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Mikhail Khodorkovsky and Yukos

Chelovek c rublyom (Man with a Ruble)

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Pride Goes before a Fall?

In the spring of 2003, Mikhail Khodorkovsky, Russia's richest man and the CEO of Yukos, the second-largest Russian oil producer with a market capitalization of US$26 billion, made two public announcements that immediately attracted the attention of the media, business community, politicians, and researchers and educators in Russia and abroad. Khodorkovsky's announcements provoked waves of speculation about the future of the global energy industry and Russia's political and economic prospects.

First, Khodorkovsky expressed his intention to step down from his job in 2007. He has worked consistently long hours over the years—in 2003, it was up to ten hours a day, six days a week—and he does not want to be working so hard after the age of 45 (a milestone he will reach in 2008). Khodorkovsky's revealing of his retirement plans was the first announcement of that sort made by an oligarch in the history of the new Russian capitalism, and it sparked strong rumors (which he denies) about his ambitions to succeed President Putin when the latter's almost certain second term expires in 2008.

The second announcement came on April 22, when a smiling Khodorkovsky and Evgeny Shvidler, CEO of Sibneft, Russia's fifth-largest oil company, revealed an agreement to merge their companies into a giant oil producer with an estimated US$45 billion market value. YukosSibneft would be the biggest of the Russian oil companies, producing 30% of the total Russian oil output. (The second-largest company produces around 18%). Combining Yukos and Sibneft would form the world's fourth-largest combined oil reserves. The scale and timing of the deal made it an event of global importance, creating a company able to compete with ExxonMobil, Shell and BP.

According to the terms of the deal, Yukos would pay core private shareholders of Sibneft, including the notorious Roman Abramovich (one of the most influential oligarchs during Yeltsin's era, and currently governor of Chukotka), US$3 billion for 20% of Sibneft and exchange another 72% belonging to the group for the shares of Yukos proper (not more than 26%). Khodorkovsky would become the CEO of YukosSibneft, while Shvidler, a long-time associate of Abramovich, would chair its board of directors.

Both the financial terms of the deal and the new composition of shareholders received mixed reactions in the Russian media and business community. Over the last few years, Khodorkovsky had developed a reputation as Mr. Corporate Governance of Russia, promoting principles of transparency, protection of minority shareholders' rights, and separation of executive and oversight bodies. Under his guidance, Yukos had become a model Russian corporation, with a fully transparent shareholder structure and a board of directors dominated by independent members, comprehensive financial reporting, and strong investor relations efforts.

Sibneft, on the other hand, had a reputation for being one of the *least* transparent oil companies, with a history of shareholder rights abuses, corporate wars for assets, and outdated accounting and reporting systems. Its shareholder composition had never been clear—some

Russian mass media speculated that former Kremlin kingmaker, Boris Berezovsky, was still a part owner.[1]

The combination of Khodorkovsky's announcements left the Russian and international business communities puzzled, but it was not the first time the oligarch had surprised the world with an unexpected move—and in the past, such moves had always brought him significant dividends.

And the surprises were not over yet. On October 25, 2003, Mikhail Khodorkovsky was arrested and thrown in jail. The Sibneft merger was in jeopardy. World financial markets reacted as Khodorkovsky made statements from his cell. What would the outcome be?

A Model (But Very Ambitious) Soviet Youth

In the summer of 2002, Yukos' CEO, Mikhail Khodorkovsky, went to visit the Yukos-sponsored "New Civilization" camp for young Russians. Participating children spend two weeks organizing and working in "Newlandia," a society with its own parliament, private entrepreneurs, and common currency (the "rudol"). The children learn about the democratic process by levying taxes and passing laws to govern their society. In addition to various government jobs they can choose, they can also opt to run for election to parliament or become entrepreneurs.

Only one boy made any serious rudols that summer, ending the two weeks as a rudol millionaire (compared to the average profit of a few hundred rudols). He did it by finding loopholes and working very hard—making an initial quick profit on a business venture, then amassing a "fortune" by lending money at high rates to the eternally strapped Newlandia parliament. The other children in the camp had chosen steady, but poorly paid, government jobs over the hardscrabble life of the Russian entrepreneur. The realities of the camp paralleled life in Russia—mirroring the choices of their parents, most of the children said they thought it was better to work for the government than to strike out on their own. Khodorkovsky might have been thinking of the citizens of Newlandia when he commented at the 2003 Davos conference that he was alarmed that so many young Russians wanted nothing more than to pass the civil service exam, which, at best, leads to a meager but steady salary of about US$200 per month. He said, "Does this not tell us that society is projecting some sick ideas on our youth?" [2]

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1 Source for "Boris Berezovsky was still a part owner": Kranz, Patricia, "He's got the oil. Now can he make money?" *Business Week* International Edition, Feb 2, 1998, Number 3563, p. 19.

Source for the shareholders composition and a reputation of being non-transparent: Наталья Готова, Юрий Хнычкин "ПРЕЗИДЕНТ «СИБНЕФТИ» НАСТОЙЧИВО РЕКОМЕНДУЕТ НЕ ПУТАТЬ КОМПАНИЮ С ЕЕ АКЦИОНЕРАМИ" Gotova, Natalia; Khnychkin, Yuri, "Sibneft's President Strongly Recommends Not to Mix The Company and Its Shareholders," *Kompania*, May 28, 2001, Number 166, pp. 12-13.

2 Aris, B, "Land of Bureaucratic Opportunity," The Moscow Times, January 30, 2003.

Khodorkovsky is well placed to know that only a very few determined and lucky Russian entrepreneurs make it all the way to the top.

Doors Wide Open

Mikhail Khodorkovsky was born to a typical family of Soviet-era engineers in Moscow. Like many of the young people of his age group, he grew up in a cramped two-room apartment. His parents worked at Kalibr, a plant that manufactured high-precision measurement instruments. Although his father supplemented his salary by moonlighting in other jobs, there was never enough money for the small luxuries of life. During school vacations, Mikhail helped the family out, earning a little money sweeping streets or doing carpentry work. In his free time, he practiced martial arts. Despite the hours spent working during vacation, he was a good student. In high school, he was selected for an advanced chemistry class, and after graduating in 1981, he went on to the Moscow Chemical and Technological Institute.

