

2011

COUNTRY PROFILE



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COUNTRY PROFILE CONTENT

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I. ECONOMY OF UKRAINE

The Last Chance

Ukraine will have to play its last aces and swallow "bitter pills" for better economic prospects in 2011



Ukraine has been building capitalism for twenty years, hoping to revive its economy and raise the standard of living of its citizens to the level of the developed world. But its achievements are still lower than those it attained as part of the Soviet Union. In 2009 the country's GDP dropped by 15.1%, to 63% of Soviet Ukraine's in 1990. The crisis took Ukraine back to the level of 2005. In the dollar equivalent, the national economy collapsed by 35%, to \$117.4 billion.

However, it is not only the scale of the collapse that was frightening, but also the emergence of a number of new factors that are slowly poisoning the state's economy and finances. In addition, unfortunately, it would also not be advisable for Ukraine to turn its back on the powerful foreign "friends" that surround it.

The country continues to suffer from corruption, poverty, a demographic crisis and a black market economy. The increase in prices of energy and the ballooning of state debt have become new challenges for the authorities in recent years. Moreover, environmental risks also weigh heavily on Ukraine.

Luckily, at least political instability dropped off the list of problems in 2010. The formation of a strong system of power is proceeding rapidly, and is supported by the population, which grew tired of political chaos and the irresponsibility of the previous state authorities.

In the existing situation, the consolidation of the authorities is the main reason for optimism, as it gives Ukraine a chance to dramatically cut the burden of its problems, while at the same time speeding up and improving its economic development.

Dynamics of Ukraine's nominal GDP:

Year	GDP in actual prices, UAH billion	Average official hryvnia rate, UAH/\$	GDP in dollar equivalent, \$ billion	Change of GDP in dollars against previous year, %
2007	720.731	5.05	142.719	32.5
2008	948.056	5.2672	179.992	26.1
2009	914.720	7.7912	117.404	-34.8
2010 forecast	1,083.10	--	--	--
2011 forecast	1,253.00	--	--	--

©Source: The National Bank of Ukraine, government; estimates by Interfax-Ukraine

Serious but Stable Condition

The influence of the most painful crisis phenomena weakened in 2010, but deeper reasons for economic vulnerability still exist

and are waiting to make another appearance on the stage.

In January through September 2010 growth of GDP was recorded, which, unfortunately,

was mainly due to the comparison effect from earlier weak figures, although there was some improvement in the situation on the foreign markets.

The influence of these generators of economic dynamics is weakening, however. The growth of Ukraine's GDP in Q3 was a mere 3.5% compared to the same period last year, and this was the lowest quarterly result in 2010. In the first half of the year growth was notably stronger: in Q2 it was 5.9%, and in January-March it stood at 4.9%. In Q4 the situation worsened: in October-December 2009 the fall of GDP slowed to 6.8% from 16% in Q3, compared to the same period in 2008.

The second burden for the economic dynamics in the near-term outlook lies in the worsening of external demand for metals (which accounted for 26.1% of Ukraine's total exports of goods in January-September 2010). Prices of metal products on the foreign markets are dropping, as hopes for a revival of business activity proved unfounded. In addition, each month inflation eats away part of the competitive edge of Ukrainian producers that they gained in 2008-2009 due to the hryvnia's devaluation by 60%.

The volatility of the foreign markets restricts the dynamics of the industrial sector, showing how much Ukraine is exposed to fluctuations in the international commodity trade sector: almost half of Ukrainian exports consist of raw materials and primary products.

In September through October the resurgence in industrial production remained at the rather high level of 10.2% compared to the same period in 2009. Over the first ten months of 2010 industrial production grew by 10.7% year-over-year, whereas its increase was 10.8% over the first nine months, and 10.9% over the first eight months. Engineering saw the highest increase of 32.9% over January-October, while metallurgy grew by 12.3%.

But these figures pale into insignificance con-

sidering that in 2009 industrial output in Ukraine dropped by 21.9%, including a collapse of 26.4% over January-October (engineering fell by 49.7%, and metallurgy by 33.5%).

It is obvious that the poor harvest also damaged GDP in the second half of the year. The agriculture sector will also be hurt by the controversial introduction of grain export quotas, which might be prolonged into 2011.

Metallurgy: a Purse or a Curse?

Ukraine accounts for some 20% of the world's iron ore and 30% of its manganese, and coking coal stocks are to be found in Ukraine: could we have asked for any more from nature? But the lack of incentives (including fiscal) for the modernization of production, a low-cost workforce and a preferential price of gas until 2009 led to the stagnation of industrial modernization. According to the World Bank, in 2000-2008 low prices of gas for Ukraine saved the country some 7.6% of GDP.

As a result, over 30% of Ukrainian steel is smelted at out-of-date and energy-wasting open-hearth furnaces (against less than 1% elsewhere in the world). Modern electric furnaces produce a mere 5% of Ukrainian high quality steel, and besides, the energy consumption of open hearth furnaces and electric furnaces differ by over four times. The sector needs about \$20 billion in investment for modernization, but attracting such a large amount of investment might take years.

Due to this, the growth of competition even at traditional product markets might become an unavoidable obstacle to growth in the Ukrainian economy: the world's output of metal products exceeds the existing demand by a third.

Sport Runs up National Debt

The slowdown of construction in Ukraine dropped to 9% over the first ten months in 2010, year-over-year, while in January-

September it was 12.6%. Investment into the fixed capital of the sector increased only by 2.5% over the first nine months of the year against the same period in 2009. But a certain amount of activity is seen in the sector, as well as progress in the simplification of licensing process.

The situation improved in many respects due to the implementation of the Program on Preparing for and Hosting the Euro 2012 European Football Championship Finals in Ukraine.

Unfortunately, what is good for the construction sector is not always good for taxpayers. The lack of private investment is forcing the state to spend more budget assets on this program, thus increasing its share of general financing. In fact, the problem lies in the massive levels of corruption in the state, where an increase in such expenditures means a rise in bribes taken by officials rather than better results of work.

These results in big public investments by a state with a very small per capita GDP. Initially, the 2010/2011 national budget envisaged the allocation of UAH 10.9 billion and UAH 9.4 billion respectively to the Euro 2012 project, and now government expenditure of UAH 23.7 billion and UAH 28.8 billion is envisaged.

As for the prospects of the sector, it is impossible to ignore the drastic fall in mortgage crediting, which will slow down the

housing construction and is expected to last until the end of 2010 and even into 2011.

One more factor influencing the state's prospects is the increase in its debt burden. Ukraine has paid for its rather modest economic achievements with a considerable increase in its financial obligations in the private and state sectors. According to the National Bank of Ukraine (NBU), the Ukrainian authorities and Ukrainian corporations have to pay back external debts of at least \$42.1 billion (without interest) on July 1, 2010 through July 1, 2011: the short-term external debt at the end of the first half of 2010 increased by 14% to 40.3% of the general sum of the state's gross foreign debt.

According to the calculations of the Accounting Chamber of Ukraine, in 2009 every fifth hryvnia of the national budget's revenue was spent on debt reimbursement, while every fourth hryvnia will be allocated for this in 2010. In autumn 2010 the Ukrainian Finance Ministry forecasted that in 2011-2013 about UAH 156 billion would be spent on paying back and servicing the national debt (the planned revenue of the national budget in 2010 equals UAH 252.7 billion).

Under such conditions, further budget investment expansion might result in serious problems. In addition, if capital expenditures were increased at the expense of a hryvnia emission, then under conditions of high corruption this step would lead to negative consequences rather than speeded up development.

State debt payment forecasts, UAH billion:

Year	Overall	Foreign	Domestic	Servicing	Repayment
2011	53.48671	14.42770	39.05901	19.61156	33.87515
2012	47.39908	19.83105	27.56803	16.75592	30.64316
2013	55.21047	36.61017	18.60030	13.47514	41.73533

©Source: Finance Ministry, as of October 2010

The Customer Is Always Right

One plus point is the revival of the domestic demand. It is well known that the more

economic agents save, (rather than spend), the higher the probability of a cutback in production and a slowdown in economic activity. Against the background of a 23.5%

increase in deposits by the public in January-October 2010, and despite a 9.9% fall in the crediting of the population over the same period, retail grew by 5.8% over ten months in 2010, year-over-year. This prevented the economy from suffering an even more serious slowdown in Q3.

Domestic consumer demand used to be one of the main generators of economic growth in recent years, before the crisis. It was supported by consumer credits from external loans, and not only wages rising. But the hryvnia devaluation during the crisis brought a halt to the credit expansion, and produced a mass of non-performing loans. According to Fitch Ratings, over 50% of credits at Ukrainian banks in the first half of 2010 were non-performing or restructured loans.

The authorities should draw the appropriate conclusions from the mistakes committed earlier. For instance, they should support a rise in domestic consumption by creating incentives for a gradual expansion of the wage share in prime cost of products, instead of encouraging crediting at the expense of mass consumer goods imports. It is impossible to continue the populist practice of increasing wages in the government payroll to an amount that outstrips productivity. A further increase in the national budget deficit and the government debt will critically unbalance the financial architecture.

As a result, the total influence of the above-mentioned factors on the economy might slow the growth of GDP to about 2% in October-December. This does not cast doubt on the government's forecast of GDP growth of 3.7% in 2010 – that is quite a realistic figure. But it would still not hasten a return to pre-crisis levels of economic growth, especially, if global economic development slows as well. The Ukrainian Economy Ministry said that the economy of Ukraine might regain the ground it lost in the financial crisis only in 2013. All the same, this target is achievable, as Ukraine's GDP was only 74.1% of the level of 1990 in 2008.

Investments Wanted

The economy of Ukraine is still far from an investment recovery, and one should admit that difficulties with doing business, considerable fiscal pressure and corruption do not encourage entrepreneurs to make long-term investments. According to the State Statistics Committee of Ukraine, capital investment was UAH 103 billion over the first nine months of 2010, which is 2.9% lower year-over-year. Considering that the calculation of the capital investment index ignores inflation, the actual index fell by 13%.

Ukraine is still dropping behind in the race for domestic and foreign investment. According to the State Statistics Committee, the net gain of direct foreign investment was \$2.5 billion in January-September 2010, which is 14.3% less year-over-year. This is hardly surprising.

According to the Global Competitiveness Report 2010-2011 carried out by the World Economic Forum, Ukraine was 89th in the world in terms of competitiveness, down from 82nd last year. However, the country managed to maintain such advantages as its highly educated population, a flexible and effective labor market and the promising size of the domestic market.

But responsibility still remains a problematic issue for the country. According to the study, out of 139 states Ukraine was 138th in terms of the protection of rights of minority owners, 135th in terms of the protection of property rights, and 134th in terms of the independence of the judiciary. The level of bribe taking put Ukraine in 127th position. Ukraine was also 132nd in terms of "macro-economic stability." In addition, it was 136th for the effectiveness of its taxation system, and 131st in pressure from customs formalities. Finally, Ukraine ranked 138th for the reliability of its banking system.

The World Bank's evaluation is no more optimistic. According to its report, Doing Business 2011, over the year Ukraine

rose by two positions, from 145th out of 183 states. In terms of “conditions for business startup” Ukraine jumped by 18 positions to 118th, which was one of the biggest gains it achieved in the rankings.

At the same time, in terms of “investment protection” the state dropped by one place to 109th. According to the report, the evaluation of the taxation system of Ukraine remained unchanged – the state is still 181st: Ukraine imposes 135 taxes per year, while other states in the Eastern Europe and the Middle Asia have only 41.7 taxes per year, and developed states only 14.2.

Ukraine’s government payroll tax burden equals 43.3%, which is much higher than in other countries in Eastern Europe or in Central Asia and the developed states, which this figure is 22.9% and 23.3% respectively.

One of the foremost Ukrainian economists, Professor Anatoliy Halchynsky, points to another problem that hinders development – an administrative market lacking normal competitive conditions.

In Ukraine, those companies that are promising both technologically and structurally still cannot stand competition, unlike those who managed to integrate into the system of power and make up its economic foundation. According to him, due to this the number of innovationally active enterprises in Ukraine is seven or eight times lower than in countries with developed market systems.

A Lack of Well-Wishers

None of Ukraine’s neighbors is interested in seeing its economic development. Ukraine’s political gestures (such as giving up its nuclear arsenal) brought no economic dividends. The current policy of the European Union is mainly aimed at increasing the sales of its goods on the Ukrainian market, without any trade barriers. Considering the highly developed technologies and much more favorable crediting conditions in Western Europe,

such an approach results in a mechanism of “the equality of the unequal.”

Such “friendship” might only result in the final destruction of Ukraine’s ability to produce highly processed goods and make the country absolutely dependent on imports.

Another strategic “friend” of Ukraine is Russia. Recently, the Ukrainian authorities have been making friendly gestures to their northern neighbors. But these gestures do not solve the problem of the confiscation of over UAH 131 billion in Ukrainian citizens’ savings by Russia. This problem tops a growing list of Ukrainian complaints against Russia. The latest addition to the list came in 2009, when Ukraine signed a gas agreement with rather unfavorable provisions, which Russia is unlikely to change.

The Key Problems

Poverty is the main problem of the country. The process of the impoverishment of the population did not stop with Ukraine’s GDP growth recovery in 2010. According to the Ukrainian Labor and Social Policy Ministry, a quarter of the population (12.5 million people) has nothing left to lose. In addition, the poverty level increased by 0.4 percentage notches to 26.4% in January-September.

According to the World Bank, the percentage of Ukraine’s population that is poor dropped from 47% in 2002 to 12.3% in 2007 at the expense of increasing wages on the government payroll at a level disproportionate to economic development. The economic crisis let this indicator return to 16%.

Of course such a percentage of the poor is not enough to cause social upheaval, but the tendency is rather alarming. As poverty is the key reason for the demographic crisis (about five million Ukrainians are working abroad), which has caused a pension crisis. According to the International Monetary Fund, in 2003 through 2009 the Pension Fund of Ukraine increased its expenditures from 9% to 18.1%, which is higher

than elsewhere in the world: one pensioner will be supported by each payer of pension contributions until 2020.

Such problems as corruption, criminality and a black market economy are also connected with poverty. According to experts, over 45% of the country’s GDP is hidden in “the shadows,” which is a critical level. Shadow wages payments account for nearly 50% of all wage payments. Against such a background, corruption is a powerful force with sufficient resources to nullify any measure that could change the situation.

In connection with this, it is important to solve the problems gradually. Ukraine is unlikely to progress without a radical suppression of corruption. That is why the immediate implementation of tax reform by the new authorities appears to be a mistake. Tougher requirements on small businesses with the existing level of corruption and the lawlessness of officials could only have the effect of reducing employment. In addition, this would do no good to the fiscal sphere.

The attempt to save commercial banks by using budget assets was a striking example of this principle. In 2009-2010 under the national program for bank recapitalization, three financial establishments received UAH 17 billion in budget assets. But in September 2010 it appeared that they needed another investment of UAH 12.5 billion. Meanwhile, the Main Control and Supervision Office of Ukraine has discovered that some UAH 10 billion had been removed from these financial establishments via fake contracts.

The creation of conditions for an expansion of the wage share in the prime cost of products could become a possible solution to the poverty problem. According to Ukrainian trade unions, the wage share in the cost of production was a mere 6% in 2009, while this index in European states was 30%. Increasing this index would not only expand

customer demand, but also form an additional flow of funds for pension payments.

Further stimulation of enterprises by encouraging a cheap workforce compels the most qualified experts to leave for foreign markets, eliminates incentives to employees, and reduces entrepreneurs’ interest in modernization. In addition, it corrupts the population and eats away the state finances, as people prefer relying on social aid from the government instead of independently earning a living.

System Benefits

But despite the problems, Ukraine has a great deal of potential. Privatization could provide considerable support to the budget for other one or two years. The amount of the country’s agricultural land makes the farming sector very attractive, especially in times of increasing food shortages in the world. Moreover, the country’s geographical position is advantageous for the development of transit potential.

Of course, taking advantage of these plus points will require considerable investment, and this in turn is impossible without a radical improvement in the investment climate. In addition, delaying reform might mean Ukraine, like a number of other states, will end up trailing the leading countries for good.

The problems should be properly evaluated before taking the appropriate measures to reorganize the public administration sector and form a stable foundation for the country. Such an evaluation would allow certain decisions to be taken, and political will and a reliable system of power would help realize them.

Taking this into account, we can state that the current strong system of power in Ukraine is the main hope for overcoming the negative tendencies. The statement made by the President in the autumn of this year gives us the reason to hope that

the authorities realize the severity of the problems and know how to solve them. The main question remains this: how quickly will they manage to crush the inertness of the current system, and what will they lose?

“I think that the key task for today is, first of all, successful implementation of the reform and modernization of the state, and secondly, an effective domestic and

foreign policy,” Ukrainian President Viktor Yanukovich said at a meeting of the National Security and Defense Council of Ukraine in November.

We would like to believe that the aims of the reforms would be correctly determined and the restriction of the financial interests of the population will result in rapid economic growth in time.

Consensus forecast for 2010-2011 (as of November 2010):

Index	Average over 2010	Average over 2011	Minimum 2010	Maximum 2010	Minimum 2011	Maximum 2011
Nominal GDP, UAH trillion	1.079	1.270	1.042	1.102	1.227	1.360
Real GDP, %	4.2	4.6	3.5	5.7	4.0	5.5
Inflation (from Dec to Dec), %	12.2	10.7	9.5	13.8	8.9	15.2
Exchange rate UAH/\$, at the end of the year	8.01	8.05	7.50	9.00	7.50	9.00

This information, which is based on calculations of state and non-governmental analytical centers, was provided by the Ministry of Economic Development and Trade of Ukraine.

II. POLITICAL UPDATE

Ukrainian political review 2010



Early 2010 saw a political change at the top in Kyiv following Viktor Yanukovich's victory in the presidential elections, bringing to an end the Orange era and marking the start of a new period in the country's development. President Yanukovich defeated Prime Minister Yulia Tymoshenko by almost one million votes in the February 8 second round of voting to become Ukraine's fourth head of state since the country gained independence in 1991. Thanks to changes in parliamentary procedure which were introduced following the presidential elections, President Yanukovich was soon able to establish a new coalition with a comfortable majority in the Ukrainian parliament and was bolstered by defections from former Orange coalition member parliamentary deputies. Senior Party of Regions official Mykola Azarov was appointed Prime Minister of the new government which boasted one of the largest cabinets of ministers in modern Europe.

Local elections scheduled to take place in May 2010 were postponed by the new authorities until late October. These elections were the first to be held since the recent change in government and were conducted under new regulations which changed the terms of participation for political parties. The local elections resulted in considerable regional successes for President Yanukovich's Party of Regions in all but the country's western regions, where nationalist party Svoboda scored major localized successes. The next major electoral test for the country will now be the next parliamentary elections, which are scheduled to take place in 2012 but which may yet be moved forward.

Autumn also saw a landmark Constitutional Court ruling annulling changes to the Ukrainian constitution which had first

been introduced as part of a compromise deal struck at the height of the Orange Revolution in December 2004. The court's decision meant that considerable powers were returned to the office of the president, placing President Yanukovich in a similar constitutional position to that enjoyed by former Ukrainian president Leonid Kuchma. The 2004 changes had created a degree of constitutional confusion in the country, blurring the institutional boundaries between the offices of president and prime minister and leading to institutional gridlock on numerous occasions throughout the Orange era. Following the 2010 court to revert to the original 1996 constitution, Ukraine's president is now once more clearly established as the most powerful figure in the country's political system.

