UKRAINE

Eastern Europe's rising star

Since becoming independent from the former Soviet Union in 1991, Ukraine has plotted a colorful path on its journey to becoming the modernizing, pro-Europe country it is today. The Orange Revolution in late 2004 saw an end to protests against a rigged presidential election in favor of Viktor Yanukovych, after which the charismatic, West-leaning Viktor Yushchenko was inaugurated as President in January 2005. Yanukovych made a dramatic comeback in March last year when he won democratic parliamentary elections to become Prime Minister.

Formally declared a market economy by the E.U. in December 2005, which has allowed it to trade with both the E.U. and the U.S., Ukraine is now actively preparing to enter the World Trade Organization and has E.U. membership in its sight. Ukraine has come a long way in a short space of time. As President Yushchenko says: "We have moved from a one-party system with an independent foreign policy to a democracy that has implemented all the mechanisms needed for a free and transparent economy. Today, two thirds of the economy is in private hands."

"Today, two thirds of the economy is in private hands"

More than 50% of the country's gross domestic product (GDP) is attributed to ferrous metallurgy and chemical production and as such, Ukraine's industrial sector is seriously dependent on energy supplies. As Prime Minister Yanukovych notes, the government must therefore ensure stable gas supplies this year, not only for Ukraine itself, but also for transport to Europe. A huge injection of inward investment is needed to help modernize the industrial and energy sectors and important structural reforms have been brought in to facilitate this.

Viktor Yushchenko
President

Minister of Finance Mykola Azarov says: "No one is going to invest in the country if nothing is being invested internally, so we are planning to double the level of state investments this year. The volume of private investments should total about U.S.$20 billion over the next year. In 2008, we are expecting U.S.$8 billion in state investments, and U.S.$40 billion in private investments.

"Our task for the year is to keep the inflation rate below 7.5%. We will do our best to liberalize the regime to a maximum degree and open branches of foreign banks in Ukraine. We will continue to deregulate entrepreneurial activities and contribute to economic freedom as far as possible. There is no alternative."

Diversification will obviously be crucial to sustaining future growth. Economics Minister Volodymyr Makukha notes: "We have every chance of becoming a prosperous and effective market economy with high values in civil society and a well-developed middle class with a competitive economy. Our five-year action plan, 'Competitive Ukraine' aims to switch the structure of our economy from industrial to high-tech. We have a tremendous number of educated people, huge amounts of software designers and people who have done a great deal of scientific research in biotechnology. We need to put a major emphasis on these sectors, as well as on telecommunications and IT."

Ukraine's stable financial system has improved the population's confidence in the banking sector. After the Orange Revolution, retail loans went up by 125% and many European banks entered the market, such as BNP Paribas, Crédit Agricole and Banco Intesa. By 2008, 50% of the Ukrainian banking sector is forecast to be in foreign hands as the government paves the way for mergers and acquisitions.

ProCredit Bank is a development-orientated bank offering a wide range of services through 52 branches across Ukraine. It is part of Frankfurt-based ProCredit Holding AG. The group specializes in

Viktor Yanukovych
Prime Minister

providing formal credit to small and micro-businesses in transition economies and developing countries in Africa, Latin America and Eastern Europe. ProCredit Bank offers finance and credit to "ordinary people," to quote its general manager Dirk Haböck. It found a willing market in Ukraine in 2001, and is looking to expand its U.S$300 million portfolio. Haböck explains: "Eastern European banks in the 1990s had little interest in financing business, yet there were many opportunities for private businesses to start up. So the establishment of ProCredit Bank (called Microfinance Bank at the time) changed things radically. Very quickly, local banks realized the demand was there and that clients paid back."

With an average 20% year on year growth in disposable income and real wages, private equity is booming. Horizon Capital was the first private equity investor to arrive on the Ukrainian market and manages two funds—the Western NIS Enterprise Fund, which started in 1995, and the Emerging Europe Growth Fund, started ten years later—totalling U.S.$280 million. Natalie Jaresko, managing partner, says: "In 1995, most funds were financed by the U.S. government, or the European Bank for Reconstruction and Development (EBRD) because the market was not sophisticated enough to be able to identify suitable deals. However, we were able to get to know the business culture and identify interesting opportunities. From 1995 to 1998, we were unfortunately dealing with a collapsing economy, and very high levels of inflation, but in 1998, a major change occurred. The financial crisis in Russia and the devaluation of the currency both there and here created an opportunity, and consumer goods companies were the first to take advantage.

