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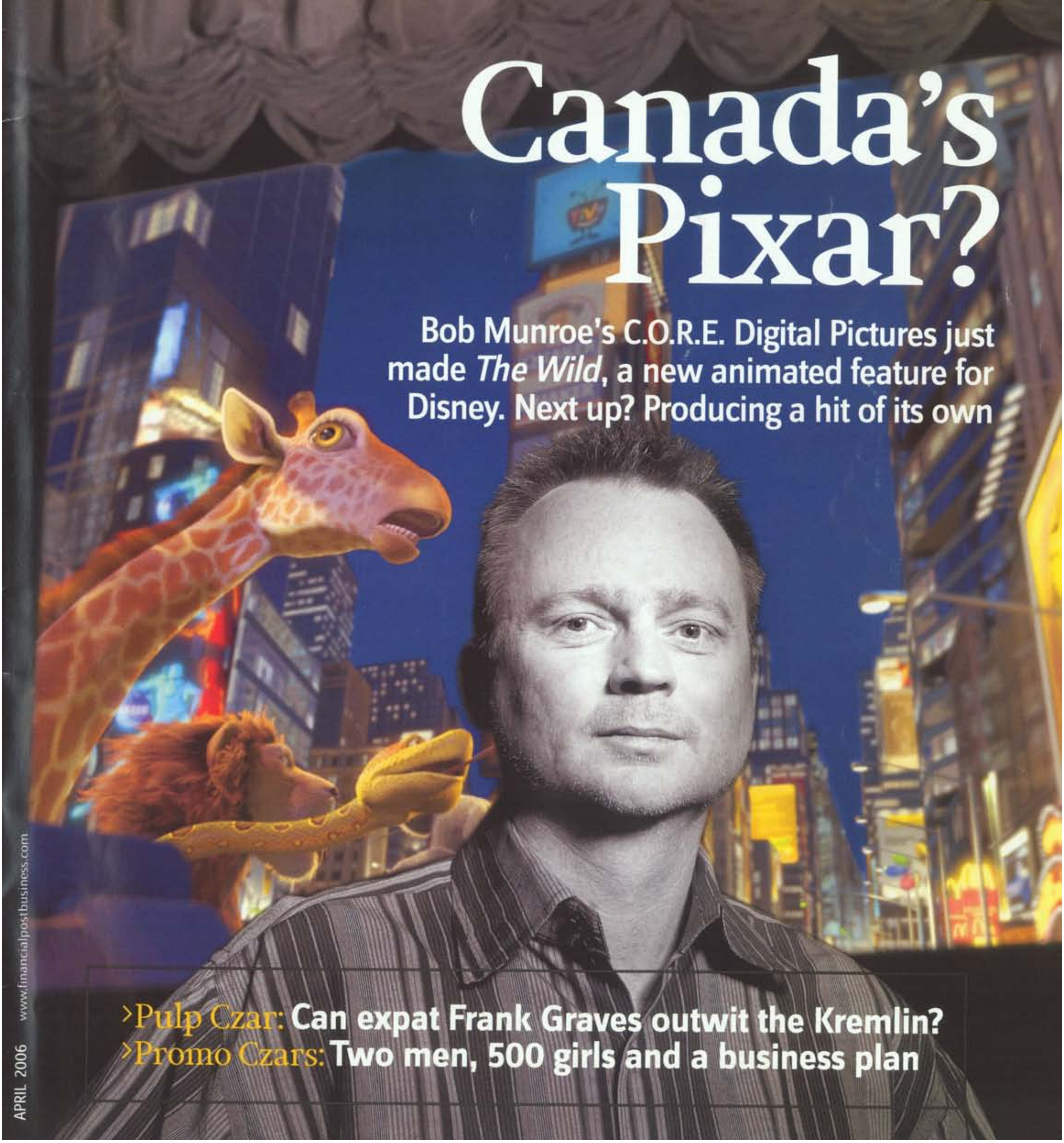
# BUSINESS



# Canada's Pixar?

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>Pulp Czar: **Can expat Frank Graves outwit the Kremlin?**

