

“If Putin can reduce the oligarchs’ stranglehold on the economy he will go a long way to preventing an Orange-style revolution in Russia”



President Putin is reducing political risk and making Russia a safer destination for investment capital, argues William Browder, CEO, Hermitage Capital Management

Should Russia have an Orange-style revolution?

It would be our worst nightmare here in Moscow to have a political revolution that carried any hint of a re-nationalisation programme, like the Orange Revolution in Ukraine. One of Putin’s central goals in the past five years has been to ensure that the oligarchs play a productive role in society while at the same time avoiding the upheaval that would come from a wholesale review of the Yeltsin privatisations. I think he remains dedicated to this effort because he realises that if he falters, the people of Russia might end up addressing the problem on their own by other means, such as revolution.

Do you believe that Putin is pursuing a programme of legitimising capitalism in the eyes of the Russian population?

At the moment, 22 individuals own 40% of the economy. To explain this concentration of wealth, as some pundits do, through comparisons to the ‘robber baron’ capitalism America experienced in the 1890s, is utter nonsense. Even at the height of the Gilded Age in America, there were over 750,000 individuals who controlled 45% of the economy. If Putin can successfully reduce the oligarchs’ stranglehold in the economy to give the individual Russian a real stake in the economic success of their nation, he will go

a long way to preventing an Orange-style revolution in Russia.

So what investors should want, expect and hope for is not an Orange-style revolution but for Putin to continue his strategy?

Yes. What we call the ‘de-oligarchisation’ of Russia reduces catastrophic political risk à la the Orange Revolution, and ultimately makes Russia a safer destination for investment capital.

Did the Yukos case make a joke of Putin’s previously excellent tax and judicial reforms?

Putin has been trying to deal reasonably with a very complex dilemma to which there are no elegant solutions, and on balance, he is making progress where it matters most. At the end of the day, tax reforms are working in Russia. Rates have fallen across the board, and people are paying their taxes for the first time in recent history. The costs of simply obeying the law have fallen and the price for non-compliance has risen dramatically. As a result, there was a four per cent budget surplus last year, and the government expects another four per cent surplus this year. Many oligarchs saw what happened to Khodorkovsky and made the decision to avoid the same fate by paying their taxes.

As for judicial reform and the legal system, Putin is trying to fix a system suffering from the legacy of the last ten years, when oligarchs would simply buy favourable court decisions. This state of affairs wouldn’t be tolerated in any country. In America there are checks on business influence, including racketeering laws, which provide some assurance that, ‘If nothing else works, the government can use these to stop the bad guys.’ We don’t have that in Russia, and as a result Putin had to take the extraordinary steps we all witnessed.

More criticism of Putin has begun to surface in the press. Are cracks beginning to show in the regime?

Recently I was at a conference where a lady stood up and said, “I am a small businessperson, not very successful, but I completely agree that Putin is taking the right approach to the oligarchs.” Basically, Putin is popular because this is the right thing to do. The majority of Russians agree with him. It is not fair for people to be arrested for stealing a loaf of bread, while those who steal \$10b go unpunished.

Is there a liberal fight back underway, possibly grouped around Kasyanov?

Kasyanov isn’t a liberal. He is a representative of the old oligarch regime,

and the average Russian recognises this. When Putin fired Kasyanov on February 24, 2004, Putin's popularity ratings rose in response.

There is no need for a liberal 'white knight' to come lead an opposition. There are real liberals who currently sit in the government actively implementing economic and political reforms which fit within the best traditions of Western liberalism. It would make sense for these people, such as Kudrin, Gref and Zhukov – instead of Kasyanov – to lead any liberal-leaning coalition.

Yuganskneftegas is now in state hands. How do you square your support for the government's actions over Yukos with your support of the private over state sector?