"Since 1999, there has been a dramatic change in the economy. We have seen an average of 5% GDP growth annually. Much of it has to do with the institutional reforms Yushchenko pushed through when he was PM. When he eliminated bartering from the economy, for example, the money really started to flow in. People had disposable incomes, they started improving their diets and their living arrangements, and they had enough confidence in their salaries to start using credit. Ukraine has 48 million people, so there is a solid resource base for private equity. You can attract multinationals and other industry consolidators because it is a large enough market to build a brand in."

Horizon Capital builds companies that are transparent and profitable, which have captured a substantial market share in the economy with brands, distribution systems and logistics. Jaresko says: "We look at companies that have growth rates of 30-50% year on year. We bring in international standards and practices and work hand in hand with the management.

"Ukraine is a really well-hidden secret within Europe. It is an energy importing country, yet it is growing at a fast pace, despite the major increases in oil and gas prices. The Ukrainians see themselves as Europeans, from a cultural and consumer purchasing perspective, so it is very easy to bring the types of products multinationals are selling globally into this market."

"From a cultural and consumer purchasing perspective, Ukrainians see themselves as Europeans, so it is easy to bring multinational products into the market"

More and more Ukrainian companies are seeking capital for modernization, says Anatoliy Balyuk, chairman of the Securities and Stock Market State Commission of Ukraine: "We should see Ukrainian companies conducting Initial Public Offerings (IPOs) in London soon." Companies such as SCM, Interpipe and Khortytsia are certainly heading in this direction.

Dragon Capital, a leading securities broker, investment banking and private equity and asset management firm, completed 12 IPOs and private placements in 2006 alone. Tomáš Fiala, the company's managing director, says: "Ukraine is the poorest country in per capita terms of all the large countries in Europe. It is very much undervalued and will continue to outperform. Per capita income has more than tripled in the last six years and we expect it to double from the current level by 2010. It is growing 20-25% a year in U.S. dollars."

Those who dared to come to Ukraine before the presidential elections and take the political risk have done very well, Fiala points out. "Investments are growing at an average of 30-35% per annum and generating very good returns," he says. "Last year, FDI made up 9% of the GDP—more than U.S.$7 billion. Much of it was part of Mittal Steel's acquisition, but there have also been transactions in the banking sector. This year, we are expecting U.S.$4.5 billion —around 4.5% of GDP. "

Dragon Capital is the largest Ukrainian stockbroker by trading volume and a four-time winner of the Euromoney (U.K.) award for best equity house. "These awards are based on feedback from investors and company managers in the U.K., where 40% of our clients are based. They like our service the most in terms of sales coverage, execution of their orders, time, cost, settlement, research and recommendations as to where to invest," Fiala says.

The company is arguably Ukraine's biggest promoter in the West. Fiala says: "We make it easier for foreign investors to navigate the opportunities. We have a strong research department; we know the owners of the companies they are dealing with, so we can advise them on their acquisitions. We have raised two thirds of all the foreign investment in Ukrainian companies and already have double the market share of our closest competitor.

"Everything that happened in Central Europe is happening here. Countries that were poor now have booming economies. Ukraine is one of the last boundaries where this will happen. The market is still under-penetrated compared to Poland or the Czech Republic."

The key is in the execution, Fiala maintains. He says: "There are local specifics, but the marketplace is developing very fast and the standards are converging with Europe. The fact that Ukraine is not in the E.U. is not important; the important thing is that trade flows. The E.U. countries are now Ukraine's main trading partners. The banking sector has accelerated this convergence by introducing international standards. Two years ago, 9% of assets were controlled by foreign banks—now it is over 30%. By the end of this year, it will be more than 50% with all the acquisitions in the pipeline. Everybody uses a bank and every company needs to be more transparent, so auditing companies are overloaded with work. Two years ago, 70% of their clients were international companies; now 70% are local companies.


Alex Frishberg
founder,
Frishberg & Partners


Milan Pajevic
director general,
Slav Invest


Tomáš Fiala
managing director,
Dragon Capital

Big players have seen this happening in the Czech Republic, Romania, Poland and the former Yugoslavia. It would be a mistake to miss out on the last opportunity in Eastern Europe."

Increased transparency is indeed a fundamental for instilling investor confidence, and a key government aim, across all sectors. As the first international audit firm to arrive in Ukraine in 1991, Ernst & Young has seen a healthy demand for its services, particularly from corporations. Alexei Kredisov, managing partner, says: "Ukrainian businessmen, business owners and state officials are realizing the need to enhance transparency and efficiency as they become ready for the market economy's rules of the game, at the same time as securing ownership rights of the Ukrainian assets."