As a student, Mikhail was very active in the Komsomol organization (the Young Communists League), which operated under the Communist Party's guidance and united almost all Soviet youth aged 14 to 28. The principal objective of Komsomol, which comprised over 40 million members at the end of the 1980s, was the political and moral upbringing of new generations of Soviet citizens. Well equipped for that task, it had a powerful nationwide apparatus with hundreds of thousands of full-time bureaucrats and its own mass media, production, recreation, and entertainment facilities worth billions of dollars. After earning a degree in 1981, Khodorkovsky worked for a short time as a chemical engineer, and also as a Komsomol boss. Within a short space of time, he was elected second secretary of the Komsomol committee for the Frunzensky district (one of the 31 boroughs in Moscow).

About that time, Komsomol organizations were given the right to set up economic entities, and many began to explore various new opportunities that had emerged with the reform-minded Gorbachev government's promotion of *khozraschyot*, an economic model based on self-financing. Many of the Komsomol organizations went into business for themselves, running cafés, discos, travel agencies, and the like, funding these ventures initially with loans or subsidies from their own coffers. Komsomol organizations that managed to turn a profit were allowed to retain (and use as they saw fit) any proceeds they made from such ventures. It was understood that some of the profits ended up in the pockets of the young Komsomol organizers.

Secretary Khodorkovsky saw an open door and rushed through it. The self-financing proviso turned out to be a tremendous opportunity not only to advance his own career, but also to, for all practical purposes, mint money—and legally. Opportunity, plus political connections, plus huge ambition: this was the secret formula that Khodorkovsky and a few other entrepreneurial Russians, men who would become known as "the oligarchs," used to build their own private empires in the so-called Wild East.

Legend has it that the ambitious young deputy head was groomed by Communist Party bosses, and perhaps even the KGB, as their front man for their experiments in capitalism. Khodorkovsky himself once admitted that nothing could be achieved in those days without patronage and political sponsorship. The undeniable fact is that Khodorkovsky far surpassed his original masters, whoever they might have been.

Khodorkovsky's first venture, with several partners, was a youth café that did not do well, largely because it was not in a prime location. He then founded the Center for Scientific and Technological Creativity of the Youth. Officially, the mission of this, and many similar Komsomol-related organizations, founded under the self-financing proviso, was to disseminate scientific and technological information via books and other publications. Khodorkovsky decided to increase the Center's profits by expanding its function from information-dissemination to consulting: he would offer consulting services, based on the technological expertise of the Center's publications factory directors, who had discretionary funds available to use on scientific and technological research projects.

These activities were soon put to a much better use for his new Center and a business for himself—converting idle money sitting in Russian company accounts into hard cash. Under the Soviet economic system, wages were centrally regulated and were always paid in real money; commodities, on the other hand, often changed hands between companies via "virtual cash"—a state subsidy that could be "traded" but could not be converted into real money. State-owned companies that accumulated excess virtual funds were not allowed to convert that credit into real-money income. However, they *could* pay for services using this virtual cash. Khodorkovsky realized that "red" directors could wire their virtual funds to the Center (as they eventually did to many similar companies' accounts as well) in exchange for "consulting services". They received some of the cash back, gaining real money, and Khodorkovsky also profited, because fully self-financed organizations, such as the Center, did not have the same restrictions on turning the virtual money into cash. The directors had the added comfort of knowing, when they dealt with the Center, that they were working with "the authorities", because of the Komsomol connection. They felt good about dealing with Khodorkovsky too: people described him in those days as honest, very hard working, and never flashy. The result was that the young man was literally making money out of nothing.

In the summer of 1987, Khodorkovsky's Komsomol superiors told him that he would have to choose between a career in the upper hierarchy of the organization and going off on his own to continue his "self-financing tricks". Khodorkovsky amazed everyone by announcing that he would continue his entrepreneurial efforts. He later said he knew that people thought he was crazy, given that a career within any Soviet organization was expected to be much more secure, not to mention more profitable, than any self-financing venture. Later, after he had made an initial success of his venture, some of his older friends reminded him that they had lived through an earlier period of *khozraschyot* in the 1960s—a liberalization that was later repealed. Many people who had tried to exploit that earlier wave of capitalism had ended up in jail. Khodorkovsky explained, "I did not remember this! I was too young! And I went for it."[3]

And then, not long into his self-employment, things got *really* serious. Sooner than his competitors, Khodorkovsky understood that the business of transforming virtual money into hard cash would not last long. He decided to put what remained of his virtual money to work,

3 Hoffman, David (2002). The Oligarchs; Wealth and Power in the New Russia, New York: Public Affairs, p. 107.

first exchanging it for foreign hard currency with Soviet export companies, then buying products from foreign companies with his new currency, and finally reselling these products in Russia, with astronomic margins, for virtual cash (and thus beginning a new cycle of virtual-to-real-cash conversion). The most popular product category was personal computers, and his most frequent customers were huge, state-owned companies. Rumor has it that Khodorkovsky and his friends were also producing counterfeit (well known Western brands) stonewashed denim clothes, which were fashionable at the time. There may have been other opaque types of business activities under the roof of the Center for Scientific and Technological Creativity of the Youth as well, including imports of counterfeit cognac and vodka. As if all that wouldn't keep a person busy enough, the Russian magazine *Profil* reported that Khodorkovsky combined development of this first business with moonlighting as a carpenter *and* studying in the evenings for a second degree from the Moscow Plekhanov Academy of National Economy![4]

Although it is difficult to separate fact from fiction regarding Khodorkovsky's business activities in the late 1980s, a few things are clear. He had no financial capital to start with and relied on other resources. His ingenuity, intelligence, and determination played an important role, but he also built on his people skills in two distinct ways, both of which helped him throughout his business career. First, he developed and maintained enduring ties with his original scientific colleagues, his new business partners, and his Communist Party and Komsomol superiors (who apparently enjoyed working with the energetic man they referred to as a *rebyata*, or "young fellow").[5] Second, unlike many other entrepreneurs of the *perestroika* era, he managed to build a team early on that followed him throughout his subsequent business initiatives. Having started out together, as a group of students looking for self-financing opportunities, this team continued (and continues still) to work with Khodorkovsky on his later, grander ventures. The team members have never let one another down, although they treat outsiders according to the principle, "If one parrot dies, we'll buy another one."

