Privatisation or re-nationalisation in Russia? – Ownership and corporate governance under the current regime

Abstract

The recent years have brought along considerable strengthening of the role of the state in key Russian industrial sectors. There are clear signs of re-nationalisation in the strategic natural resource-based industries in particular, where the Russian State has increased its direct ownership as well as levied indirect control mechanisms. The increased role of the state has inevitable consequences on enterprise performance and corporate governance. While the state ownership in Russia has often seen to result in negative outcomes, including enterprise mismanagement, weakened corporate governance practices and poor performance, the recent increase in state ownership and control has not undermined the overseas investor confidence. The stock issuances by large Russian enterprises have attracted considerable interest on world stock exchanges and the Russian companies are engaged in increasing numbers of international mergers and acquisitions. The key issue remains to reach the equilibrium between the economic and strategic interests in regard to state ownership and control in Russia.

1 Introduction

During the 1990s, the former socialist countries of the Commonwealth of Independent States (CIS) have taken considerable steps towards privatising their enterprise sectors to rebuild their industrial competitiveness through more efficient enterprise management and governance. At divergent levels, the restructuring has facilitated the economic upturn across the CIS, as the private enterprise sectors are gradually catching up with the Western corporate governance.

Within the CIS, Russia has been the leading country in terms of the share of private sector in a country's economy from the very beginning of the transition period. During the recent years we have, however, witnessed reversed development in privatisation in Russia. Initiated by re-nationalisation of some of Russia's most prominent oil assets, the state is evidently regaining control over the country's strategic industrial sectors.

The strengthening of state ownership through reformation of state holding companies and the introduction of hybrid forms of private and public governance has in many instances come at a price of destabilising the credibility of the Russian institutional and legal environment. On the other hand, the recent developments have thus far done little to undermine the investor confidence in the Russian economy; as indicated by several examples of the past year, the increased governmental support through strengthened control and ownership in many Russian companies has been one of the major drivers of the stocks of the companies involved both on domestic and international exchanges.

In the current article, we discuss the development of privatisation and corporate governance in Russia in comparison to other CIS, with subsequent presentation of related Russian company cases and discussion on ownership, control, and corporate governance in Russia, given the increasing state leverage in the country's industrial sector. While extensive international critique has been posted on the subject of re-nationalisation of Russian industrial assets, we attempt to provide constructive discussion on pros and cons of the increasing role of the state in the Russian economy. Aimed to facilitate discussion among policy makers, investors, and academics alike, we offer an insight into ownership and corporate governance issues of the Russian enterprise sector in regard to increasing state control over the Russian industrial assets.

2 Earlier research on ownership, control and corporate governance in Russia

In recent years, a number of scholars have studied the issues of ownership and control in the Russian enterprise population, and particularly in the major industrial corporations. For example, the management transformation of the Soviet enterprise, and the consequent implementation of new productivity criteria in Russia and the CIS, has been examined by Liuhto (1999a; 1999b). Enterprise history in terms of state involvement was found to be a significant predictor of performance. Generally, the studies on ownership, control, and the development of corporate governance in the Russian industry generally suggest high levels of ownership concentration on one hand, and superior performance and governance practices of private companies over the state-owned ones, on the other (e.g. Murav'ev

2003; Guriev and Rachinsky 2004). While both the agency and stakeholder theories have gained some support in explaining the development of corporate governance in Russia, the scholars have further recognised the possibility of Russia developing its own distinctive model of corporate governance, based on the conditions of its unique institutional environment (e.g. Puffer and McCarty 2003; McCarthy and Puffer 2003).

In particular, the effects of ownership concentration on corporate governance have drawn the interest of scholars. Guriev and Rachinsky (2004) stress the high level of ownership concentration in Russia, with the 23 largest business groups controlling more than a third of the sales in their sample representing the Russian industrial field. Guriev et al. (2004) conclude that the concentration of enterprise shares in the hands of a large shareholder has, up to a certain level, a positive impact on corporate governance. However, when too large a block of shares is consolidated by a large external shareholder, the effects of any further increase in their shareholding on corporate governance were found negative.

