

# Truth and Beauty...

## (and Russian Finance)

### *Yukos: The coming “Russian Boom?”*

*Loud noises in Russia are not always good news!*

*Once again, Yukos' highly-paid and very professional spin doctors are verifying our oft-stated observation that you can make the Westerners believe almost anything when it comes to Russia! The oligarchs, the strikingly rapacious men largely responsible for Russia's catastrophic decline in the late 90s, are once again being lionized as heroes for Russian reform...the mind boggles!*

*In fact, Khodorkovsky is coming under attack for the simple reason that he was caught not just trying to strip away the State's remaining hydrocarbon assets and infrastructure, but more generally because – frustrated in this attempt – Yukos/Menatop has resorted to literally buying up the Duma, paralyzing reform legislation and seeking to reestablish oligarchic ownership of the Russian government à la 1997. Putin simply cannot tolerate this, except at the cost of surrendering any hope of accelerating and completing Russian reform. Contrary to the disinformation being disseminated by Yukos' spin doctors, Russia's best hope for reform is a pro-Kremlin super-majority in the next Duma, allowing the President to push through reformist legislation in the teeth of entrenched opposition by the corrupt bureaucracy and the greedy oligarchs.*

#### **THROUGH AN OIL-BARREL, DARKLY...**

*Some weeks ago, in our first report on the Yukos follies, T&B expressed dismay that the crowd of Western Russia-watchers had – for once – gotten it pretty much right – God! We should have been a bit more patient! As the Yukos spin-doctors sprung into action, even some of the brighter local commentators – as well as the preponderance of Western journalists – are taking Yukos' press agency as gospel truth. Oddly enough, while most of the global banks have proved totally clueless, a couple of strategists at local institutions (among them our friend Chris Weafer who has just issued*

*an admirably sane, comprehensive and well-argued review of this circus<sup>1</sup>) have been less easily misled by the errant oil major.*

*In one of his previous incarnations, T&B was the first Western analyst to put out a (speculative) “buy” recommendation on Yukos – this at a price of 0.72 in 1999, at a time when the oil company was still excluded from the RTS. We took the risk of recommending a company with a reputation as deeply controversial as theirs not because we saw signs of some miraculous moral transformation, but simply because they convinced us that a shift to best Western standards of corporate governance was in their economic interests. We now fear that hubris and ambition are getting the better of such rational strategic thinking.*

*Khodorkovsky’s press conference upon return to Moscow predictably triggered a market reaction verging on panic. Not just Yukos – but the entire range of Russian blue chips tanked on the basis of a total cock-and-bull story concerning the threatened wholesale revision of privatization. In fact, at Sovlink we urged our clients not to sell into the crash – we believe we were witnessing the massive transfer of valuable Russian assets from the hands of nervous foreigners into those of long-term domestic players. Any investor inclined to rush for the exits on the basis of such stories should probably not be trading this market...for the others, rest assured – our beloved Russian oligarchs have not been selling...quite the contrary, the real money Russian accounts are on the bid!*

## **BACK ON SOLARIS**

Last week T&B had the surreal experience of trying to explain to one investor why the fact that the President’s special advisor Illarionov had spoken of the risk of a “new civil war” was really nothing to worry about! Understandably, our investor asked us how we thought the market would have taken it had the special advisor to Mr. Blair made a similar statement? Point well taken, but – hey, Russia is different! Here on Solaris, one must always distinguish between theater and reality. First, a few clarifications:

### **-What triggered the attack on Yukos?**

We have previously discussed the relevance of Transneft, Rosneft, and Gazprom to this affaire. We would here simply add that we have learned that, besides controlling a very substantial block of Gazprom shares via various structures, Yukos/Menatop has been a major lender to the gas monopoly. T&B hardly needs to remind its readers that the uses and abuses of the Russian bankruptcy code have classically been a major factor driving lending practices...Russian corporate lending is frequently driven by the hope that the borrower will not be able to repay!

Due to his frustration at his inability to gain control of the remaining infrastructure and hydrocarbon assets owned by the State, Yukos/Menatop set out to build a political counterforce. It is widely believed that Platon Lebedev was the point man, buying up a slew of deputies and expecting to do better still in the next Duma. Certainly, Yukos people openly boasted of the size of their Duma faction. We invite the reader to imagine the reaction in the UK were, say, BP to more or less openly buy up some 15-20% of the House of Commons!

