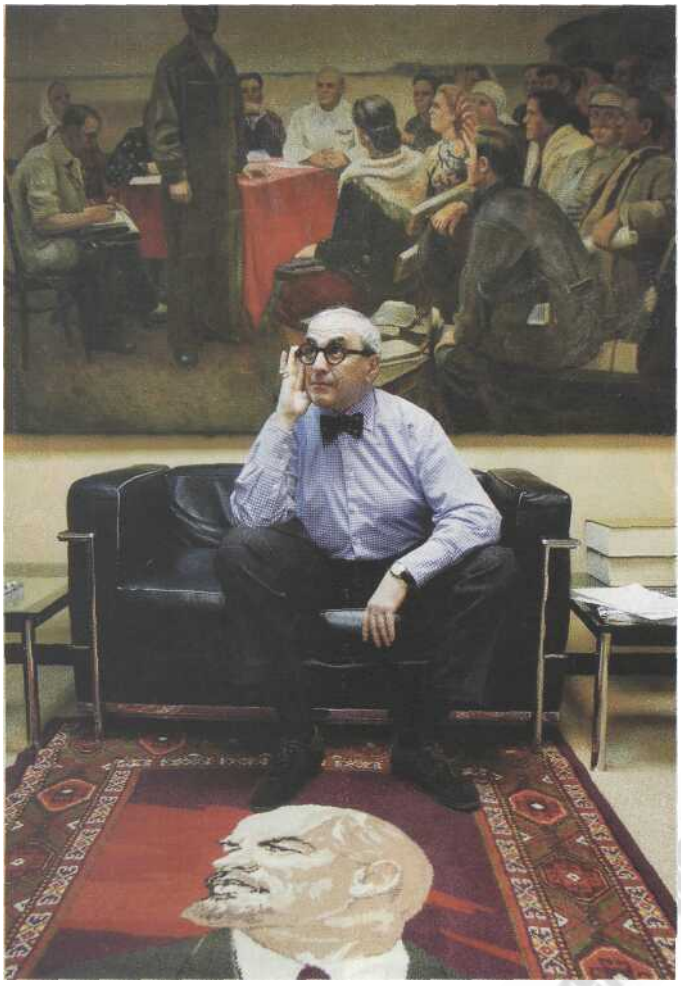
HOW THE KGB (AND FRIENDS) TOOK OVER RUSSIA'S ECONOMY

VLADIMIR PUTIN PUT HIS PALS IN CHARGE TO BRING ORDER OUT OF CHAOS. BUT WILL THEIR HEAVY HAND BE THE RUIN OF RUSSIA'S BOOM?

BY BILL POWELL

LONG BEFORE THE SMALL GROUP OF MEN gained control of a $1.3 trillion economy, they could be found gathered at a lakeshore deep in the forest, trying to relax amid the upheaval of the new Russia. Lake Komsomolskoye, named after the youth wing of the Communist Party, lies about 60 miles north of St. Petersburg, just one of 700 lakes on the isthmus connecting Russia and Finland. There the group, many of whom helped run Russia's second-largest city, would retreat for weekends among the tall, lakeside cedars in a private compound of dachas, or country houses. Vladimir Putin, then head of external relations for the St. Petersburg mayor, was a member of the group. So was Vladimir Yakunin, who had revived a bank started by the Communist Party, and Igor Sechin, then Putin's chief of staff. The group called itself *ozero*, meaning "the lake," and one of its frequent

AUTHORITY FIGURES: FORMING THE FORCEFUL FRONT ROW AT THE OPENING OF A RAILROAD FERRY IN 2006 WERE, FROM LEFT, TRANSPORT MINISTER IGOR LEVITIN (A FORMER ARMY OFFICER), VLADIMIR PUTIN (EX-KGB), RAILWAY CHIEF VLADIMIR YAKUNIN, AND DEFENSE MINISTER SERGEI IVANOV (BELIEVED TO BE EX-KGB).