Menatep Bank

One day in 1988, foreseeing the imminent end of his "virtual money" business, Khodorkovsky walked into Zhiltsobank, a specialist branch of Gosbank, the central bank of the Soviet planned economy, and asked for a loan so that he could continue some of his other business activities.[6] Bank officials turned him down, explaining that they could give credit only to other banks. Undaunted, Khodorkovsky set up a new banking entity, The Commercial Innovative Bank for Scientific and Technological Progress, with the help of connections within Gosbank. The newly created Commercial Innovative Bank then purchased the Center for Scientific and Technological Creativity of the Youth, which Khodorkovsky renamed Menatep-Invest (Menatep being an abbreviation for Interbranch Scientific and Technological

4 Profil, November 21, 1998, No. 43 (115).

5 Hoffman, David (2002). *The Oligarchs; Wealth and Power in the New Russia*. New York: Public Affairs, p. 107.

6 Hoffman, David (2002). p. 119.

Programs). Gosbank, when approached by Menatep for a loan, agreed to finance Khodorkovsky's ongoing computer import business. Even Khodorkovsky himself seemed amazed that he was meeting practically no obstacles from the Soviet system. His success seemed almost too good to be true. But it *was* true: Khodorkovsky opened a new business, Menatep, and turned a new page in contemporary Russian business history.

Initially, Menatep did little more than finance Khodorkovsky's trading and currency businesses, but later, the business became an authorized intermediary for government financial credit to state-owned companies. Menatep took money from the government, loaned it to enterprises, then collected their payments and returned the money to the government. Khodorkovsky invented and used a financial model that allowed him to hold on to the cash long enough to use it to make a profit for himself. The experience honed his already impressive skill at maintaining excellent relations with government authorities. Rumors about his connections circulated widely at that time.

Mikhail Khodorkovsky was growing not only ever more wealthy, but also ever more wily. His next step was to tap into huge piles of cash sitting under the mattresses of millions of Soviet citizens unable to use their savings in the deficit-stricken economy. He started an advertising campaign, unprecedented in the country, to get people to invest in his bank, with a core message, "Buy shares in Menatep and get rich." To explain to Soviet citizens at large the advantages of capitalism in general, and the merits of Menatep in particular, Khodorkovsky and a colleague published *Chelovek c rublyom* (Man with a Ruble) released in 1991, the year that the Soviet Union ended. This publication was a heartfelt defense of capitalism, designed to interest people in investing. Khodorkovsky was no longer recognizable as the earnest Communist youth he once was—although the new bank's culture reflected the reclusive, low-key nature of its founder, who still wore jeans and flannel shirts to work. Nevertheless, years later, Khodorkovsky remarked, "If the old Mikhail had met the new one, he would have shot him."[7]

On the heels of the Soviet Union's collapse, Boris Yeltsin's government introduced privatization-oriented market reforms in Russia. In 1993, Anatoly Chubais, head of the privatization effort, engineered a vouchers-for-shares scheme in which Russians could purchase, for a negligible amount, vouchers worth 10,000 rubles. Those vouchers could then be exchanged for stock in their industry of choice, or put to work in an investment fund. Again, Khodorkovsky was quick to see a potential for profit: with many Russians daunted by the prospect of making such a choice in a new and nebulous investment environment, Menatep was able to buy up huge quantities of privatization vouchers, thereby gaining access to valuable assets in such industries as plastics, metallurgy, textiles, chemicals, and food-processing. The big prize was still ahead, however.

By 1995, a handful of Russian entrepreneurs—the new breed of oligarchs—had accumulated monetary and material assets worth hundreds of millions of dollars, and gained enough political weight to move on to the sacred cow of the Russian economy: raw material-producing companies. Exempted from the vouchers-for-shares program, these companies were now privatized via a "loans-for-shares" scheme. In this scheme, proposed by the

7 Slevin, Peter (1991). "The New Soviet Up-and-Comers Trade Party Line for Bottom Lines," *Miami Herald*, August 18.

oligarchs and agreed to by a cash-hungry government, some of the largest enterprises were transferred, via auction, to those private investors offering the highest price (a total that could, and in most cases did, include loans and future investments). The government entrusted a number of banks controlled by the oligarchs to conduct the auctions. In the manner of all foxes guarding henhouses, those oligarchs had feathers in their mouths (and new assets in their pockets) when the Russian state sold such assets as Norilsk Nickel, TNK, Severstal, Svyazinvest, and Sibneft.

Menatep was put in charge of handling the bids in the privatization auction for Yukos Oil, the then second-largest oil company in Russia (and the fourth-largest in the world). Russian oil directors had a reputation for being a caste apart, never letting Moscovites, ex-Komsomol boys, or "New Russians" into their oilfields (which, being located primarily in the northern parts of the country, were also geographically removed from Moscow's control). Nevertheless, Khodorkovsky—who had no experience in the oil industry, but recognized its huge cash-generating potential—managed to appropriate Yukos in the privatization auction, working out what the Russian mass media later described as one of the most unusual and audacious deals in the history of Russian privatization. Although a number of other large Russian financial-industrial groups made aggressive bids for the company, the winning bid was made by a company controlled by Khodorkovsky himself. Other, higher bids had been disqualified on "technical grounds," but there was no evidence that Menatep had broken any existing Russian laws in acquiring its stake in Yukos. In trying to find foreign investors, Khodorkovsky had personally approached a number of Western investors, but was turned down by all of them on the grounds that the risks, given the approaching presidential elections, were too high.

Khodorkovsky and his partners paid US$350 million (in loans and promised investments) and acquired US$3 billion in debt. (Yukos, at that time, did not include the Eastern Oil Company, which Menatep took control of in 1997). The partners now had a 78% share of Yukos, a fantastic bargain, considering that two years later, when Yukos shares began trading publicly, the market cap had reached US$9 billion (which, by then, included other acquisitions that Yukos had made in the mean time). Khodorkovsky made no secret of the fact that Yukos would be a cash cow for the financial industrial conglomerate, Rosprom, which he set up as a holding company for Menatep's industrial assets. Rosprom, by that time, had interests in about 100 different companies, spanning a wide range of industries. Shifting his primary interest to the development of Rosprom, Khodorkovsky stepped down as Menatep's CEO (remaining its chairman, however). In 1997, he assumed the job of Yukos' CEO.