One must always remember when discussing the Yukos affair that it is not the first stage in a massive re-nationalisation campaign but rather the embodiment of an intense personal dispute between President Putin and Mikhail Khodorkovsky. There is no credible sign that the Kremlin intends to allow Yukos-style state action to spill over to other companies. It is also useful to remember that even with Yuganskneftegas held by the state, 82% of Russian oil production is privately owned. Lukoil, Sibneft, TNK-BP, Tatneft, Surgutneftegas – not to mention 15 other companies – are all private. The private sector is well represented in the Russian oil and gas industry. Finally, although Yuganskneftegas is now held by the state, the Gazprom-Rosneft merger should not be seen as anything more than a reorganisation of assets already controlled by the state. If anything, this merger gives the minority investors in Gazprom some stake in Rosneft, which they did not have before.

How do you think the government will go about lifting the Gazprom ring fence without making it look like an enormous windfall for foreign investors?

The number of domestic investors who own Gazprom probably exceeds the number of foreign holders by an order of magnitude. I don't know how the government will ultimately lift the ring fence, but when it happens, it will validate those in the market who expect share liberalisation and will probably be considered a form of appeasement to

portfolio investors after Yukos.

Nashi – the Kremlin-sponsored youth organisation – have been quoted as saying that their enemies are those who see Russia as “a feeding trough for the global economy”. Does it suit the Kremlin to have people making comments like this?

This is pluralism. There are lots of people running around now saying lots of things, some of which are crazy. Ultimately, Russia has one big thing going for it: it produces an enormous amount of natural resources, the world is consuming them, and Russia is selling them at high prices and collecting lots of money. The stabilisation fund is growing, Russian corporate earnings are increasing and domestic liquidity is on the rise. These are very good macroeconomic trends for Russia, and the Kremlin knows this. It suits Russia to be one of the primary commodities engines of the world going forward for the near- to middle-term. Eventually Russia will need to become a fully-integrated modern economy, but realistically Russia must focus on where it has a comparative advantage at the moment, and that is in commodities and natural resources.

Is it worrying that the administration seems intent to keep Russia out of the capital markets and not issue debt?

At the moment, the Russian government is a net creditor to the world. With hard currency reserves at record highs and continuing federal budget surpluses, it just does not make sense to borrow. On the domestic front, of course, Russia needs to develop its banking system and increase inter-firm liquidity so companies within Russia can borrow money more easily. Russia needs to develop its capital markets further so more Russian companies can finance growth through equity issuances. In both those areas, the country has a long way to go before it can approach even some of the lesser developed countries of the world. There are many things I spend time worrying about as a portfolio investor in Russia; the fact that Russia isn't seeking to increase its debt to the rest of the world isn't one of them.

Is the new subsoil law unnecessary?

It keeps getting watered down, and as

far as I can tell it only applies to a very limited number of assets now. Ultimately, Russia realises that it needs capital to exploit the country's main competitive advantages in commodities and natural resources. At the same time, various local interests have lobbied hard to keep various 'national treasures' from being open to foreign investment and ownership. The Kremlin ultimately may not be as successful as we might like in liberalising the investment regime for natural resources, but whatever outcome we have will be a lot more liberal than places like Saudi Arabia, Kuwait and Venezuela. And in the final analysis, Russia is competing against these countries for foreign investment, so there is reason to be cautiously optimistic.

How should investors respond to the euphoria which greeted the revolution in Ukraine?

I would discourage people from relying on their political enthusiasm for what happened in Ukraine as the basis of a decision to commit capital to the Ukrainian market. It is important not to confuse the political fairy tale of Yushchenko with a viable investment case.

From a stock market perspective, Ukraine doesn't make a lot of sense at the moment. The market trades at roughly 15 times earnings, which is twice the valuation of Russia. The average daily trading volume on the Ukrainian market fluctuates between \$2m and \$4m, compared to \$500m to \$1b in Russia. This creates enormous execution risk for portfolio investors in Ukraine. From a legal viewpoint, Ukraine's corporate law and its minority shareholder protections in particular are around five to ten years behind Russia. There has been a litany of abuses in the past, and it is unlikely that those abuses will just stop because of a regime change. Some of the shenanigans may actually become more commonplace. The market looks a lot like Russia did in the mid-'90s.

That said, the main positive argument for Ukraine is that they are hoping to join the EU at some distant date in the future, and there is therefore convergence play. But there are going to be a lot of ups and downs between now and then, and we expect there will be plenty of better entry points than what we see in the current euphoria. 