In the international sphere, 2010 saw concerted efforts by the new administration to rebuild relations with Russia following five years of geopolitical antagonism. April saw the signing of a bilateral accord in Kharkiv which extended the Russian Black Sea Fleet's lease of the Ukrainian port city Sevastopol for a further 25 years, guaranteeing the Russian military presence in Crimea until 2042. In line with the Kharkiv Agreement, Ukraine also received favourable terms for its Russian gas supplies. In contrast to the previous Orange administration's pursuit of NATO membership, President Yanukovich adopted a policy of neutrality and declared Ukraine an officially non-aligned nation before informing the military alliance that the country would no longer be interested in receiving a Membership Action Plan (MAP). However, while future membership of NATO is no longer on the agenda in Kyiv, Ukraine has maintained its practical cooperation with NATO forces throughout the year and



remains committed to developing strong professional ties with the alliance in a variety of sectors. President Yanukovich's first international trip as Ukrainian head of state was to Brussels – a symbolic step which was widely interpreted as a deliberate attempt by the new Ukrainian leader to demonstrate the importance he placed on Ukraine's EU integration. President Yanukovich has stated that European integration remains the country's top international priority and 2010 has seen progress made in bilateral talks between Brussels and Kyiv over a new Association Agreement which will include a free trade agreement. This future Association Agreement is expected to be finalized in the second half of 2011. It is being seen by both sides as a major step towards closer bilateral ties and a document which

reflects the strategic importance of Ukraine to the EU's neighbourhood policy. President Yanukovich has also pushed for a visa-free regime with the EU as a component part of any eventual Association Agreement. EU officials, meanwhile, have stressed that any future free trade agreement would also depend on the Ukrainian government's domestic commitment to the democratic principles adhered to by all EU member states. Meanwhile, throughout 2010 Ukrainian officials refused to rule out Ukrainian participation in a possible Eurasian trade bloc involving Russia, Kazakhstan and Belarus. The coming year should see Ukraine's leaders make the definitive choice between free trade ties with the EU and the CIS, with the country's WTO membership also playing a role in determining the outcome.

III. EURO 2012

EURO 2012 and the Goal for Brand Ukraine

Major political and sports events have significant implications for how countries are perceived in the world. USA surged to first spot in Futurebrand's 2009 Country Brand Index, due largely to the popularity of President Obama and the turnaround of the world's perception of America triggered by his election. Canada became brand #1 in 2010 Country Brand Index also in part because of the heightened awareness of Canada's attractiveness with Winter Olympic Games in Vancouver. Sports events like the World Cup in South Africa and the Olympic Games in China have attracted attention for these nations – and in the case of China, have definitely contributed to shifting perceptions of the country across the world.

EURO championships have a track record of positively impacting countries hosting the tournaments not only perception-wise, but also naturally triggering development of new tourism flows. Active communications efforts of Portugal – EURO 2004 country host – allowed improving perception of the country by 74%. Over three quarters of the number of tourists, who came to Portugal for EURO 2004 – visited the country for the first time and expressed willingness to visit again. Though dominant majority of the EURO tournaments audience is comprised of men, 95% of them travel with family and friends (medium size group consists of two to four people) and they usually stay in the country for 3-5 days. In Portugal, average spending of over 50% of tourists comprised 500-1000 EURO, which provides a good idea on the possibilities of EURO impact into GDP even without the multiplier effect which is brought about by the tourism industry development, triggered by EURO hosting.

What is the story with Ukraine? What is its current perception and challenges vis-a-vis EURO 2012?

Throughout all years since independence, Ukraine has lacked a systemic effort to manage its reputation. The country fails to make it into country brand indexes at all because people surveyed internationally do not have a clear perception of the nation. When it is mentioned or noticed, it is often perceived as part of Russia or its reputation is blurred with things like gas wars with Russia and creating problems with gas supply to European Union countries or Chernobyl.

Apart from the international community noticing a reverse in Ukraine's foreign policy this year, the Ukrainian presidential elections held early in 2010 have not so far had a dramatic effect upon Brand Ukraine in the eyes of the international audience. If Ukraine's reputation history since 1991 was a cardiogram, one would probably still see only one noticeable peak – that of Orange revolution, when the country created its own news for the world. Revolutions make it to world news channels, society's active movements gain momentum and support from those countries and their media, which find democracy, political and media freedoms at the core of their governing principles. Ukraine was in vogue for several months in the western media. It was a part of the conversation of the world audiences. People around the world gave it a thought.

Leaving aside the fact that this momentum of engagement of the world audiences with Ukraine was not sustained and moreover somewhat lost in the years after Orange revolution – Ukraine now has another chance – this time with a sports event like EURO 2012, to speak to foreign audiences when

they will again be ready to notice Ukraine. Even more, it is a chance, when foreign audiences will be ready to not only observe but really be involved, visit the country for a reason and hopefully enjoy their experience to the extent that they would be ready to spend more and to come back.

EURO 2012 is not a panacea but a catalyst to make the best possible preparations to host European family of fans in Ukraine and by having them experience true diverse hospitable beautiful nation create long-term advocates of Ukraine in the world scene for the years to come. As a country whose top-ten pool of incoming tourists currently consists of visitors from Russia, Belarus and Moldova, followed by a host of other post-Soviet nations, and concludes with Germany and USA as the only representatives from developed high-spending nations, Ukraine could leverage EURO 2012 to draw attention and interest from the EU nations and dramatically influence its current tourism flows.

Looking ahead, the country has the potential to leverage UEFA Euro 2012 as a major forthcoming sports event – to raise its profile in the international community. The challenge is to effectively use the time remaining up to EURO 2012 for a well-planned proactive communications effort on behalf of Ukraine.

In the fall of 2010, the country's government has presented the official country logo and launched a series of advertising reels which would be showcasing Ukraine and the Euro 2012 host cities on CNN and Euronews. Though communications experts would have advocated a more profound approach to brand Ukraine development, these efforts will inevitably contribute to somewhat raising awareness of Ukraine abroad. At the same time, current video reel will have to compete with numerous similar advertising campaigns on behalf of the most European and developing nations in the cluttered international media space.

The nation would need to decide which of its and the country attributes should become the focus of positioning and communications. It has a lot to choose from: over a thousand-year history that is reflected in the grand architecture of Ukraine's cathedrals and castles; its role as the cradle of the Eastern Slav civilization; the close inter-connection of its royalty with Europe's royal families; Cossacks who in 1710 introduced a democratic constitution. In terms of geography and natural resources, Ukraine is the precious owner of 28% of global reserves of extra-rich black soil, as well as several climate zones: from moderate continental in Kyiv to subtropical Crimea, from the Carpathian Mountains to the Black Sea.

Ukraine could also leverage further the legacy of famous individuals of Ukrainian origin, who are often more cherished abroad than in Ukraine itself. Among them are Roxelana Hurrem (Suleiman the Magnificent's spouse and strategist), Ihor Sikorsky (helicopter innovator), Serge Lifar (ballet master), Serhiy Korolev (rocket engineer), as well as many artists and actors from Kandinsky and Malevich to Andy Warhol and Mila Yovovich.

Ukraine has its gems in the contemporary art, fashion, music areas which deserve to be highlighted and contribute to a picture of a deeply-rooted on one hand but, from another point of view, modern, innovative, dynamic and rich culture Ukraine possesses.

It is important to take into account the changing international media landscape, evolving audience expectations and the increasing importance of online in making travel decisions. There'll be no holistic place marketing campaign without proper rating in the Future Brand Country Brand Index and similar rankings, joint projects with Discovery Channel and National Geographic, key national media of the priority markets for Ukraine, professional representation of Ukraine at major tourism fairs and expos, decent foreign language country guides and massive multi-language online presence.

Ukraine could also advance its position with more effectiveness if it learns to leverage private professional and public initiatives, like Discover Ukraine, which increase the capacity of the marketing effort for the country. Such initiatives also provide continuity which is one of the keys to success in country and regions marketing, while often government projects depend on political will and stakeholders. With DiscoverUkraine2012, in which professionals and the public already volunteer their knowledge to the government and maximize the efforts of businesses in a united effort, the state can benefit and the world will have the chance and incentive to discover the truth and beauty of Ukraine.

Hopefully, one of Europe's largest countries will treat its reputation as its asset as only a well-planned integrated communications campaign that starts with unique brand Ukraine development and focuses on leveraging a multitude of channels can succeed amid strong competition from other countries.

Discover Ukraine:

DiscoverUkraine is a professional and public initiative to develop international reputation of Ukraine as the country is preparing to host Euro2012 football championship. This platform unites the efforts of project partners – businesses, public sector organizations, the media, destination marketing and communications experts - to show the best of Ukraine and highlight the steps Ukraine is taking to raise its international profile for tourists, investors and general public. DiscoverUkraine is demonstration of the best that Ukraine can offer to the world, via products of the Ukrainian businesses, progressive cultural projects, accomplishments of great Ukrainians.

One of the key project elements is www.discoverukraine2012.org online platform - a website targeted primarily at foreigners, and that promotes Ukraine as diverse and hearty, contemporary and authentic coun-

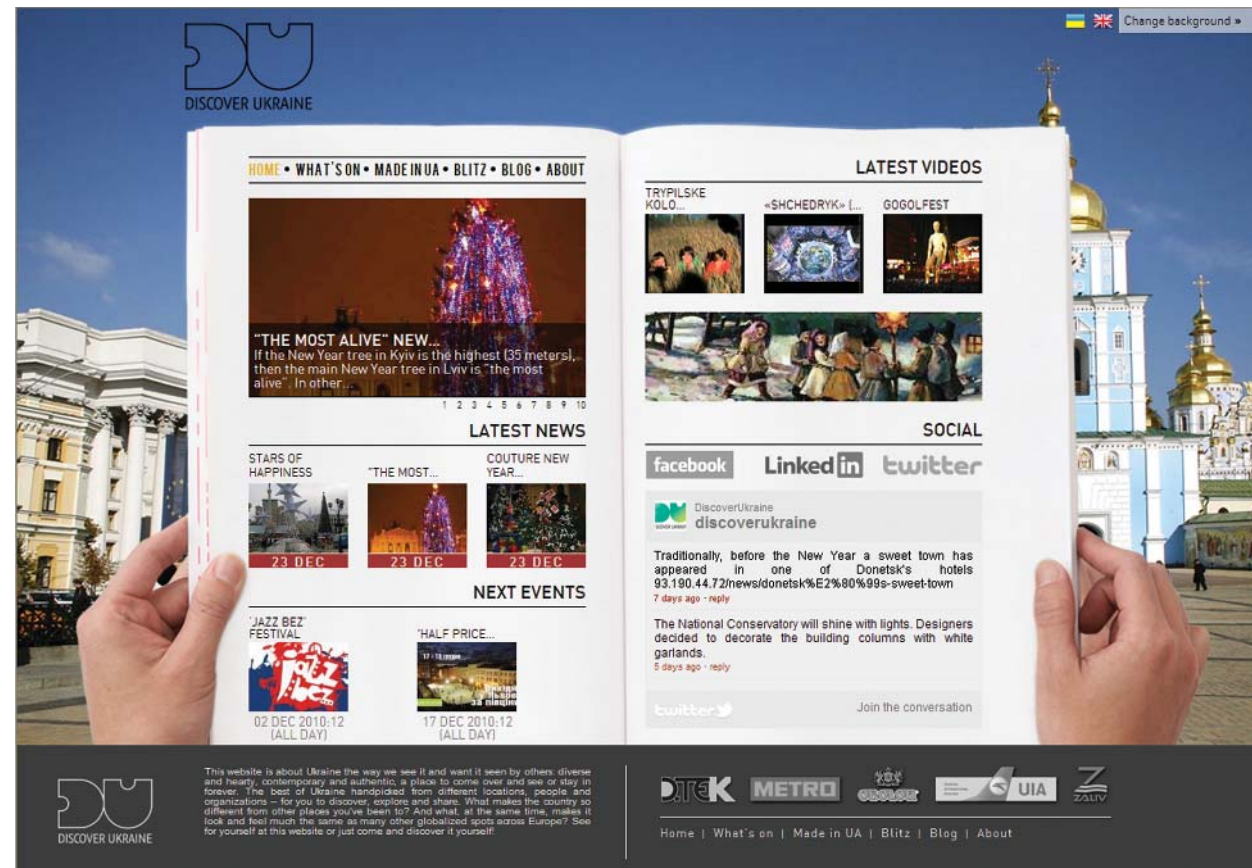
try, a place to come over and see or stay in forever. The best of Ukraine is handpicked from different locations, people and organizations to show what makes the country so different from other places and what, at the same time, makes it look and feel much the same as many other globalized spots across Europe.

Other initiative components include renewal of Great Ukrainians commemoration sites abroad and support of progressive cultural undertakings, as well as a video news release (VNR) contest for students of Kyiv-Mohyla Academy School of Digital Journalism to produce promotional video reels about the most interesting projects in Ukraine.

The initiative was made possible due to The American Chamber of Commerce in Ukraine with the help of the PR Committee Working Group on Information Policy Development. Project co-organizers include DTEK (the first private power company in Ukraine, part of the financial and industrial group "System Capital Management" (SCM), METRO Cash & Carry (a sales division of the METRO GROUP, one of the largest and most international retailing companies), Obolon Corporation (the largest Ukrainian beverage producer), Ukrainian International Airlines (a classical European level airline company that provides passengers with a wide range of services), and OJSC "Shipyard "Zaliv" – (one of the leading shipyards in the Eastern Europe, specializing in the construction and repair of vessels). Project partners currently feature "Krayina Mriy" ('Land of Dreams', international festival of ethnic music organized by Oleh Skrypka), Ukrainian Fashion Week (a professional fashion event in Ukraine that fully meets the global standards of pre-a-porter fashion weeks), Business Ukraine (an independently owned English language magazine published in Kyiv and covering Ukrainian current affairs), Lviv Today (an English and Ukrainian language monthly lifestyle magazine covering culture, business and society in the capital of Western Ukraine), PlaceID – online resource on

marketing of territories. PRP Ukraine is the organizer and driver of DiscoverUkraine. PRP is a leading PR consultancy in the Ukrainian market, an affiliate of one of the most rewarded and accoladed global PR consultancy Weber Shandwick which has led Beijing and Sochi to their success with Olympics. Having been for years a gateway for multinational companies approaching CIS markets and providing consulting to local companies entering the world capital markets, in 2008 PRP Ukraine established an offering in the area of place branding

and marketing – PRP PlaceID. In the years since its inception, this practice has consulted and revamped marketing efforts for Ukrainian regions: from Lviv Regional State Administration on the Lviv International Economic Forum in 2008 and 2009 and Donetsk Regional Council on international media efforts for Donetsk Investment Summit in 2008 to the Council of Ministers of Crimea on establishing and successfully executing The Black Sea Economic Forum in 2010 and supporting international outreach for the Ministry of Agriculture of Ukraine.



www.discoverukraine2012.org online platform that promotes Ukraine is targeted primarily at foreigners and is part of a larger professional and public initiative.

IV. OVERVIEW BY SECTORS

1. AGRICULTURE

AGRO BUSINESS. Legal Aspects

BAKER & MCKENZIE

1. MAIN SPHERES

The main spheres of agro business, which may be of interest to the investors in Ukraine, are as follows:

- cereal crops growing and realization;
- sunflower growing and realization;
- cattle and chicken growing for production and realization of milk, meat and eggs;
- vegetable growing; and
- grape growing.

2. SPECIAL REQUIREMENTS

In order to conduct agro business in Ukraine in certain cases a legal entity is required to obtain such approval documents as permits, certificates, and licenses. Also, the agricultural products must comply with quality, sanitation and health safety requirements established by Ukrainian legislation for certain types of agricultural products.

The legal entities shall also insure certain agricultural products, such as cereal crops.

In recent years, licensing, quotas, as well as indicative prices were used to apply to some types of cereal crops, sunflower oil, and seed, based on the balance of supply

and demand on the internal Ukrainian market. Thus, the Ukrainian Government has established quotas for the export of wheat, barley, corn, rye, buckwheat, as well as mixtures of rye and wheat, until December 31st, 2010. The indicative prices with respect to the export of any agricultural products have not been fixed. The Government representatives have continually emphasized the necessity to establish such export quotas for 2011 as well. Also, there are quotas for production of sugar beets and sugar to be realized on the internal market of Ukraine. It cannot be excluded either so that fixing quotas with respect to other agricultural products may be reinstated. The accession of Ukraine into WTO may also have a certain impact on the regulatory requirements to the export of agricultural products, but exact implications are yet unclear.

The export of agricultural products is subject to licensing. Licensing is a declarative procedure carried out as part of the export monitoring policy and it does not have any restrictive impact on the export of goods.

3. STATE SUPPORT

Ukrainian state authorities regulate the prices for certain types of agricultural products, inter alia, cereal crops, sunflower, sugar, etc. State authorities establish the minimum and maximum prices for agricultural products, implement trade and financial

interventions, and administrative regulation in order to maintain the prices for definite agricultural products within the margin between the minimum and maximum prices.

The state also supports the producers of the agricultural products by way of (i) granting budget credits; (ii) compensating the whole or partial amount of the interest under the credit agreements between the producers of agricultural products and banks; (iii) providing subsidies; and (iv) providing of cash grants.

As an additional measure of support for agricultural production due to the world financial crisis, the Parliament of Ukraine ruled that refinancing of the banks by the National Bank of Ukraine is subject to the prolongation by such banks of the credits of the agricultural enterprises for the term of refinancing, but no less than 365 days.

4. CERTAIN TAX ISSUES

Instead of the application of general taxation, agricultural enterprises are allowed to be registered as payers of a fixed agricultural tax ("FAT"). In order to be a FAT payer, the enterprise's profits derived from realization of agricultural products must exceed 75% of the total amount of the gross profit of the enterprise for the current (preceding) year. FAT substitutes a number of other taxes and obligatory payments, which are applicable under general rules of taxation of Ukrainian legal entities.

The agricultural enterprises (qualifications are the same as for FAT) may also choose the special value added tax ("VAT") regime. Under this regime, the amount of the VAT calculated with respect to the agricultural products supplied by the agricultural enterprise is not payable to the budget, but rather the VAT amount may be used by the agricultural enterprise for the compensation of the VAT amount paid for the production factors and for other purposes necessary for agricultural production. Moreover, as an additional measure

for support of agricultural production due to the world financial crisis, the Parliament of Ukraine ruled that the amount of VAT paid by the processing enterprises for selling milk and milk products, meat and meat products must be entirely used for providing cash grants to the agricultural enterprises supplying milk and meat to respective processing enterprises.

5. LAND FOR AGRICULTURAL PRODUCTION

Right of ownership

Ukrainian land law provides for certain conditions and limitations with respect to the persons entitled to acquire agricultural land in Ukraine. According to Ukrainian law, only Ukrainian citizens and companies founded by Ukrainian individuals and/or legal entities may acquire and own agricultural land provided that the company's charter documents foresee such activity as agricultural production.

The Land Code contains a number of transitional provisions which postpone or limit the application of certain provisions of the Land Code until a future date. These transitional provisions establish that (i) until 1 January 2015 individuals and legal entities may acquire agricultural land of up to 100 hectares and (ii) until the laws "On Land Market" and "On State Land Cadastre" are adopted, certain agricultural land (in particular, land shares, land plots formally designated for commodity agriculture and/or land plots allocated in kind to the owners of the land shares for the private agricultural household) may not be sold or otherwise disposed of unless such alienation results from inheritance or withdrawal of land for public purposes as well as agricultural land plots of municipal and state ownership may not be sold.

As a general rule, once the above restrictions are lifted, acquisition of rights to the state-owned or municipal land plots without structures on it shall require an auction.

Right of Lease

Ukrainian individuals and legal entities, foreign individuals, legal entities, and joint ventures may lease the agricultural land plots of the state, municipal or private form of ownership. The lease right is based on the agreement concluded between the owner of the land plot and the entity, and shall be subject to the compulsory state registration. As a general rule, the lease right to the state or municipal land without structures on it may be sold and acquired through the auction. The land share ("payi") can also be leased under the land share lease agreement.