This period was the nadir in Khodorkovsky's relationship with both foreign and Russian investors. He later said about that period that if an individual conducted business in Russia in a Western manner, he was simply "torn to pieces and forgotten," and yet the traditional Russian way of doing business was no longer acceptable, even within that country's borders. For example, Menatep's minority shareholders—Russians—complained that the company's management, with Khodorkovsky at the helm, lacked transparency, efficiency, and a focus on profitability. The situation was even more difficult for foreign partners. For example, the American oil conglomerate, Amoco, had reached an agreement in 1993 with Yukos (before Khodorkovsky took control) to exploit one of Russia's richest oil fields, but soon found itself in an arranged marriage with Khodorkovsky after Menatep's purchase of Yukos in 1996. Khodorkovsky did not like the deal that had been worked out in that earlier agreement, and asked Amoco to put in more money for a smaller stake. Amoco executives refused to renegotiate, believing that documents they had in their possession backed them up. However, Khodorkovsky said that he had specifically asked to see a signed contract that would require Yukos to continue negotiations with Amoco, but, to his surprise, no such document was ever shown to him.[8]

Either way, this type of situation was fairly common. Westerners were caught in a bind—they wanted Russian oil, but they found it extremely difficult to trust the oligarchs in control.

Then came the 1998 Russian financial crisis. The Moscow office of Menatep Bank went under when the government devalued the ruble by 400%, and defaulted on its debt. Khodorkovsky transferred the bank's remaining funds to Menatep St. Petersburg, which was still solvent, but he still had to deal with angry creditors there—among them, several foreign banks whose loans to Menatep were secured by Yukos shares.

Khodorkovsky tried to work out a three-year repayment plan, based on income from oil exports rather than Yukos shares, but two of the creditors refused. In a still controversial sleight-of-hand, Yukos threatened to make a share offering that would effectively dilute the creditors' stake to the extent that those shares would hold little remaining value. Some people claimed that, at the same time, Yukos assets were transferred to off-shore shell companies—claims that have always been disputed by Yukos. In any case, seeing that they would be left empty-handed, the creditors backed down and agreed to sell their shares to Khodorkovsky. The share offering was cancelled, and the assets were brought back into Russia. Khodorkovsky (with some core partners) regained control of Yukos.

Building a Competitive Business

In his early days, Khodorkovsky built successful businesses from scratch, inventing new business models and using, to his advantage, loopholes: first in the Soviet planned economy and later in the chaos of the emerging Russian market system. He competed the way that seemed best to him then: in an open fight. Yukos was a different story, a new challenge of an unprecedented scale. Although Yukos' stand-alone reserves totaled 12.2 barrels as of January 1, 2003 (which included the output of subsidiaries acquired after 1996), it was not nearly as profitable when Khodorkovsky acquired it in 1996. Formed in 1993 by combining several Siberian oil production facilities, Yukos had 11,000 wells, badly in need of repair, and 90,000 employees, waiting for unpaid wages and dreaming of pumping more and more oil at any cost. The accounts were less than transparent, and the company had a debt load of almost US$3 billion. Yukos moved swiftly to lay off 11,000 employees and divest non-core businesses, such as a cigarette factory the company owned, but it was still far from maximizing its production capacity.

Khodorkovsky, who likes to repeat that he isn't an oilman, developed a strategy tailor-made for Russia: combining advanced Western technology with an inexpensive Russian workforce and depreciated equipment to produce oil efficiently at a cost that Western companies couldn't match. Through an alliance with the French company, Schlumberger, Yukos began

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8 Klebnikov, Paul, "Russian Roulette" *Forbes*, April 20 1998, Vol. 161, issue 8, pp. 136-137.

to upgrade oil-well technologies and information technology systems, with the goal of increasing production by 50% by the year 2005. Yukos hired scores of expatriates for key posts, including a chief financial officer from Schlumberger, and brought in some younger-generation Russian managers from Menatep and other of Khodorkovsky's businesses.

The drastic cost-cutting measures began to pay off fairly quickly, but the Russian financial crisis of 1998 threatened that early success. Khodorkovsky responded with a new restructuring program, which set a trend for other Russian oil companies to follow a few years later. Yukos spun off many services and centralized the management of remaining services, splitting "upstream" and "downstream" operations (i.e., drilling/extracting and refining/marketing) into separate business lines. At the same time, the company continued to invest in modern technology, both in the core business and in management systems. These moves soon paid off: the net income of Yukos rose to US$2.5 billion on sales of US$7.2 billion in 2000. In 2001, Yukos increased production by 18%. In 2002, Yukos achieved phenomenal results, increasing oil production to 69 million tons, revenues to US$11.7 billion, and net income to US$3 billion. To date, the company has built a cash war chest of US$3.5 billion, and Yukos has become an industry benchmark in Russia, both in its operating results and in its management systems.

Having mastered oil company management, Khodorkovsky looked forward to new challenges and was pretty clear about what he wanted for Yukos. In an interview with the authors of this case study, he said:

> "In three years [Yukos] will have finalized everything within Russia in terms of efficiency, and we'll start testing ourselves outside Russia. And five years from now, we'll have many features of an international company, but completion of the process of building an international company will probably take place in seven to eight years. In parallel with that, we'll have to carry out diversification of our business, moving from oil to energy. In ten years' time, we'll be a stable energy company, like British Petroleum ... I have been following that role model for five years now."

The 2003 merger with Sibneft looked like an important step toward achieving this vision.

Cult of Transparency

Today—despite Mikhail Khodorkovsky's sojourn in jail—Yukos serves as a model Russian company, practicing standards of sound corporate governance. Khodorkovsky said that the late-1990s battles with minority shareholders forced him to understand what corporate governance was all about, and to realize how important it was to any public company. However, although Yukos was doing well as recently as 2001, he felt that it was still undervalued on the stock market, because, he acknowledged, there was a lack of trust on the part of investors. He said at the time, “In part, this [mistrust] can be removed by improving transparency, and we are working in that direction.”[9]

Signaling a move to internationally recognized standards of corporate governance, Yukos adopted GAAP (Generally Accepted Accounting Principles) and published three years of GAAP-standard accounts in 2002. Khodorkovsky invited experienced foreign businessmen, such as former vice-presidents of Credit Lyonnais and Phillips Petroleum, to sit on the Yukos board. The Yukos website provides extensive and daily updated information about the company, stock market quotes, production volume, and corporate plans. Investors’ briefings and conference calls have become routine for the company.