Giving the lie to the story that the raid on Menatop/Yukos was triggered when the oil major’s push for reform antagonized some shadowy and deeply reactionary faction in the government, we have learned that the factor finally triggering the raid was in fact the threatened resignation of two of the principal reformers in the current government, Gref and Kudrin, who recently went to see Putin, complaining bitterly about the fact that lobbying by big business was tying up all reform legislation in the Duma – reportedly, stating that it was “becoming impossible to work under these conditions.” Duma speaker Seleznyov came to Putin with similar complaints only a few days later.

The main business-lobbying group was, of course Yukos – which, in particular, had succeeded in blocking reform of mineral resources taxation. Khodorkovsky was increasingly becoming a political

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<sup>1</sup> Equities Corrected: Enough, Already! Alfa Bank Strategy report.

force to be reckoned with, and had Putin not allowed his men to strike back, politicians of all stripes would have sensed that the center of power was shifting, and would have rushed to get in front of it. The oligarchs would have – as in the 1995-1998 period – privatized the Russian state!

### **-Who triggered the market collapse?**

Yukos. Khodorkovsky's crude but effective PR campaign has been aimed at creating maximum fear in foreign investors – hoping to convince them that Russia is about to return to the dark days of the Soviet regime. Publicly, they are casting themselves as the last force protecting Russian liberalism; while privately, they are spreading outrageous fabrications about power struggles, blackmail, and the rise of dark, reactionary forces.

### **-What next?**

Khodorkovsky has surprised us by showing no sign whatsoever of backing down – Putin, of course, cannot back down. The investigation is now moving down a dangerous slope – from economic misbehavior to allegations of criminal behavior, including several murders. Like the other oligarchic structures, the early history of Yukos was not pretty. There have been numerous allegations of criminal misconduct (none of which has yet been substantiated in a court of law), and several violent deaths have yet to be elucidated. Of the various murder investigations which have reportedly been opened, one involves the killing of Vladimir Petukhov, the former mayor of Nefteyugansk, a city situated astride Yukos main oil fields. Before his death, Petukhov had been a major thorn in Yukos side, campaigning aggressively against the oil company. The company officially condemned the killing, and denies being involved in any way. Even in Russia, while it is relatively easy to drop a tax investigation, it is far more difficult to drop one for murder of a public official. Once the genie is out of the lamp, it will not be easily shoved back in.

This is all most unfortunate. Whatever his history, Mr. Khodorkovsky is perhaps the man who has made the single greatest contribution to transforming the Russian investment climate – and to selling it abroad. The transformation of Yukos from ugly duckling into a somewhat oily swan was a stunning exercise in management skills. Their reservoir rationalization, fieldwork, and corporate communications have been exemplary. Yukos was – is – and will certainly remain – a truly world-class oil company – the only Russian company capable of competing as an equal against the global majors.

Khodorkovsky, on the other hand, is personally moving into the danger zone; by current trends, it is not entirely inconceivable that he may end up living abroad. This would be unfortunate, but investors should rest assured that Yukos – while possibly facing a hefty tax bill – is under no substantial threat. All its assets are still there, while its competent and multinational management continues to work professionally, despite the siege mentality now prevailing at its headquarters. Although the Sibneft deal would seem to be imperiled by the impossibility of their issuing the expected jumbo Eurobond, their bankers privately claim that the deal is still do-able.

Most importantly, though, **the overall Russian equity market is under no credible threat.** The nonsense about a forthcoming reversal of privatization published in certain local newspapers – generally quoting obscure analysts at Russian think tanks – is unworthy of serious attention. Although Yukos/Menatap and much of the press would have us believe that there is currently an attack on privatization, we would again hasten to reassure our readers that this is self-serving tripe!

Early on in this story, Mr. Gref made it abundantly clear that privatization was not about to be revisited, Prime Minister Kasyanov recently came out, declaring the same. Although some of the notoriously corrupt deals of the 90s are being reviewed in the context of a political dogfight, we note that none of the oligarchs who have stayed out of politics have been targeted – Alekperov, Potanin, Bogdanov, Friedman, etc. are continuing to build their fortunes in peace – the attacks show no sign of spreading beyond Yukos. In particular, there is no reason to assume that the recent resumption of the investigation into Millhouse capital has anything to do with the pre-98 privatizations: it was

triggered by a criminal suit filed eighteen months ago by Andreev, the former owner of Avtobank, Ingostrakh, and Nostia, asserting that he was pressured into selling his stakes at a knock-down price by threats of violence. Some of the allegedly stolen assets were quickly resold, with Avtobank – still in default on NDFs sold before the '98 crash – being sold to Nikoil.