RED SCARE? LAWYER ALEKSANDR DOBROVINSKY SAYS AN UNNAMED SENIOR GOVERNMENT OFFICIAL TRIED TO FORCE A CLIENT, VLADIMIR NEKRASOV, TO SELL HIS RETAILING COMPANY AT FIRE-SALE PRICES. NEKRASOV, WHO SITS IN JAIL ON TAX CHARGES, DECLINED.

guests was a bright young lawyer named Dmitry Medvedev who worked in the St. Petersburg government. One prime topic of their lakeside conversation back then: how much they disliked the unfolding chaos of Boris Yeltsin's Russia.

More than 15 years later, many of these same men (and some of their closest friends) now run the country. Since Putin became President in 2000, thanks to President Yeltsin's unexpected resignation, other members of the lake group have risen to the highest levels in Russian business and politics. Sechin, 47, now chairs Rosneft, the state-owned oil company; Yakunin, 60, heads Russian Railways. And Medvedev, 42, was chairman of Gazprom, Russia's largest company, until succeeding Putin as Russian President in March. While Putin, 55, stepped into the No. 2 role of Prime Minister, no one doubts that he has extended his regime.

Although Russia's military incursion into its former republic of Georgia was the most dramatic expression of Russia's new nationalism, a similar campaign has been gaining momentum in the realm of business. Putin and his pals have moved swiftly to reassert the government's control over key sectors of the Russian economy, pushing aside—and sometimes punishing—outside investors and many of the so-called oligarchs, the flashy entrepreneurs who grew fabulously wealthy when Yeltsin liberalized the Russian economy. In all, the state has taken back an estimated $100 billion in assets held by private hands in the 199os, according to analysts. For Putin & Co., business is the new frontier. "These days," says Boris Nemtsov, leader of the largest opposition party in Russia and a former deputy prime minister under Yeltsin, "these guys are all about money as much as anything else."

The nationalistic zeal of these executives and leaders may be explained by something else the lake group members share: Almost to a man, they served in the Soviet-era KGB, which comprised both the foreign intelligence service (of which Putin is an alumnus) and also the dreaded internal security apparatus, which had intimidated and terrorized several generations of Soviet citizens. While Putin proudly acknowledges his time in the KGB, others do not, yet their resumes are filled with postings that former KGB officials cite as common covers for the intelligence agency. Rosneft's Sechin, for example, worked as a translator in Angola and Mozambique in the early 198*os*. Yakunin spent six years as a diplomat at the Soviet mission to the United Nations. Medvedev is a notable exception, having no apparent KGB background. Among the top Russian bureaucrats and business leaders, more than one-quarter have their roots in the so-called power ministries of the government, of which the old KGB is first among equals, according to Olga Kryshtanovskaya, a sociologist who tracks Russian elites. These men are known collectively as the *siloviki*, from a Russian word for "force." "You could say they control the crown jewels of the Russian economy," says journalist Yevgenia Albats, who has written a book on the KGB (the security service that succeeded has the acronym FSB).

For the vast majority of Russians, the pedigree of the men now running Russia Inc. is not something they dwell on. Medvedev, Putin's handpicked successor, enjoys immense popularity among citizens, and most foreign CEOs support him too. These days, for Russians and foreigners alike, the bottom line trumps all—and Russia under Putin and his successor has been pumping profits. "There's no question, economically speaking, the last eight years—the Putin era—have been very successful compared to the previous eight," says Roland Nash, head of research at Renaissance Capital. Economic growth since 2001 has averaged 7% a year. The Russian stock market has added no less than $1 trillion in wealth, fueled by a surge of foreign investment getting in on Russia's boom.

Yet for all the talk of prosperity and stability under Putin & Co., foreign companies operating in today's Russia—especially those in Russia's valuable energy and natural-gas sectors—$ave suddenly started getting nervous. Stories of Russian power plays have grown too numerous to dismiss: of business leaders thrown in jail on bogus charges, assets taken by dubious lawsuits, partnerships with Russian companies suddenly turning into struggles over control.

