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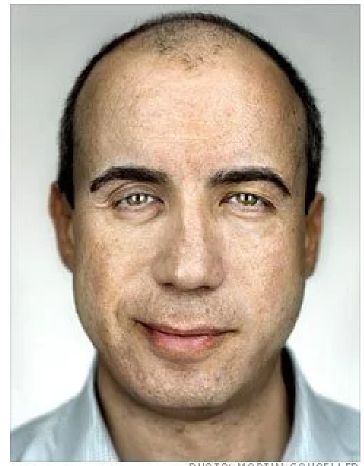
Facebook's friend in Russia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By **Jessi Hempel** October 4, 2010

DST's Yuri Milner makes big bets on social media companies and brings new clout — along with a mysterious oligarch backer — to Silicon Valley.

Yuri Milner has 50 friends on Facebook. Mark Zuckerberg is one of them. They met a couple of years ago when Zuckerberg, the Facebook founder and CEO, was trying to learn more about a Russian social network that Milner partly owned. Then, in the spring of 2009, Zuckerberg sold Milner 2% of Facebook for $200 million.

At the time, more than one Silicon Valley insider wrote the investment off as dumb money. Zuckerberg knew better. Milner and his partner, Gregory Finger, had built Digital Sky Technologies from a small Russian investment venture to a holding company that controlled the businesses behind 75% of the pages served on the Russian-speaking web. And because the online-advertising market is far less robust in Russia than in the U.S., DST's companies had already found ways to make money that U.S. companies hadn't tried. "I talked to a bunch of different [venture] firms and I spent time with [Milner] and I was like, this guy is clearly smarter and more insightful and has more experience in what we are doing," Zuckerberg tells *Fortune*. It helped that Milner, 48, offered great deal terms: His investment valued Facebook at $10 billion, an eyebrow-raising amount at the time, and he didn't ask for a board seat or any other special privileges.

A mere 16 months later, Milner has invested nearly $1.3 billion in American Internet companies. He has increased his Facebook stake to just more than $800 million for roughly 10% of the company, which makes him the second-largest outside investor after Accel Partners. He followed this with mega-investments in Silicon Valley's hot social-gaming company Zynga and group-buying site Groupon, and he paid $188 million to buy the chat service ICQ outright. The investments have attracted the attention of international media companies like Chinese Internet behemoth Tencent and South

African media giant Naspers, which have both taken stakes in DST. Now valued at $4 billion, DST is preparing for an initial public offering in London as early as November.

Milner has amassed so much influence in Silicon Valley that entrepreneurs now ask for “DST-style” deals. By that they mean investments in which they receive a lot of money at high valuations without having to give up any control of their companies. Milner generally doesn’t demand the kinds of protections other investors cling to — preferred shares of stock, for example, or a board seat that would let him help influence how decisions are made. He doesn’t think he needs them. His bets are so large that if he’s wrong, preferred shares won’t cushion his loss.

The story of how a soft-spoken physicist rose up from the chaos of post-communist Russia to become a global social-media mogul involves strategy, chance, and a good deal of pluck, but it also includes a mystery. One of DST’s largest outside investors is the Russian oligarch Alisher Usmanov (pronounced ah-lee-SHER Us-MAH-nof), who emerged from obscurity to become one of the country’s wealthiest men. The origin of his wealth is not clear. He spent six years in an Uzbek jail on a conviction of fraud and embezzlement in the 1980s, charges he contends were false and politically motivated. Less than a decade later he emerged as a board director at a Russian bank. In 1989 a Soviet court dismissed the charges against him and expunged his record. In 2000 the Supreme Court of Uzbekistan ruled that the original charges against him had been unjust. Usmanov holds 25% of DST and controls two of the eight board seats.

Who is Alisher Usmanov?

Despite his association with someone who has spent time in prison, Milner has won over Silicon Valley. “Originally there were a lot of reservations,” he tells me the first time we have breakfast at his de facto Manhattan headquarters, the lobby restaurant of the Four Seasons Hotel. But then, he explains, “As we shared our views and rationale and our vision, everything else was slowly fading away.” That vision is gutsy. Milner believes the network effect of the social web will result in explosive growth for a handful of companies globally, and just as he has done with the Russian Internet, he plans to own a piece of most of them.

Early last summer Russian President Dmitry Medvedev made his first visit to Silicon Valley. Former Secretary of State George Shultz hosted a dinner in his San Francisco penthouse, where thick layers of fog obscured the bay below. California Governor Arnold Schwarzenegger and Cisco CEO John Chambers were among the guests who sipped champagne as the President arrived with his entourage. And there, alongside Russia's ambassador to the United States, was Yuri Milner.