One section on the Yukos website (added in 2003) is devoted exclusively to corporate governance. The first subheading is “Principles and Priorities”:

> “Yukos Oil Company believes strongly in the same principles of corporate social responsibility that are recognized in the majority of developed countries today, and is committed to putting them into practice in all aspects of its activities.
>
> Yukos’ challenge is to ensure social stability and promote development in all spheres of life in the regions where it operates. In doing so, the Company does not attempt to replace the government and the vital role it plays in socio-economic development. Our contribution to the government’s social policy is limited to creating jobs and paying taxes.
>
> Nevertheless, Yukos plays an active and significant role, both materially and otherwise, in addressing the most acute social problems in its regions, while at the same time encouraging the local populace in developing initiative and independence.”[10]

The statements above are accompanied by a photograph of Khodorkovsky and UN Secretary-General, Kofi Annan, shaking hands just after they signed the UN’s Global Compact initiative. By signing this agreement, Khodorkovsky committed Yukos to observe international standards in the areas of human rights, labor, and the environment.

Yukos is evidently still focused on improving its reputation with Russians—among them, its own employees—and the world. In addition to addressing Principles and Priorities, the Yukos website also includes sections on Knowledge, Effectiveness, Cooperation, and Responsibility, with each section sending a clear message about Yukos being a responsible corporate citizen. Khodorkovsky set up a special “image committee” within the organization, headed by him personally. Although the committee was initially formed to counter Khodorkovsky’s reputation for unfair asset-grabbing, it spontaneously dissolved as it became apparent that Khodorkovsky’s image in the press had improved. The board of directors, for their part, quickly moved to address issues of corporate governance, persuading the business community

9 Bahree, Bhushan and Whalen, Jeanne, “Russia’s Yukos Starts to Win Over Its Doubters,” *Wall Street Journal*, May 4, 2001, p. A13.

10 www.Yukos.com

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that "Yukos is a transparent company", and burnishing Yukos' image in the eyes of the employees of the organization.

Following the motto "Yukos—a transparent company" (an unusual slogan for a Russian business), Khodorkovsky disclosed details of his ownership of Yukos (he controlled 36% of shares) in 2002, a move that was welcomed by analysts: "It's a first for one of the oligarch groups, and it will have a powerful and beneficial emulation effect for all the others."[11] Somewhat disingenuously, Khodorkovsky said, "Now we understand how business is done in the West. As a shareholder, I earn money in dividends and with the increase in the market capitalization of my company."[12] This philosophy worked well for Khodorkovsky. In 2001, *Forbes* magazine listed him among the world's 538 billionaires, with a net worth of US$2.4 billion. In 2003, he became the wealthiest Russian, his personal fortune topping US$7 billion.

Khodorkovsky's drive for sound corporate governance and Yukos' solid financial results paid off for other shareholders as well. The company became a star of the Russian stock market, helping it to become one of the best performing markets in the world in 2002-2003. Yukos' capitalization grew from US$21 billion in December 2002 to US$30 billion in July 2003. But Khodorkovsky believed that Yukos was still undervalued by international standards: its market capitalization to income ratio is around 8, while global players, such as Exxon and BP, have a ratio in the range of 18 to 21. The reason for its undervaluing lies in the risks inherent in doing business in Russia, and he worked hard to reduce those risks.

Business and Politics

Since his early days as a Komsomol entrepreneur, Khodorkovsky has understood the importance of political connections in Russia, and has consistently nurtured his network in the corridors of power. The acquisition of Yukos made these connections even more important. Oil is the principal Russian export and major hard-currency earner for the government. The industry is still heavily regulated and taxed by Russian law, but it is also—and probably more importantly—regulated by informal interventions of key government officials, including the president. Khodorkovsky is open about the importance of the political network. He said, for example, that while the Sibneft deal was being negotiated, "governors of concerned regions, ministries, the prime minister, and, of course, the president, were informed about our intentions … and we immediately received an approval."

In the 1990s, direct lobbying was the most important tool in dealing with the government, and Khodorkovsky excelled at it, winning not only Yukos, but many other assets, too. He had powerful contacts in high places. One of Khodorkovsky's former partners was one of Putin's deputy chiefs of staff.[13] However, times have changed, and tactics have had to be adjusted. Khodorkovsky described the new realities of Russia in the following way: "Previously, we

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11 Whalen, Jeanne, "Russia's Richest Man Discloses Worth," *The Wall Street Journal Europe*, June 21-23, 2002, pp. A1, A8.

12 Klebnikov, P., "The Oligarch Who Came in From the Cold," *Forbes*, March 18, 2002, Vol. 169, No. 6, p. 110.

13 Klebnikov, P., "The Oligarch Who Came in from the Cold," *Forbes*, March 18, 2002, pp. 110-112.

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were all focused on the cash revenues of our business, since no one believed that the situation would last. Now that things are stabilizing, people are more interested in increasing the value of their property."[14]

That objective requires structural changes and improvements in the overall business environment—improvements that will reduce Russia-specific risks and increase the capitalization of Russian companies. Instead of fighting one another for access to the almighty Russian president to gain some short-lasting favor, as in the Yeltsin years, the oligarchs decided, at the turn of the millennium, to unify their efforts and attempt to bring about changes to the economy at large.

In 2000, Khodorkovsky was one of the key figures involved in seizing control of the Russian Union of Industrialists and Entrepreneurs (Russian acronym: RSPP), previously a dormant association of red directors. The group's new leaders now use the organization as a platform for direct dialogue with Russia's president and government. Khodorkovsky became one of the members of its governing board and the head of its international affairs committee, and he was an ever-present participant in regular meetings with President Putin.

Elected in 2000 for a four-year term, Vladimir Putin represents a sharp contrast to his ailing predecessor, Boris Yeltsin. Always youthful and sporty, Putin is trying to provide new momentum to the Russian economy, and he needs the support of big business in that endeavor. That support is not automatic, however: he has made it clear that Yeltsin's practice of making political decisions with oligarchs and granting favors to selected financiers is over. Putin's administration has created a "Council on Entrepreneurship" under Prime Minister Kasyanov—a council of which Khodorkovsky is a member. The council regularly meets with the premier and the president to discuss the oligarchs' proposals for economic and legal reforms. Khodorkovsky calls the president and his own oligarchic peers "counterparts" in the dialogue about Russia's economy. He praises Kasyanov's government as "the most liberal and professional" in current Russia's history.