Aggravated by the invasion of Georgia, those concerns have sent the Russian stock market plunging more than 30% since May. Unless Russia can moderate its growing reputation as a strong-armed economic regime, its appeal as an emerging market maybe coming to a close. Says Renaissance's Nash: "There's no question the outside investment community is watching this now very, very closely." Lately the PR has been disastrous. Consider the case of BP, which thought its partnership with a group of Russian billionaires, TNK-BP, was a textbook joint venture. Instead, the British oil company finds itself under attack: Its Russia-based employees have been hit with dubious charges of industrial espionage, the CFO of the venture recently stepped down, and the CEO has publicly complained of "sustained harassment of the company and myself" by Russian authorities. Industry analysts believe they've seen this scenario before—last year Royal Dutch Shell was forced to cede control over its Sakhalin oilfield to Russian companies (see "Shell Shakedown" on fortune.com)—and predict BP will eventually pull out in frustration, followed by a state-controlled energy giant taking over the business.

The BP case raises vexing questions for an economy now bathing in the luxury of $115-per-barrel oil. Bill Browder, who had been one of Russia's biggest foreign portfolio managers until his visa suddenly was revoked without explanation in 2005, wonders whether the current crop of CEOs and government leaders have "any serious commitment to property rights." The fact that so many people sitting atop corporate Russia were schooled not at Harvard or Stanford but at a notorious espionage and security agency does not reassure Browder, whose Hermitage Capital Management has been raided repeatedly by Russian authorities in the past year for a variety of alleged improprieties (none of which have been proven). "This happens every day, all day long," Browder told *Fortune*. "If you own a piece of property [that the government wants], you can be the target of this type of raid."

Foreigners aren't the only targets of the government's escalating land grab. An early warning came with the 2003 prosecution of billionaire Mikhail Khodorkovsky, CEO of Russia's oil company Yukos, who is now serving an eight-year prison term in Siberia on a questionable tax-evasion and fraud conviction—an effort led by Igor Sechin, who was then Putin's deputy chief of staff. Sechin, who declined to be interviewed, then folded Yukos into state-owned Rosneft and a year later became chairman of the state-owned oil company (all the while maintaining his position as Putin's right-hand man). The addition of Yukos helped transform Rosneft from a lackluster state business to a strong performer, with $36.2 billion in revenues last year. Khodorkovsky now awaits another trial on fresh charges of embezzlement and money-laundering. "As soon as one sentence is over, they'll add another," he told the Times of London in May, alleging that Sechin plundered his company "out of greed." A Russian government spokesman says Khodorkovsky was lawfully convicted.

In late July, Putin again removed the velvet glove and cocked his fist at an oligarch who had displeased him—in the process

PUTIN'S INNER CIRCLE

MANY OF THE MEN IN KEY CORPORATE AND GOVERNMENT ROLES PROUDLY ACKNOWLEDGE SERVING IN THE KGB. OTHERS DO NOT, BUT THEIR INVOLVEMENT HAS BEEN REPORTED ON IN THE RUSSIAN PRESS. HERE ARE SOME KEY PLAYERS:

SERGEI VIKTOROVICH CHEMEZOV

KGB connection: Neither confirms nor denies affiliation. Russian press and *Fortune* sources confirm KGB post.
Kremlin role: Member of the State Military-Industrial Commission.
Corporate title: General director of Rosoboroneksport since April 2004; chairman of AvtoVAZ.

SERGEI BORISOVICH IVANOV

KGB connection: Served as a KGB officer with stints in Scandinavia and Africa, according to press reports and *Fortune* sources.
Kremlin role: First deputy prime minister in charge of the military-industrial complex.
Corporate title: Chairman of United Aircraft Corp.

VIKTOR PETROVICH IVANOV

KGB connection: Served as officer of the Leningrad branch.
Kremlin role: Assistant to the President since March 2004; deputy head of the presidential administration in charge of staffing since 2000.
Corporate titles: Chairman of Almaz-Antei; chairman of Aeroflot.