Emphyteusis

The Civil Code and Land Code introduced a notion of "emphyteusis", which is the right to use someone else's land plot for agricultural purposes under agreement between the landowner and the land user. In many aspects the emphyteusis is similar to the regular land lease. However, to the best of our knowledge, currently there is little prac-

tice with respect to the application of emphyteusis in Ukraine. The reason for this is, inter alia, the lack of the statutory procedure for the state registration of the emphyteusis agreements, which is the condition for the emphyteusis agreement to be valid. However, such procedure shall become effective from 1 January 2011, which may substantially broaden the practice of the application of emphyteusis in the sphere of agricultural production.

Alternative Options of Obtaining Rights to Agricultural Land

The entity interested in carrying on the agricultural activity in Ukraine may consider the ownership of the agricultural land plots indirectly through the establishment of, or acquisition of a stake in, a holding entity the subsidiaries of which will act as the direct lessees or owners of the agricultural land plots. The above option will help avoid possible procedural and administrative complications involved in the re-execution of the title documents to the land plots.

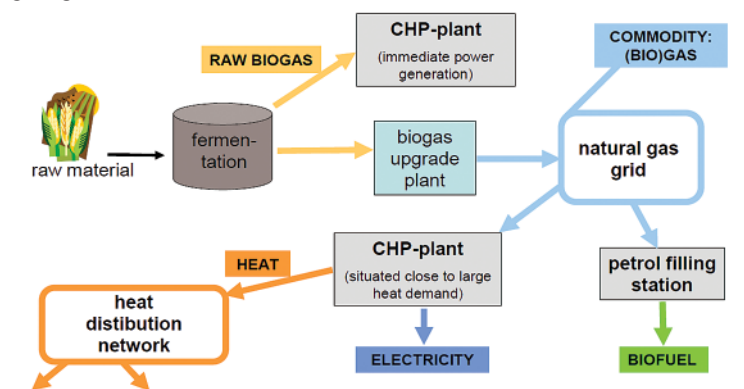
Biogas – "Energy of Regions" and the Question of an Overall Concept



Just with its designation the "Party of the Regions" marks an outstanding initiative. According to scientific studies there is a significant interrelation between regional decision-making authorities and the economic power: the more decentralized the allocation of sovereignties is, the stronger flourishes the economy.

A contribution to regional development far away from metropolises of Kyiv and Donetsk can also be made by means of enhancing the biogas production. While the law-maker currently supports only the production of electric energy from renew-

able sources via "green tariffs", biogas falls by the wayside. Yet its applicability is extremely manifold, as the following scheme shows:



Thus, biogas can be burnt immediately after its generation in a heat and power cogeneration plant or it can be refined to attain the quality of natural gas, so that it's possible to feed it in the natural gas grid. Being taken therefrom, it can perform any function, which can also natural gas can perform (as their chemical properties after refinement are completely identical): as fuel for industry and households, as motor fuel or, after being burnt in a heat and power cogeneration plant, as electricity and heat.

The current one-sided promotion of electric power (from biomass, however, only as long as it is of plant origin, whereby animal waste is omitted and the classification reference of landfill gas remains in question) is astonishing. After all, Ukraine has no actual deficits in this sphere (even if the introduction of „green tariffs“ is basically to be welcomed). On the contrary, natural gas must be imported on a large scale. Such dependence could be reduced step by step, for instance, but not only, through a „green tariff“ for feed-in of biogas or by means of tax incentives for biogas as biofuel. The opportunities for promotion are as manifold as the possibilities to use biogas.

However, in this consideration it is also important what the biomass is obtained from. Nowadays, Ukraine has enough cultivation areas, so that even the targeted cultivation of biomass would be justifiable (in terms of cost effectiveness). In the long run, a world-wide food shortage is forecasted, so that it will result in competition for cultivation areas. Whether then energy or bread are cultivated, will be determined by the market prices.

For efficiency reasons alone, utilization of plant and animal wastes still enjoys the priority. The implementation costs are reduced here to logistics and transport costs, or storage costs, respectively. In this regard, small-scale plants absolutely make sense. They can be limited to the needs of an agricultural farming enterprise or, depending on the size of the enterprise, include the

supply for smaller neighbouring communities. Not only do decentralized energy solutions contribute to better efficiency of farming and animal-breeding enterprises, they also create workplaces in the regions, especially in structurally weak areas. Moreover, decentralized solutions prevent losses in the grid, which inevitably occur in case of central generation and further distribution over many miles.

However, biogas is not to be regarded as the solution for problems of energy supply in general. Biogas is to be viewed as an element of an overall solution. The way to clarify the energy issue considered in its entirety is per se the subject of an energy strategy. Although Ukraine disposes of such one, not many people will ever consider it as a thought-out basis.

From the viewpoint of strategy, staking on „green tariffs“ only makes as little sense as sticking to nuclear power. The challenges to the future's energy mixture will be enormous in any case. It's a matter of own resources and of how they can be used ecologically, it's a matter of imports and of the price for dependency thereon, it's a matter of the ability of consumers in industry and households to bear the growing energy costs, whereas especially the „green tariffs“ become a cost driver in the course of further development of renewable energies. The way to the „green Age“ leaves indeed no alternatives, as the conventional energy sources are exhaustible and the mankind is, thank God, more and more interested in sustainable development and is less and less willing to accept the wear-out of their environment.

Ukraine should simply have the courage to take its own way. Copying of „western“ laws alone will not be enough, the more so as their patterns in the countries of origin by no means encounter undivided support and often lead to economically unreasonable distortions. Furthermore, each advancement („green tariff“) must also be made in one strategic context. An essential element of

such an energy strategy in future should quite certainly be the (decentralized) biomass use.

*Wolfram Rehbock, Attorney, Senior Partner
Arzinger Law Firm*

NB: Taxations of biofuels

For the purpose of enhancing the production and use of biological types of fuel and in order to develop the national fuel market in Ukraine by introducing biomass as sustainable raw material for manufacture of biological types of fuel, Ukrainian legislation provides for a wide range of allowances regarding taxation of activities connected with the use of biological types of fuel (apart from other alternative types of fuel and energy efficient technologies).

1. Income tax allowances

The Law of Ukraine „On Company Profit Tax“ of December 28th, 1994 # 334/94-BP (namely Article 7) stipulates the following allowances:

Temporarily, for the ten years' term, starting from January 1st, 2010 the following shall be exempt from taxation:

- Biofuel manufactures' profit derived from sale of biofuel;
- Companies' profit derived from simultaneous production of electric and heat power and/or from the production of heat power with the use of biological types of fuel;
- Machinery, equipment and tools producers' profit as specified by Article 7 of the Law of Ukraine „On Alternative Types of Fuel“ of January 14th, 2000 # 1391-XIV for manufacture and reconstruction of technical tools and means of transport including self-propelled agricultural machinery and power plants consuming biological types of fuel received from sales of the machinery, equipment or tools referred to above,

which were manufactured in the territory of Ukraine.

Amounts released in connection with the provision of tax allowance shall be directed by tax payers at reduction of prices for products.

2. Allowances on payment of import customs duties

Pursuant to Article 19 of the Law of Ukraine „On Single Customs Tariff“ of February 5th, 1992 #2097-XII the following shall be exempt from customs duty payments:

- Within the period from January 1st, 2010 till January 1st, 2019 machinery, equipment and tools applied for reconstruction of existing and construction of new biofuel production units and for manufacture or reconstruction of technical tools and means of transport for the purpose of consumption of biofuels which are classified according to the UKT ZED Codes (codes of goods groups) specified by Article 7 of the Law of Ukraine „On Alternative Types of Fuel“ provided that such products are not being manufactured and have no analogues in Ukraine.
- Technical tools and means of transport, including self-propelled agricultural machinery and power plants which consume biological types of fuel and are classified under UKT ZED codes specified by Article 7 of the Law of Ukraine „On Alternative Types of Fuel“, provided that such products are not manufactured in Ukraine.

3. Allowances for Value Added Tax

The VAT Law provides for exemption from valued added tax with regard to the following transactions:

- On supply of machinery, equipment and tools determined by Article 7 of the Law of Ukraine „On Alternative Types of Fuel“, in the territory of Ukraine;

- In similar cases subject to exemption from import customs duties (see 5.2. above).

In the event of violation of regulations regarding the special purpose use of products referred to above, the tax payer is obliged to increase tax liabilities in compliance with the taxation period results in which such viola-

tion occurred to the value added tax amount which was due to payment on the date of import of such goods, as well as to pay a penalty charged on such amount of tax in terms of 120 % of the discount rate of the National Bank of Ukraine as of the date of increase of the tax liability and for the period from the date of import of such goods up to the date of increase of tax liabilities.

Anna Pogrebna, Attorney, Partner

2. BANKING AND FINANCIAL SERVICES

The Banking Sector The Currency Control Regime The Anti-Money Laundering Set-Up



1. Banking Sector

1.1. Overview.

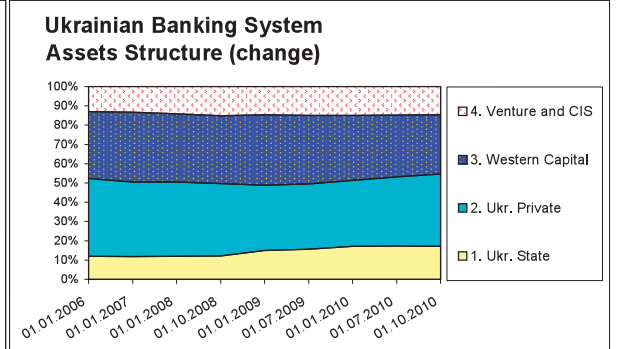
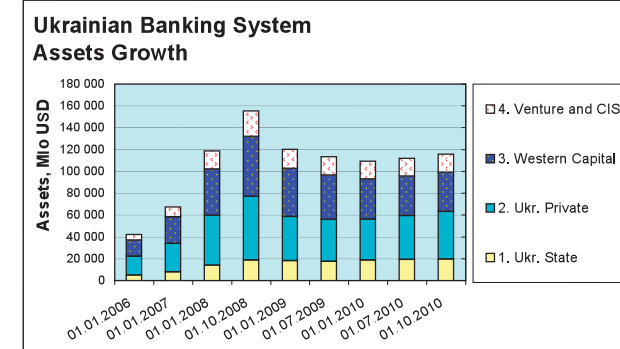
Ukrainian Banking System - Assets & Capital

Ownership Structure

Date of report	28.12.10									
Data source: National bank of Ukraine										
	01.01.06	01.01.07	01.01.08	01.10.08	01.01.09	01.07.09	01.01.10	01.07.10	01.10.10	
NBU official FX rate:	5,05	5,05	5,05	4,8611	7,7	7,6303	7,985	7,907	7,9135	

Total Assets

Total Assets, Mio UAH	Date										*interim		
	01.01.2006	01.01.2007	01.01.2008	01.10.2008	01.01.2009	01.07.2009	01.01.2010	01.07.2010	01.10.2010				
Group by Ownership											Share	Y-to-D	
1. Ukr. State	25 595	40 088	71 643	91 599	139 103	134 737	149 733	152 824	156 435		%	%	Mio UAH eq.
2. Ukr. Private	86 372	131 555	230 714	283 765	313 168	293 392	298 672	318 133	344 703		17,1%	4,5%	6 702
3. Western Capital	74 224	123 443	212 211	266 124	338 856	307 731	293 831	283 629	282 763		37,6%	15,4%	46 032
4. Venture and CIS	27 687	45 094	84 829	114 116	134 959	128 834	131 214	130 670	133 596		30,8%	-3,8%	-11 067
Total	213 878	340 179	599 396	755 604	926 086	864 695	873 450	885 256	917 497		100,0%	5,0%	44 048
+/-, %		59,1%	76,2%	26,1%	54,5%	-6,6%	-5,7%	1,4%	5,0%				
Share of Western Banks:	34,7%	36,3%	35,4%	35,2%	36,6%	35,6%	33,6%	32,0%	30,8%				
Total Assets, Mio USD													
1. Ukr. State	5 068	7 938	14 187	18 843	18 065	17 658	18 752	19 328	19 768				
2. Ukr. Private	17 103	26 050	45 686	58 375	40 671	38 451	37 404	40 234	43 559				
3. Western Capital	14 698	24 444	42 022	54 746	44 007	40 330	36 798	35 871	35 732				
4. Venture and CIS	5 483	8 929	16 798	23 475	17 527	16 885	16 433	16 526	16 882				
TOTAL	42 352	67 362	118 692	155 439	120 271	113 324	109 386	111 958	115 941				



- As of October 1st, 2010 Ukraine has 176 active banks (Russia: ~1000).
- Total Assets of the banking system as of October 1st, 2010 amounts to UAH 917bn (USD 116bn eq.). Since the beginning of the year growth of assets was +44bnUAH or 5%. Top 50 represent ~90% of assets and 84% capital of the banking system.
- Top 10 banks constitute ~50% of the banking system assets and capital. Concentration level is stable over past 3-5 years and lags behind EU zone and neighboring Poland and Russia, where ~50% are covered by Top 5 banks.
- Assets growth in 2010 results mostly from Ukrainian Government T-bills investments by banks.

- Two banks are historically state-owned: the savings bank - Oschadny and UkrEx-Imbank, an ex-part of USSR Vnesheconombank, now a universal bank with a focus on export/import operations and a financial arm of the Ukrainian government in relations with international financial institutions.
- 3 more banks – Rodovid Bank, UkrGaz-Bank and Bank Kyiv – have been saved by the government to calm crisis waves on the market in 2008. Strategy of privatization, merger or closure of each of them is being discussed by government and regulator.
- Historically, Credit Agricole CIB came in 1993 (at that time under Credit Lyonnais brand). Six other western banks came during the late 1990s: ING, Citibank, Raiffeisen, HVB, Unicredito and PKO. If ProCredit Bank Ukraine started in 2001, as MicroFinance bank, a wave started in 2005: SEB purchasing Bank Aggio, Raiffeisen purchasing Aval, BNPP purchasing 51% of UkrSibbank (increased to 80% in 2009) Credit Agricole purchasing in 2006 Index Bank, OTP purchasing the “historical” Raiffeisen.
- In 2007 Swedbank purchased 2 banks of TAS Group, due to be merged by the end of 2009 into Swedbank. In 2008 Commerzbank entered Ukrainian market via purchase of 60% of Bank Forum, still operating under such name. Two Italian banking groups – Intesa and Unicredit – purchased in 2008 Pravex Bank and UkrSotsbank respectively.
- 2007 and 2008 have been marked by massive coming of regional and neighboring countries banks with a business model similar to previously mentioned Western banks dwelling on cheap external funding for further development of consumer, car and mortgage lending. Such banks established presence via 2nd Tier banks like Universalbank (EFG Eurobank Ergasias) Piraeus Bank (both – Greece), Credit Europe Bank (Turkey).
- Separate group is represented by leading Russian banks that moved to Ukraine to follow their clients, get market share and touch the ground in retail business outside Russia (Alfa-Bank, VTB Bank and Sberbank). Two banks are now in Top 10 (Alfa – No.7, VTB – No.10). VEB, Russian state-owned bank, entered the Ukrainian market at the end of 2008 by purchasing the “troubled” Prominvestbank (No. 8 at the moment).

Table 1. Western-Owned Banks

Data as of 01.07.2010 1 USD = 7,907 UAH Data in Mio USD

Rank by Assets	Bank Name	Country	Total Assets	Total Capital	# by Capital	Net PNL
4	Raiffeisenbank Aval	AT	6 827	813	4	5
5	UkrSibbank	FR	5 660	469	7	- 160
6	UkrSotsbank	IT	5 397	767	5	2
10	OTP Bank	HU	3 388	385	9	30
13	Forum	DE	2 163	49	49	- 187
18	Swedbank	SE	1 562	-233	176	6
21	Erste Bank	AT	1 265	111	27	- 18
22	Universal	GR	1 175	122	24	- 9
23	ING Bank Ukraine	NL	1 147	183	20	23
25	UniCredit Bank Ukraine	IT	1 107	107	28	2
29	Pravex	IT	849	118	26	- 19
33	MorTransBank	CY	634	65	41	0
34	Kredobank Ukraine	PL	634	32	63	- 45
35	Index-Bank	FR	625	61	43	- 8
36	Citibank Ukraine	US	610	124	23	20
39	Credit Agricole CIB	FR	504	77	35	21
41	Piraeus Bank ICB	GR	448	37	58	- 6
45	SEB Bank	SE	392	53	47	- 37
48	Volksbank	AT	348	32	65	- 9
50	Procredit Bank	DE	340	29	70	- 2
63	Bank of Cyprus (Ukraine)	CY	205	78	34	0
67	Astra Bank	GR	185	134	22	1
75	Home Credit Bank	CZ	150	45	51	1
81	Platinum Bank	US	138	46	50	0
118	Plus-Bank	PL	61	23	83	0
152	Deutsche Bank DBU	DE	29	28	72	0
155	ProFinbank	FR	28	15	103	0
Grand Total			35 871	3 770		- 389

- The most burning issue of banking sector development is about the future of the banks in NBU receivership – Nadra and Rodovid. Taking into account, among others, the pressure from IMF, the market discusses possibility of Rodovid bank closure, bearing the burden of private deposits repayment to clients of Ukrprombank - the biggest casualty of the crisis. Nadra Bank, which liquidation is asked by many, keeps looking after negotiations between government and potential private investor.