>Promo Czars: **Two men, 500 girls and a business plan**

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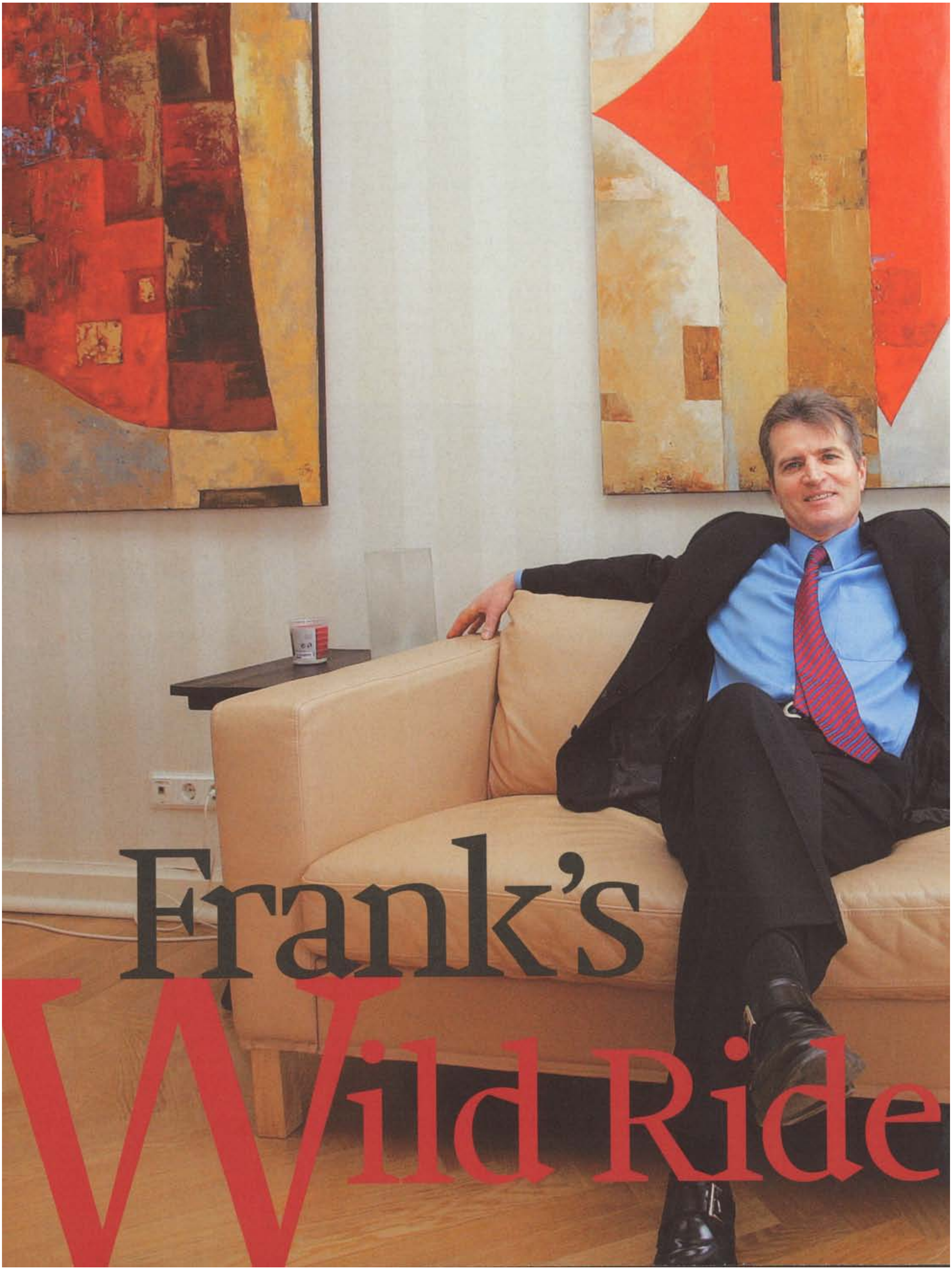
# Frank's Wild Ride



Earlier this decade, Frank Graves won a battle of private armies for control of Russia's largest forest firm, Ilim Pulp. Could those same old wounds be fuelling a Kremlin-backed grab for the company?

BY JOHN GREENWOOD ›PHOTOGRAPHY BY SERGEI KIVRIN

# Frank

Graves has learned to appreciate the finer things in life. His gracious St. Petersburg apartment, originally built in the 17th century, boasts 11-foot ceilings, bathrooms modelled after those in the famous Tiffany hotel not far away, and a clear view of the glittering dome of St. Isaac's Cathedral. A life of luxury is just one of the rewards of running Ilim Pulp, Russia's biggest forest company. The 50-year-old former Tembec Inc. pulp salesman from Canada arrived in Russia four years ago to take on a mission: to assume day-to-day operations at Ilim, modernize its network of rusting, Soviet-era mills, update its management structure and, finally, lead it to an IPO on the vaunted New York Stock Exchange.

