Analysis

The Russian Oligarchs and the Economic Crisis

By Stephen Fortescue, Sydney

Abstract

This article makes the seldom heard argument that Russia's oligarchs have played a positive role in the country's economic development. After the Yukos affair and before the economic crisis, the oligarchs' commercial activities and their relationship with the state presented a mixed picture. The crisis reduced the oligarchs' revenue streams and therefore exposed them to debt-repayment problems, but again the picture is mixed, with the fate of each of the companies depending on its particular situation. Ultimately, the state does not see the economic crisis as an opportunity to nationalise the oligarchs' enterprises and they are likely to weather this storm.

A Positive Contribution

In 2006 I published a book entitled *Russia's Oil Barons and Metal Magnates*. There I argued, rather unfashionably, that on balance the oligarchs – by whom was meant the small group of private businesspeople who through the 1990s had built up a major presence in the Russian economy, above all in the oil and metals sectors – had played a positive role in Russian post-Soviet economic development. They were value adders rather than asset strippers. In difficult circumstances they had turned around enterprises that, when they obtained them, had been riddled with debts and run-down assets. Given that, I was critical of Putin's approach towards them, as demonstrated above all in the Yukos affair, of a refusal to recognise their right to an autonomous and legitimate role in the economy and polity, meaning at best their exclusion from the policy process and at worst their dispossession and the full nationalisation of strategically important business.

In the period between the completion of that book (roughly the end of 2005) and the unequivocal arrival of the global financial crisis in Russia (roughly September 2008), a case could be made that my confidence in the positive economic contribution of the oligarchs was given further support, and that my fears of the Yukos effect were exaggerated. At the same time, however, there were counter-indicators on both counts, indicators that became more troubling as the crisis hit. This article examines the effectiveness of the oligarchs in the management of their businesses, post-Yukos and particularly in crisis conditions, and the attitude of the state towards them, as expressed in their place in the policy process and the level of intrusion of state ownership and management in their areas of business activity.

Post-Yukos, Pre-Crisis

At the beginning of this decade the oligarchs displayed a sudden willingness to improve their standards of corporate governance, including greater transparency and a better attitude towards what minority shareholders remained. Presumably this shift derived from their desire, as they gained firm operational control of their businesses, to claim secure and legitimate property rights. It was a trend that continued post-Yukos, driven in particular by the oligarchs taking their companies public through initial public offerings (IPOs), usually on foreign exchanges. To do so required the transparent consolidation and auditing of accounts, the release of shareholder details (sometimes revealing unexpectedly large holdings of quieter partners behind the highly public oligarchs), the election of independent board members, the payment of dividends, etc. The release of shares onto the public equity markets was usually limited to 10–15 per cent and the oligarchs remained in firm control. They usually claimed that the purpose of the IPOs was not so much to raise funds, but to learn and implement the appropriate corporate practices of a large "public" company with global ambitions. Those ambitions were further realised through large-scale foreign asset purchases, particularly from about 2005. Thus Rusal became the biggest aluminium producer in the world, with extensive holdings on every continent, and Severstal became the fourth biggest steel producer in northern America. Throughout this period the oligarchs' businesses earned record revenues and profits, and they undertook substantial investment programs.

As late as the middle of 2008 one might have spoken confidently of the impressive ambitions and business skills of this small group of entrepreneurs. But already there were danger signs. Was this headlong expansion simply the "irrational exuberance" of a few individuals who had made their initial fortunes through good connections with the state and who were now doing no more than riding the wave of an unprecedented commodity boom and cheap credit? Were their management capacities being stretched as their empires expanded? Both the image and the substance of the global businesses they wanted to run needed large and complex management structures, very different from the hands-on approach to which they were used, and involved operations in a range of countries and cultures with which they were quite unfamiliar. There were signs of costs, in particular management costs, getting out of control; of difficulties controlling the activities of senior hired executives (it is said that Norilsk Nickel's ill-judged purchase of LionOre was driven by a senior foreign executive; it was certainly strongly opposed by major shareholder Mikhail Prokhorov); and of the oligarchs themselves struggling to maintain focus as they pursued a myriad of other personal business and non-business interests.

While the commercial activities of the oligarchs might have presented a mixed picture, so did their relationship with the state. Fears that the Yukos affair was the precursor of an all-out program of nationalisation of strategic assets proved unfounded. True, Roman Abramovich sold his Sibneft to the state-owned Rosneft (and used the proceeds to, among other things, buy a half share in the privately-owned coal and steel producer Evraz) and Mikhail Gurtseriev was driven out of his second-echelon oil company Russneft in a stye reminiscent of earlier oligarch dispossessions (although it was Deripaska's privately owned Basel that came forward as the recipient of the assets). Beyond that the oligarchs remained in place.

They even maintained a significant, albeit reduced, role in policy making. After a brief post-Yukos settling down period big business regained its access to the president, both on a personal and collective level (the latter through the Russian Union of Entrepreneurs and Producers, RSPP, under its new head Aleksandr Shokhin). Even in such a sensitive area as tax administration, business was heavily involved in negotiating new post-Yukos procedures for tax audits, arriving at an outcome with which the business community ultimately expressed satisfaction. The major cost to the oligarchs of the Yukos affair was the not inconsiderable one of having to pay formal taxes in full and at the onerous rates imposed on resource (particularly oil) revenues and the informal taxes that came with the "corporate social responsibility" expectations of the government. But as long as oil and metal prices were sky high, that was a burden they could manage.