Table 2. Banks under NBU Temporary Administration

Data as of 27.12.2010

Data in Mio USD

Rank by Assets	Bank Name	Country	Total Assets	Retail Deposits	Total Capital	Net PNL
11	Nadra	UA	2 921	61	49	1
22	Rodovid	UA	1 335	150	23	- 532
82	Dialog-Bank	UA	147	9	159	8
107	SotsComBank	UA	88	16	97	- 5
Grand Total			4 491	236	328	- 528

1.2. Assets Evolution

Ukrainian Banking System - Assets

Assets Growth by Client Type

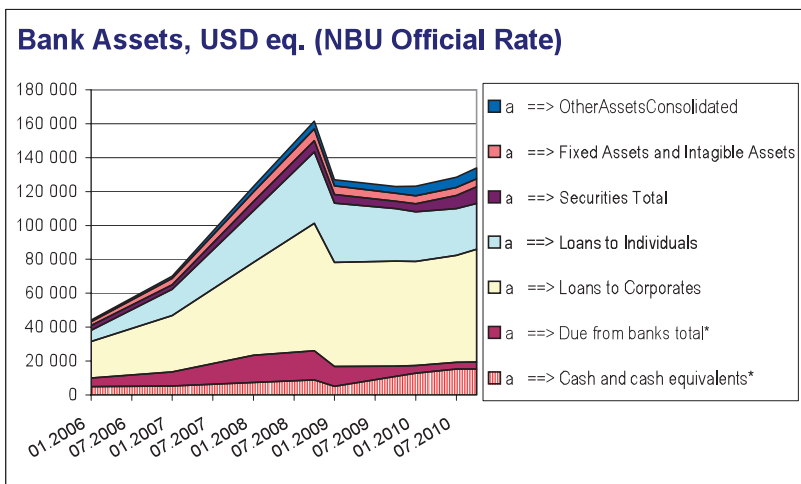
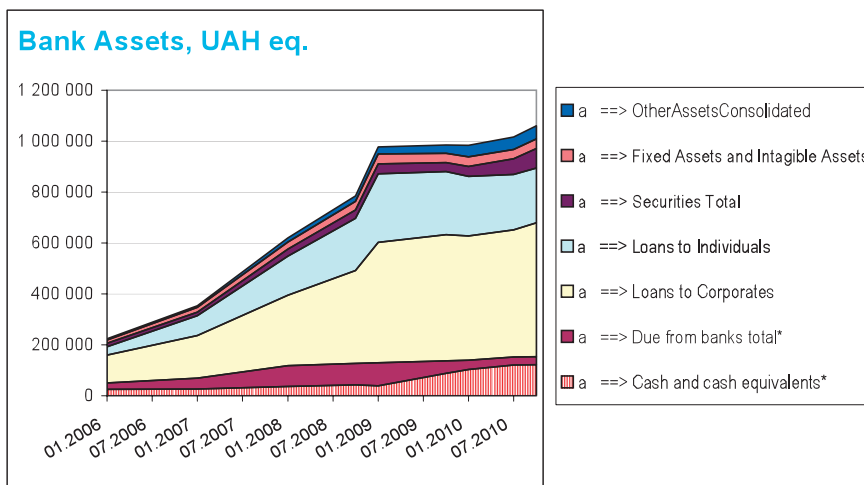
Date of report:	28.12.10									
Date:	01.01.06	01.01.07	01.01.08	01.10.08	01.01.09	01.10.09	01.01.10	01.07.10	01.10.10	
UAH per 1\$	5,05	5,05	5,05	4,8611	7,7	8,01	7,985	7,907	7,9135	

Assets										
	Units	01-2006	01-2007	01-2008	10-2008	01-2009	10-2009	01-2010	07-2010	10-2010
Assets	Mio UAH	213 878	340 179	599 396	755 604	926 086	889 959	873 450	885 256	917 497
Growth (per period)	%		59,1%	76,2%	26,1%	22,6%	-3,9%	-1,9%	1,4%	3,6%
Growth rate (Y-to-D)	%		59,1%	76,2%	26,1%	54,5%	-3,9%	-5,7%	-4,4%	-0,9%
Assets, USD eq.	Mio USD	42 352	67 362	118 692	155 439	120 271	111 106	109 386	111 958	115 941
Loans Portfolio										
	Units	01-2006	01-2007	01-2008	10-2008	01-2009	10-2009	01-2010	07-2010	10-2010
UAH Loans to Individuals	Mio UAH	13 730	28 329	54 970	77 450	75 016	66 476	63 465	61 094	61 614
UAH Loans to Corporates	Mio UAH	67 563	95 547	158 828	197 539	225 116	275 880	281 529	299 835	320 105
FC Loans to Individuals	Mio UAH	19 768	50 182	100 476	130 366	198 374	181 254	170 421	156 643	153 327
FC Loans to Corporates	Mio UAH	42 371	71 253	112 589	160 568	235 413	220 557	207 685	198 708	205 376
Total Loans / Total Assets	%	67%	72%	71%	75%	79%	84%	83%	81%	81%
LC Loans (Corp.+Indiv)	Mio USD	16 098	24 530	42 336	56 569	38 978	42 741	43 205	45 647	48 236
Growth rate (Y-to-D)	%		52,4%	72,6%	33,6%	-7,9%	9,7%	10,8%	5,7%	11,6%
FC Loans (Corp.+Indiv.)	Mio USD	12 305	24 047	42 191	59 849	56 336	50 164	47 352	44 941	45 328
Growth rate (Y-to-D)	%		95,4%	75,5%	41,9%	33,5%	-11,0%	-15,9%	-5,1%	-4,3%
LC Loans Share	%	57%	50%	50%	49%	41%	46%	48%	50%	52%
Loans to Individuals (LC+FC)	Mio USD	6 633	15 547	30 781	42 751	35 505	30 928	29 291	27 537	27 161
Growth rate (Y-to-D)	%		134,4%	98,0%	38,9%	15,3%	-12,9%	-17,5%	-6,0%	-7,3%
Loans to Corporates (LC+FC)	Mio USD	21 769	33 030	53 746	73 668	59 809	61 977	61 267	63 051	66 403
Growth rate (Y-to-D)	%		51,7%	62,7%	37,1%	11,3%	3,6%	2,4%	2,9%	8,4%
Loans to Individuals - Share	%	23%	32%	36%	37%	37%	33%	32%	30%	29%

Quarterly data

Loans by Currency

Loans by Client Type



Total bank assets grew from +/- USD 42bn (12/2005) to +/-USD 111bn (10/2009) via +/-USD 120bn (12/2008). Overall 3 times growth (USD) over the last three years. Peak reached in October 2008 – USD 155bn (just before UAH revaluation).

Commercial loans grew up even faster between 2006 and 2009: 3.7 times – loans in UAH; 4.6 times – loans in foreign currencies, from USD 12bn in 01/2006 to USD 60bn in 10/2008.

Development of loans portfolio in 2009 - 2010 reflects crisis and its consequences:

- UAH denominated loans total amount continue to grow in 2009, mainly driven by massive state support of state companies and banks: +9% in 4Q 2008, +14% in 2009, +10% in 2010 so far.

- FC loans, if accounted in USD eq., show slide of -6% in 4Q 2008 and -11% in 2009, and -5% in 2010 so far.

Overall Commercial loans in USD terms increased 3.5% since the beginning of 2010. Loans are massively prolonged when borrowers appear to be incapable to repay them in the current market slide of activity, or restructured in exchange for partial repayment. Some FC loans to individuals, on advice and with the support of the National Bank of Ukraine, are converted into local currency to ease the burden of interest payments.

- Rating agencies mention that as of mid of 2010 the banks that they rate have restructured loans on average for more than 35%. On top of such loans, overdue loans exceed 10% of the loans.

1.3. Assets/Liabilities Imbalances

Ukrainian Banking System - Loans Portfolio

Clients & Currency Structure

Date of report: 28.12.10

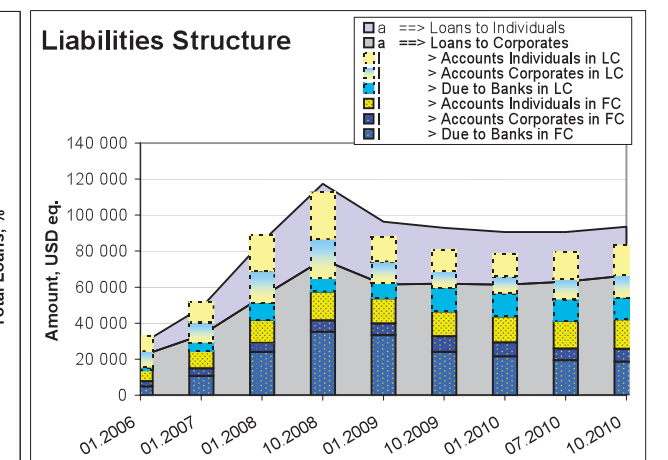
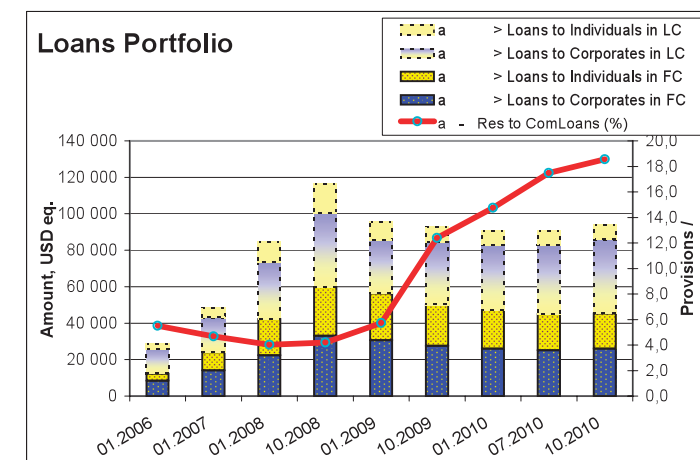
Date:	01.01.06	01.01.07	01.01.08	01.10.08	01.01.09	01.10.09	01.01.10	01.07.10	01.10.10
UAH per 1\$	5,05	5,05	5,05	4,8611	7,7	8,01	7,985	7,907	7,9135

Loans Structure

	Units	01-2006	01-2007	01-2008	10-2008	01-2009	10-2009	01-2010	07-2010	10-2010
Total Clients' Loans	Mio UAH	142 277	245 523	430 052	570 395	741 816	747 775	726 296	719 570	744 082
Total Clients' Deposits	Mio UAH	147 094	202 929	318 389	404 320	436 727	350 284	349 636	383 483	416 683
Total Loans / Total Deposits	%	97%	121%	135%	141%	170%	213%	208%	188%	179%
FC Part of Clients' Loans	Mio USD	12 305	24 047	42 191	59 849	56 336	50 164	47 352	44 941	45 328
FC Part of Clients' Deposits	Mio USD	9 034	13 892	17 795	22 240	20 460	22 563	22 064	21 955	23 541
FC Loans / FC Deposits	%	136%	173%	237%	269%	275%	222%	215%	205%	193%

Total Loans to Corporates	Mio USD	21 608	33 221	54 737	75 229	61 423	61 977	61 267	63 051	66 403
Growth (per period)	%		53,7%	64,8%	37,4%	-18,4%	0,9%	-1,1%	2,9%	5,3%
Growth rate (Y-to-D)	%		53,7%	64,8%	37,4%	12,2%	0,9%	-0,3%	2,9%	8,4%
- FC Share Loans to Corporates	%	39%	42%	41%	44%	50%	44%	42%	40%	39%
Total Loans to Individuals	Mio USD	6 565	15 397	30 422	42 110	34 916	30 928	29 291	27 537	27 161
Growth (per period)	%		134,5%	97,6%	38,4%	-17,1%	-11,4%	-5,3%	-6,0%	-1,4%
Growth rate (Y-to-D)	%		134,5%	97,6%	38,4%	14,8%	-11,4%	-16,1%	-6,0%	-7,3%
- FC Share Loans to Individuals	%	60%	65%	65%	64%	74%	73%	73%	72%	71%
Total Loans to Fis + Securities	Mio USD	7 838	11 128	21 597	23 821	16 876	10 467	9 385	11 857	13 786
Growth (per period)	%		42,0%	94,1%	10,3%	-29,2%	-38,0%	-10,3%	26,3%	16,3%
Growth rate (Y-to-D)	%		42,0%	94,1%	10,3%	-21,9%	-38,0%	-44,4%	26,3%	46,9%
Loans Loss Provision	Mio USD	-1 811	-2 556	-3 891	-5 590	-6 136	-12 244	-14 170	-16 958	-18 512

Quarterly data



Non-performing loans is a major problem of the banking system for all categories of banks. Reserves accumulated by banks are building up quickly: from 4% of loans portfolio in October 2008 to 14% in October 2009 to 18% in October 2010. Yet many analytics estimate that loans portfolio remains under-provisioned.

The rally for deposits was launched by banks after 2008 financial crisis dried out the flow of foreign financing from abroad. By raising rates, marketing new short-term & bonus products the banks reached visible stabilization of domestic funding. The banks have kept and even increased deposit base since January 1st,

2009: population deposits have grown up UAH 46.5bn to reach UAH 260bn as of October 1st, 2010, corporate accounts are up UAH 20bn and total UAH 136bn during the same period.

But some banks achieved it at a price...their funding became expensive!

Lending did not restart really: banks still have to provision their assets, the economy is progressing at a small pace, the legal environment remains a plague for banks. In 2010, so far, loans to individuals were decreasing (first 9 months: -8%, UAH 19bn, to UAH 213bn). Loans to corporations increased to UAH 508bn as of October 1st,

1.4. Income and Expenses

Net Banking Income at banks stagnates in 2010: -5%, UAH 50.8bn as of October 2010 versus UAH 54bn in October 2009.

Operating expenses contracted slightly as a result of closure and re-location of offices and staff expenses control. As of October

2010 or +4%, UAH 24bn, since January 1st, 2010. The increase over the last 10 months is the result of loans to Naftogaz, Ukrainian Railways, Ukravtodor...

The banks' loans to deposits ratio is improving: 2.19 as of January 1st, 2010, now at 1.85 (but at 2.05 in FC!). To be noted that the FC borrowing from banks abroad decreased from USD 42bn at the start of the crisis to +USD 30bn now, Western-owned banks being the biggest beneficiaries of such funding.

Excess of funds went in 2010 into securities market where banks' outstandings have grown twice from UAH 38.5bn at the end of 2009 to UAH 76.7bn in October 2010.

2010 Administrative & Staff expenses were -UAH 25.8bn (compare to -UAH 27.5bn in October 2009). Cost-to-income ratio estimation remains around 50%.

Net Result remains negative as loans loss provisions continue to eat into banks earn-

ings: -UAH 36bn for 10 months of 2010, improved from -UAH 48.8bn for 10 months of 2009.

Capital increase is a big concern for the banks. After urgent and "emergency" capital infusion of UAH 35bn in 2009, the banks continued the pace in 2010 by adding or declaring that they would add UAH 31bn in 2010.

1.5. Other market comments

As of the end of November 2010, even if the banking sector seems "stabilized" and no significant accident occurred, it seems obvious also that the restart at a significant level of the banks' intermediation/lending activity will not occur soon. Banks are caring about their bad loans, provisioning them, raising capital...and waiting for the economy to step by step emerge from the crisis.

Banks have reopened the selling of most popular banking products like car loans and consumer finance loans, although pricing and conditions remain high and rigorous:

17-20% in UAH for 3-5 years. Mortgage lending is restarting slowly at 20-25% for 5-10 years loans.

1.6. Market Regulator

The National Bank of Ukraine (NBU) regulates the banking activity, banks being subject to very significant constraints in their day to day activities, even if the NBU enforcement capacity is not perfect. As highlighted by the NBU, the Banking sector is faced, mostly for its non-western owned portion, with challenges: fragmentation, capital adequacy, insider loans, tax games, insufficient provisioning...

Following change in political landscape the management team of NBU is being also changed. But thanks to the IMF support, some positive changes were decided. These changes should reinforce the NBU independence, force that Bank to focus more on inflation management and less on FX management, the FX risk being transmitted to the economic sectors (FX hedging possible in 2011).

Ukrainian Banking System - Capital & Profitability

Capital and Income/Expences Evolution

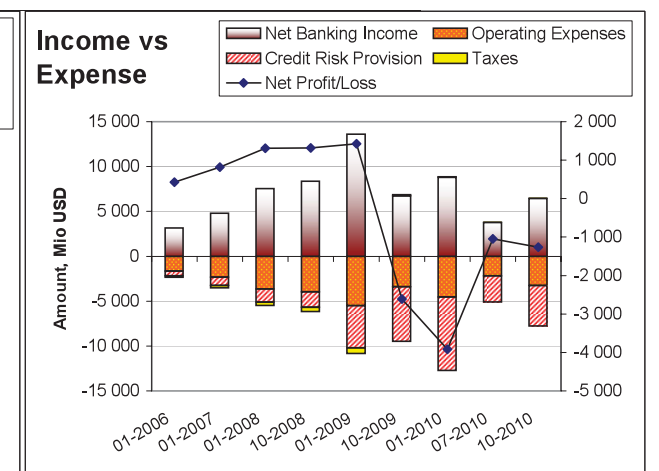
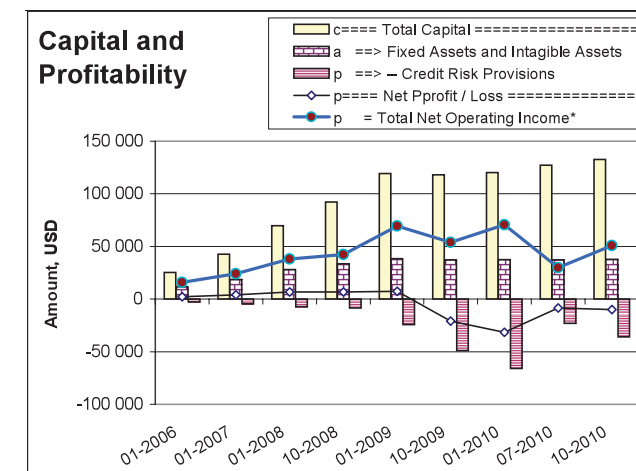
Date of report: 28.12.10

Date:	01.01.06	01.01.07	01.01.08	01.10.08	01.01.09	01.10.09	01.01.10	01.07.10	01.10.10
UAH per 1\$ NBU rate	5,05	5,05	5,05	5,05	5,11289	8,0215	8,0356	7,9224	7,901

Capital / Results

	Units	01-2006	01-2007	01-2008	10-2008	01-2009	10-2009	01-2010	07-2010	10-2010	
Capital	Mio USD	5 040	8 429	13 778	18 249	23 326	14 706	14 959	16 051	16 808	
Growth (per period)	%		67,2%	63,5%	32,5%	27,8%	-37,0%	1,7%	7,3%	4,7%	Quarterly data
Growth rate (Y-to-D)	%		67,2%	63,5%	32,5%	69,3%	-37,0%	-35,9%	7,3%	12,4%	
Total Assets	Mio USD	42 352	67 362	118 692	149 625	181 128	110 947	108 697	111 741	116 124	
Net Profit/Loss	Mio USD	430	821	1 311	1 320	1 429	-2 611	-3 919	-1 048	-1 266	
*CAD Ratio	%	11,9%	12,5%	11,6%	12,2%	12,9%	13,3%	13,8%	14,4%	14,5%	
*ROE Ratio	%	8,5%	9,7%	9,5%	9,6%	6,1%	-71,0%	-52,4%	-8,7%	-10,0%	
*ROA Ratio	%	1,01%	1,22%	1,10%	1,2%	0,8%	-9,4%	-7,2%	-1,3%	-1,5%	
Net Banking Income	Mio USD	3 153	4 790	7 536	8 379	13 598	6 719	8 793	3 774	6 429	
Net Banking Income	Mio UAH	15 925	24 190	38 059	42 312	69 526	53 900	70 658	29 902	50 798	100,0%
Net Interest Income	Mio UAH	8 122	13 680	22 229	25 720	37 552	41 193	53 726	23 577	38 008	74,8%
+ Interest Income	Mio UAH	19 029	30 259	50 842	60 061	88 370	91 833	119 083	55 335	84 740	
- Interest Expense	Mio UAH	-10 907	-16 579	-28 613	-34 341	-50 818	-50 640	-65 358	-31 757	-46 732	
Net Commissions Income	Mio UAH	5 238	7 562	11 056	11 230	17 695	9 972	13 097	5 732	9 041	17,8%
+ Commissions Income	Mio UAH	5 775	8 315	12 450	12 705	19 872	12 203	16 107	6 954	10 959	
- Commissions Expense	Mio UAH	-537	-753	-1 393	-1 475	-2 187	-2 231	-3 010	-1 222	-1 918	
Trading+Reval. Results	Mio UAH	1 187	2 047	2 896	3 483	11 523	1 363	1 965	1 035	1 700	3,3%
Other Income	Mio UAH	1 319	835	1 532	1 870	2 750	1 372	1 870	-441	2 049	4,0%
Operating Expenses	Mio USD	-1 659	-2 353	-3 668	-3 993	-5 506	-3 423	-4 560	-2 191	-3 267	
*Cost/Income Ratio	%	52,6%	49,1%	48,7%	47,7%	40,5%	50,9%	51,9%	58,1%	50,8%	
Credit Risk Provision	Mio USD	-550	-908	-1 437	-1 698	-4 718	-6 088	-8 197	-2 917	-4 535	
Taxes	Mio USD	-161	-278	-405	-516	-635	162	81	23	38	

Avg Monthly Income	
2009	2010
5 888	5 644
4 477	4 223
1 091	1 005
164	189
156	228