But there's been a snag, and now even the luxurious surroundings aren't enough to soothe Graves's mounting frustration. "It's a very difficult environment here," he says in a telephone interview. "You're very isolated. I know this phone is being listened to."

In North America, a good chunk of the forest business has been on life support for years. But in Russia, with its vast forests and low currency, it's a different story, especially when you take into account that China, the world's fastest growing economy, is sitting on the doorstep. In Russia, Ilim is a major player, with an array of assets including three of the biggest pulp mills in the country and access to some of the biggest softwood forests on the planet. It also has the kind of profit margins that would make a North American chief executive green with envy. So you'd think Graves's job would be easy: What investor wouldn't want a piece of that?

Yet his road has been anything but smooth. As soon as Graves reported for work, he was enlisted by the company's reclusive owners to fight off a hostile takeover attempt by a rival oligarch who laid siege to Ilim with a private army. After the oligarch gave up the chase, Graves should have been able to finish the job he was hired for. But now there's trouble again, and this time it's even more serious: Officials within President Vladimir Putin's government are said to be muscling their way to the table, angling for control over Ilim. The Kremlin has already wrapped its tentacles around some of Russia's biggest companies, a trend that has a lot of Western investors worried.

Amid mounting speculation linking the Kremlin to Ilim, Graves recently dumped plans for the IPO. Instead, he is leading the hunt for a strategic investor to take a minority stake in Ilim, a quicker, less ambitious strategy that would still fulfill his goals: to bring in some much needed investment capital; help the founders realize some gains; and put himself in line for what will undoubtedly be a nice completion bonus on the way out. But even as Graves revs up his sales campaign, questions are being asked about who really owns Ilim. On one side, the Kremlin's lurking. On the other, there have been reports in Russia that International Paper, the U.S. forest-products giant, has done a deal to buy a stake. Graves denies both claims (though Ilim has confirmed it has been in talks with International Paper along with several other industry players regarding the possibility of such a deal). All we know for sure is that what should have been a predictable tale of wealth creation has become an uncertain adventure, with more plot twists and shadowy characters than a Russian novel.

ONE OF THE first things forest industry types will tell you about Russia is that it's got a lot of trees. During Soviet times the resource was held in low esteem by Communist party leaders, who were much more keen on higher-profile industries like mining and industrial manufacturing, which were not hidden away in the hinterland and produced a higher-value output. The legacy is that the country's forests have for the most part been left alone — or at least not nearly so heavily harvested as forests in North America and Europe. Today, Western experts speak in hushed tones about Russia's vast timber reserves, said to account for nearly one-quarter of the world's standing forests.