The "dialogue" is yielding positive results for the Russian economy, the government, and, to a large extent, the oligarchs. Under oligarchic pressure, the Russian parliament adopted a flat income tax rate of 13% and reduced corporate profit taxes and mandatory social security contributions. Tax collections have significantly improved with these changes, allowing for some extra government spending on social issues and defense. Helped by favorable oil prices, the Russian economy has grown for three consecutive years, the ruble is stable, and inflation is under 14%. The RSPP has adopted a "Charter of Corporate and Business Ethics" and set up a Commission on Corporate Ethics, which serves as an effective out-of-court settlement body for Russian businesses.

Russian oil exports, increasing at double-digit rates, are beginning to rival OPEC's output. However, in 2002, the Russians were being pressured by OPEC to cut their exports to force an increase oil price per barrel on the world market. Khodorkovsky strongly argued against a reduction of oil production. He did, however, comply with small, temporary reduction in the winter of that year.

14 Ibid.

"Kremlinesque Intrigue" in Western Attire?

Khodorkovsky, in his interview for this case in 2002, admitted that the most efficient business is a one-person entrepreneurial venture. Every multi-person enterprise brings with it inefficiency. However, because some tasks require the efforts of more than one person, organizations will always exist.

The extraction and refining of oil necessitates an organization of considerable size. At the time of its acquisition by Khodorkovsky (via Menatep), Yukos had a legacy of inefficiency at all levels in the organization—along with huge potential. Khodorkovsky has been obsessed with the notion of achieving organizational efficiency in order to make the most of that potential. Although he met with some resistance—managers in the oil fields have wanted to continue drilling new wells instead of increasing the output from existing wells, and heads of regional operations wanted to keep their huge support-services infrastructures—his goal was to keep only the most efficient employees and businesses. As Khodorkovsky said in his interview for this case:

> "Approximately 10% or 20% of us, working in large corporations, provide the other 90% of the world with goods and services. And the motto for all corporations is the same: "efficiency." If you can't work better than somebody else, then go to the street [i.e., get out]. If I can find someone who is cheaper than you are—go to the street. This is not a very benevolent corporate culture.
>
> The remaining 80% of the workers have a much easier life. The other categories of workers—bureaucrats, medium-size businesses, etc.—all have a much less stressful kind of job. You can find idlers [within corporations], but they are a weakness within the organization. That's why my task is to build an efficient organization. All the areas where I can't be the most efficient have to be divested."

Khodorkovsky created a strictly hierarchical organizational structure. In his interview, he explained that his company could be depicted as a combination of three pyramids: one dealing with upstream oil production, the second in charge of downstream production, and the third taking care of the financials, staff, and corporate affairs. Within each pyramid is a modified matrix structure:

> "What we are trying to achieve is that within the framework of the pyramidal structure, we build what I call an 'electron cloud'. In a good pyramid, you have an electron cloud of people who are not tied to individual atoms."

Within each strictly delimited pyramid, according to Khodorkovsky, no deviation is permitted from standard operating procedures at the lower levels. He said:

> "For God's sake, no deviation from the procedures! If I see deviation from standard operating procedures at a low level, I need to catch the deviant immediately and put him in an upper level position or, if I have a sufficient number of people there, kick him out. Because if I leave him where he is now, this person starts getting involved in what, during Soviet times, we used to call *ratsionalizatorstvo* [a term that meant internal improvement activities, or

intrapreneurship]. This was a special word with a positive connotation. This process would be called something like *rationalization,* in English. It referred to the people who put new ideas forward.

Now imagine a situation when I have oil production going on for twenty years. Statistically, every ten years I could have a build-up of sulfur, which could cause an explosion. I don't know when exactly this sulfur build-up is going to occur during this period of ten years. That's why there is a written procedure saying: 'Purge the [oil] reservoir every six months.' Then this innovator, or *rationalizator,* comes in. He sees that there is *no* sulfur accumulating in the tanks. He sees that he's been observing the cleaning process for several years, but there has been no accumulation of sulfur between cleanings. He gets into the tanks a few times, and then he says: 'Look, guys, I have made some calculations here: if sulfur build-up continues at this rate, then it means that we can do the cleaning once every two years, rather than every six months.' So he starts doing it once every two years. After that, I have an explosion of sulfur at, say, a reservoir at my Sergievskneft production facility. I start to dig for causes, and find a *rationalizator* there."

Because of his strong belief that people should obey rules, Khodorkovsky felt that many jobs required employees who might be described by staff psychologists as "dumb but reliable." When asked what kinds of jobs there are at Yukos for graduates of the world's top business schools, Khodorkovsky replied that out of 110,000 jobs, he could offer approximately 3,000 positions to engineers and business school graduates, people who "have attended all the classes and taken notes of what the professors were saying in a good handwriting." Such people could be hired for jobs in which they would be paid decently and would "feel just fine." Khodorkovsky said:

"I'll tell these people 'You are never going to make a lot of money at Yukos, but [on the other hand] I am not going to force you to think. You will only have to do exactly what you know how to do. If you have to do something different, you will be retrained first.'

For some people [with real talent and potential] I have 70 [top] jobs. For the whole of my company there are 70 jobs like this. If you are ready to compete for any of those 70 jobs, then we'll be happy to consider you. [There are not 100 or 200 jobs like this], as I don't need that many top people. These are very expensive people, and I need to produce my oil cheaply."

To motivate the talented people within that 70-person cohort, the company offers above-market salaries for professionals. Khodorkovsky looked for key people whom he considered to be the best on the global market. In fact, he claimed that for these positions he would consider only the top five professionals in a given field. As a result, his talent search extended beyond Russia in recent years. Yukos currently hires top executives from Schlumberger, Amoco, PennzEnergy Corporation, Credit Lyonnais, Phillips Petroleum, and companies of that ilk. There are now more than 50 Westerners working in the Yukos headquarters building in Moscow. The company can also boast of significant local talent—people whom every headhunter in Moscow and beyond would dream of capturing.