Ukrainian Banks

Banks' Ratings

Date of report: 28.12.2010

Moody's as of: 01.11.10

Bank Name	Bank Financial Strength	DEPOSITS				SENIOR DEBT				SUBORDINAT		OUTLOOK
		LC LT/ST	FC LT/ST	NSR LT FC	NSR LT FC	LC LT/ST	FC LT/ST	NSR LT FC	NSR LT FC	LT LC	LT FC	
BANK FINANCE AND CREDIT, OJSC	E	Caa1/NP	Caa1/NP	Ba2.ua								STA
CIB CREDIT AGRICOLE, PJSC	D	Ba2/NP	B3/NP	Aa1.ua		Ba2/-		Aa1.ua				STA(m)
CREDIT DNEPR BANK	E+	B3/NP	B3/NP	Baa3.ua								NEG
DONGORBANK, PJSC	E+	B2/NP	B3/NP	A3.ua		B2/-		A3.ua				NEG(m)
EXPRESS-BANK	E+	B3/NP	B3/NP	Baa3.ua								NEG
FIRST UKRAINIAN INTL BANK	E+	B2/NP	B3/NP	A3.ua				A3.ua				NEG(m)
FORUM BANK	E+	Ba1/NP	B3/NP	Aa1.ua								STA
OTP BANK (UKRAINE)	D-	Ba1/NP	B3/NP	Aa1.ua								STA(m)
PIVDENNYI BANK, JSCB	E+	B2/NP	B3/NP	A1.ua				A1.ua				STA
PRIVATBANK	D-	Ba3/NP	B3/NP	Aa1.ua		B1/-						NEG(m)
PROMINVESTBANK	E+	B2/NP	B3/NP	A2.ua								STA
RAIFFEISEN BANK AVAL	D-	Ba1/NP	B3/NP	Aa1.ua		Ba1/-		Aa1.ua				STA(m)
RODOVID BANK	E	Caa2/NP	Caa2/NP	B3.ua								DEV(m)
SAVINGS BANK OF UKRAINE	E+	B2/NP	B3/NP	A2.ua		B2/-		A2.ua				NEG(m)
SUBS. BANK SBERBANK OF RUSSIA	E+	Ba2/NP	B3/NP	Aa1.ua		Ba2/-		Aa1.ua				NEG(m)
UKREXIMBANK	D-	Ba3/NP	B3/NP				B1/-			B1		NEG(m)
UKRGASBANK	E+	B3/NP	B3/NP	Baa3.ua								STA
UKRGAZPROMBANK	E+	B3/NP	B3/NP									NEG
UKRSIBBANK	D-	Ba1/NP	B3/NP	Aa1.ua			B1/-					STA(m)
VAB BANK	E	Caa1/NP	Caa1/NP	Ba1.ua			Caa1/-					POS

Fitch as of: 01.11.10

Name	Long Term Issuer Default Rating	Outlook - Long Term Issuer Default Rating	Short Term Issuer Default Rating	Individual Rating	Support Rating	National Scale Rating	Outlook - National Scale Ratings
Forum Bank	B	Stable	B	E	4	AAA(ukr)	Stable
Industrial Bank	B-	Stable	B	D/E	5	-	-
Khreschatyk Bank	B-	Stable	B	D/E	5	BBB-(ukr)	Stable
Pivdenniy Bank	B-	Stable	B	D/E	5	-	-
Pravex Bank	B	Stable	B	D/E	4	AAA(ukr)	Stable
Privatbank	B	Stable	B	D/E	5	-	-
ProCredit Bank (Ukraine)	B	Stable	B	D/E	4	AAA(ukr)	Stable
Savings Bank of Ukraine	B	Stable	B	D/E	4	AA-(ukr)	Stable
Ukreximbank	B	Stable	B	D	4	AA-(ukr)	Stable
UkrSibbank	B	Stable	B	E	4	AAA(ukr)	Stable
Ukrsotsbank	B	Stable	B	E	4	AAA(ukr)	Stable
VTB Bank (Ukraine)	B	Stable	B	E	4	AAA(ukr)	Stable

Standard & Poors as of: 01.11.10

Name	Long Term Credit Rating	Outlook - Long Term Credit Rating	Short Term Credit Rating	National Scale Rating
Alfa Bank (Ukraine)	CCC+	Positive	C	uaBB
Kredobank	B-	Stable	C	uaBBB-
Nadra Bank		Withdrawn		
Privatbank		Withdrawn		
Ukrsotsbank		Withdrawn		
Unex Bank		Withdrawn		

2. Currency Control

In Ukraine, Currency Control is very strict and complex. It is governed by laws and by regulations of the National Bank of Ukraine (NBU). Regulations frequently change, therefore please consult your banker.

The purpose of Currency Control is to prevent the illegal export and import of valuables, goods, services, and the transfer of funds abroad, as well as to control the timely settlement of payments for goods and services under external trade contracts.

For individuals

Import/Export of cash:

- Residents and non-residents may export and/or import without declaration the equivalent of EUR 10 000. Amount exceeding equivalent of EUR 10 000 should be accompanied with a written declaration. For amount exceeding EUR 10 000 the confirmation from the bank evidencing that funds were withdrawn from the individual's account should be presented.
- Funds disposal (possibility to withdraw cash wired from abroad without account opening):
- Disposable funds are limited per transaction and per day to the equivalent of UAH 50 000 (applicable for residents and non-residents).

Non-commercial transactions:

- Wire transfers in foreign currency are limited to equivalent of UAH15 000 per day without account opening for residents and non-residents. But for residents – without supporting documents; for non-residents – with confirmation of the source of money.

- Wire transfers in foreign currency in amount which exceeds the equivalent of UAH 15 000 per day can be done by residents and non-residents from the current account (for residents with supporting documents, for non-residents – without supporting documents).

For more details, please ask your banker.

For commercial operations/companies

The following administrations are involved in the currency control process:

- Customs – it controls the export/import of goods and valuables.

- Banks – authorised by the National Bank of Ukraine, control all operations and inform the NBU and State Tax Administration (STA) in case of violations and are liable if such control is not executed properly.

Main types of activities subject to Currency Control and some key rules or constraints:

Export/import of valuables, goods and services:

- Exporting companies should receive payment within 180 days after shipment of goods.
- Importing companies can pre-pay 100% but should receive goods or services within 180 days.
- Capital market operations (sale/purchase by non-residents of domestic securities; sale/purchase by residents of foreign securities; dividend payments abroad, etc.).
- Cross-border loans (loans granted by non-resident lenders).
- Currency purchases.

Main documents used to perform Currency Control:

For sales/purchases of goods – trade contracts, customs declarations, invoices.

For services (including royalties) – Contracts and documents proving that services were provided. When such services provided by same foreign supplier exceed equivalent of EUR 100 000 it is required to obtain in addition from a designated state entity a certificate on price relevance.

For capital market divestments incl. dividend payments – investment agreement and a document proving that investment was made and registered in Ukraine.

If shares are sold by a non-resident, or if a divestment originally was made in kind and the proceeds are to be repatriated, an “estimation certificate” issued by a licensed Ukrainian appraiser is required. In addition, cash divestments of investments made in kind must have been made possible by a treaty between Ukraine and divestor’s country.

For cross-border loans – loan agreement, NBU registration notice, and local bank’s consent to service such a loan.

For currency purchases – contracts, invoices and custom declarations as mentioned above.

For payment of dividends or repatriation of proceeds from the investment activity banks can purchase foreign currency only on the 6th calendar day after the relevant UAH amount has been provided to the bank.

Purchased Foreign Currencies must be transferred within five banking days.

3. Anti-money laundering set-up in Ukraine

Anti-Money Laundering measures are regulated by the new Law “On prevention and counteraction to the legalization (laundering) of the proceeds from crime” of May 18th, 2010, #2258-VI (hereinafter the Law).

In the context of the Law “legalization (laundering) of the proceeds from crime” are any actions related to funds (property) received as result of a crime aimed at the concealment of the origin of said funds (property) or assistance to a person who is abettor of said crime.

The Law excludes tax crimes from the list of crimes subject to it. Laundering in Ukraine is related to prostitution, drugs, arms, terrorism and other crimes. This “understanding” of the Law is still not perfect, i.e. authorities are inclined to include tax crimes also.

The system of financial monitoring consists of two levels: the initial and the state levels.

The following entities are involved in the initial level of financial monitoring:

- banks, insurance (reinsurance) companies, credit unions, pawn-shops and other financial institutions;
- payment organizations, members of payment systems, acquiring and clearing institutions;
- commodity, stock and other exchanges;
- professional operators in securities market;
- asset management companies;
- postal operators and other institutions executing the financial operations of funds transfers;
- branches and representative offices of the foreign subjects of economic activity rendering financial services in Ukraine;
- subjects of entrepreneurial business rendering the intercessory services during the execution of sale-purchase real estate operations;
- subjects of economic activity executing the trade of precious metals, precious stones and related goods for cash in case the amounts of related operations equal or exceed UAH 150 000 or its equivalent in foreign currencies;
- subjects of economic activity conducting lotteries and gambling games including casinos and electronic (virtual) casinos;
- notary publics, lawyers, auditors, audit companies, physical persons-entrepreneurs rendering accounting services, subjects of entrepreneurial business rendering legal services; a 2010 novelty!
- physical persons-entrepreneurs and le-

gal persons executing financial operations with goods (rendering services, performing works) for cash in case the amounts of said operations equal or exceed UAH 150 000 or its equivalent in foreign currencies; new in 2010!

- other legal persons rendering the financial services which are not financial institutions by their legal status. A 2010 novelty also!

The following entities are involved in the state level of financial monitoring:

- National Bank of Ukraine
- Ministry of Finance of Ukraine
- Ministry of Justice of Ukraine
- Ministry of Transport and Communication of Ukraine
- Ministry of Economy of Ukraine
- State Ukrainian Commission of Securities and Stock Market;
- State Ukrainian Commission of Regulation of Financial Services Markets;
- State Committee of Financial Monitoring or Financial Monitoring Unit (hereinafter FMU).

FMU is a more than 300 persons staffed central body of executive power whose head is nominated by the Cabinet of Ministers of Ukraine.

Financial transactions subject to compulsory financial monitoring:

A financial transaction shall be subject to compulsory financial monitoring if its amount equals or exceeds UAH 150 000 or its equivalent in foreign currencies (for subjects of economic activity conducting lotteries and gambling games – UAH 13 000 or its equivalent in foreign currencies) and

if such financial transaction also has one or more of the specific features stipulated in the Article 15 of the Law, i.e. if certain objective criteria are being met, reporting to FMU is compulsory. All insurance related incomings or payments above UAH 150 000 must be reported, for instance.

Financial transactions subject to internal financial monitoring:

- A non-standard or a complicated financial transaction or several related financial operations that have no evident economic sense or obvious legal purpose.
- A financial transaction that is not compliant with the activity of the client of the subject of the initial level of financial monitoring.
- Repeated financial transactions the nature of which gives the grounds to believe that their purpose is to evade the procedures of compulsory financial monitoring.
- Financial operations defined by the typologies of the international organizations fighting against money laundering.

Internal financial monitoring (article 16 of the Law) can also be applied to other financial transactions when subjects of the initial level of financial monitoring have grounds to believe that such financial transactions are aimed at legalization of “laundered” proceeds.

Subjects of entrepreneurial business rendering the intercessory services during the execution of sale-purchase real estate operations have to perform internal financial monitoring in case the amounts of said operations equal or exceed UAH 400 000 or its equivalent in foreign currencies

Reporting to the FMU on a financial transaction subject to internal financial monitoring is the result of an assessment by the reporting institution, which is based on defined subjective criteria.

FMU has right to stop for up to five days all debit operations on a customer's accounts in case said customer's operations are suspected to be related to money laundering.

Subjects of the initial level of financial monitoring are obliged to "know their customers" and able to prove it. I.e. in their files there should be the evidence that their customers-legal persons, physical persons, banks and other financial institutions have been identified according to the identification rules defined by the Law that includes also identification of the ultimate/beneficial owners of the customers and the managers/authorized persons of the customers. Identification rules also prescribe to identify non-resident and resident politically exposed persons (PEP) among customers, their ultimate/beneficial owners and their managers/authorized persons.

Subjects of the initial level of financial monitoring are obliged to classify the customers by their risk appreciation for such customers to perform money laundering operations. Such classification has to be performed in

accordance with criteria defined by FMU and approved by the subjects of the state level of financial monitoring.

The Law covers also "terrorism" related activities. Based on a list of terrorists provided by FMU the subjects of the initial level of financial monitoring are required to prevent for up to two days a financial operation to be executed, if a participant or a beneficiary of a transaction is a person included in such list. FMU has the rights to extend such time to up to twelve days.

The Law in many aspects respects international AML practice (for instance, the extension of the entities to be subjects to the initial level of financial monitoring, identification of PEP, customers risk-based classification) but it substantially increases the volume of transactions that are subject to compulsory financial monitoring and mandatory reporting to FMU. This is a questionable move for a country in which counter powers need still to be developed and in which the independence of State Regulators and Supervisors still is questioned.

* * *

After more than seven years of implementation, the anti-money laundering set-up in Ukraine resulted in more than 5.6m transactions being reported to the FMU by the subjects of the initial level of financial monitoring.

As of October 1st, 2010 among the subjects of the initial level of financial monitoring registered by FMU there were 1052 banks and their affiliates as well as 4560 non-banking entities.

For three quarters of 2010 years 611 364 transactions have been reported to FMU of which 590 681 (97%) transactions have been reported by banks. 75% said reported transactions were subject to compulsory financial monitoring.

But a very low volume of criminal cases was initiated as a consequence of such reporting (for example, according to FMU statistics 131 cases for 3 months of 2010).

3. CUSTOMS

Customs Valuation: Theory and Practice

by Igor Dankov, Senior Manager, PwC Ukraine

The purpose of this article is to analyze the current practice of determining the customs valuation of goods imported into Ukraine for compliance of such practice with the principles of the World Trade Organization (the WTO), the analysis of the approach of the State Customs Service on this matter and providing recommendations for improvement of the customs valuation methodology.

Determining of customs value of goods being imported to Ukraine is of vital importance primarily for purposes of taxation. For example:

- in accordance with the Law of Ukraine On Unified Customs Tariff, ad valorem import duties are imposed at a percentage rate of the customs value of the goods and other items subject to duty.
- according to the Law of Ukraine On Value Added Tax for goods being imported to Ukraine by taxpayers, the taxable basis includes the contractual value of such goods, but not less than the customs value indicated in the customs declaration including certain expenses.

In addition to taxation purposes, data regarding customs value is used for keeping statistical records, and in corresponding cases, for the calculation of fines provided by Ukrainian legislation.

Consequences of improper determination of customs value

Erroneous determination of the value for customs purposes may result in

- Essential delays in customs clearance as the customs administration will require additional documentary evidence; underpayment of taxes, or excessive payment, if the customs administration recognize improper customs valuation after releasing the goods.
- Underpayment of taxes being collected during customs clearance will result in fines of up to 100% of the underpaid tax. Taxes paid in excess are not possible to refund.

Correlation between customs and invoiced value

The value for customs purposes may differ from the invoiced value, i.e. the price of the goods indicated in the invoice. In many instances the customs value differs from that of the invoiced value. The disparity can be caused by

- objective factors, e.g. when applying the method of customs value determination by the transaction value, in which case the customs value may be adjusted by adding or subtracting certain expenses;
- subjective factors when the customs administration compare the declared customs value with the values of identical or similar goods which have been already customs cleared. In this case, more often than not the customs administration appoint the customs value on the basis of the customs value of identical or similar goods, if higher. Even providing additional documentary



evidence does not give the declarant the accuracy of fixing the customs value as transaction value.

So, there is a question of how to determine customs value correctly. Theoretically, the rules of determination of the customs value of imported goods generally correspond to the requirements of the WTO. The main source of customs valuation here is Article VII of the GATT "Valuation for customs purposes" and the Agreement on Implementation of Article VII of the GATT.

In other more developed countries, members of the WTO, the customs value is determined as transaction value in around 95% of all cases. In Ukraine, the percentage is between 70% and 80% of all cases according to figures from the State Customs Service. Accordingly, in 20-30% of all cases the customs authorities reject the declared customs value and determine it at a significantly higher level which results in excessive payment of taxes by importers.

Theory: customs valuation by the rules of the WTO

The customs valuation rules are stated in chapter XI of the Customs Code of Ukraine (CCU). On the whole, these rules correspond to the requirements of the WTO, especially to the Agreement on Implementation of Article VII of GATT.

The general provisions for determining the customs value of imported goods in Ukraine are as follows:

- The customs value is determined by the declarant.
- The customs administration check the accuracy of the customs value, including an audit after the goods are released.
- Determination of the customs value should be based on information prepared in a manner consistent with the principles of accounting that are ac-

ceptable in a corresponding country and are appropriate for the used method of valuation.

- The declared customs value of goods and the sources lodged for purposes of valuation have to be formed on objective, properly documented and quantifiable data.
- If a declared customs value attestation is required, the declarant should present all necessary information to the customs administration in order to ensure verification.
- Customs administration is entitled to be convinced of the reliability and accuracy of any statement, document or declaration presented for purposes of determination of the customs value.

Determination of the customs value of imported goods in Ukraine is performed through the following methods:

- Based on the transaction value of the goods being valued;
- Based on the transaction value of identical goods;
- Based on the transaction value of similar (analogous) goods;
- Deductive method;
- Computed method;
- Fallback method.

The primary basis for customs value is based on the transaction value. The other methods are applied as follows:

- If customs value cannot be determined by method 1, there should be a process of consultation between the customs administration and the declarant with a view to arriving at a basis of value using methods 2 or 3. During such consulta-

tions, customs and the declarant may exchange information in confidence.

- If methods 2 and 3 cannot be used to value the goods, then they may be determined either by method 4 based on the valuation of similar or identical goods that have been sold to unrelated buyers, or correspondingly, to method 5;
- Each method subsequent to the transaction value (method 1) can only be used if the method previous to it cannot be used;
- The deductive (method 4) and computed (method 5) methods may be reversed by the declarant;
- If it's not possible to apply any of the first 5 methods, then the customs value should be determined by the fallback method (method 6).

Theory: application of the transaction value method (method 1)

Determining the customs value by method 1 is performed as follows:

- The customs value of imported goods shall be the transaction value, that is the price actually paid or payable for the goods when sold for export to Ukraine, adjusted for some expenses as defined by the CCU, if required.
- The price actually paid or payable is the total payment made or to be made by the buyer for the benefit of the seller and/or for the benefit of the seller through third parties and/or to the parties related to the seller. Such payments may be made directly or indirectly by way of money transfer, letter of credit, collection or other payments (e.g. promissory notes, transfer of securities, etc.).
- The price actually paid or payable refers only to the price of valuated goods. Thus, the flow of dividends or other pay-

ments of the buyer for the benefit of the seller that do not relate to the imported goods are not part of the customs value.

- Additions to the price actually paid or payable shall be made only on the basis of objective, documented and quantifiable data.
- In determining the customs value, there should be added to the price actually paid or payable certain other expenses if they were not included to the price actually paid or payable.

The most common additions to the price actually paid or payable include

- expenses of loading, unloading and handling charges associated with the transport of the imported goods to the airport, port or other place of entry to the customs territory of Ukraine;
- the cost of insurance and transportation expenses of the valuated goods to the airport, port or other place of entry to the customs territory of Ukraine;
- royalty and licence payments related to the goods being valued that the buyer must pay, either directly or indirectly, as a condition of sale of the goods being valued, to the extent that such royalties and licence fees are not included in the price actually paid or payable. The mentioned payments may include payments for patents, trademarks and copyrights.

No other additions other than those defined by the CCU to the price actually paid or payable are allowed.

How customs value is determined in practice

As mentioned above, in 20% – 30% of cases the customs administration do not accept the customs value declared by a declarant according to method 1. As a result,

the value is determined by the customs administration at a higher level, and such value is a ground for duty and VAT rating. Accordingly, in many cases, importers are paying excessive taxes imposed on imported goods.

The reason for disagreement of the customs administration is that there are higher prices listed in the price database of the State Customs Service. In other words, during a customs inspection a comparison is made between the level of the declared customs value with that of identical or similar goods that have already been cleared and available in the price database of the State Customs Service.

If there are higher prices in the price database, they are almost automatically used by the customs administration as the customs value of the declared goods based on methods 2-6 for the determination of the customs value.