Gref, Kasyanov, and a host of others have repeatedly reassured investors that there is no question of reviewing privatization. Putin remains deeply committed to the modernization of the Russian economy – with no interest in trying to right the wrongs of his predecessors. Simply put, a truly nasty fight is now underway between one major oligarch and the Putin government. It is a fight the oligarch cannot possibly win.

This is a fight we could have lived without, yet – not only is Russian reform not imperiled – it would have been gravely jeopardized had the government allowed the Oligarchs to grab control of the Duma. We reiterate our oft-stated hope that the Kremlin party will win a super-majority in the next parliament, allowing enactment of vital reform and curtailment of the privileges of the entrenched bureaucracy.

## APPENDIX I

### **REFLECTIONS ON AN OILY MESS – WESTERN PERCEPTIONS OF RUSSIA**

#### **Déjà vu – Believing 3 impossible things before breakfast**

The current media circus reminds T&B of nothing so much as the huge scandal, which broke out as Gusinsky (and Berezovsky) met their sticky ends. For those who may have forgotten, following Putin's election and his warning to the oligarchs to stop meddling in politics, the Russian government suddenly ceased bankrolling Gusinsky's bankrupt media empire. In response, this man who had done as much as anyone to grab state assets and to abuse the political system, who had corrupted legislators, bribed functionaries, and shamelessly manipulated his own press to further his political aims – suddenly sought to cast himself as a martyr for democracy, liberalism and the Westernization of Russia! Quite hilariously, he was joined in this endeavor by Boris Berezovsky, surely one of the most devious and manipulative human beings to have graced the planet in our lifetimes!

This seemingly miraculous transformation in perceptions – inconceivable anywhere but in Russia – was aided by several factors:

- The oligarchs' very professional manipulation of the media; this was, in turn, greatly facilitated by the fact that Western public and much of the press are deeply suspicious of Russia. The right wing is nostalgic for the certainties of the cold war, while the left feels betrayed by Russia's violent shift towards raw capitalism. Happy to believe that Russia never really changes, both are easy targets for even the crudest PR.

- The appallingly clumsy attempts at communication by the Russian government: while the opposition feeds the press with carefully crafted statements drafted by foreign media consultants, government press releases appear to be written by middle-ranking functionaries with limited knowledge of Western languages or media. The government allows long silences, followed by a rash of contradictory statements as every cook, driver and secretary in the ministry takes advantage of their 15 minutes of fame! Desperately in need of improved communications skills – however good its intentions – the Russian government could make itself look suspicious distributing Christmas toys to sick children!

- The existence of a large contingent of Russian liberals – the quixotic Helsinki refuseniks – also locked in a lifelong straggle against a Soviet system which happens to have collapsed 15 years ago! Starved for attention and increasingly marginalized, they can be recruited by virtually anyone, no matter how dubious, with a few dollars and a score to settle.

#### **SHORT MEMORIES**

History, as Marx noted, repeats itself – first as tragedy, then as farce. Yukos – currently spreading a series of pernicious myths – is finding both domestic but especially Western audiences anxious to lap it up! While we have attempted to lay some of these myths to rest in recent issues of T&B (see [www.sovlink.ru](http://www.sovlink.ru), strategy) there are two to which – given their relevance to investment decisions – we must return here: first, that this fight somehow represents a struggle between liberalism and Soviet-style repression, and second, that “property rights” are under attack.

#### **THE GREAT LIBERATOR?**

The myth of a Russian oil company as the leading force for political liberalization is one that we should not have to deal with in a serious publication! The history of Yukos/Menatep speaks for itself. What is now the poster-child for Russian corporate transformation was once one of the worst offenders: the egregious abuse of minority investors, the wasting of entire provinces, and the dark

allegations (albeit never substantiated in a court of law) of criminal pressure on recalcitrant officials suggest the extreme ambition subtending the creation of Russia's premier oil company. Although we were the first to hail its transformation into more transparent standards of corporate governance, we have always maintained that this was driven not by some sudden change in moral code, but rather, by economic expediency. In this, it is not fundamentally different from businesses anywhere else.

Latterly, Mr. Khodorkovsky had been quite happy to support the Putin government for precisely as long as it gave him substantially everything he wanted. His ambition has outgrown his allotted portion, and he has taken to ratcheting up pressure on the Russian state to achieve his ends; he has certainly gone far beyond the limits that Mr. Putin was disposed to tolerate, especially from someone whom he sees as a parvenu with a dubious past. Khodorkovsky makes much of the KGB background of his opponents, yet he speaks rather less of his own deep roots in the Komsomol (Communist Youth Organization) and its possible involvement in his early business dealings.