NIKOLAI PATRUSHEV

KGB connection: Served as head of Federal Security Service (FSB), a successor organization to the KGB.
Kremlin role: Head of Russia's security council.
Corporate title: No current corporate ties.

VLADIMIR STRZHALKOVSKY

KGB connection: Served as a KGB officer with the Leningrad branch of the Soviet security agency from 1980 to 1991, according to government website.
Kremlin role: Until recently served as head of the Federal Tourism Agency.
Corporate title: New CEO of Norilsk Nickel.

IGOR IVANOVICH SECHIN

KGB connection: Denies any ties. Multiple Russian press reports and *Fortune* sources confirm his career as former KGB officer.
Kremlin role: Deputy prime minister in charge of energy industry.
Corporate title: Chairman of Rosneft since July 2004.

VLADIMIR IVANOVICH YAKUNIN

KGB connection: Denies any ties. (Spent six years as part of Soviet delegation to the UN.)
Kremlin roles: Former deputy transport minister and deputy railway minister.
Corporate title: Head of Russian Railways since 2005.

spooking investors in a major Russian company listed on the New York Stock Exchange. Putin overtly threatened Igor Zyuzin, the CEO of Mechel, a mining and metals giant, accusing him of price fixing in order to evade corporate taxes. When the billionaire Zyuzin failed to show up at a meeting with Russian authorities, saying he was ill, Putin told a group of steel executives in Nizhny Novgorod: "Illness is illness, but I think he should get well as soon as possible. Otherwise, we will have to send him a doctor and clean up all the problems." Investors in MecheFs stock were the ones who were sick after that remark, given the implications. Mechel plunged 30% in a single day of trading in New York. Putin declined to be interviewed for this story.

Hoping to calm nervous investors, the leaders of Russia Inc. have taken great pains to give their businesses a sheen of transparency and respectability. Two years ago Sechin and his CEO, Sergei Bogdanchikov, hired former Morgan Stanley banker Peter O'Brien to be Rosneft's CFO. Bogdanchikov runs the day-to-day business in Russia, and O'Brien presents a reassuring face to the West. Both ultimately answer to Sechin, who in turn answers to Putin.

But skeptics believe the buoyancy of the Russian economy, and a corporate sector in which key assets are increasingly controlled by the state, can't last. "These guys are running around now acting as if they're geniuses," says a senior executive at a foreign subsidiary based in Moscow, "because the Chinese and Indians are getting rich and driving up demand for everything. Talk about being born on third base and thinking you hit a triple."

A cautionary example is the oil and gas sector, the main beneficiary of the sharp rise in prices over the past three years—and a key sector in which the state has reasserted control. Production, analysts note, may actually decline this year as a result of flagging investment. In response, Russia cut corporate taxes in the oil and gas sector this past spring, but it's not clear that it will be enough to revive what should be a booming industry. A former Yukos executive who did not want to be identified says the problem is soaring costs and aging fields—both of which require "the industry's best technology and management to rectify. Unfortunately, they're doing their level best to drive that out of Russia. Look at Yukos. Look at TNK-BP now."

THE STATE HAS TAKEN BACK AN ESTIMATED $100 BILLION IN PRIVATE ASSETS.

THE PHILOSOPHICAL GLUE THAT HOLDS TOGETHER MANY OF THE sitoviki, the former spooks now running Russia, is that they despised the myriad changes in their homeland during Boris Yeltsin's presidency. They believed the dissolution of the Soviet Union was a humiliation, and the chaos, crime, and corruption that erupted in the decade that followed were a disaster. And the thing about it is, they are not entirely wrong.

I was here back then, as a foreign correspondent during Yeltsin's second term, from 1996 to 2000. Putin and his cronies are surely misguided in their nostalgia for the Soviet Union and the Cold War rivalry with the West. But the second part of the indictment of post-Soviet Russia—the economic chaos, the crime, and the corruption that the guys now in charge dwell on when they speak of those years—well, they're right about that. What happened to average Russians in that period was often deplorable. Virtually anyone who worked for the state, including teachers and military officers, would go for months without being paid because the government was broke, literally defaulting on its sovereign debt in 1998.I once traveled to Kamchatka, in the Russian Far East, to interview the family of a young military officer who had killed himself because he could not afford to throw his wife a birthday party. The government hadn't been paying his unit's salaries.