In most cases, an appeal to the State Customs Service on a determined customs value is pointless. Moreover, an appeal to the court system is a long-term procedure that may complicate customs clearance.

Position of the State Customs Service

To prove its position concerning the usage of information about the customs value of identical or similar goods, the State Customs Service makes reference to Article VII of the GATT, which establishes that:

- the value for customs purposes of imported merchandise should be based on the actual value of the imported merchandise on which duty is assessed or of like merchandise (subparagraph 2 (a) of Article VII of the GATT);
- “actual value” should be the price at which at a time and place defined by the legislation of the country of importation, such or like merchandise is sold or offered for a sale in the ordinary course

of trade under fully competitive conditions (subparagraph 2 (b) article VII of the GATT);

- when the actual value is not ascertainable in accordance with subparagraph (b) of this paragraph, the value for customs purposes should be based on the nearest ascertainable equivalent of such value (subparagraph 2 (c) article VII of the GATT);
- the wording of subparagraphs (a) and (b) permits a contracting party to determine the value for customs purposes uniformly either (1) on the basis of a particular exporter’s prices of the imported goods, or (2) on the basis of the general price level of like merchandise (Annex I to article VII of the GATT).

Thus, a comparison of the amount of the declared customs value to the amount of the customs value of identical or similar goods already cleared is conducted in order to be convinced that the declared customs value is based on the “actual value”. Such information is located in the price database of the State Customs Service. If there are prices of a higher level in the database, even in case of additional explanations of the declarant, they are used as the base of the customs valuation of the goods.

There is no way to agree with such a position of the State Customs Service as it is not based on a system-defined analysis of article VII of the GATT and the Agreement on Implementation of Article VII of the GATT. Article VII of the GATT particularly establishes that:

- it would be in conformity with Article VII to presume that “actual value” may be represented by the invoice price, plus any non-included charges for legitimate costs which are proper elements of “actual value” and plus any abnormal discount or other reduction from the ordinary competitive price (Annex I to Article VII of the GATT);

- the customs value of imported goods should not be based on arbitrary or fictitious values (subparagraph 2 (a) of Article VII of the GATT).

The purpose of the adoption of the Agreement on the Implementation of Article VII of the GATT is, among other things:

- Recognizing the need for a fair and neutral system for the valuation of goods for customs purposes that precludes the use of arbitrary or fictitious customs values;
- The recognition that the basis for valuation of goods for customs purposes should, to the greatest extent possible, be the transaction value of the goods being valued.

The Agreement on the Implementation of Article VII of the GATT establishes that:

- the primary basis for customs value is defined in Article 1 (i.e. by a transaction value of the goods being imported) and the imported goods should be valued according to the clauses of this article if the provided conditions are fulfilled;
- the customs value of the goods imported shall be the transaction value; in other words, the price actually paid or payable for the goods when sold for export to the country of importation, adjusted in accordance with the provisions of Article 8 provided:
 - (a) that there are no restrictions as to the disposition or use of the goods by the buyer;
 - (b) that the sale or price is not subject to some condition or consideration for which a value cannot be determined with respect to the goods being valued;
 - (c) that no part of the proceeds of any subsequent resale, disposal or use of the goods by the buyer will accrue

directly or indirectly to the seller, unless an appropriate adjustment can be made in accordance with the provisions of Article 8;

(d) that the buyer and seller are not related, or where the buyer and seller are related, that the transaction value is acceptable for customs purposes under the provisions of paragraph 2 of Article 1.

- if the mentioned conditions are not fulfilled, the customs value cannot be determined according to the transaction value of the imported goods and that the subsequent valuation methods are applied in sequential order.

It is further necessary to mention Decision 6.1 of the WTO Customs Valuation Technical Committee on “Cases where customs administrations have reasons to doubt the truth or accuracy of the declared value”. According to this decision:

- If the customs administration, after the lodging of a declaration, has a reason to doubt the truth or accuracy of the particulars or of documents produced in support of this declaration, the customs administration may ask the importer to provide additional explanations, including documents or other evidence, that the general declared value represents the total amount actually paid or payable for the imported goods, adjusted in accordance with the provisions of Article 8 of the Agreement on the Implementation of Article VII of the GATT.
- If after receiving further information, or in the absence of a response, the customs administration still has reasonable doubts about to the truth or accuracy of the declared value, it may be deemed that the customs value of the imported goods cannot be determined under a transaction value of the imported goods.

Decision 6.1 of the WTO Technical Committee on Customs Value was applied primarily to prevent customs fraud. The key issue is customs' doubts of truth or accuracy of the declared customs value.

Current customs legislation of Ukraine implements the mentioned Decision 6.1, though not in full. It's particularly unclear when customs' doubts begin to emerge. Following worldwide practice, such doubts should begin to emerge in cases such as the following:

- There are signs of fraud in the documents;
- There are inaccuracies in the documents;
- There are arithmetical mistakes in the documents;
- There are differences in the documents.

In cases such as these, the customs administration should properly substantiate the reasons for doubting the declared customs value. Lack of justification of doubts results in arbitrary defining of the customs value, which is contrary to the provisions of the Agreement on the Implementation of Article VII of the GATT.

In such a way, based on the regulations of the WTO, at the time of control of the customs value defined by the transaction value of imported goods (method 1) the customs administration should be convinced that:

- all the conditions of applying method 1 hold true (points (a) – (b) above);
- there is accuracy in the declared customs value. In other words, all the provided adjustments were included;
- the documents of the declared customs value are trustworthy. In other words, there is a lack of counterfeit documents

and misrepresentation of data about the customs value.

If observations are absent, the customs administration should accept the transaction value as a basis for determining the customs value, irrespective of the existence of any other prices in the database.

The customs value is lower than the goods' direct manufacturing costs

According to Article 265 of the CCU, if the customs administration comes to the conclusion that the declared customs value is lower than the direct costs of the manufacturing of such goods, including raw materials and/or components forming a part of the goods, customs is empowered to oblige the declarant to determine the customs value in another way than has been used.

Based on this provision, the customs administration practices inquiries to the declarant with the requirement to provide the calculations of the goods' price. It is practically impossible to receive the calculation of the price. In case of not providing such documentation, the customs administration is entitled to determine the value independently on the basis of the existing information (mostly from the price database). It's necessary to note that the mentioned provision of Article 265 does not correspond with the rules of the WTO in the following ways:

- Comparison of the customs value with direct costs is not anticipated by the Agreement of the Implementation of Article VII of the GATT.
- The primary method of determining the customs value is the transaction value of the imported goods (method 1). But comparison of the customs value with the direct costs is in fact applying method 5, computed value. Such method may be applied only if the previous four methods before it cannot be used.

Appeal on decisions of defining the customs value

The appeal procedure on decisions of determining the customs value is not perfect. But in case of a disagreement with such a decision, the declarant is entitled to turn to the customs administration with an application to release the declared goods into free circulation with payment of the taxes corresponding to the customs value determined by the customs office. Such a possibility is anticipated by Article 264 of the CCU.

The term of warranty obligations should not exceed 90 calendar days from the moment of the release of the goods into free circulation. If after the declarant paid the taxes corresponding to the customs value defined by the customs office a decision on accepting the customs value declared by the declarant will be adopted by customs, the amount of overpaid taxes will be returned to the declarant within 30 days from the day of the decision was adopted as provided by legislation.

The declarant is entitled to appeal the decision of customs on determination of the customs value to the customs administration of a higher level and/or to the courts. Appeal by judicial procedure however can take a very long time – up to a year and longer.

The procedure of release under warranty is recommended to apply when a judicial appeal is anticipated. The release of goods under warranty will be additional evidence of the declarant's disagreement with the decision of customs on determination of the customs value for the court.

Also, if the decision to appeal to the court is adopted by the importer, it's necessary to document certain facts which may impact the court's decision – to prove the impossibility to present customs with additional documents or to offer to explain to customs in writing how the customs value was defined, etc.

It is recommended to expedite the documents endorsing the customs value while clearing the goods in order to reduce the risk of rising disputes with customs on the determination of the customs value.

4. ENERGY

Legal Aspects of Application of a "Green" Tariff as a Tool for Development of the Alternative Energy Sector in Ukraine.



Legal Framework

Considerable attention has recently been paid to introduction of energy efficient technologies and accordingly to improvement of the current laws in Ukraine. Thence there can be observed an existing trend of legislative amendments aimed at promoting development and attraction of investments in the renewable (alternative) energy sector of Ukraine.

Nowadays adaptation of the Ukrainian laws to the EU laws is a priority component of the Ukrainian policy given Ukraine's aspirations to eventually gain full membership in the European Union. The Law of Ukraine "On the National Program of Adaptation of the Ukrainian Laws to the European Union Laws" provides for gradual adaptation of Ukraine's own laws to those of Europe, so in the alternative energy sector, Ukraine is governed specifically by the provisions of Directive 2001/77/EC of the European Parliament and Council on the Establishment of Favourable Conditions for Sales of the Electric Energy, as Generated by Renewable Energy Sources at the Domestic Electric Energy Market" dated September 27th, 2001.

The principal legislative acts regulating the issues related to the introduction and development of the renewable energy industry in Ukraine are as follows:

- the Law of Ukraine "On Energy Saving" dated July 1st, 1994, as amended and modified by the Law of Ukraine "On Amendment of Certain Legislative Acts

of Ukraine Concerning the Promotion of Energy Efficiency Measures" dated March 16th, 2007;

- the Law of Ukraine "On Electric Energy" dated October 16th, 1997, as amended and modified by the Law of Ukraine "On Amendment of Certain Legislative Acts of Ukraine Concerning the Establishment of "Green" Tariff" dated September 25th, 2008, and by the Law of Ukraine "On Amendment of the Law of Ukraine "On Electric Energy" in order Encourage the Use of Alternative Energy Sources" dated April 1st, 2009;
- the Law of Ukraine "On Alternative Fuels" dated January 14th, 2000;
- the Law of Ukraine "On Alternative Energy Sources" dated February 20th, 2003;
- the Law of Ukraine "On the Combined Generation of Heat and Electric Energy (Cogeneration) and the Use of Waste Energy Potential" dated April 5th, 2005, etc.

The main principles of the state policy of Ukraine in the electric energy sector consist particularly in promoting the alternative energy industry as an environmentally friendly and fuel free energy subsector. To date, there exist the following mechanisms to encourage the alternative energy sector development:

- Establishment of a "Green" tariff – a special tariff rate – at which there is purchased the electric energy, as gen-

erated by power generation facilities using alternative energy sources (except for blast furnace and coke gases, and as regards the use of hydro power it only pertains to that generated by small hydro power plants of installed capacity not exceeding 10 MW);

- commitment by the Wholesale Electricity Market of Ukraine to purchase the electric energy, as generated by power generation facilities using alternative energy sources, at the "Green" tariff;
- establishment of the State Energy Conservation Fund in order to provide for funding of measures for the efficient use of fuel and energy resources (being of declarative nature);
- tax and customs exemptions, namely:
 - (a) exemption from taxation of the profits realised by enterprises from sales, in the customs territory of Ukraine, of goods produced and of equipment operating on alternative and renewable energies, of energy efficient equipment and materials, the essential condition being the obligation to appropriately apply the funds released due to such a tax exemption having been granted, i.e. for the taxpayer to assign the funds to increase the production output;
 - (b) exemption from taxation of profits of the enterprises, which are put on the State Register of the Enterprises, Institutions and Organisations Engaged in Development, Implementation and Application of Energy Saving Measures and Energy Efficiency Projects, but in the amount not exceeding 50 per cent of the profit total subject to taxation;
 - (c) exemption from VAT of imports, into the customs territory of Ukraine, of the equipment operating on alternative and renewable energies or materials and components to be used to manufacture such equipment, energy efficient

hardware and materials, with mandatory compliance with the prescribed conditions;

- (d) exemption from duty of equipment operating on alternative and renewable energies, energy efficient hardware and materials, as well as supplies and equipment to be imported and used to manufacture the equipment operating on alternative and renewable energies, with mandatory compliance with the prescribed conditions;
- Government subsidies to encourage development and application of energy efficient technologies, equipment and supplies (being of declarative nature) etc.

Application of "Green" Tariff

Business entities that have applied to the National Electricity Regulation Commission of Ukraine meet all the required conditions and have provided all the necessary information in full are entitled to have the "Green" tariff applicable thereto.

De jure the "Green" tariff may be established for the electric energy to be generated by alternative energy sources, which include solar, wind, geothermal, wave and tidal energy, hydropower, energy of biomass, organic waste gas, gas from sewerage treatment facilities, biogases, methane from coal deposit degassing, conversion of the waste energy potential of technological processes.

However, the fact that the Law of Ukraine "On Electric Energy" prescribes a mechanism of calculation of the "Green" tariff rate only for the electric energy to be generated from alternative energy sources such as energy of wind, biomass (i.e. of plant origin), solar radiation and hydropower, the latter only being generated by small hydro power plants, causes that de facto the "Green" tariff may be established for the electric energy, as generated at the power generation facilities using only these alternative energy sources.

However on April 29th, 2010, it was for the first time for the years of the “Green” tariff existence that the National Electricity Regulation Commission adopted a resolution approving a “Green” tariff for one of the enterprises generating the electric energy from an alternative energy source such as biogas.

The resolution is a precedent not only for the electric energy producers using biogas but also for the producers using all other kinds of alternative energy, as settled in the laws (geothermal, wave and tidal energy, energy of organic waste gas, the gas of sewerage treatment plants, methane from coal deposit degassing, conversion of the waster energy potential of technological processes), despite the lack of a mechanism for calculating the “Green” tariff for those energy sources.

Thus we can conclude that the position of the National Electricity Regulation Commission regarding the electric energy sector regulation is that a “Green” tariff may be approved for business entities generating electric energy with the use of any kind of the alternative energies, as provided by the laws of Ukraine, and the mechanism for calculating the “Green” tariff, failing its settlement in the laws, shall be prescribed immediately by the National Electricity Regulation Commission.

The “Green” tariff shall apply upon the following conditions:

- when electric energy is generated with the use only of alternative energy sources. In the event that electric energy is generated with simultaneous use of alternative energy sources and use of traditional kinds of energy, no “Green” shall be applicable;
- the share of raw materials, supplies, fixed assets, works and services of the Ukrainian origin in the cost of construction of an electric power facility generating electric energy with the use of alternative energy sources is not less than 30% - starting

from January 1st, 2012 – and at least 50% - starting from January 1st, 2014. In the production of electric energy with the use of solar power, already starting from January 1st, 2011, the share of the supplies and raw materials of the Ukrainian origin in the cost of manufacture of solar modules must be at least 30%;

- existence of a certificate witnessing the conformity of the electric power facility generating electric energy with the use of alternative energy sources to its design documentation, the requirements of the Government standards, and the construction norms and regulations.

For the “Green” tariff to be approved for them, business entities shall:

- apply to the National Electricity Regulation Commission of Ukraine (NERC) for a license;
- file an application in NERC for the “Green” tariff approval;
- become a player of the Wholesale Electricity Market of Ukraine.

Obtaining of a License to Engage in Electric Energy Generation, Transmission and Supply

The laws provide that in case a business entity owns or uses equipment generating electric energy with the use of alternative sources of installed capacity of not less than 10 MW or intend to sell the generated electric energy at the Wholesale Electricity Market of Ukraine it shall obtain a license to engage in electric energy generation, transmission and supply. Such a license shall be issued by an authorised Government agency – the National Electricity Regulation Commission of Ukraine.

Thus, before applying to NERC for a “Green” tariff, a business entity must obtain a license for generation of electric energy from alternative energy sources.

“Green” Tariff Approval

The National Electricity Regulation Commission of Ukraine shall exercise the powers, as vested therein, to approve the “Green” tariff, to establish or revise the “Green” tariff in order to encourage the generation of electric energy from alternative energy sources.

For a “Green” tariff to be approved for it, a business entity must file an application and a package of documents, as specified in NERC’s Resolution “On the Approval of the Procedure for Establishing, Revising and Terminating the “Green” Tariff for Business Entities” dated January 22nd, 2009.

The application and the documents shall be considered by NERC within 30 calendar days and, within the subsequent 15 calendar days, NERC shall adopt, at a public session, a resolution approving or refusing to approve a “Green” tariff for that specific business entity.

In case a “Green” tariff shall have been approved for a business entity, it must report quarterly to NERC on its activities of generation of electric energy from alternative energy sources.

Acquisition of the Status of a Player of the Wholesale Electricity Market of Ukraine.

The Wholesale Electricity Market of Ukraine is a market established by business entities to transact electric energy purchase and sale under the Wholesale Electricity Market Membership Agreement.

Upon obtaining the required licenses for electric energy generation and supply, in order to access Wholesale Electricity Market (WEM), a business entity must file an application and a prescribed list of documents in the Board of the WEM.

A resolution admitting the application to WEM or refusing to admit the same shall be adopted by the WEM Board within 30 days.

In case the WEM Board shall have adopted a positive resolution regarding a business entity, it shall be granted a 28-day period to sign the Wholesale Electricity Market of Ukraine Membership Agreement and thereafter such business entity shall acquire a full WEM membership.

Mechanism of Sales of the Electric Energy Generated from Alternative Energy Sources at the “Green” Tariff

According to the laws of Ukraine, a business entity that generates electric energy from alternative energy sources and that has had a “green” tariff approved for itself shall be entitled to make sales of such electric energy:

- immediately to the consumer;
- to State-Owned Enterprise “Energorynok” through the Wholesale Electricity Market of Ukraine.

However, though the right of a business entity to sell electric energy immediately to consumers is formal and provided by the Ukrainian laws, in reality, due to the immediate consumers lacking economic, social or administrative incentives to market the electrical energy generated from alternative energy sources, the cost of which is considerably more expensive as compared to the cost of the electric energy generated from traditional energy sources, it is almost impossible.

Thus, in practice nowadays, producers of the electric energy from alternative energy sources may only sell electric energy to SE “Energorynok” through the Wholesale Electricity Market.

Pursuant to the laws, SE “Energorynok” shall purchase, through the Wholesale Electricity Market, the electric energy, as generated at power generation facilities using alternative energy sources, at the “Green” tariff.

Essential Aspects of “Green” Tariff Application:

- the laws of Ukraine provide for a fixed minimum rate of the “Green” tariff and binds the “Green” tariff on Euro, thus, in case of implementation of a project of generation of electric energy from alternative energy sources, the investor is protected against UAH potential inflation;
- the “Green” tariff rate will be gradually reduced, due to reduction of ratio, which is one of the elements of the “green” tariff calculation formula. Thus, for the electric power facilities that generating electric energy from alternative energy sources, which are commissioned (or significantly upgraded) after 2014, 2019 and 2024, the ratio will be respectively reduced by 10%, 20% and 30% of its base rate;
- the whole amount of the electric energy generated shall be paid in full at the “Green” tariff through the Wholesale Electricity Market in cash, without application of any kinds of set-off of arrears in the payments for electric energy;
- in case of amendment of the laws governing the procedure for encouraging the generation of electric energy from alternative energy sources (namely the “Green” tariff application) business entities shall be subject to the previous procedure as in effect on the date of commissioning of the electric power facilities generating electric energy from alternative energy sources, unless such business entities wish to select a new procedure;
- the “Green” tariff shall be applicable until January 01, 2030.

Statistics

As of late October 2010, in the Register of Electric Power Facilities Using Alternative Energy Sources (except for blast furnace and coke gases, and as regards the use of hydro power it only pertains to small hydro power plants) there stand 53 business entities that use, in their electric energy generation, wind energy, energy of biomass, biogas, hydropower, solar energy, energy of coal gas, conversion of the waster energy potential of technological processes and of an atmospheric residue of the oil viscosity breaking process.

Among these 53 business entities generating electrical energy at electric power facilities with the use of alternative energy sources, 31 have had a “Green” tariff approved for themselves.