The Crisis

For many the crisis has confirmed what they always knew: the oligarchs were reckless adventurers, enriching themselves by taking dubious advantage of circumstances rather than their own talents. As oil and metal prices crashed, they were left struggling with a mountain of debt, both personal and corporate. They would be unable to repay the debts and the inevitable outcome would be their assets ending up in the hands of the state (a state very likely representing the interests of a new group of would-be oligarchs).

There is no doubt that the crisis has wrought havoc with the revenue streams of the oligarchs' businesses, and so exposed them to the danger of not making debt repayments on loans for which the security is substantial shareholdings in their businesses. When those debts are owed, as many are, to state-owned banks, the spectre of nationalisation appears. Whether such an outcome will be avoided depends, firstly, on the liabilities of individual firms, secondly, on the capacity of the oligarchs to manage their businesses into a better position, and, thirdly, on the approach of the government.

The debt picture is a mixed one, with not all oligarch firms equally exposed. In the oil sector the most heavily indebted company is the state-owned Rosneft. It has had to make long-term arrangements with the Chinese to shore up its finances. The privately-owned oil majors appear able to cover their debts for the moment. In the metals sector – overwhelmingly privately owned – Deripaska's Rusal (along with his struggling vehicle manufacturer GAZ) provides the most dramatic example of an overwhelming debt mountain, undoubtedly the result of "irrational exuberance". Rusal's strategic "vision" had changed regularly over the years, eventually coming to look like "buy everything", albeit with a focus on aluminium smelting and upstream integration. The other most indebted metal magnates found themselves in that position through the need to invest heavily in dilapidated plant (Evraz) or, for latecomers to the sector, to pay a high entrance fee (Usmanov's Metalloinvest). Someone like Aleksei Mordashov, who had obtained his stake in the relatively modern Severstal early and cheaply, was able to undertake his ambitious foreign expansion program with little existing debt and high cash reserves.

Of the oligarch-owned resource firms only Rusal and Evraz took advantage of the government's emergency program to provide funding through the state-owned Vneshekonombank (VEB) to pay off foreign debts. A number of other resource firms, especially Mechel and Metalloinvest, have substantial short and medium term commercial debts with state-owned banks, and some individual oligarchs, including Potanin, Deripaska and Usmanov, have substantial personal debts with shares in their businesses as security. If those debts are not repaid and, as a result, ownership of shares held as security is transferred, Russian state-owned banks could end up with major shareholdings in a substantial portion of the metals sector.

Before discussing the likelihood of that happening, we will consider the prospects for the resource sector, particularly metals, trading its way out of difficulty. With, very roughly speaking, prices currently hovering around the cost of production and future price prospects highly uncertain, producers would be unwise to rely on price increases to raise revenues to the level needed to pay off corporate debts and to provide the dividends that their owners need to pay off personal debts. They need to reduce the costs of production. They appear to have some but not unproblematic room to do so. Their biggest costs are raw material inputs, the prices of which have plummeted as rapidly as the prices of the producers' own output. However most producers own their input suppliers, so falling input prices are a mixed blessing. Labour costs offer some opportunity. Overstaffing has been a continuing feature of Russian industry, and labour costs were rising very rapidly in the lead-up to the crisis. Russian workers have shown some willingness to accept such 1990s phenomena as reduced hours for reduced pay, and even no pay at all. But the recent events at the Pikalevo alumina plant, with Putin having to intervene forcefully after stood-down workers blocked highways, suggest that care in this area is required. Although prepared to tolerate limited redundancies and reduced working hours, the government is unwilling to allow wholesale capacity closures. All oligarch firms are on the government's list of "system-forming enterprises", the clear point of which is to send precisely that message. The government would presumably have no such objection to capacity closure and asset disposal abroad, and a number of metals firms have already taken that route. Business lobbyists constantly call for tax cuts as a way to improve firms' profitability. The government has regularly made hopeful noises, including with regard to oil sector excises and export duties, but as yet has delivered little.

While none of these cost-cutting opportunities are totally convincing, the oligarchs have considerable experience of crisis management, having taken over their businesses in very difficult circumstances in the mid-1990s. In the first quarter of 2009 Rusal cut its costs by $554 million and could well meet its target for the year of $1.1 billion. With those sorts of savings available, the oligarchs might muddle through again.