Earlier research has additionally focused on state shareholdings in Russia due to continuously high share of state ownership in the Russian industry. The results generally suggest lower quality of corporate governance in the state-owned companies. In their study, Kuznetsova and Kuznetsov (1999) pointed out the inability of the state to act as a responsible shareholder and to utilise its power to the benefit of the firms in which it had shares. According to Guriev and Rachinsky (2004), both the private enterprises controlled by minority shareholders and large external owners outperformed the state-owned companies in Russia. Similarly, Murav'ev (2003) concluded that the performance of the companies with state ownership was significantly worse than that of privately-controlled enterprises. As opposed to the common misconception that only the low quality assets were left under the state control, Murav'ev (2003) found the reasons for poor performance of state-owned companies in weak control over the companies and inadequate monitoring of managers. In a related study on mechanisms of state ownership in the enterprise sector, Kuznetsov and Murav'ev (2001) found management through a state holding company preferable to direct government control.

On average, the researchers have found the quality of corporate governance to be higher in large enterprises having lower unit costs of introducing corporate governance standards (Guriev et al. 2004). Similarly, McCarthy and Puffer (2003) cite that small Russian companies seldom have the resources to attract significant foreign investments and seek listing on stock exchanges, thus, lacking any major incentives for developing corporate governance. Corporate governance has been found to be an important factor of restructuring the privatised companies in all transition economies, improving relations among shareholders, directors, and managers (Filatotchev et al. 2003; Shekshnia 2004). Due to the aforementioned reasons, the large companies have been at the forefront of this development, being the first to become involved in corporate governance issues (McCarthy and Puffer 2003). In addition, Black (2001) concluded that the quality of corporate governance is highly positively correlated with market value of large Russian enterprises listed on domestic and foreign stock exchanges. Since the number of the latter has considerably increased in the recent years, we can expect the impact of good corporate governance to have diminished somewhat, but likely to remain significant.

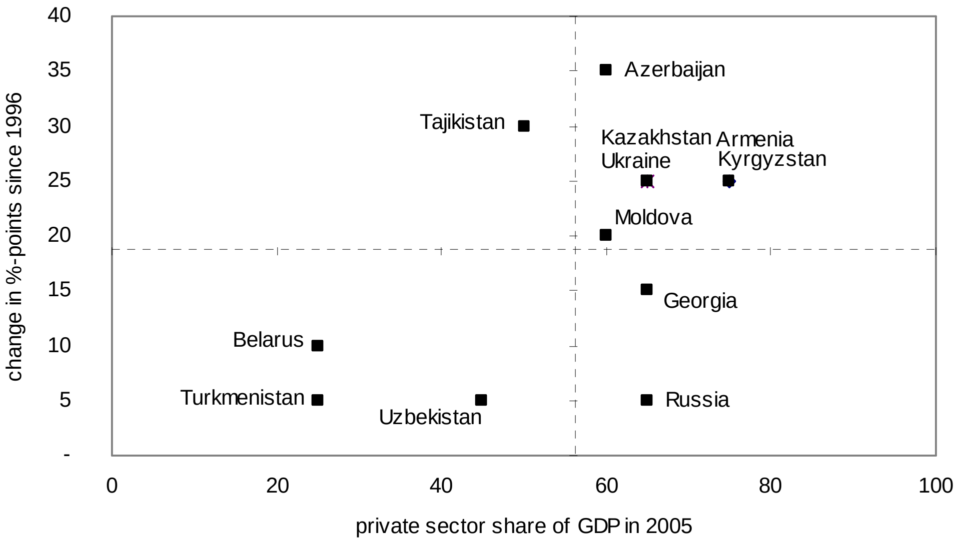
To conclude, the earlier literature indicates the relatively modest implementation of corporate governance practices in Russia. Additionally, the researchers have found the state ownership to have a profound impact on enterprise performance and corporate governance. In our current article, we focus on both issues by providing insights in recent developments of industrial ownership in Russia.

3 Macroeconomic overview on privatisation and corporate governance in Russia

In comparison to the other transition economies in Central and Eastern Europe, CIS countries in general have been more cautious in implementing transitional reforms in the area of enterprise restructuring. The European Bank for Reconstruction and Development (EBRD) assessment in 1996 categorises most of the Central-Eastern Europe and the Baltic States as “countries in advanced state of transition” and the CIS countries to the intermediate or low transition stage categories. The following review concentrates on the developments in the CIS.