Kind of Alternative Energy Source				
Small hydro power plants	Wind power plants	Solar power plants	Bio-mass power plants	Biogas power plants
21	5	2	2	1

For comparison purposes, at the end of 2009 there were 42 business entities generating electric energy with the use of alternative energy sources, and 19 of them had a “Green” tariff applicable thereto.

Thus, today in Ukraine there is a tendency to increased interest of investors for such sector as generation of electric energy from alternative energy sources, primarily due to the introduction of Government incentives, which has significantly improved the profitability of such business entities.

Cogeneration in Ukraine

Cogeneration technologies that provide simultaneous generation of electricity and heat are being developed and implemented

all over the world. The economic efficiency of such technologies and their potential to reduce pollution make cogeneration



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projects attractive for investors and for governments.

A few advantages of cogeneration technologies include:

- Inexpensive electricity due to high fuel efficiency and lower production costs;
- Reduction of hazardous pollutants and greenhouse gas emissions;
- Reduction of costs for electricity and heat transportation; and
- The possibility to use traditional types of fuel (coal, natural gas and oil) and also renewable power sources (biomass and geothermal energy).

In general, Ukraine has great potential for developing cogeneration projects. It has already created and is constantly updating a legal framework for implementing and managing cogeneration projects.

Legal Basis for Cogeneration in Ukraine

On the legislative level, cogeneration is governed primarily by the laws “On Electricity Industry”, “On Power Saving” and “On Combined Generation of Heat and Electricity (Cogeneration) and Use of Exhaust Power Potential” (the Cogeneration Law).

The first two laws regulate activities connected with generation, transmission and the supply of power and establish the legal, economic and social framework for activities in the field of electricity industry. The Cogeneration Law is more specific and regulates specific aspects of generation, transmission and supply of electricity and heat generated by cogeneration facilities.

Other areas of cogeneration that are regulated relate to investment, construction, tax and such other issues.

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There are a number of regulatory acts adopted by the Cabinet of Ministers of Ukraine and other government bodies that are important for implementation of projects and use of electricity and heat produced at cogeneration facilities, especially, the acts of the National Electricity Regulatory Committee of Ukraine (the NERC), the regulatory authority responsible for issuing licenses and determining tariffs for electricity and heat produced by cogeneration facilities.

Considering the peculiarities of state regulation in the area of cogeneration, companies planning to invest in cogeneration projects must pay close attention to the following issues, especially when determining the economic feasibility of a project:

- The general implementation strategy for a cogeneration project involves construction of a cogeneration unit on the basis of certain power facilities or independently from such facilities. In the first case, special attention should be paid to controlling power and heat generating facilities and choosing the most effective form of cooperation with their owners, especially since most of the heat facilities/infrastructure are in municipal or state ownership with specific use limitations.
- Licenses, permits and other authorization documents are required by law before or during construction of a cogeneration unit and its operation.
- Prices and tariffs for electricity and heat produced at a cogeneration unit under certain terms are subject to state regulation.
- Land acquisition for the plant is also an important consideration.

Strategies to Implement Cogeneration Projects

If the cogeneration project is implemented through a modernization of state or mu-

nicipality-owned heat or electricity generators, the investor can choose one of the following strategies for acquiring rights to the assets: lease, concession or purchase of such facility (privatization). Alternatively, an investor may obtain use of the necessary assets through an agreement on joint activity without creating a separate legal entity, a joint venture with the creation of a legal entity or an asset management agreement.

Lease – Long-term lease is one of the most common and straight-forward strategies for construction of a cogeneration unit using objects that are in local or state ownership.

Despite its simplicity, this strategy has issues that can make it more complicated and less attractive for cogeneration activities. First, under the law “On State Budget for 2010” property that is in local or state ownership may be leased only pursuant to a competitive tender, which involves bureaucratic competition procedures. Second, the law restricts the flexibility of the terms and conditions of the lease agreement that may be entered into with the local or state authorities.

As to cogeneration projects that are leased, the issue of ownership right to upgrades and improvement of a leased object or compensation for such improvements are particularly important. Such issues should be clearly addressed in the lease agreement, taking into account restrictions imposed by law. For example, the Law of Ukraine “On Lease of State and Municipal Property” entitles a lessee to retain the upgrades made at its expense if they can be separated from the property without damage.

Concession – Concession is less commonly used than leasing. Concessions can only be applied in certain areas specified by the law. The Law of Ukraine “On Concessions” specifies that generation and/or transmission of electricity objects may be operated pursuant to a concession.

A concession is designed to protect state and local authorities’ rights (i.e. the plant’s owner) more than the investor’s rights. However, one of the advantages of a concession over the other approaches with the owners of state or municipal property is the right of purchase of the object of concession. The law allows a purchase pursuant to privatization rules if under a concession agreement such property was created or built or upgraded for no less than 25 % of its value as of the date of privatization.

Purchase – Current law in Ukraine allows the state or local authorities to sell state or local property through privatization, provided that certain procedures are carried out. As a rule, privatization involves transfer of ownership rights to state and municipal property on a competitive basis.

However, the law prohibits certain objects from being privatized, such as heat distribution networks and infrastructure. Local authorities may also prohibit sale purchase of certain municipal enterprises or other municipal entities.

Partnership With Owners – Instead of acquiring rights to the assets themselves, investors may consider entering into a partnership with the municipal or state entity, to share in the ownership and management rights. Establishing a joint venture through the creation of a limited liability company is the most tested approach.

Public-Private Partnership

With respect to projects involving state or municipal enterprises, Ukraine has taken certain steps towards facilitating cooperation between state/municipal authorities and private investors. On October 30, 2010 the new Ukrainian Law “On Public-Private Partnership” (PPP Law) took effect. This law defines the principles, procedures and forms of contractual partnership between state and local authorities and private partners in different areas, including the area of production and supply of heat and electric-

ity. As part of such partnership, state/local and private partners may enter into agreements on concession, joint activity, product distribution and other agreements.

One of the advantages of the PPP Law is that it secures investors’ rights. Under the PPP Law, rights and liabilities of the parties under a public-private partnership agreement are governed by the laws of Ukraine in effect on the date of its execution.

However, in joining a public-private partnership project one should remember that the private investor does not obtain ownership to the state or municipal property and the property must be returned to the state or municipal owners after the termination of the public-private partnership.

Licenses and Permits

Activities involving combined heat and electricity generation are subject to licensing by the NERC (the Cogeneration License). The owner of a cogeneration plant that supplies electric power and heat to other entities must obtain a license to supply electricity under a non-regulated tariff. Notably, the legislation that regulates licensing of supply of electric and heat power by cogeneration plants contains gaps that are covered under clarifications issued by NERC.

To obtain a Cogeneration License the owner of a cogeneration plant must submit to the NERC the following documents: (i) application; (ii) confirmation of fee payment; (iii) certified copies of state registration certificate and certificate for inclusion in the Unified State Register of Enterprises and Organizations of Ukraine; (iv) certified copies of statutory documents of owner-legal entity; (v) description of the business activity, including the list of cogeneration facilities; (vi) a copy of the permit for hazardous works and operation of hazardous machines, mechanisms and equipment; and (vii) a copy of the document confirming title to the cogeneration facility and such other documents.

The NERC has 30 days to decide whether to issue a license to the applicant or reject an application. The term of the license is determined by the NERC; however, it may not be less than three years.

While conducting cogeneration activities the licensee must adhere to the rules (licensing terms) for combined heat and electricity generation established by NERC Regulation # 997, dated November 2nd, 2005 (Licensing Terms). Among other issues, licensing terms prohibit “cross-subsidizing,” using profit gained from electricity sales for financial support of (i) heat generation or other, (ii) other activities of the licensee or (iii) affiliated companies of the licensee.

Construction and operation of the cogeneration facility also require a number of other permits, consents and authorizations from state or local authorities, including construction permit, permit for hazardous works and operation (use) of hazardous machines, mechanisms and equipment, etc.

Depending on to whom the owners of cogeneration facility want to supply electricity, the facility may be subject to “qualification,” which is conducted by the National Agency on Efficient Consumption of Energy Resources to confirm that the cogeneration facility complies with efficiency requirements provided in the Cogeneration Law.

If the owners of the cogeneration plant generate electricity for their own needs, or supply directly to particular customers there is no need for qualify the unit. However, supplying electricity to a wider range of customers or to the wholesale market will require qualification of the cogeneration facility.

Tariffs

Tariffs for electricity and heat generated by the cogeneration plant should be approved by the NERC.

Calculation and approval of tariffs on electric and heat power produced by the cogeneration plant is based on the Procedure of Calculation of Tariffs on Electric and Heat Power approved by the Regulation of NERC # 897 on October 12th, 2005 as amended (the Tariffs Procedure).

Tariffs are approved by the NERC for a year. The company must file with the NERC, at least 90 days prior to each year, the following documents: (i) calculation of tariffs; (ii) calculation of expenses per one unit of product; (iii) explanatory note; (iv) calculation of tariffs (monthly); (v) technical characteristics; (vi) reports forms of which established by NERC; (vii) data about number of the cogeneration plant staff; and (viii) data about the accounting value of the cogeneration plant. The applicant should also provide NERC with the investment program which is subject to approval by governmental energy authorities.

Tariffs on supply of electric power under non-regulated tariffs should be determined by an agreement between a supplier and purchaser of electricity. However, the NERC must approve the tariff for wholesale power if the cogeneration plant supplies the electric power to the Ukrainian Wholesale Electricity Market.

Rights to Land

An investor in a cogeneration facility should pay special attention to land issues at an early stage, as acquiring land-use rights for building a cogeneration facility is often a tricky process. If the land will be subleased, any defects in the original lease or registration of the original lease must be resolved. Also, land is often leased from local authorities, meaning that negotiations and approval for a lease or sublease can take a long time as well as a number of steps and approvals. Finally, if the land is owned by state or local authorities, then a competitive tender process may be required before the land can be legally leased or sold to a third party.

5. Fast Moving Consumer Goods (FMCG)

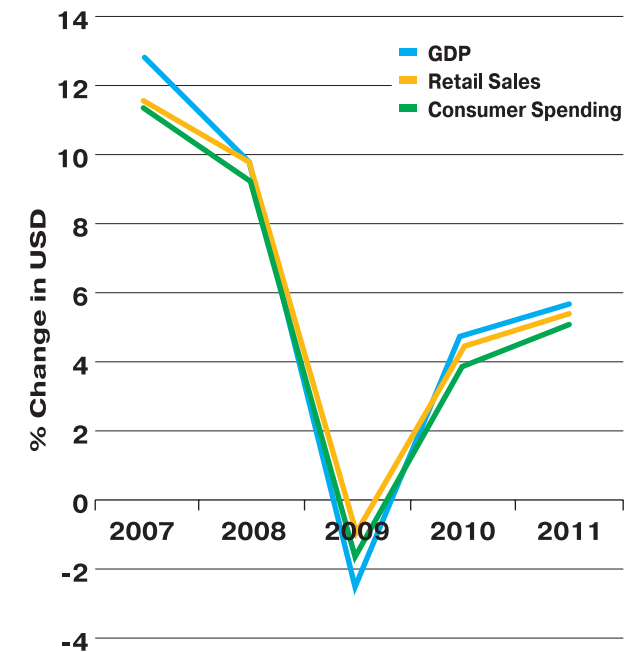
FMCG Sector Overview



1. Retail Developments

Macroeconomic overview, key figures

The world economy saw negative growth in 2009 – 2010. The majority of industrialized nations slid into recession while growth slowed down in emerging markets. A recovery began in the second half of 2010 and is expected to continue into 2011.



Global: Growth of Key Macroeconomic Indicators, 2007–2011

Source: Planet Retail Ltd – www.planetretail.net

From the perspective of retail attractiveness in 2008 Ukraine moved from 5th to 17th place and kept the positions in 2009. Such low ranking among other reasons was caused by ongoing political instability, high inflation, credit freezing, and poor infrastructure. Despite this in 2009

A. T. Kearney stated it was high time to enter Ukrainian retail market due to a very low cost of entry. The situation changed in 2010, when Ukraine was not included in GRDI by A. T. Kearney. That means Ukraine is no longer one of the TOP 30 most attractive markets in the world.

	2004		2005		2006		2007		2008		2009		2010	
	UA	RUS	UA	RUS	UA	RUS	UA	RUS	UA	RUS	UA	RUS	UA	RUS
Country risk	43	56	46	52	42	43	41	62	42	31	30	31	-	55
Market attractiveness	32	56	34	58	37	59	43	52	40	52	33	58	-	63
Market saturation	83	77	82	71	76	53	44	53	38	50	46	51	-	32
Time pressure	79	100	90	92	81	90	88	90	60	90	87	100	-	62
Place in ranking	11	1	3	2	4	2	5	2	17	3	17	2	49	10

Source: A. T. Kearney

Ukrainian economy felt the world crisis later at the end of 2009 and through four first months of 2010. Real GDP growth in second quarter of 2010 was mostly driven by increased household consumption, which grew by 5.1% and is the main component of GDP (73%).

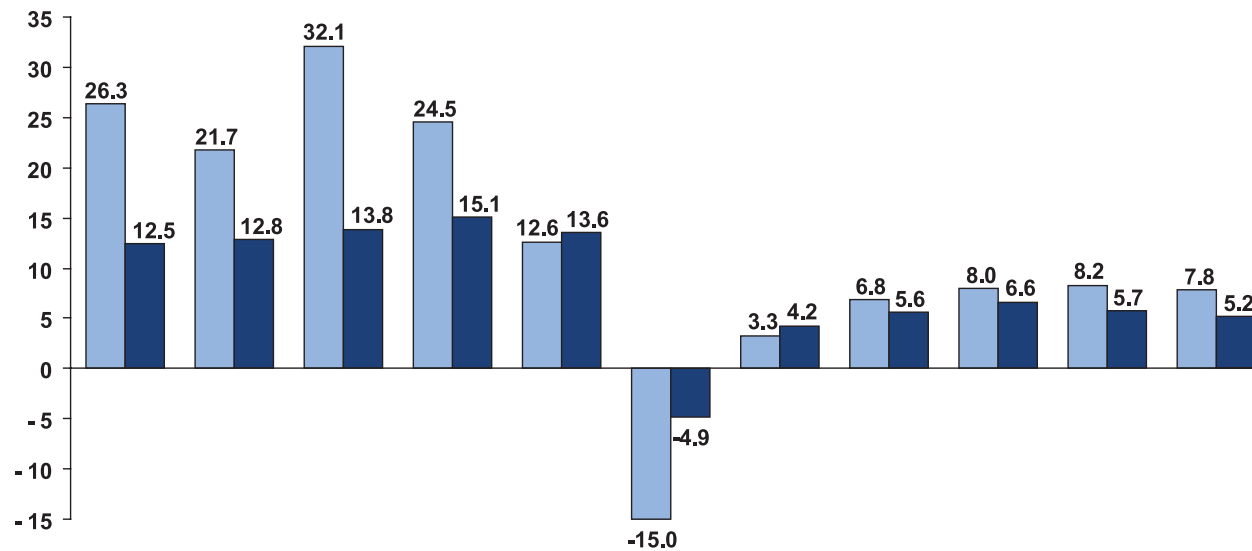
With negative development of GDP in 2009 almost in all industries besides agriculture in 2010 the situation stabilized. Trade and repair industry has a growth of 4.2% in second quarter 2010 and its share in GDP is 13%.

Source: FERI, State Statistics Committee of Ukraine

Within 10 months of 2010 the turnover of Ukrainian retail companies and HoReCa segment has increased by 5.8% up to UAH 221.4 billion year to date. At the same time according to the State Statistics Committee retail turnover increase for the last nine months amounted to 5.1%. In Kyiv during January – October 2010 the turnover amounted to UAH 40.9 billion, in Dnepropetrovsk and Donetsk

regions – UAH 19.5 billion and UAH 19.66 billion accordingly. The least turnover was tracked in Sevastopol – UAH 2.56 billion.

Compared to Russia Ukraine used to show much higher retail sales growth rates over the last years. But retail sales per capita in Ukraine are more than twice lower as in Russia (863 EUR vs. 2348 EUR) in 2009.



Retail Sales Growth in Ukraine and Russia (% real)

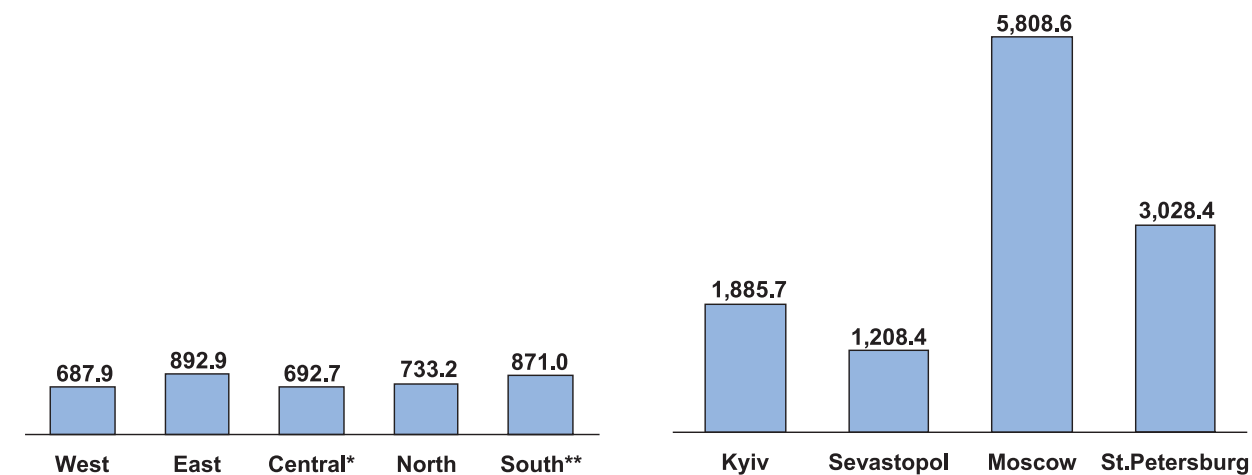
Source: FERl

The highest level of average retail sales per capita is in Eastern/Southern Ukraine, the lowest in Western Ukraine. Kyiv has much lower average sales per capita than Moscow.

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Average retail sales per capita in different regions of Ukraine, €

Average retail sales per capita in main Ukrainian and Russian cities, €



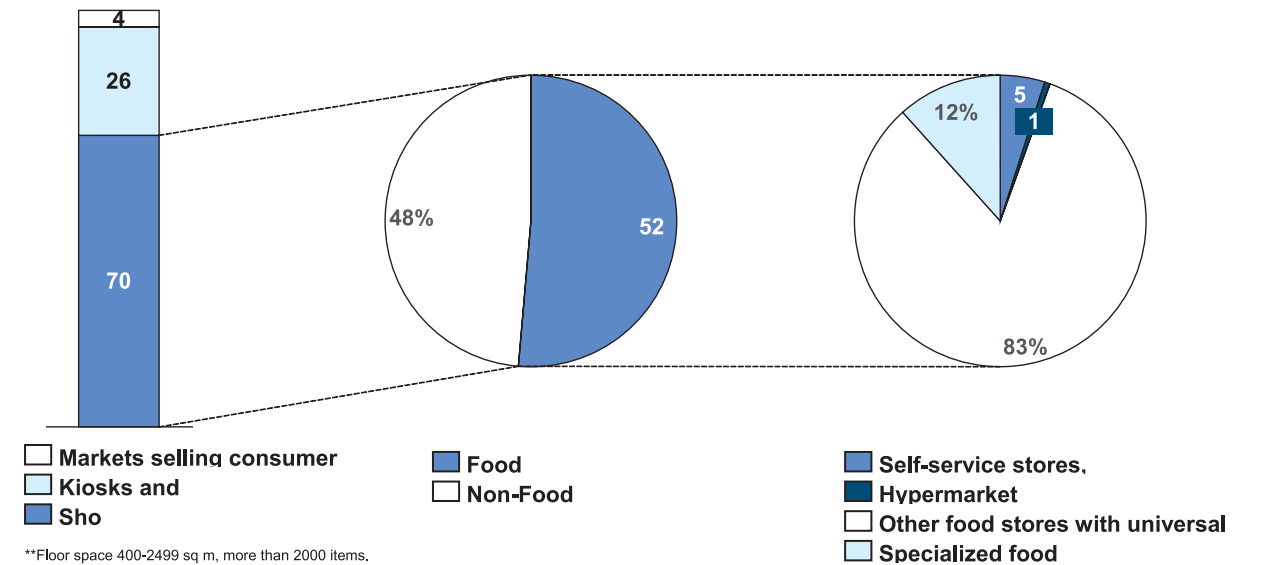
* Without city of Kyiv, ** Without city of Sevastopol
Source: FERl, State Statistics Committee of Ukraine, State Statistics Service of Russia

Formats development

According to the number of different retail market players, Ukraine has still a high level of non

chain retail in comparison to other European countries that creates a big future potential.