Last spring, sitting at a table in a large receiving room in the headquarters of the Russian national rail system, I told its current CEO, Vladimir Yakunin, one of Putin's closest friends, that foreign correspondents in Moscow used to have a saying about Russia in the late 199os: The turmoil "was good for journalism—but bad for Russia." He perked up instantly. He looked at me and said in his fluent English (from his six years in New York City, ostensibly as a diplomat): "You were right." Unprompted, he then brought up an infamous incident from 1994, when Yeltsin visited Berlin for a ceremony to accompany the withdrawal of Russian troops. To men like Yakunin, the fact that the troops were leaving—in effect, in defeat—was bad enough. Yeltsin then added insult to injury when, plainly tipsy after a long lunch, he started playfully conducting a German military band that was playing outside the home of the German President. Even today, the memory makes Yakunin seethe. "Embarrassing," he snaps.

It's a revealing moment. For the board members of Russia Inc.—men like Yakunin, Sechin, and Sergey Chemezov, who runs Russia's $6.2-billion-a-year weapons-export monopoly—strong feelings about the past are guiding their vision of Russia's future. They're not naive enough to believe the entire Soviet Union can be restored. Indeed, they are not naive at all. But like Yakunin, they are almost all nationalists—fiercely so. And as such, their first instinct is to expand still further the role of Mother Russia in the national economy. Yakunin gets particularly animated when talking about how he has insisted that the foreign companies that want to sell railcars to Russia must now manufacture locally. And what has the international reaction been to that? "Our foreign partners have been very enthusiastic," he says, beaming. An executive of one foreign supplier to Russian Railways acknowledges that he has productivity and quality

concerns with moving manufacturing into Russia. "But at the end of the day, we'll do it if we have to," the executive says. "The market is promising to us."

VLADIMIR PUTIN INHERITED A RUSSIA IN UTTER DISARRAY. THE nation had defaulted on its sovereign debt and devalued the ruble, and was having trouble paying hundreds of thousands of state employees. Putin implemented a budget discipline that simply didn't exist under Yeltsin—thanks in part to a team of advisors who were not former intelligence agents but trained economists. He even included some fiscal liberals like Finance Minister Alexei Kudrin. One advisor, Andrei Illarionov, who was Putin's senior economic advisor in the Kremlin as well as his personal representative to the G-8, had impeccable free-market credentials, and he and Kudrin put the country's economic policy on a firm footing. They implemented a 13% flat-tax rate and created a national stabilization fund, drawn from taxes on oil and gas sales, that now amounts to $157 billion.

But some of those same advisors are frustrated that they've stabilized Russia's finances so the government could then grab control of swaths of the economy. Illarionov left the Putin administration in late 2005 because of what he saw coming: a state with an appetite that went beyond simple control of key assets, like oil and gas and diamonds and copper; a state that, if it didn't like what the owner of a business was doing, would push that owner aside. Last year he publicly lamented a growing "climate of fear" in Russia.

Bill Browder, who co-founded Hermitage Capital in 1996 with the late billionaire banker Edmond Safra, would be the first to acknowledge he made a fortune in Russia. While running Hermitage, he became a tenacious promoter of minority shareholder rights in the new Russia, fighting famously fierce battles at Gazprom and UES, Russia's largest electric utility. "I was persistent, but I think other minority investors, foreign or Russian, believed I was a constructive force," he said. Yet Browder evidently made some high-powered enemies as well. He has not been able to get back into the country since his visa was revoked in late 2005, but that was to become the least of his worries. In early 2007 an officer of the Interior Ministry called Hermitage's office in Moscow and—according to transcripts of the conversation provided by Hermitage, which taped the call—hinted that Browder's visa issue might be resolved "depending on how you behave [and] what you provide." Hermitage officials believe this was an effort to elicit a bribe from them. They declined. (The Moscow office of the Russian Interior Ministry declined to comment for this article.) Four months later, a 25-man team from the Interior Ministry raided Hermitage's Moscow office, seeking, the chief investigator said, tax documents related to one of Hermitage Capital's clients. The same day, a unit showed up at the Moscow office of Hermitage's law firm, Firestone Duncan, seeking similar documents. When one of the attorneys objected, witnesses say, he was escorted to a conference room and beaten.