The private sector share of the GDP in 1996 (the starting point for our review period) ranged from 15 to 50 per cent in all CIS countries except Russia, where the private sector share had reached 60 per cent in the wake of voucher-based mass privatisation schemes in the 1993-1994. More than 15.000 medium to large companies employing more than 80 per cent of the work force experienced ownership transfer to private entities. The cash-based second phase of privatisation was initiated in the beginning of 1995; a continuation of fast and revenue maximisation oriented policy, but in the end led to significant controversies. After 1996, the pace of privatisation in Russia has been slow, as a new approach aimed towards transparency and enterprise restructuring was taken by the government (EBRD 1996). Figure 1 plots CIS countries on the dimension defined by the 2005 level of privatisation (a rough estimate of the EBRD) and the pace of change during the last 10 years.

Figure 1 Development of privatisation during 1996-2005 in the CIS



Sources: EBRD 1996, 1997, 2004, 2005.

Ukraine and Kazakhstan among others have been active in their privatisation schemes during 1996-2005. They have reached similar level in the share of private sector of GDP as Russia, who achieved most significant development during the first half of the decade. Many of the privatisation plans were hold off and have not yet become part of the reality in Russia, a fact of which good examples are some of the major corporations in Russian industries. Belarus is a story of its own with changing registration policies during the late 1995 largely halting the privatisation and the corporatisation processes; therefore the position in the lower-left, poor-results/no-effort -quadrangle.

During the focus period the level of private sector share of GDP in the CIS countries has actually decreased only twice. The first of these rare occasions took place during 1998-1999 in Moldova, where the political situation has been somewhat unclear with signs of re-nationalisation souring the investment climate. The second is more recent and indeed interesting from this article’s point of view: the indicator dropped from 70 to 65 per cent in Russia during 2004-2005. The reasons behind the negative development in Russia are predominantly the re-nationalisation of large companies in the oil and gas sector. In addition, the decisions to increase regulation in the “strategic industries”, has increased the state involvement in the enterprise sector (EBRD 2005). The future will tell whether this divergent development from most of the other major CIS countries continues to broaden. Currently the level of privatisation ranges from 25 per cent (Belarus, Turkmenistan) to 75 per cent (Armenia, Kyrgyzstan) among the CIS countries.

Enterprise restructuring and the development of corporate governance in the CIS, are also of significance in the scope of this article. Until 1996, the predominant source of restructuring had been the tightening of access to government subsidies and soft bank credits, as well as the increased scope for import competition and the liberalisation of new enterprise development. However, the implementation of stronger bankruptcy laws had so far been on the backburner. In Russia, the level of government subsidies to firms and individuals experienced a significant drop from 23 per cent of GDP in 1992 to approximately 2 per cent in 1995, demonstrating a significant improvement in restructuring of the enterprise sector (EBRD 1996).

In the area of corporate governance the newly formed financial-industrial groups pushed for improved management practices and corporate governance in their respective conglomerated companies (EBRD 1996). This favourable development during 1996-2005 in Russia, as well as in other CIS countries measured by the five category index for governance and restructuring[1], is depicted in the Figure 2.

[1] The EBRD index for corporate governance and restructuring involves a five step categorisation:

Category 1: Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance

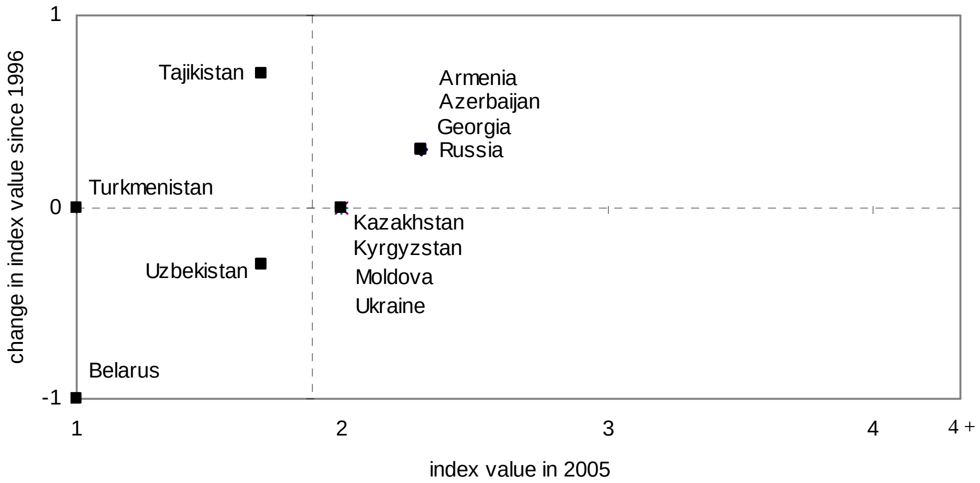
Category 2: Moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance

Category 3: Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (e.g. through privatisation combined with tight credit and subsidy policies and / or enforcement of bankruptcy legislation)

Category 4: Substantial improvement in corporate governance, for example, an account of an active corporate control market; significant new investment at the enterprise level

Category 4+: Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring

Figure 2 Corporate governance and restructuring during 1996-2005 in the CIS



Sources: EBRD 1997, 1998, 2004, 2005.

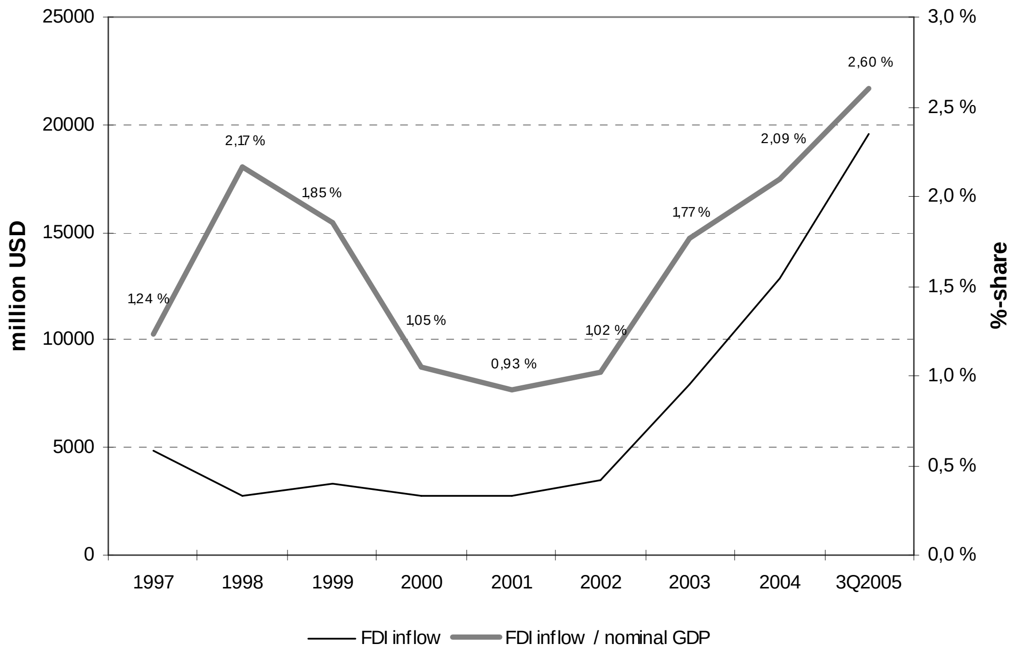
The current state and the ten-year-change oriented set-up in the Figure 2, allows us to distinguish between above and below average countries in terms of current position, and the positive or negative development during the ten-year focus period. Russia managed to improve its position with the change of the millennium, by initiating reforms on bankruptcy laws in 2002, and due to the continued momentum from financial-industrial groups to modernise corporate governance practises in large companies. However, due to the lack of stimulants from the areas of ownership right reforms and increased competition, the restructuring process is just beginning to take hold in many companies lesser in size.