Khodorkovsky said that money was a key element in the motivational system within Yukos. However, he strongly believed that benefits and perks should *not* play a significant, motivational role in an organization—a theory that goes against the grain in Russia. He believed that people should work for a fair wage or salary and should then be able to make their own choices in terms of how to spend the money. Social benefits at Yukos are not as extensive as they are at some other Russian companies. The official company policy is to provide them only if they are not available (for a price) elsewhere. Khodorkovsky said: "The most important thing an individual has is his or her freedom, and money constitutes the material foundation of freedom. If an individual is tied up by social benefits, this is non-freedom." [15] As far as Khodorkovsky is personally concerned, he is not motivated by the desire to earn more money: "I have enough money to last for ten of my lives."

Despite Khodorkovsky's disdain for social benefits, Yukos has one of the most advanced human resource management systems in Russia. It was recently recognized as such, winning the Grand Prix of 2001, an HR management contest in Moscow. The HR division's major focus is on recruiting, training, and developing technical and managerial expertise. The company has set up a whole department at a technical university in the Siberian city of Tomsk to train engineers for its oil fields, thereby creating a corporation-wide pool of young employees with high potential. (Yukos finances the relocation of its employees from Siberia to Central Russia.) In addition, it has set up assessment centers for thousands of its middle managers.

Yukos also takes employee communication seriously. Unlike most Russian organizations, it has an employee-friendly website that provides a lot of information about the way people at Yukos work, study, develop their skills, spend their free time, and participate in charitable activities, with illustrations provided by children of Yukos employees.

The website has a section called "Family Album," which includes stories about the lives and careers of about three dozen Yukos employees from different parts of the country. There are also stories, with pictures, about people who have worked in Russia's oil fields and refineries from World War II to the present day. They all illustrate the Yukos motto: "Employees of various Yukos enterprises make one family—the Yukos family."[16] The tone and style of the stories bring a feeling of *déjà vu* to older readers: they hark back to Soviet-era articles about worker dynasties, loyal to the same plant for several generations; or accounts of "heroism at work" that the Soviet Press used to produce in large quantities. Still, the notion of "family", as used by Yukos' corporate-image designers, is quite revealing: we see who is the father figure in the family and how he watches over his family members, despite his conviction that "money rules."

The website also has a lot of information about philanthropic and disaster relief projects supported by Yukos. Among many other projects, Yukos sponsors scores of children's homes and orphanages in the regions in which it operates. Khodorkovsky and his top executive team personally provided financial backing for an orphanage. Top executives spend time with kids from this orphanage, and many executive team meetings are held close to the location of this

15 Khnychkin Yu. (2002) Osnovnuyu Stoimost Sozdyut Predprinimatelskiey Mozgi. *Kompaniya*, August 12, 2002.

16 www.Yukos.ru

facility. Although these activities began seven years ago, no effort has been made to publicize them.

In Moscow, a city where job opportunities for qualified individuals are relatively bountiful, Yukos is considered the employer of choice. Westerners and Russians coming to work for Yukos bring with them the most advanced oil-exploration and business techniques. However, according to a former Amoco executive who leads Yukos' exploration team, in order to succeed, new executives have to learn to live in a management culture that "remains distinctly Russian, permeated with Kremlinesque intrigue." This executive says, "The only way you can survive [at Yukos] is if you have a few key people in the organization—Russians—watching your back against disloyalty by other Russians." He finds the Yukos top management "tough and smart," and adds that working for Yukos is like being involved in "the extreme sport of the oil industry."[17]

Serial Entrepreneur or Global CEO?

Khodorkovsky says that he once had an argument with his father about whether a diffident person can be a successful business leader, or whether one needs to be emotional to be successful in that job. (Khodorkovsky apparently said yes to the former; his father, no.) A leader in an organization, claims the oligarch, should not be emotional, because personal sentiments lead to feelings that prevent the leader from getting rid of ineffective businesses. Therefore, in Khodorkovsky's opinion, a detached leader is very necessary for a mature business.[18] Khodorkovsky claims that he, himself, is an entrepreneur, with the type of leadership profile that is particularly useful to the organization at the stage of creating a business and growing it, and believes that he should be replaced by an unemotional professional when his business matures.

In any case, Khodorkovsky is known to be a calm person. As one of the top managers in the organization said: "I've never seen [Khodorkovsky] angry. Irritated, yes, but not angry." When asked if he ever has temper tantrums and throws phones at people, as some red directors have been known to do, he answered:

> "In order for me to get angry, I must desperately want something, but at the same time be absolutely helpless in terms of achieving it. Beyond the boundaries of my own family, I never face such situations."

He explained to us that he never gets angry with subordinates, because if an employee is not doing his job correctly, it's not the employee's fault; it's his own. The problem is that he, Khodorkovsky, selected the wrong person for the job or failed to explain some necessary procedure well. "If it is impossible to explain [that procedure] to him [in such a way that the job gets done right], then . . . I fire him."

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17 Whalen, J. "An Unlikely Exporter of Russian Capitalism Goes With Profit Flow," *The Wall Street Journal Europe*, May 16-18, 2003, pp. A1 and A5.

18 Shmarov, A. (2001). "Russian Managers. Special Project of Expert Magazine," *Expert,* October 1. 2001.

However, as CEO of Yukos, Khodorkovsky did not fire people easily. In "Kremlinesque intrigue"-style, he says he has created a so-called Administrative Reserve department, with a capacity of 30 positions. At the time of writing this case, this "Corporate Siberia" counted seven people in it. The concept of such an "honorary exile" was well mastered in the former Soviet Union, where high-level executives and governmental officials who had made mistakes, were transferred to positions with lofty titles but no authority in governmental institutions, research and teaching organizations, or embassies in the smallest of the third-world countries.

Khodorkovsky ran Yukos in an informal way. While he remained involved in investment, sales, and HR decisions, he no longer signed documents or negotiated with buyers and suppliers.[19] Describing his major task as that of coordinating the actions of managers, Khodorkovsky preferred not to spend too much time in the office, restricting his workload to 50 hours per week.

Speaking softly and deliberately, Khodorkovsky seemed like a man who has achieved what Abraham Maslow called "self-actualization"[20]—i.e., becoming the best one can be. Indeed, as a voracious reader, and a student of world-famous politicians and executives, he believed that it is the self-actualization dimension of work at Yukos that made his top-level managers tick and allow the organization to squeeze them dry. Khodorkovsky told us:

> "Obviously, top managers work at the self-actualization level. 'The squeezing model' is built around the concept of constantly encroaching on a person's desire for self-actualization. [At Yukos] you constantly feel the breath of the person 'in line' behind you. The issue is not that the runner-up will necessarily take your position. It's that tomorrow that person may get ahead of you, and then you'll no longer be number one. You'll just be number two. For that, comparing yourself to the [external] competition is very useful."