Legal firm Frishberg & Partners is also in demand for its corporate services. As a specialist in due diligence, mergers and acquisitions, anti-trust, real property transactions and business litigation, the firm has an impressive portfolio that includes most of the foreign embassies based in Kiev and a number of multinationals, including Hewlett-Packard, KLM Royal Dutch Airlines and Philips.

Company founder Alex Frishberg was born in Kiev, although his family emigrated to the U.S. in 1975. After graduating from

The Hyatt Regency Kiev, opening in May 2007
www.kiev.regency.hyatt.com

Washington University School of Law, he worked for Hogan & Hartson before returning to his roots in 1991. He says: "We pride ourselves on being a company that has local knowledge combined with an American way of doing business."

Ukraine's booming residential market now offers one of the highest yields in Eastern Europe. Office, warehouse and retail spaces are also highly valued as they are in relatively short supply. XXI Century Investments is a real estate investment, development and property management company with a portfolio of diversified assets in this area. As chairman Lev Partskhaladze notes: "In Kiev today there is about 70m^2 of shopping space per 1,000 people and in the rest of Ukraine, there is about 20m^2 per 1,000 individuals. So there is huge potential." XXI Century Investments is even listed on the AIM of London Stock Exchange.

Meanwhile, project management company Slav Invest offers the benefit of 13 years' experience within the Ukrainian market. It completed a successful British American Tobacco factory project last year and has built 39 McDonald's restaurants in nine of the country's largest cities.

Slav Invest's director general Milan Pajevic says: "Large companies choose us because

Radisson SAS Hotel, Kiev, for business or leisure
www.radissonsas.com

we choose the correct way of doing business over the easy way, and we have a highly specialized team who know the local market."

Ukraine is now ranked third in the A.T. Kearney Global Retail Development Index. When German retail giant Metro arrived, it brought European standards of working, and other brands currently considering Ukraine, such as Auchan and IKEA, will only strengthen the marketplace even more. Igor Balenko, chairman of the Furshet supermarket chain, says: "Taking into account that 50% of the retail market is currently unoccupied, there will be serious competition within five to seven years."

Furshet, the second largest company in Ukraine, has been extremely successful in recent years, mainly thanks to strong investment of around U.S.$90 million from the EBRD and Euroventures. The company has 71 stores around the country and plans to open another 30-40 this year. Balenko says: "We use all money for development and invest in the regions more than in Kiev because we know this will be more lucrative in the long run. We are the first chain to have a presence in the regions and in the future, it will be impossible for competitors to go there. This regional policy will be our competitive advantage."

For consulting, project management, architecture and engineering www.slavinvest.com

To capitalize on the country's largely untapped tourism potential, the government has pledged to get the infrastructure up to "European standards" over the next five years. Set up 15 years ago, Ukraine's flagship airline, Ukraine International Airlines (UIA), is certainly expecting a boom. UIA, whose annual revenue growth has been reaching 25% in recent years, currently runs some 300 scheduled flights and offers over 3,000 destinations through its partner network.

Yuri Miroshnikov, who joined the company in 1993 and became president in 2004, says: "Irish leasing firm GPA, the co-founding shareholder of UIA, set a very effective package of targets, rules and procedures. It insisted that the company should buy brand new aircraft and be run independently."

Pioneering UIA, the first company to set up a joint venture of that scale, became the first Boeing operator in the region, and Miroshnikov notes, was awarded the IATA Operational Safety Audit (IOSA) certificate "ahead of some European carriers."

He says: "We have a strong infrastructure and a high caliber staff. Plus, we operate a fleet of 12 aircraft and could add three aircraft every year, which would satisfy an explosive type of demand quickly."

International hotel brands are already moving in. Radisson SAS Hotels and Resorts was the first to arrive in Kiev in 2005 and recently announced the opening of another establishment in 2009, near the international airport. General manager Conrad Meier says: "We have set the trend, particularly in terms of Western-style customer service."

The Hyatt Regency Kiev, due to open in May, will be the city's first five-star hotel. Stephen Ansell, general manager, says: "Kiev has not yet been discovered by the short-break market. It is a dynamic city with a real sense of energy. There is huge potential and we look forward to playing our part in that."

www.businessoutlook.co.uk