Hermitage's ordeal was just beginning. Investigators soon launched a hunt for its assets at four different banks at which it held accounts in Moscow: Citibank, HSBC, Credit Suisse, and ING. The company then discovered that its ownership of three Russian subsidiaries was wiped off the government's official share registry. The only way that can be done in Russia is to have, among other documents, the original corporate seal. The Interior Ministry, thanks to its raid on Hermitage's law firm, had taken that and all the other documents necessary to effect such a change.

It got worse. After the fact, Hermitage learned that a company it had never heard of, Logos Plus, filed a lawsuit accusing Hermitage of bilking it out of $376 million in a sham transaction involving Gazprom shares. Three lawyers, saying they represented Hermitage, showed up at a St. Petersburg court and essentially admitted guilt. They were impostors—they had nothing to do with Hermitage. But the judge promptly or-

RESOURCES GALORE

RUSSIA'S TEN LARGEST COMPANIES, RANKED BY 2007 REVENUE.

A WORKER WELDS A GAZPROM PIPELINE IN SIBERIA.

1. GAZPROM
Revenue: $98.6 billion
Revenues at Russia's natural-gas monolith (No. 47 on the *Fortune* Global 500) grew 21.6% in 2007, but stagnating production cast doubts on the company's future.

2. LUKOIL
Revenue: $67.2 billion
A publicly traded company among state-controlled giants, Lukoil operates gasoline stations in Russia, the U.S., and Europe.

3. ROSNEFT OIL
Revenue: $36.2 billion
The government-owned oil producer saw net income jump 264% in 2007 to rank 21st in profits on the Global 500.

4. SURGUTNEFTEGAS
Revenue: $23.3 billion
The publicly traded oil and gas company's profile could rise when pipeline operator Transneft starts transporting oil through Eastern Siberia, a Surgutneftegas stronghold.

5. SBERBANK
Revenue: $20.8 billion
After boosting revenues 44% in 2007, the state-owned bank landed on the Global 500 (No. 406) for the first time.

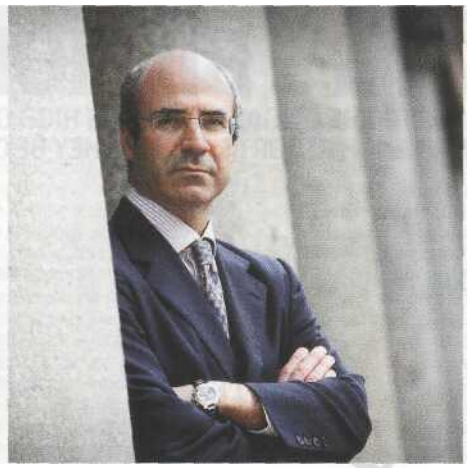
6. MMC NORILSK NICKEL
Revenue: $17.1 billion
The world's largest nickel and palladium producer, a public company, just installed a Putin pal, and ex-KGB official, as its new CEO.

7. SEVERSTAL
Revenue: $15.2 billion
Publicly traded steel giant Severstal is aggressively pursuing foreign acquisitions such as a $775 million purchase of U.S. steelmaker Esmark.

8. SISTEMA
Revenue: $14 billion
The telecom giant is headed for the silver screen—a spokesperson announced in July that the company is building a $250 million film studio in St. Petersburg.

9. EVRAZ GROUP
Revenue: $12.8 billion
The federal government is cracking down on publicly held coal mining and steel company Evraz and others for creating artificial shortages at home.

10. TATNEFT
Revenue: $10.6 billion
Recent clashes with the Ukrainian government left the oil and gas firm without its own refinery, but Tatneft's profits jumped 42% in the first half of this year.