As for Khodorkovsky himself—a man who still prefers a turtleneck to a suit and tie—he remains, in many ways, a young man who has not yet lost his youthful desire to change the world.

Speculation about his next moves abound—that is, once he leaves jail. The most popular theory seems to be that Khodorkovsky may go into politics and even eventually run for president of Russia. If such activities are in the plan, publicizing Yukos' philanthropic activities and being featured in the company of people like Kofi Annan might have been part of Khodorkovsky's long-term election campaign strategy. Khodorkovsky declined to comment on this.[21]

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19 Bushueva, E. & Osetinskaya, E. "Khodrkovsky otmeril sebe srok." *Vedomosti*, April 4, 2003.

20 Maslow, A. (1943). A Theory of Human Motivation. *Psychological Review*, 50, 370-396.

21 Whalen, J. "An Unlikely Exporter of Russian Capitalism Goes With Profit Flow," *The Wall Street Journal Europe*, May 16-18, 2003, pp. A1 and A5.

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Khodorkovsky calls himself a crisis manager, saying, "Changing from a Russian company to an international one … getting mixed up in a new fight—now that's interesting."[22] And, given the progress at Yukos, he has gained a respectable track record in crisis management.

However, he faced the greatest crisis of his career in 2003. In early July, Khodorkovsky's closest associate (and president of the Menatep group), Platon Lebedev, was arrested on charges of wrongdoing during the privatization of a Russian mining company in 1994. Khodorkovsky himself was questioned by the prosecutor's office as a witness. Prosecutors searched Yukos' offices and charged some of its employees, including the head of security, with a range of crimes from tax evasion to plotting murder. Yukos' stock plummeted at the time. People speculated that this event might be linked to Khodorkovsky's recent support of SPS and YABLOKO, two liberal parties in opposition to President Putin. Then, in September, Putin addressed the issue head on by announcing that there was no political motivation behind the scandal, and said that his government would not reopen investigations into the privatizations of the 1990s. By mid-October, Yukos' shares had fully recovered their historic high. Russian businessmen continued to criticize Khodorkovsky personally, but Putin said that Khodorkovsky's support of political parties was "an important contribution to society."

But the situation was still very unstable. In late October, Khodorkovsky was arrested on charges of fraud and tax evasion, and the Russian stock market plunged 10%. On November 4th, 2003, Mikhail Khodorkovsky abruptly resigned as CEO of Yukos. In a statement from his prison cell, Khodorkovsky said he was resigning in order to protect Yukos and his employees from "the blows directed at him and his partners." He would be replaced by Simon Kukes, a US citizen of Russian descent.

However, the brilliant Sibneft-Yukos merger was in jeopardy. Sibneft's founder (and owner of the English soccer club, Chelsea), Roman Abramovich, saw his chance to take the upper hand. Sibneft demanded top management jobs and a greater equity stake for his company. When Yukos executives refused to reduce their company's equity stake, Sibneft announced it would suspend the merger. The Wall Street Journal reported that Abramovich was considered a "trusted ally of the Kremlin, who has several times taken over assets from tycoons who have had a falling-out with President Vladimir Putin."[23]

The Succession Question

But people still wondered, Sibneft or no Sibneft, who could possibly replace Mikhail Khodorkovsky, and how? In an analysis of the announcement made by Khodorkovsky regarding his retirement (long before his arrest), the Russian business daily *Vedomosti*

22 Whalen, J. "An Unlikely Exporter of Russian Capitalism Goes With Profit Flow," *The Wall Street Journal Europe*, May 16-18, 2003, pp. A1 and A5.

23 Whalen, J. "Yukos Would Cede Management Jobs To Rescue Merger," *The Wall Street Journal Europe*, December 2, 2003, pp. A1, 4.

reminded readers that there had been only three (more or less) successful cases of business leadership succession in Russia thus far.[24]

Once again, Mikhail Khodorkovsky had done the unexpected. By the end of 2003, he was no longer CEO of Yukos, but his influence, even from his prison cell, was undoubtedly as powerful as ever. Succession at Yukos, though abrupt, appeared to be smooth and logical.

On November 3rd, 2003, Khodorkovsky wrote from his prison cell:

> "Wherever I may work, I will do my all for my country, Russia, in the great future of which I firmly believe."

What would the future hold for Mikhail Khodorkovsky? Russia, and the world, waited and watched.

24 Bushueva, E. and Osetinskaya, E. "Khodrkovsky otmeril sebe srok." *Vedomosti,* April 4, 2003.

Exhibit 1

An Announcement by the Chairman of the Yukos Oil Company

Written by Mikhail Khodorkovsky from his prison cell, posted on the company website www.yukos.com

YUKOS Oil Company's unprecedented success has no equivalents in the history of Russian and international business.

Over the past seven years, the Company has eliminated debt arrears of US$3 billion. Production costs have been reduced sixfold, while production itself has doubled. Taxes paid by the Company to all levels of government will be in excess of US$5 billion this year. Over US$100 million is spent annually on philanthropic programs.

We were the first Russian business to consistently implement the principles of financial transparency and socially responsible business behavior. We introduced international standards of corporate governance. We were able to achieve absolute recognition and trust on the Russian and global markets.

We created the most efficient company in the country.

Over the next few years, I had set myself the goal of building an international energy company – a leader of the world economy.

But the situation that has developed today forces me to set aside my plans to continue my personal involvement in YukosSibneft's development. As a manager, I have to do all I can to pull our workforce safely out from under the blows that are being directed at me and my partners. I am leaving the Company. I am confident that the extremely professional, close-knit team of highly experienced managers, supported by the Board of Directors, will successfully handle the challenge of the globalization of YukosSibneft's business.

I would like to express my deep appreciation to everyone who took part, together with me, in building the best Company in Russia. Together, we did something that seemed unthinkable seven years ago.

My own future plans involve continuing my work as Chairman of the Management Board of the Regional Public Organization, "Otkrytaya Rossiya". Its philanthropic activities support the education and upbringing of young people and civic initiatives to build an open and truly democratic society in Russia.

Wherever I may work, I will do my all for my country, Russia, in the great future of which I firmly believe.

Mikhail Khodorkovsky

Moscow, 3 November 2003

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