Belarus is the underperformer of the group, while Ukraine and Kazakhstan perform above average even though they have not achieved any significant change since 1996. It is important to note, that in the five-step category of the index (1 – 4+), all the CIS countries lie in the range of 1 to 2.3, with only one country crossing categories into positive direction, namely Tajikistan. The changes have been marginal in proportions, if any. In real terms, there has been no significant improvement during the last ten years from the regime of *moderate policies and weak enforcement* in the area of corporate governance and restructuring in the CIS. The *significant and sustained action* in the promotion of corporate governance and standards of conduct seem to be lacking across the spectrum.

The above considerations on privatisation and corporate governance are important factors in determining the investor confidence and consequently the direction of economic development in Russia. Perotti and van Oijen (2001) argue that the resolution of political risk resulting from successful privatisation has become a significant factor in supporting the rapid growth in stock valuation in the emerging market economies (EME). The determinants of FDI in transition economies have been argued to correlate with for example country risk, which in turn is influenced by the private sector development in general (Bevan and Estrin 2000). In addition, Jensen (2002) has confirmed the significance of political factors, such as the level of economic reform and level of state capture by the political and economic elites, to the volume of transition economy FDI inflows.

Along these findings that establish the relationship of investor confidence and economic development in the form of both portfolio and direct investment contribution, we may take into consideration the observations on FDI inflows to Russia and integrate them to the previously presented elaborations on privatisation and corporate governance. Figure 3 depicts the development of annual FDI inflows during the last decade and plots the significance of the same to the Russian economy, namely the nominal GDP.

Figure 3 FDI inflows and its importance in Russia during 1997-2005



Sources: Russian Central Bank 2006; Rosstat 2006.

The bump in 1998 FDI inflow share of nominal GDP is mainly due to the financial distress of the time, as the value of the rouble depreciated against the USD. With relatively more stable exchange rate development after 2000, the figures are more informative. The accumulated FDI inflow during 1-3Q05 made 2.60 per cent of the Russian nominal GDP: a significant rise from the trough of 2001 with 0.93 per cent contribution. We can make cautious inferences that the favourable development in corporate governance as well as the stable and high share of the private sector in the economy has increased investor confidence, a fact that is confirmed by the A.T. Kearney's investor confidence ranking of Russia as the 11th most attractive market in the world (A.T. Kearney, 2004). However, while the ranking has already declined from the previous years due to unfavourable developments in the level of political risk, the FDI figures show no downward movement. This suggests a twofold impact of increasing state control in the Russian industry on the country's investment profile – despite the increased political risk in Russia due to state interventions in the enterprise sector the recent developments have not undermined foreign investor confidence. This paradox will be discussed in more detail in the following chapter.

4 Redistribution of ownership and control – a company-level insight

As indicated by the decreasing share of private sector in the Russian GDP, the past years have been marked with considerable increase in state control over the country's major industrial assets. Through a series of ownership arrangements initiated by the notorious probe around the country's once-largest oil producer, Yukos, the Russian State is effectively regaining the control over several companies in strategic industries. While widespread concerns have been voiced, on ownership rights, institutional development, and functioning of the legal system in Russia, the increased state control has not entirely been met with disguise – the turnover and value of Russian stock exchanges have hit record-high levels, and international investors are hailing the upcoming IPO's of newborn or restructured Russian state-owned companies on the major stock exchanges of the world.

Hence, when discussing the increasing state leverage and control over Russian industrial assets, we are bound to consider the matters of increased investor confidence and, in some instances, greater transparency delivered by state ownership of the Russian enterprises. In following, we provide three divergent company cases, which highlight the recent developments in the balance between public and private ownership in Russia. The brief company cases are followed with discussion on corporate governance implications of the recent changes in industrial ownership and control in Russia.

Gazprom: liberalisation and state control

Gazprom share market liberalisation and removal of the ring-fence initiated in 2005 is among the most significant recent developments in the Russian enterprise sector. After the collapse of Gazprom and Rosneft merger in 2005, the Russian government introduced an alternative plan and arranged a purchase of additional 11 per cent of Gazprom's shares, accumulating a majority stake in the company. As of the end of 2005, the government directly owned 50 per cent +1 share in Gazprom, while controlling additional 4.55 per cent through subsidiaries. Along with the accumulation of a controlling stake, the government has introduced a liberalization plan for Gazprom's shares, ratified by the president. Most importantly, the steps of implementation of the plan include lifting of limitations on trading of Gazprom's shares by foreign investors on Russian exchanges and lifting the 20%-limit on foreign ownership of the company's shares.