While cost cutting of that level might help Rusal restore profitability over the longer term, it will not help it pay its very short-term debts. Its fate and the fate of other firms with short-term debt problems are out of their hands and in the hands of their creditors. Banks, both Western and Russian, have been prepared to help out by restructuring loans (with the exception of the obstreperous Alfa Bank). Deripaska has won short-term moratoriums on debt repayments from Western banks. The Russian government's attitude, however, is not totally clear. Its spokespeople have regularly stressed that there is no interest in seizing or managing private assets. The government now declares itself unwilling to continue to provide itself with the mechanism – state-owned banks providing credits with shares as security – to do so. The VEB program was suspended in February with only 20 per cent of its funding allocated, and private firms have been told they will receive no further loans. Igor Shuvalov, the first deputy prime minister in charge of managing the crisis, even suggested in a Bloomberg interview on 18 March that the government would rather see foreign banks take ownership of the assets than the government do so. However, with regard to the VEB-program, in his 6 April address to the Duma Putin declared that the shares would be taken over by the state if the loans were not repaid on time, an intention confirmed by VEB chair Vladimir Dmitriev in a 15 April interview in *Kommersant*. This would affect Rusal, Evraz, and, through Rusal's 25 per cent holding, Norilsk Nickel. But negotiations on rescheduling the loans are nevertheless underway, with the state's purchase of new convertible bonds being the currently favoured approach. My guess is that the government will continue to find ways to reschedule oligarch corporate debt.

In the meantime private business representatives continue to be included in the policy process. The more-or-less institutionalised meetings of president and prime minister with business associations continue; each have one-on-one meetings with individual oligarchs; and business leaders are regularly included in the *ad hoc* but increasingly institutionalised meetings (*soveshchaniia*) that appear to have taken over from formal state bodies as the primary decision-making forum in crisis conditions.

The global economic crisis is providing a stern test for businesses and governments throughout the world. I retain hesitant confidence in the capacity of the oligarchs to weather the storm. While the government might be simply playing a waiting game, it is not my sense that it wants to take advantage of the situation to carry out a major nationalisation program in the resource sector. It rather hopes that the oligarchs will, as deputy prime minister and senior silovik Igor Sechin called upon them to do, “show [your] toughness, inventiveness, energy”, and minimise the need for a hard-pressed government to become involved in their affairs.

About the Author

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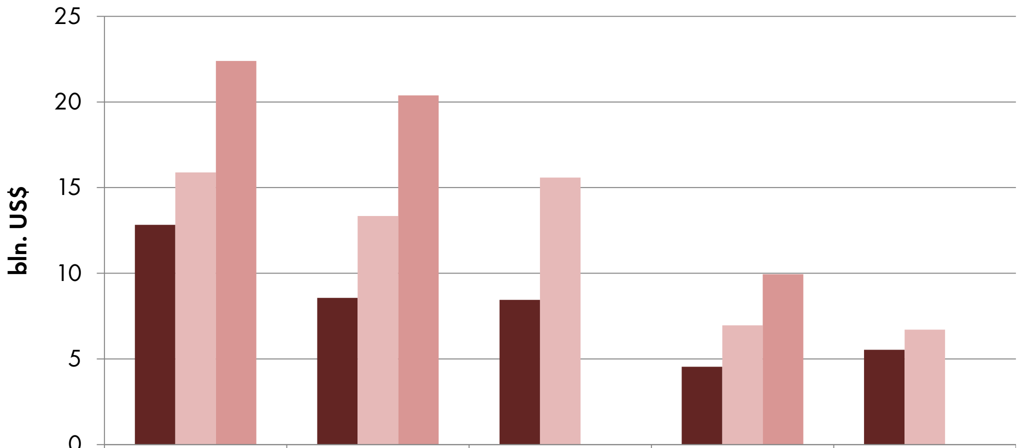
Further reading

- Stephen Fortescue, “The Russian aluminium industry in transition”, *Eurasian Geography and Economics*, vol.47, no.1, 2006, pp.76–94.
- Stephen Fortescue, “Business-state negotiations and the reform of tax procedures in post-Yukos Russia”, *Law in Context*, vol.24, no.2, 2006, pp.36–59.
- Stephen Fortescue, *Russia’s Oil Barons and Metal Magnates. Oligarchs and the state in transition*, Palgrave, London, 2006. (Available in Russian translation as *Russkie neftianye barony i magnaty metalla. Oligarkhi i gosudarstvo v perekhodnyi period,* Stolitsa-print, Moscow, 2008.)
- Stephen Fortescue, “The Russian steel industry, 1990–2009”, *Eurasian Geography and Economics*, vol.50, no.3, May–June 2009, pp.1–23 (forthcoming).
- Sergei P. Peregudov, “Konvergentsiia po-rossiiski: ‘zolotaia seredina’ ili ostanovka na poluputi”, *Polis*, no.1, 2008, pp.91–108.

Tables and Diagrams

Economic Development of Russian Metal Companies

Diagram 1: Turnover of Russian Metal Companies 2006 – 2008 (in Bln. US Dollars)



	Severstal (Aleksei Mordashov)	Evraz (Roman Abramovich)	Rusal (Oleg Deripaska)	Mechel	Metalloinvest (Alisher Usmanov)
2006	12.83	8.56	8.45	4.54	5.54
2007	15.88	13.35	15.59	6.96	6.71
2008	22.39	20.38	n.a.	9.95	n.a.

Sources: magazine Ekspert, http://expert.ru/ratings/; *annual or financial reports:* http://www.evraz.com/, http://www.severstal.com/