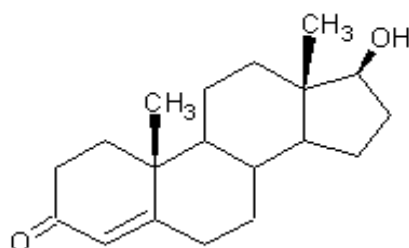
### ***REDISTRIBUTING THE SPOILS?***

Sources close to Putin inform us that he is uncharacteristically furious. Instead of settling his problems locally, Khodorkovsky went running first to the US embassy, then to his Washington lobbyists – to Mr. Putin, this looks little short of treasonous. Khodorkovsky is a businessman with substantial issues to be settled, not some Soviet era refusnik, pretending to diplomatic protection (the stupidity of the US ambassador becoming involved defies human comprehension...imagine for a moment the response were the Russian ambassador to draft a letter to the State department demanding explanations over the treatment of Enron!) Certainly, Khodorkovsky's approach has done nothing to ease the problems he faces in Russia, nor to endear him to the Russian public.

### ***TYGER, TYGER BURNING BRIGHT?***

It is possible that there is method in Khodorkovsky's seeming madness. One of our more perspicacious US clients reminds us that Yukos had made an offer to buy back its shares at a very attractive price, but this only for holders as of July 4. If these now-vested owners sell their shares, presumably, neither they, nor the buyers, would have the benefit of participation in this deal.

Nevertheless, we frankly doubt that this explanation alone would suffice to explain Yuko's attitude to this conflict. The cost has been substantial – their borrowing power has been crushed – their multi-currency jumbo bond is now the mandate from hell and their reputation as a safe, Western oil company is badly compromised. Therefore, in the absence of further evidence, we believe that the motor force is simply the unbridled ambition of its owner – testosterone poisoning, if you will...



Testosterone

## APPENDIX II

### **BBC - IN PRAISE OF OLDER WOMEN – “AUNTIE” WE LOVE YOU!**

T&B occasionally repeats its assertion that news coverage in the Russian media is not materially less free and fair than what we encounter in many Western countries, most particularly the US. Anyone watching the Fox network will realize how the prostitution of the press by financial interests can be far more effective than the heavy-handed censorship beloved of totalitarian regimes. While we have recently encountered more critical and incisive coverage in the weeklies, this was, unfortunately, sadly absent when it would have been most useful – in the run-up to the war.

The international television networks did somewhat better. CNN did what it could to maintain impartiality, but especially, several of our readers have written arguing that we have unfairly neglected the courageous, honest and balanced coverage by BBC International. They are right!

It is now becoming increasingly obvious to even the most gullible observers that the Iraq war was a total farce – a pure political play, planned long in advance, scripted by a US administration with a totally cynical disregard for any of the supposed justifications for an act of war carried out outside any framework of international law. Public support was built on the basis of disinformation, lies, and manipulation. Both in the UK and the US, it is now rapidly fading. As the army of occupation sinks into an unwinnable war of attrition – now pleading for logistic support from the international community it so recently scorned – the BBC International stands out for its critical coverage amidst the crowd of flag-wavers.

While the BBC (“auntie”, to its friends!) had historically been the target for criticism by the parties of the right –irritated by its supposedly liberal bias, to its credit the Conservative Party huffed and puffed but never dared to attempt to muzzle the press. Now, with Tony Blair increasingly cornered and cut-off, we are being treated to the odd spectacle of a supposedly left-leaning labour government trying to crush one of the sole domestic voices of dissent. Its heavy-handed campaign may have accidentally caused the tragic death of a Mr. Kelly, the main source of a BBC story about a thoroughly dishonest weapons dossier used to justify invasion of Iraq. While the BBC did everything possible to protect its source, the UK defense ministry, probably with the acquiescence of Blair, leaked his identity to the press, resulting in intolerable pressure and his eventual suicide.

In any war, truth is the first casualty...yet it is then that objective and critical voices are most vitally needed. While the Blair government is currently seeking to reduce it to being just another cheerleader for its foreign adventures, and despite credible threats to its independence, the BBC has refused to be cowed. A great British institution, we are sure they will prevail...certainly, we wish them every possible success!

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