The dramatic shift in plans in just 12 months, from integrating Gazprom and Rosneft, to restructuring and liberalisation of Gazprom shares, implies strong backing at the highest federal level and interest of the state to gain the position of a dominant shareholder in the company. While removal of the ring-fence can be expected to deliver positive effects particularly in the field of corporate governance, the growing urge of the government to actively control the country's major energy assets should not be overlooked. As witnessed by another major event in Russia's energy sector in 2005, the liberalization of Gazprom shares came with a price of further consolidation of the sector.

In late 2005, Gazprom purchased 75.7 per cent of the shares in Russia's fifth-largest oil producer, Sibneft, from its principal owner, Millhouse Capital, associated with a Russian industrial magnate, Roman Abramovich. The $ 13-billion deal, combined with the earlier overtaking of Yukos' main production subsidiary, Yuganskneftegaz, by state-owned Rosneft put the state in control of a third of Russia's oil production, compared to just below 4 per cent in 2003.

Svyazinvest: a long way towards privatisation

Svyazinvest is Russia's state-owned telecommunication holding and fixed-line monopoly, comprising several regional fixed-line operators. The government currently owns a 75%-share in Svyazinvest, valued at $ 5 billion, with the remaining 25 per cent belonging to another Russian financial-industrial holding, Access Industries[2]. As an

[2] The principal shareholder of Access Industries, Leonard Blavatnik, bought the share from Mustcom consortium belonging to George Soros.

owner of the blocking share in Svyazinvest, Access Industries holds the right to intervene in any future reorganisation of the holding.

The privatisation of Svyazinvest has faced numerous delays during the recent years, due to somewhat mixed interests of the groupings inside the Russian government. Included in the group supporting the privatisation are the liberal-minded top officials from the Telecommunications Ministry and Svyazinvest. The voices hindering the privatisation include the military and government security agencies, afraid of losing their preferential tariffs, and facing more operational restrictions with the Russian fixed line network in private hands. However, the two strategic groupings have already been promised preferred treatment and considerable subsidies to set up networks of their own once the Svyazinvest privatisation is completed.

The delay in privatisation implies certain strategic governmental interests around the holding. Despite the long-lagged process, the latest developments suggest the auction should be expected during 2007, as the government is narrowing the list of suitable buyers for its 75%-stake. As indicated by earlier developments in the process, the Russian government is not eager to hand over the control in a company that controls more than 70 per cent of the country's telecommunications infrastructure to a foreign owner. It thus remains obvious that the government is seeking the possibility to retain certain leverage over Svyazinvest by introducing a manageable domestic buyer for its stake.

AvtoVAZ: strengthening the control

Russia's largest carmaker, AvtoVAZ, has been one of the flagships of Russian machinery industry since the Soviet era. For the domestic car manufacturers, the development in Russian passenger car market in the recent years has been troubling at best. Weak quality of production, troubling financial conditions and growing demand for foreign cars have driven many domestic producers on the verge of bankruptcy. Moreover, the expected WTO membership of Russia has been predicted to hit hard on domestic automotive and other manufacturing industries.

In late 2005, the former owners of AvtoVAZ, led by Vladimir Kadannikov, swiftly sold out their shares in the company to undisclosed buyers. The event was followed by sudden change in the company's management, as more than 100 executives of the state-owned armament exporter, RosOboronExport, took control over AvtoVAZ. As suggested by the quick turn of events, the State seemingly has a definite goal of securing control over the car manufacturer. Currently, the state directly owns 2 per cent in the company, while the subsidiaries control 64 per cent. The likely scenario includes the state increasing its ownership in AvtoVAZ to a direct majority. As reported by several market observers, the governmental plans include formulating a state-run automotive conglomerate, which would include AvtoVAZ, the major truck manufacturer, KamAZ, and off-road vehicle and truck manufacturer GAZ.

