they are probably involved, it is most unlikely that they would have tried anything this high-profile without the clear consent of the President. Putin clearly works by making certain that no one faction is totally ascendant. We believe that the oligarchs have shown culpable and truly extraordinary hubris, and are now facing the inevitable consequences – rather mild, all things considered...

A number of observers have most bewilderingly opined that the defeat of Khodorkovsky and his ilk in the current fight would mean a major setback for Russian reform. This view strikes us as singularly clueless! In order to continue with – indeed, to accelerate reform – Putin desperately needs a strong pro-Kremlin majority in the Duma. If the “liberal” vote is split amongst a welter of small parties, there will be no solid majority – the new Duma will be reminiscent of its 1996 predecessor – a talking shop where a gaggle of free-lance deputies sell their votes to the best bidder, while the KPRF systematically obstructs any substantial progress. On the other hand, a landslide victory of the Kremlin-backed party would be a boon for Russian reform. Skeptics are reminded that, in the first 3 years of Putin’s regime, we have seen more real reform than at any time since Peter the Great; whatever the short-comings, the reform process has to be reinforced, not reversed: turning the state over to a government of the oligarchs would constitute a major step backwards.

### **BUY / SELL / HOLD?**

From the investor’s standpoint, it probably depends upon time-horizon. The next few weeks will likely be marked by a good deal more volatility. Contradictory stories will be circulated, outrageous statements will be issued, worrisome bills will be passed by some bent legislators and everyone will cry out for “divine intervention.” Mr. Putin will sit back and quietly watch... of course, in the end, it will all blow over. Putin will not drill for oil. Khodorkovsky won’t play politics. Investors will live happily, as economic growth goes from strength to strength. In the meantime, at least one local institution is greatly enjoying the flight out of the suddenly-controversial blue chips into the undervalued second-tier. Ufaneftekhim, anyone?

#### **Rapacious**

Russian law requires that any party acquiring 30% of the shares in a company must offer to buyout the remaining shareholders. This requirement can be lifted by a vote of 50% of shareholders (who make it to the shareholders meeting) excluding any related parties. Given that Millhouse Capital & other Sibneft majorities own more than 75%, Sibneft is continuing in its great tradition of making a mockery of investor interests by calling for a vote to lift this buyout requirement.

An interesting aside: ever since the trouble started, Gazprom has been tanking, this despite the fact that it is one of the few oil companies to be totally unaffected. Some unidentified big local buyers have stepped off the bid. Perhaps Yukos has other things to worry about...

## ***UNDER THE MACROSCOPE***

### **The global markets are currently bewildered.**

The back-up in US bond rates has been spectacular. Global fixed income markets have been crushed – especially in Japan, where rates on 10-year JGB have doubled. European bonds have also been hit hard (despite the absence of any signs of economic recovery). While this sell-off initially benefited the equities, these now appear to have lost momentum and are drifting down on the back of weak economic indicators. Meanwhile, the dollar is totally becalmed, while the economic numbers continue to come in soft, making a mockery of the expected US rebound. What is going on?

T&B believes that one of the factors at work could be a delayed effect of the change in the US tax code. By cutting the rate of taxation of stock dividends AND capital gains to 15% while bond dividends are taxed at up to 36%, a very unlevel playing field has been established. Investors have rushed to sell bonds in order to purchase high-yielding equities. A large part of the fixed income portfolios were foreign assets – US funds have been selling down these positions, repatriating the proceeds to redeploy in equities, while taking profits on their currency exposure.

One further factor explaining the collapse in treasuries may have been less support from Asia. Asian central banks are reportedly buying fewer bonds, while Japanese investors have been selling foreign bonds to cover huge losses in the JGB market. In any event, given that bonds continue weak despite increasing signs of deflation and the absence of any strong growth indicators, it is obvious that some technical factor is at work, rather than a revolution in economic expectations.

Arguing against our interpretation is the fact that low-yielding NASDAQ stocks have actually outperformed their stodgier dividend-paying peers – perhaps this is a function of the decreased taxation of capital gains (or perhaps - as T&B has long suspected - equity markets are simply not entirely rational).

Obviously, this shift is decreasing two of the supposed motors for US economic rebound: the falling dollar, and the flattening yield curve. While the recent fall in the dollar is still very substantial, the rise in 10-year rates will essentially crush the mortgage refinance trade, if it is not reversed by Fed action; this should show up in the statistics starting next month.

T&B believes that once the repatriation is finished, the dollar will resume its slide. On the other hand, the shift in tax-efficiency of equities by comparison with bonds is more durable, and may provide some support to the equity market. In a wonderful illustration of the “law of unexpected consequences” these changes in the tax code will result in US long rates remaining substantially higher than would otherwise have been expected, again, absent direct intervention by the Fed. This, coupled with the risk that the Fed will resume the issue of 30-year bonds, poses a non-negligible threat to the emerging market debt class.

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