Russia has launched a major charm offensive among U.S. tech companies. In high-tech innovation, Medvedev sees an opportunity to diversify an oil-dependent economy. With the economic gyrations of the past few years, this has become more urgent. Medvedev has found business sponsorship to build an "innovation city" south of Moscow modeled after Silicon Valley. And he has convened a presidential committee that includes Milner to address innovation and technological development through efforts such as furthering broadband penetration.

In supporting Medvedev's efforts, Milner has become an unofficial ambassador to the U.S. tech scene. When the State Department sent more than half-a-dozen Internet executives from companies like Twitter and eBay (EBAY, -1.49%) last February, Milner and his wife, Julia, hosted an informal dinner to cap the event. Knowing that Accel Partners' Jim Breyer loves Impressionism, Milner took him to the State Hermitage Museum in St. Petersburg to view several Matisse paintings that weren't on public display. Milner travels monthly to meet with entrepreneurs in both New York and the Valley, where he takes his meetings at a new luxury resort on Sand Hill Road, the Rosewood Hotel.

Milner, a short man with close-cropped hair and slightly uneven eyes, was born in 1961, the year Russian cosmonaut Yuri Gagarin became the first man to orbit Earth ("That year, many boys were called Yuri," Milner observes). He studied particle physics at Moscow State University and worked as a researcher at the prestigious Academy of Sciences. In 1990, he says, he was the first post-Soviet Russian student to enroll at Wharton. After graduation, he did a stint at the World Bank and then joined Menatep, the bank founded and formerly owned by Mikhail Khodorkovsky. (One of the original oligarchs of the 1990s, Khodorkovsky refused to curry favor with the current government and now sits in jail on fraud charges that are said to be politically motivated.) Milner built Menatep's brokerage and investment-banking divisions and structured the country's first tender offer, a takeover bid for the Hershey's of the Russian candy world, a company called Red October. "Harvard interviewed me and wrote a business case about it," he says.

In 1999, Milner got his hands on a Morgan Stanley (MS, +0.02%) report, to which star analyst Mary Meeker contributed, on the rise of the European Internet. He knew Russian-language equivalents of eBay and Yahoo were destined to emerge, and Meeker's analysis suggested the time was right to launch those businesses. So he pooled resources with his friend Gregory Finger, who ran the Moscow office of the New York City — based investment fund New Century Holdings, to finance and nurture them. The crash followed quickly, however, and Milner dropped the endeavor to rescue one of his portfolio companies, the free e-mail service Mail.ru. He restructured the company, firing 70% of the staff, and turned it over to a 23-year-old engineer to run.

Milner and Finger launched DST as an operating company in 2005. They bought up large stakes in Internet properties and then helped run them. DST's first investors included Goldman Sachs and American hedge fund Tiger Global. Usmanov bought roughly a third of the company in September 2008. Last year, Milner started a second company under the DST umbrella, DST Global, which funds his international deals.

With offices in Moscow and London, Milner has built an employee base that reads like a Goldman Sachs (GS, -0.30%) alumni roster. Seventy percent of his staff came from the bank. The London office was opened by former Goldman Sachs employee Alexander Tamas. The newest partner, John Lindfors, climbed through the ranks to head European tech banking during his 17 years at Goldman. In a May interview, Milner joked to Charlie Rose: "They didn't give me a job 10 years ago, so I'm taking their people."

Despite the pedigreed partnership, when it comes to decision-making, there is no formal investment committee. Milner and Finger are technically in charge. But since Finger, who turned down repeated requests to speak with *Fortune*, spends most of his time in Switzerland these days, Milner calls the shots. It affords him a competitive advantage: While other large firms must bring terms back to structured committees, sometimes taking months to consider, Milner turns deals around in a matter of weeks.

Gideon Yu nearly hung up on Milner. It was January 2009, and Yu, as Facebook's chief financial officer at the time, had grown accustomed to receiving calls from billionaires wanting to buy a chunk of the fast-growing social network. "How do I know you're serious?" he remembers asking. Milner suggested a visit. Yu balked. "I told him, 'Don't come all the way here just to see me.'" Milner got off the phone, drove to the airport, and bought a first-class ticket to California. At 11 the next morning, he was sipping black tea in a Palo Alto Starbucks with Alexander Tamas from the London office, who helps evaluate most of the partnership's U.S. deals, when Yu arrived.