## PULP FACT, PULP FICTION, PULP FANTASY Frank Graves's four-year run at Ilim

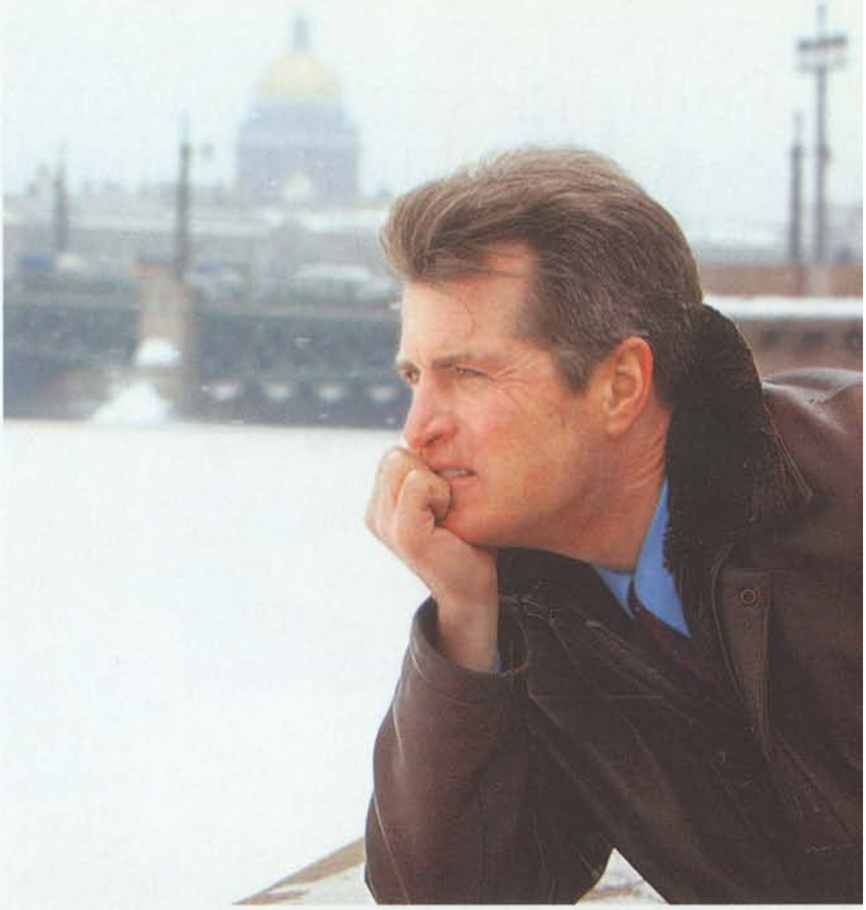
**Since taking the job of chief operating officer at Ilim Pulp in 2002, Frank Graves has been racing. First, the former salesman had to fight off an armed assault by a rival businessman. Lately, his hunt for an outside investor to take a stake in Ilim has been buffeted by rumours of a Kremlin-backed takeover. A story this big has plenty of big characters. Here's a rundown of the players:**

**Zakhar Smushkin, the current chairman of Ilim Pulp, helped form the company in 1992, buying up a string of huge mills using profits from a brief but profitable stint as a pulp trader.**

**Twin brothers Boris and Mikhail Zingarevich also started out as pulp traders. Together with Smushkin they now own a majority block of Ilim's shares.**

**Recently, Russian president Vladimir Putin has rattled foreign investors by supporting confiscation of private assets by corrupt government bureaucrats.**

**Back in the early 1990s, Vladimir Kogan struggled to earn a living. Today he is a powerful Putin ally and a key player in the Ilim saga.**



For Russian forest companies, that's a major competitive advantage over rivals in most of the rest of the world. The wood is cheap, too. As in Canada, most of the forests in Russia are owned by the state, which charges companies a fee to harvest them. The amount companies like Ilim pay is a small fraction of what North American companies pay. Russian companies enjoy other key advantages as well, such as extremely low labour costs and limited state regulation around the environment. And since Russia is right next to China, its forest industry enjoys easy access to the world's fastest growing market.

Add it all up and you begin to understand why Ilim is generating so much interest among would-be owners. As a privately held company, it doesn't disclose its financials, but unofficially, according to Graves and others, 2005 revenues were nearly US$1.4 billion, double that of five years ago, pushing earnings up to a whopping US$270 million. In other words, Ilim is a money tree.

Meanwhile, the Canadian forest industry, especially the pulp and paper side, can barely sustain itself. The once great forests of British Columbia have been hit with a devastating pine beetle infestation that is expected to reduce industry capacity by more than 20% over the next decade. In Quebec and Ontario, the industry has already started to close mills in response to growing timber shortages. In fact, across North America, forest companies are grappling with a host of problems. Supplies are declining. Labour costs are on the rise. New competitors in developing countries are gobbling up markets that North American producers once took for granted. It's not a pretty picture. "We are seeing more and more mills shut down in Canada and the United States and more start up over [in Russia]," says Craig Campbell, a partner at PricewaterhouseCoopers' global forest and paper practice. "These shutdowns are not just a blip. This is a transformational shift that is taking place."

In Russia, there is a growing realization that this transformation is not only happening, but that Ilim is at the forefront. But in a country where democracy is struggling to take hold and where old-style power brokers from the former Soviet Union vie for influence with newly elected leaders, that is not necessarily a good thing. Ilim is making a lot of money and that makes it a target.

It wouldn't be the first time that government leaders have engaged in a corporate takeover. In the highly publicized fight over the oil giant Yukos, for example, Russian president Vladimir Putin unseated Mikhail Khodorkovsky, the billionaire founder, and sent him to prison for tax evasion. Khodorkovsky insists he's been the target of a smear campaign by greedy bureaucrats, and that given the chance he could have built Yukos into one of the world's top oil producers. Instead he's sitting in prison, and much of his former company is under state control. Since then, meanwhile, the government has launched several "stealth takeovers" of other major corporations, including VSMPO-avisma, one of the world's leading titanium producers, and Avtovas, the maker of Lada cars.