As the case of AvtoVAZ indicates, the government is looking to increase its control over the key sectors of Russian industry even beyond the natural resource-based sectors. In many aspects, however, the increasing state control over the troubled carmaker may be regarded as positive development for the company. For AvtoVAZ, the acquisition essentially means even stronger state support and likely improvements in financial conditions; as a government-backed company, the credit profile of AvtoVAZ should witness major improvements among investors.

As indicated by the above cases, several divergent sectors of the Russian economy are currently undergoing significant changes in regards to ownership and control. The current restructuring of Russian industrial sector is essentially about striking a balance between public and private ownership, with both economic and political lines of consideration present.

As elaborated earlier, the impact of increased state ownership and control is essentially twofold. The deteriorating effects of such development occur both at the national and company levels. While the former category includes reduced credibility of the Russian institutional and legal environment as well as deteriorating ownership rights, the negative effects on the company level are more diverse. As the federal and regional governments regain stakes in private companies, the processes have more often than not included violation of the rights of minority shareholders. In addition, often being in positions of operating companies for their personal benefit, the managers of state-owned companies have an unimpressive record of corporate governance violations. In addition, as indicated by several earlier studies, the state-owned companies have repeatedly been found inferior to private enterprises in terms of efficiency and performance. As indicated in the report by Troika Dialog (2006), the level of corporate governance in Russia deteriorated in 2005, along with a drop in the number of well-governed companies. While the reasons can be found in many contradictory ownership arrangements throughout the Russian industry, the increasing state ownership and related violations of minority shareholder rights play a notable role in this development.

However, to obtain a comprehensive overview on recent developments, one should not only focus on deteriorating effects of increased state ownership in the Russian industry. When many of the formerly private companies controlled by oligarchic groupings have poor transparency and disclosure records[3], state ownership is to considerably enhance the level of transparency of the companies involved. In addition, the financial support through restored state ownership may be viewed as a last resort for financially troubled and mismanaged enterprises of national strategic interest, such as the case company AvtoVAZ. Furthermore, while the international observers grow increasingly concerned over institutional and legal developments in Russia, the investment community has often welcomed the increased state leverage in Russian companies as a provider of additional stability on the Russian market. In an environment characterised by relatively high political risk, increased state ownership interests in the companies is often perceived by investors as offering additional safeguard against future political interventions. As a result, the planned IPO's of several majority state-owned companies have drawn

[3] For instance Sibneft and AvtoVAZ have a long record of poor organisational transparency. Neither of the companies officially revealed the real structure of ownership behind the nominal shareholders.

enormous interest among international investors. Here, however, one needs to make a distinction between the positive reactions among the portfolio investors and often negative attitudes of strategic investors, who are likely to be more concerned about the increased state ownership and its deteriorating effects on enterprise development.

5 Conclusions

During 2004-2005, the private sector share of GDP in Russia decreased for the first time since the beginning of the transition period, indicating the increased state involvement in the enterprise sector. While the earlier studies generally confirm superior performance of private companies over the state-owned ones, the increased state ownership in Russian industry has thus far had little if any negative impact on investor confidence and FDI flows in Russia.

As indicated by the investor reactions, the impact of increased state control in Russian industry is essentially twofold. The detrimental effects of regained state ownership may include reduced credibility of the Russian institutional and legal environment, deteriorating ownership rights and purposeful mismanagement of companies and other corporate governance violations. On the other hand, increased state ownership has in some instances resulted in increased organisational transparency and assisted in improving the financial conditions of troubled companies. Furthermore, in particular the portfolio investors have regarded increased state ownership in strategically sensitive industries as a safeguard against unexpected political interventions.

Notwithstanding the positive reactions among the international investment community to increased state ownership in some instances, the long-term effects of increased state leverage are likely to include deteriorating enterprise performance, lower GDP growth rates, and weakening position of foreign firms in many industries. The recently increased strategic thinking in the Russian economy suggests increasing limitations to foreign participation in several of Russian industrial sectors. In contrast, along with the upcoming WTO membership, Russian economy should become more open towards increased foreign participation through imports and, consequently, FDI. The question remains, how the balance between economic and strategic interests in Russian enterprise sector will be maintained.

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