Yu had suspected that Milner, like many potential investors, might not have a good grasp of the business. He was wrong. Milner had been studying Facebook closely for years. He had a theory he has come to call "Zuckerberg's Law": Every 12 to 18 months the amount of information being shared between people on the web doubles. The business implications for this are tremendous, he believes. Over time people will bypass more general websites such as Google (GOOG, -1.19%) in favor of sites built atop social networks where they can rely on friends' opinions to figure out where to get the best fall handbag, how to change a smoke detector, or whether to vacation in Istanbul or Rome. "You will pick your network, and the network will filter everything for you," Milner explained. His thesis was so closely aligned with Zuckerberg's vision for the company that Yu brought him by the office. Milner had chatted with Zuckerberg before. Now they talked about an investment.

Zuckerberg was struck by Milner's intellect and his experience. In exchange for a chunk of the company, Milner offered to lend the insight culled from his work in Asia, where the Internet has evolved differently. For one, Russia has never had much of an online advertising market, so DST companies have been eking dollars and cents out of their users for the past decade through micropayment systems, subscriptions, and a robust virtual-gifts market. Because Milner owns stakes in competing companies in Russia, he can compare strategies to determine what works best. And his insight doesn't stop with Russia. Milner has a close relationship with investor Tencent, the Chinese company that owns the chat service QQ. That service has almost as many users in China as Facebook has worldwide.

Since Milner made his investment, his insights have had a significant influence on the company. Zuckerberg meets with Milner whenever he passes through town — once a month, on average — and he turned to the Russian for much of his thinking on Facebook's newly launched Facebook Credits, a virtual currency system that could in time account for

20% to 30% of the company's revenues. DST companies like VKontakte, the largest social network on the Russian-speaking web, have been selling credits for nearly a decade, and they have learned some lessons. For example, VKontakte originally let developers offer free credits to users in exchange for downloading their games. This strategy devolved into spam when users began making fake accounts to get more credits. So when Facebook launched its own system, it took steps to limit spam.

Zuckerberg has also consulted Milner about the way search has evolved in Russia. Says Zuckerberg: "It's really easy to assume that the current situation you are in is just the way it is. Yuri understands the way it is here, and I think he understands that system because he was a big part of helping to set it up." In the U.S., search is the front door to the web, providing the organizational structure on which people depend to turn up new information. In Russia, many of the social networks in which Milner invests don't make their information available to search engines, but instead build their own.

Even more important than the expertise Milner offers is the structure of his deals. He's the modern-day Masayoshi Son, founder of the Japanese investment firm Softbank, who was as much a protagonist of the early Net as he was a funder. After arriving in the Valley in 1995, the Korean-Japanese entrepreneur-turned-investor bought a third of Yahoo (YHOO) and made a substantial investment in E*Trade (ETFC, -0.07%) , rising briefly to become the world's eighth-richest man. More than companies, Son and his team placed bets on the people who ran them. So does Milner. Mark Pincus, founder of the social-gaming company Zynga, recalls meeting with Milner and Tamas at the Rosewood Hotel last fall. "They were sold on social gaming as a macro, and their big question wasn't about our company," Pincus says. "It was more about me and the management team — were we really in this?"

Once Milner decides to invest in founders, he leaves them alone. Sure, he's available for advice. But he's not looking for a quick turnaround on his investment, and he doesn't want to influence the company's decisions by taking a board seat or requesting special voting rights. In fact, Milner believes he stands to benefit more if DST has less control, because he can invest in competing companies without creating a conflict of interest. Says Milner: "We are trying to mimic the public investment pattern, so that we have a free hand in really just investing across the board."

His deals solve a big problem for startups in the post-boom market: It is tough to go public, but many web companies have been private for so long that early employees and investors are restless for returns. As part of Milner's deals, he offers to buy common shares from employees so they get the payout that keeps them motivated. It's an idea that has caught on in the Valley. "Until DST arrived, there weren't deals like that. Companies were just hanging on — deciding to go public or dealing with the complications. It changed what everybody realized could be done," said Jeremy Stoppelman. Having helped start Yelp in 2002, Stoppelman was looking for a way to reward early investors without selling the company. In July 2009, he used the DST deal with Facebook as a model to negotiate a $100 million investment from Elevation Partners.