THE CRITICS: OPPOSITION LEADER BORIS NEMTSOV (LEFT) AND INVESTOR BILL BROWDER QUESTION THE KREMLIN'S RENEWED INTEREST IN BUSINESS AFFAIRS.

dered that Logos Plus be paid the $376 million. Hermitage later learned that 15 such claims had been brought across the country, resulting in awards of $1.26 billion to the plaintiffs.

The shakedowns follow familiar patterns. Vladimir Nekrasov, former CEO of Arbat Prestige, a successful retailer that owns a significant amount of hugely valuable real estate in Moscow, is in jail, having been arrested earlier this year on charges of tax avoidance. Nekrasov's attorney, Aleksandr Dobrovinsky, claims that shortly after his client's arrest, a "senior official" from Putin's government—he will name no names—visited him and made an offer. The government would pay Nekrasov $3 million for his company—it's worth ten times that, perhaps more—and let him out of jail. Dobrovinsky declined, and Nekrasov remains in jail.

DMITRY MEDVEDEV, RUSSIA'S NEW President, has a phrase he likes to use *to* describe the "old" Russia, where the rule of law carried no weight: "legal nihilism." But legal nihilism isn't a thing of the past. "Property rights, in fact, have not improved much, if at all, since the Yeltsin years," Renaissance's Nash acknowledges. Nash believes Medvedev is serious about trying to make them mean something. In July, Medvedev pointedly stressed how important it is for Russia to have stable and transparent capital markets. It was a clear response, Kremlin watchers say, to Putin's threat against Mechel and its CEO. But it's fair to question just how much clout Medvedev and the economic liberals remaining in the government really have. After all, in early 2007, at the World Economic Forum Meeting in Davos, Switzerland, Medvedev had assured Browder he would intervene on Browder's behalf. Medvedev was first deputy prime minister then. He's President now, and Browder still can't get back into the country. In fact, there's little reason, for now, to think that Medvedev has the political clout to take on his Prime Minister—the man who effectively elevated him. (Medvedev declined to be interviewed.) Browder, for one, isn't holding his breath, and he thinks his case has repercussions for Russia's global ambitions. "It was one thing, in the 199os, to invest here—whether as a foreigner or as a Russian—when the stock market was trading at two times earnings," Browder says. "Despite the risks, it was pretty much a no-brainer." Now, however, the cost has gone up—the Russian market trades at about eight times earnings—and the risk hasn't diminished a whit. "They need to get a grip on this stuff, plain and simple, and, as Medvedev says he wants, implement the rule of law," says Browder.

MEDVEDEV "NEEDS TO IMPLEMENT THE RULE OF LAW," SAYS EXILED RUSSIA INVESTOR BILL BROWDER.

But the KGB graduates who now run Russia are getting just the kind of grip they want—an ever-tightening one on Russia's strategic assets. In early August, Putin intervened in what had been a bitter struggle in Russia's huge, strategically vital metals industry—a fight between two 'gos-era oligarchs who had both survived the transition to the Putin era. Oleg Deripaska had been making a run at Norilsk Nickel, the country's biggest nickel miner and a company that is part of Vladimir Potanin's empire at Interros, a Moscow-based conglomerate. Putin, industry analysts believe, wants Russia to create a single global competitor to the Anglo-Australian giant BHP Billiton, and he'd had enough of the industry's fractiousness. So, Moscow sources say, he "recommended" that Potanin appoint a new CEO at Norilsk. His name is Vladimir Strzhalkovsky, and up until now he has been the head of Russia's state tourism committee. And if that little data point on his resume doesn't necessarily inspire confidence in his ability to run a global mining giant, consider another: He spent 11 years in Leningrad, as St. Petersburg was known in the Soviet era, working—surprise, surprise—for the KGB.

POWELL, Bill. How the KGB (And Friends) Took over Russia's Economy. **Fortune**, Amsterdan, n. 16, p. 48-57, September. 2008.

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