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Reforms Back to Square One

By James Beadle

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Seven years after it began, the Yukos affair remains one of the most contentious and divisive aspects of the Russian investment climate. Pro- and anti-Kremlin agents are armed with clear and often valid arguments and have sufficient funding to get them publicly aired. Unsurprisingly, international investors remain confused about the case and its implications.

The initial convictions of former Yukos CEO Mikhail Khodorkovsky and his business partner, Platon Lebedev, on charges of tax evasion in 2005 came at the outset of one of the most impressive bull markets in post-Soviet history. Many agreed that the lifting of uncertainty, along with strong fundamentals, allowed asset prices to skyrocket.

Equities are rallying again now. The RTS Index rose nearly 11 percent in December, but the motivations of this bull market are quite different.

Russian shares are benefiting from strong fundamentals, sustained global demand and a weakening dollar that is driving commodity prices higher. It is true that the new verdicts have lifted a degree of uncertainty, but the result this time is unlikely to benefit Russian asset prices. Over the long term, the impact of these new sentences will be negative, although completely unquantifiable.

How do the two cases differ, and what should investors learn from recent events?

In 2005, the market rationalized that Khodorkovsky had broken the unwritten but acknowledged rule of staying out of politics, and it understood his punishment in this context. In 2010, there was no such sense of misguided justice.

The only conceivable motivations for the latest convictions are negative: personal vendettas by senior politicians or the fear that release would in some way reverse or undermine Prime Minister Vladimir Putin's power gains.

Whatever the motivation may be, Putin has used the second Khodorkovsky trial to make clear that he is unwilling to ease his informal authoritarian style, even as Russia seeks a path toward modernization.

Economic development is the innocent victim in this domestic power play. Russia's business leaders may understand the message, but international investors don't. They observe a disturbing dichotomy between words and actions. Putin has demonstrated that his arbitrary word is the law and that Russia's legal system remains feudal.

Fortunately, Russia again finds itself in a positive fundamental position with both prices and demand rising in commodities markets. As was the case during the first Yukos convictions, investors will behave amorally and follow the money. They will not fixate on individuals' fates. As a result, Russia will continue to enjoy capital inflows.

But once again, Russia's popularity as a target for investment of all forms will be hindered by insecure political structures. Foreign direct investment will be the biggest victim. Learning from Yukos, as well as Shell, BP and many others, companies will be hesitant to invest in long-term fixed assets as long as the government's word is the only guarantee that their rights and property will be respected.

It is certainly true that befriending Putin assures investors some kind of protection under the status quo, but most international companies do not operate on such principles. There is no substitute for a transparent, written and inviolable legal structure. In its absence, investors in Russia will at least require higher returns, meaning that they will expect lower entry prices and the ability to extract more value from any operations they establish in the country.

It was always clear that the Yukos affair was untouchable. But in the light of a case where many incumbent and former senior officials vouched for the defendants and where Putin intervened publicly before the trial was completed, the Dec. 30 verdict was a national setback.

From the international investor's perspective, the campaign to reform Russia has returned to square one. On the upside, however, the financial crisis has increased Russia's openness. Unlike in 2005-08, the government is actively pursuing international capital and has ceased its acrimonious foreign policy. It will again justify Khodorkovsky's sentence as an isolated, unrelated issue. This may be true, but it is even less justifiable now than it was in 2005. The Yukos affair shows no sign of ending and continues to highlight the risks associated with investing in Russia.

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