If there's anything that could get in the way of Milner's global ambitions, it's his close association with Alisher Usmanov. In July, after becoming concerned about questions this magazine was asking in the course of its interviews, he flew to New York to pay *Fortune* a visit. Milner defended Usmanov's reputation, saying, "We wouldn't have accepted his money if we didn't think he was an acceptable businessman." (See Who is Alisher Usmanov? for more on Usmanov's background.) He also pointed out that other institutions — Goldman Sachs, Tiger Global, and Naspers among them — had vetted DST before investing. (Goldman Sachs and Naspers declined to comment, and Tiger Global representatives didn't return messages.) But the "everybody else says it's okay" argument doesn't answer the question at hand: When Milner conducted his own due diligence, did it turn up anything unsavory or illegal, or did it turn up nothing at all? Milner will say only, "I cannot give you the details of that."

Usmanov is more forthcoming about the nature of their relationship. In written answers to questions, he called Milner a "good friend," and said, "I have no direct control over the company, but sometimes there are things Milner would like to know, and he comes to me for advice. I try to give it." In a subsequent phone conversation, he added that he met Milner when Milner approached him about an investment three years ago, and that he had already owned a number of digital assets, including a large stake in the diary-keeping blog community LiveJournal, so it was a good fit.

Many executives in the tech industry say they would like to know more about DST and Usmanov, but few, if any, have turned their backs on Milner. "I'm sure my parents didn't look into the Kennedy money when they voted for Jack Kennedy," says Kleiner Perkins partner Bing Gordon, who sits on Zynga's board. Zynga's Pincus says, "There's people who think you should only invest in green, ethical companies. What if your pension plan money is invested in a tobacco company?" What's important, according to Pincus, is that he maintains control over Zynga. He adds: "I don't know the facts about Usmanov other than what I've read and been told, and I know that Yuri and Alexander [Tamas] have a very different view on Usmanov and his history. I tend to believe Yuri's point of view more than what I read in the press."

Neither Zynga nor Groupon did copious amounts of due diligence before signing deals with DST, because Facebook's deal gave the firm credibility as a business partner. That deal moved fast, closing just weeks after the conversation was initiated, and Zuckerberg didn't even rely on outside bankers to negotiate it. Sources close to the company say Facebook hired a private investigator to vet DST, but Facebook wouldn't confirm it.

"We had this whole internal debate about whether it was acceptable to do something so different or whether it was too risky," Zuckerberg says. "I needed to arm myself with the answers to those questions in order to win the debate." He adds, "Just because someone comes from a slightly different culture or has a little bit of a different style, I think a lot of the time you have to look past that."

Milner believes that there are at least 50 social-web companies right now worth more than a billion dollars. He tells me this on a Friday afternoon toward the end of the summer as we sink into plush chairs in the lobby of Manhattan's Four Seasons Hotel, where 20-foot acacia trees sprout up beside marble pillars. The maitre d' here knows him by name — and knows even before he has arrived that we should be seated in a discreet corner out of the earshot of other guests. Says Milner: "For the next five years our business model makes sense. We'll keep investing in between two and four late stage consumer Internet companies a year."

On the social web, a "late stage" deal can happen when a company is a matter of months old. Blame Zuckerberg's Law, which leads to a massive double acceleration: Companies grow faster on the web, and web companies grow faster when they are social. Most recently, Milner invested in Groupon. The group-buying site was just 17 months old when Milner flew to Chicago last April, proposed a term sheet on the spot, and got the deal off the ground in 24 hours. In partnership with Battery Ventures, he injected $135 million, giving Groupon an instant valuation of $1.35 billion. The company is on track to bring in $500 million in revenues in its second year in existence. That kind of early growth makes Amazon (AMZN, -1.13%) and Google look sluggish.

Milner is picking up his pace. He is staffing up his offices, and his own travel schedule is so frantic that he often brings his family along just so he can spend time with them. In anticipation of a public offering, he recently changed the name of DST's Russian holding company to Mail.ru Group; DST Global, the company that invests in U.S. companies, will keep its name.

Milner's business strategy is risky. He may have patient investors, but he'll be in trouble if the companies in which he invested don't go public eventually. Zuckerberg, in particular, is in no hurry. Investors speculate that he won't launch an initial public offering until at least 2012. With no ability to influence the companies' timing, Milner can't guarantee when his investors will see a return.

There's also the chance that Milner will be wrong about the companies he has chosen to back. Any of them could misstep, botch its execution, or get bested by an aggressive competitor. Facebook created a firestorm earlier this year when many users — and the U.S. government — felt the new social tools it launched compromised people's privacy. Google and Apple (AAPL, +0.08%) are hot on Facebook's trail.

But Milner has a blind faith in the social web. Not that you will find him there. He has adjusted his privacy settings so conservatively that his profile doesn't appear in searches. Besides Zuckerberg, who is on his list of 50 Facebook friends?

"The usual suspects" is all he'll say.

See also:

Who is Alisher Usmanov?

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