Fears that Ilim might be next in line for the Yukos treatment emerged a little over a year ago, after Vladimir Kogan, a powerful

## helm has all the richness of a Russian novel

Aluminum magnate Oleg Deripaska dispatched several hundred armed thugs to take over two of Ilim's mills after his attempt to buy the company failed.

Alexander Branis, director of St. Petersburg-based Prosperity Fund, worries about the fate of minority investors if Ilim goes back on its promise to hold an IPO.

# Both sides in "The War in the Woods" agreed to bury the hatchet. But it may not have been buried deeply enough


**Ilim Pulp has profit margins that make North American execs green with envy. But it needs outside investment for upgrades and expansion**

St. Petersburg financier and owner of a minority stake in Ilim (he holds a 25% share), left the business sphere to take up a senior post in the Russian government, where he is now rumoured to be a close adviser to Putin. (The two have a long history together dating back to the early 1990s, when Kogan, a former computer salesman, acquired control of Promstroibank and built it into one of St. Petersburg's leading financial institutions, thanks to support from Putin, then the town mayor.) What happens to Kogan's shares will likely determine the fate of the whole company. And now that he has joined the political leadership, the fear is that they will end up in the hands of Russia's powerful bureaucracy, where they will be used to gain control over the company. "Kogan is climbing and he is already a very influential character," says Alexander Branis, a director with Prosperity Capital Management Ltd., a St. Petersburg-based investment fund with about US$1.9 billion under management. "The stakes are very high."

For his part, Graves won't admit there's even a problem. He says the rumours are untrue and that Ilim called off its IPO because management decided the company's needs for capital would be better served by locating and bringing in a strategic investor.

LIKE A LOT of Russia's major industrial companies, Ilim had its beginnings in the period of turmoil following the collapse of the old Soviet Union. Factories that had been sustained by the government suddenly found they needed cash to pay their workers, and to get cash they needed buyers for their products. It was a novel and frightening idea to many in the old guard.

Ilim was founded by three former schoolmates from the Leningrad State Technological Institute. Zakhar Smushkin, the company's current chairman, was trained as a researcher. Boris and Mikhail Zingarevich, twin brothers, started out as mill mechanics before launching a trading business selling forest products.

They came together in 1992, and in the following years they used their trading profits to buy up forest companies, accumulating a network of mills stretching across the country. Ilim was a formidable player. But the trio realized that in order for their company to continue to grow they would need bring in Western-style management systems and hundreds of millions of dollars worth of new technology to update its ageing operations. And to do that they needed foreign investment. They put together an ambitious plan to restructure the company as an open, transparent Western-style business. The goal was an initial public offering on the New York Stock Exchange, by which they hoped to raise the money needed to modernize Ilim's mills. In 2003, Smushkin promised that over the next decade the company would spend US$1.5 billion revamping its existing operations and acquiring new ones.

But the partners knew they couldn't do it on their own. Recognizing their lack of Western experience, they came in search of a

North American executive who could fill that knowledge gap and introduce Ilim to potential equity investors. Enter Graves. At the time, he was living in Toronto, working as a senior marketing executive at the Montreal-based pulp giant Tembec. Graves knew things weren't going well in North America. Many of the companies that dominated the sector 40 years ago are now fighting just to keep their heads above water. Abitibi-Consolidated, Domtar and Tembec are all the worse for wear, and indeed, some analysts predict Tembec may soon be forced to seek bankruptcy protection. "Canadian companies haven't realized who they are fighting," says Graves, who recalls that it didn't take him long to figure out that his future looked a lot brighter in Russia.

In 2002, he left Tembec to become Ilim's chief operating officer, a four-year contract position during which he would act as point man for the owners, leading the push to revamp the Soviet-era corporate structure. At the same time, he would head up Ilim's efforts on the IPO front, lining up investment bankers and introducing the company to other key equity market players.

Colleagues describe Graves as an experienced executive with a knack for sales. "He's someone who knows the market and understands the industry," says Kevin Mason, an analyst at Equity Research Associates, an independent research firm. Mason says having Graves out front gave Ilim much needed credibility in the English-speaking equity markets.

Part of the appeal for Graves was undoubtedly financial. "He's a very confident individual," says Mason. "Being a salesman, he enjoys the good things in life. You're getting paid well, you're doing interesting work in Russia. With Frank Graves, if it makes sense and he's got the money, he's going to be driving a Porsche."

Still, nothing could have prepared Graves for what awaited him in St. Petersburg. As soon as he climbed off the plane he found himself in the middle of a corporate takeover battle. Only this was a Russian-style takeover, with death threats and armed thugs.

The opponent was Oleg Deripaska, one of the richest men in the country, a focussed, ruthless player accustomed to getting his way. In the brief period since the collapse of the Soviet Union, Deripaska had amassed an aluminum empire now valued at more than US$3 billion. Then he decided to expand into forestry.

When Smushkin rebuffed his advances, Deripaska dispatched a small army of several hundred armed militia to take over Ilim's Bratsk pulp and paper mill in central Russia, one of its most valuable assets. Ilim's workers were forced out at gunpoint.

Four months later, Deripaska followed up with a plan to take over Ilim's prized Kotlas mill in northeastern Russia, the biggest pulp operation in the country. But this time Ilim fought back. Graves gathered together 80 armed men and posted them in the mill. That led to a standoff between the two sides that lasted for nearly two years. During that time Ilim's growth plans took a back seat to what the Russian media dubbed "The War in the Woods," a long, drawn-out struggle that sapped Ilim and created so much uncertainty across the sector that outside investment virtually ceased. "It was an extremely tough time," says Graves, who organized Ilim's defence in Russia while using his Western contacts to draw attention to what was happening and to try to find allies capable of persuading the Kremlin to take an interest.

One of his first moves was to bring in a high-profile public relations firm. "When Frank started at Ilim, he didn't know that much," says Mark D'Anastasio, a principal at Emerging Markets Communications LLC of Washington, D.C. "That changed fast."

A former Moscow bureau chief for *The Wall Street Journal*, D'Anastasio had plenty of experience working with Western companies in the former Soviet Union and he knew what kind of business environment they dealt with. In the months that followed, Ilim's struggle was covered by *The New York Times*, *Newsweek* and the Dow Jones newswire, and the story of its predicament at the hands of Deripaska quickly spread. It didn't take long for the Russian government to realize that the War in the Woods was driving off Western investment. In 2004, senior government officials intervened, and the two sides agreed to bury the hatchet. ("We love Putin," Graves said in a media interview at the time.) But it may not have been buried deeply enough.

If the popular press is to be believed, corporate battles in Russia are as often about hurt feelings as they are about greed, and the fight over Ilim is a case in point. According to Russian media reports, the seeds of the struggle with Deripaska were planted when Ilim's owners allegedly pressured their minority partner, Vladimir Kogan — the same Kogan now in tight with Putin — to sell his Ilim shares for less than they were worth. Things heated up further, one report says, when Ilim dumped a Kogan-owned entity as the company's auditor in favour of a better known international accounting firm, presumably a housekeeping move in preparation for the IPO. Before the sale could go through, an angry Kogan transferred his shares to his ally Deripaska, who then launched his attack. But that's just one interpretation.

As part of the settlement imposed by the government, Kogan was allowed buy back a 25% stake in Ilim. The question is, now that Kogan is a shareholder again, has he forgiven Smushkin and his partners for their original transgression? Branis says no. He says Kogan, believing the majority owners are weak, is once again angling for a way to try to take control over the company. But this time he's in a much more powerful position. So once again the biggest forest company in Russia appears to be in play.

This explains why Graves sounds frustrated over the phone. He's in a tough position. He has made major strides toward his goal of opening up the corporate structure and introducing Western concepts of teamwork and accountability. He has also updated some of Ilim's mills. But the key to the future — for the company, its founders and Graves himself — lies in bringing in an outside buyer. "Frank badly wants an investor," says one New York investment banker. It's going to be a tough sell, however, as long as there are questions about Ilim's ownership and a possible Kremlin takeover. And that could put Ilim's future on hold.

Back at Ilim headquarters, things are obviously tense. Despite the intrigue and rumours about Kremlin meddling, the company remains an appealing prize. If Graves is successful in roping a strategic investor, he will no doubt walk away with a fat bonus, and Ilim will get a boost in its bid to redraw the map of the global forest industry. If things go a different way, somebody else might get the last laugh — and the loot. "This ain't your typical Canadian pulp and paper company," says Graves. **B**