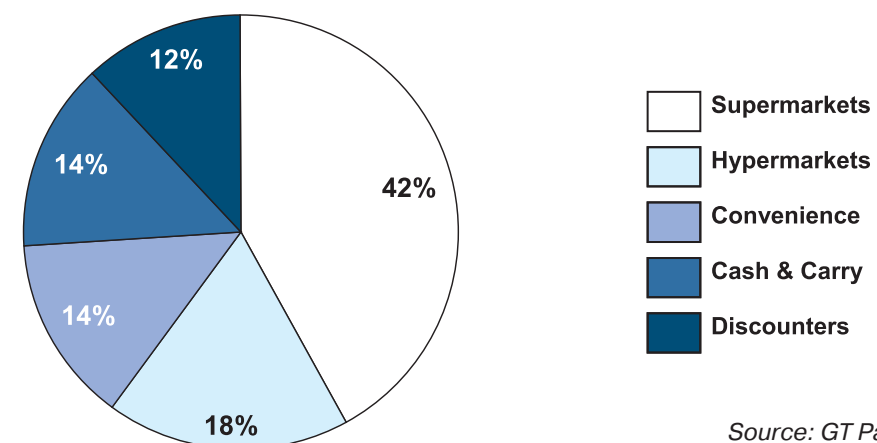
Structure of market players*, % Structure of shops*, % Structure of food shops*, %



Retail formats in Ukraine have different meaning as in Europe and are adapted to the specificities of the local market. For example, the “cash&carry” format implemented by Ukrainian companies means a substantial proportion of sales is made by end consumers. Hyper- and supermarkets often determine low prices to attract more customers. Discounters offer an expanded product range and have still a very low share of own brands

in comparison, for example, to Germany’s discounters. Convenient stores have higher floor space (150-550 sq. m.) and broader assortment (2-2.5 articles). According to the turnover analysis of main retail market players, the most money the Ukrainians leave in the supermarkets and hypermarkets that have together a market share 60%. Convenient stores and Cash & Carry formats have each a market share of 14%.

Sales structure of food chain retail, %, 2009

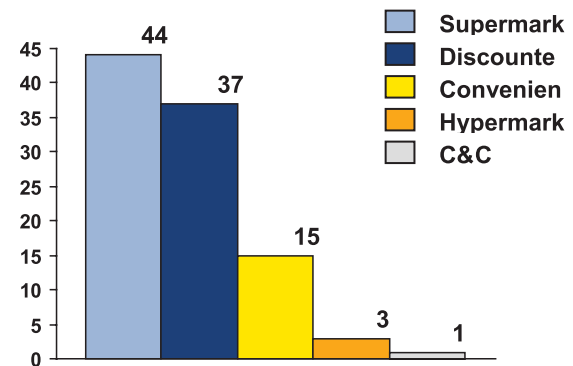


Source: GT Partners Ukraine, press

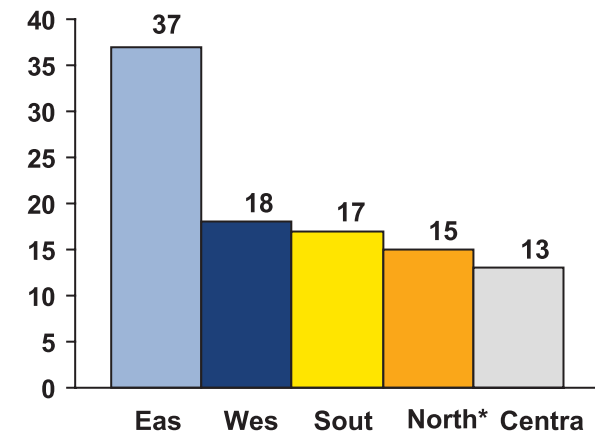
A constant decrease in number of food stores per 1000 population (2004-0.73, 2008-0.56) is a clear trend. However, the floor space per 1000 population increased

in 20% over the last four years. The number of super-/hypermarkets is increasing while the number of other non-chain stores is decreasing.

Supermarkets are the most popular store format almost in all regions, especially in Northern Ukraine where they have a market share of 53%. Convenient stores are the second preferred choice in Western and Northern Ukraine. On the other hand, discounters are the second top choice in Central and Eastern Ukraine. In Southern/Eastern Ukraine people mostly prefer hypermarkets after supermarkets.



Not only decrease in retail turnover, optimization of stores assortment, but also slowdown in expansion could be observed in 2009. The stores that still opened in 2009 were either supermarkets (44%) or discounters (37%). With its 83 stores ATB Market was a leader in store openings. In terms of geography the new stores appeared mostly in Eastern (37%) Ukraine, followed by Western (18%) and Southern (17%) Ukraine.



*Calculated according to numbers of units
Source: GT Partners Ukraine

TOP 5 retail chains in Ukraine, H1 2010

company	chain	stores format	sales floor volume, T, sq.m.	No. of outlets	Turnover from 1 sq.m., USD T
METRO Cash and Carry Ukraine	METRO	Cash & Carry	229.60	25	5.13
Fozzy Group	Silpo, For a, Fozzy	Convenient store, Super-, hypermarket	279.72	301	3.79
ATB -market	ATB	discounter	150.59	413	6.19
Furshet	Furshet	hyper-, supermarket	324.02	110	2.20
Kviza Trade	Velyka Kyshenya, Gren Hills	hyper-, supermarket	148.16	48	2.51

Source: ProRetail.info

Legislation

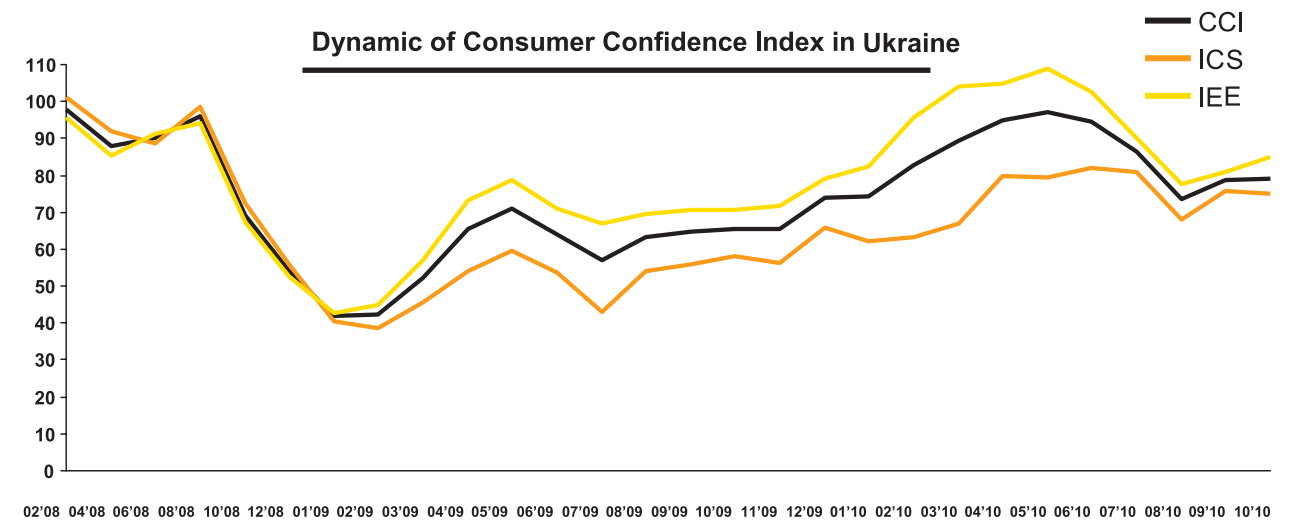
The new Government supported by Prime Minister and President started a lasting process of the amending current legislation, which within March – November 2010 resulted in ratification of the new Tax Code and numerous amendments to the Law on trade, on agriculture to name a few.

METRO Cash & Carry together with other retailers was actively cooperating on submitting its recommendations to the Law on trade to ensure it adequately regulated the market. In particular the recommendations touched an urgent need of aligning the list of socially important food products, which currently binds participants of FMCG market to restrict retail margins and payment terms.

2. Assortment development and consumer trends

High level of trust to the authorities after presidential elections in January 2010 served as the main factor that influenced a rapid increase of consumer confidence during the first half of 2010. But high infla-

tion during the last months undermined the credibility of authorities. The consumers are more optimistic about the future (IEE) than about their current situation (ICS).

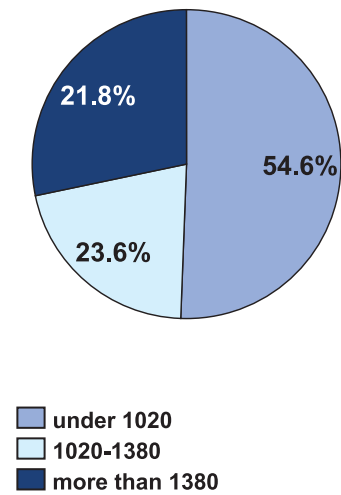


CCI – Consumer Confidence Index, ICS – Index of the Current Situation, IEE – Index of Economic Expectations (Source: GfK, International Centre for Policy Studies)

Still comparing 2Q to the previous year an income grew by 17%. The highest average disposable income per capita is in Eastern, the lowest – in Western Ukraine. According to the income structure the highest increase touched social benefits/transfers, wages&salaries and profits.

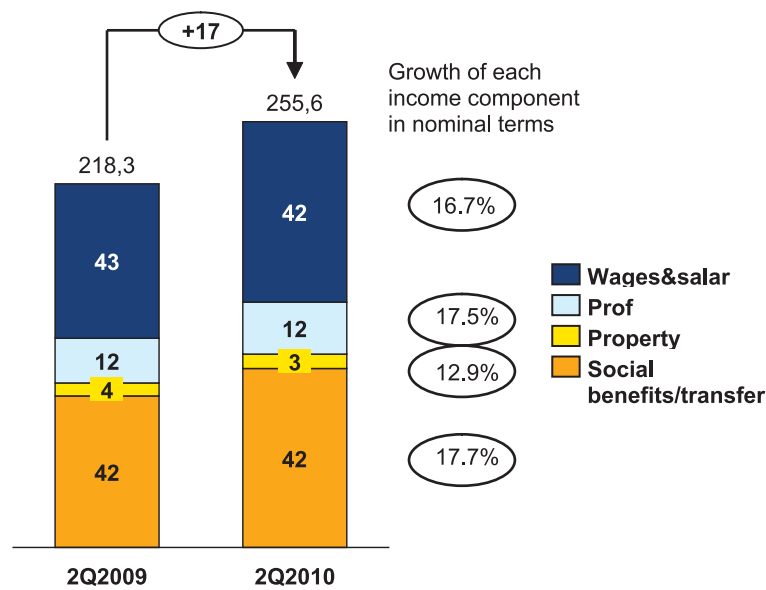
Despite growing income more than half of Ukrainian population has officially an average income lower than 1020 UAH/month.

Income differentiation, %, 2009



Source: State Statistics Committee of Ukraine

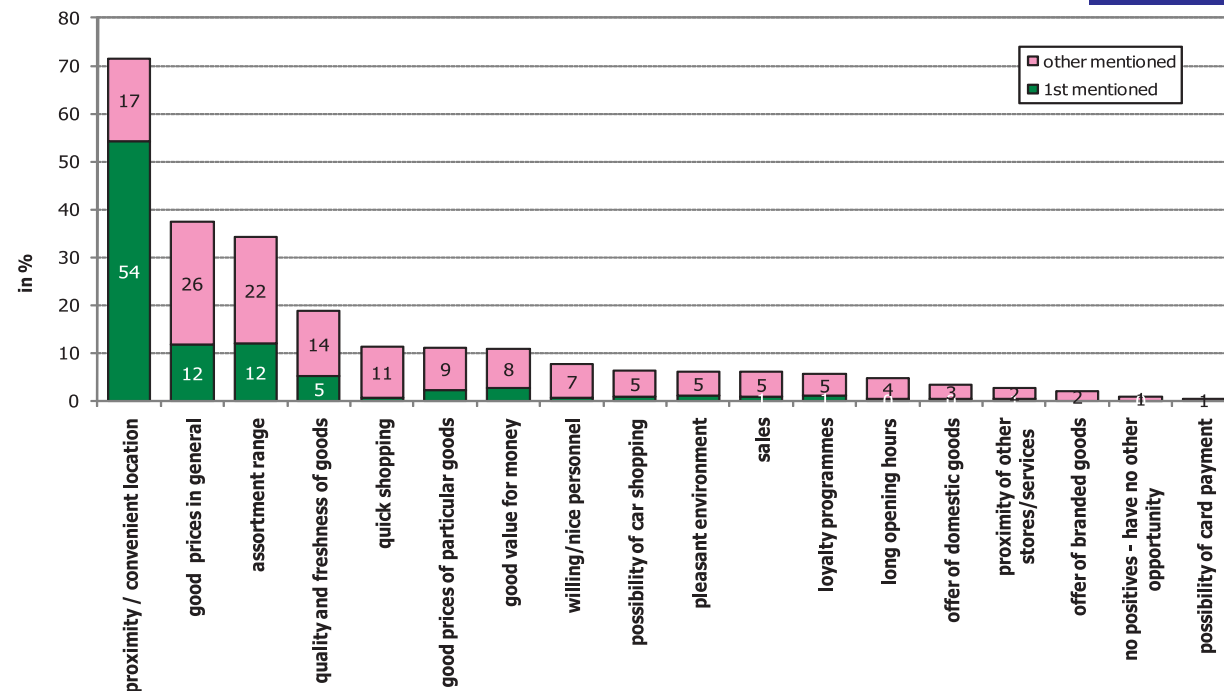
Structure of population income, nom., %, q/q



According to consumer survey* made by GfK Ukraine, 68% of Ukrainians mentioned supermarkets**, hypermarkets*** and small shops as their main places of food purchases. And still 22% of respondents visit the markets selling consumer goods.

Location near home or work, reasonable prices and wide range of products are the main factors that influence the decision of choosing a place for purchase. This is largely driven by the low number of cars per 1000 population (2008 – 132).

1.5 WHY DO YOU PREFER JUST THIS STORE?
(more answers possible)



Source: GfK Shopper trends 2010

After taking a back seat to price in 2009, sustainability and green issues are set to re-emerge as key trends in 2010-2011 internationally. In Ukraine the trend is not as strong, however, definitely exists in large cities. METRO Cash and Carry Ukraine introduced organic food products into its as-

sortment in 2010. Its stores sell 20 articles if eco vegetables and fruits, like avocado, pineapple, ginger, garlic, eggplant, cabbage, tomatoes. For customer convenience they are located on separate specially branded shelves. Organic items are present in almost all product categories.

3. Own brands as a growing phenomena



Previous recessions have shown a clear correlation between own brand market share and the status of economy. In the past, own brand sales spiked during a recession but quickly returned to normal levels at the first sign of an upturn. This time, however, own brand is sticking.

For an increasing number of retailers, the role of own brand is transitioning from generic alternative to FMCG brand. The extension of own brand into services and other key areas aims to strengthen brand equity of the retailer and drive shopper loyalty.

New frugal tendencies amongst shoppers have ignited demand for own brand, in addition to improvements in quality, marketing and SKU rationalisation efforts which have carved out more shelf space for these items.

METRO Cash and Carry launched first own brands beginning of 80th last century. Among more than 50 in 2009 6 core brands were selected for further development after focus groups with customers.

Key own brand trends in Europe such as the rise of super premium, supplier transparency and niche sub-brands will soon become evident in developing PL regions, to which Ukraine also belongs.

Today METRO offers 1.800 articles which make 10% of total turnover in general in the countries of presence. Selecting producers based on stringent quality demands, stable volumes, low prices in Ukraine METRO is looking for stable partnerships with producers, first of all looking for Ukrainian companies.

Brand manufacturers must learn to co-exist with own brand by adopting new brand-building strategies, while also working collaboratively with retailers in the form of joint promotions and planning.

In 2010 – 2012 METRO will further develop own brands with a plan to increase their share in total turnover up to 12%. For this the assortment of own brands will also extend.

Source: Planet Retail

4. Forecasts: Ukrainian retail is slowly coming back to the before-crisis figures

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Beer and Kvass Market Overview



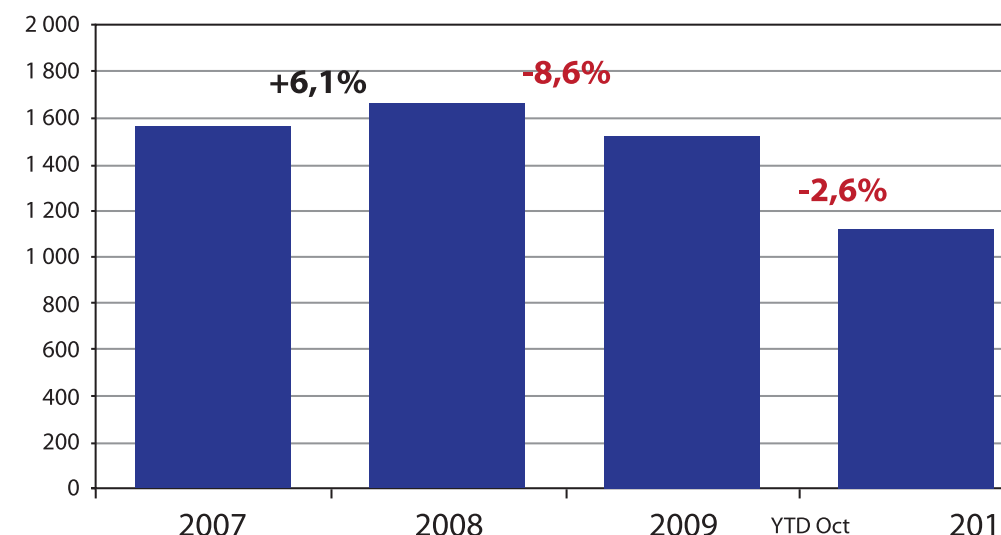
Part of the Carlsberg Group

"Slavutich", Carlsberg Group

1. Survey of the Ukrainian beer market

- The last several years has seen stagnation in the beer market after 10 years of dynamic growth. Starting with the second half of 2008 the sector is experiencing decreasing sales volumes. For the first half-year of 2010 the beer market as a whole has declined by 5.8%, though in comparison with average European indexes it still retains huge potential for growth.
- The market decline was caused, first of all, by the financial crisis of 2008 and, accordingly, by the decrease of the purchasing power of the population. In addition excise duties were increased at the same time and as result the retail price for beer increased as well.
- Consumption per capita has also decreased and in 2009-2010 it was only 57 litres of beer per capita, while before crisis it amounted to 60 litres per capita.

Beer market's dynamics in 2007-2010, million litres



Source: analytical company AC Nielsen

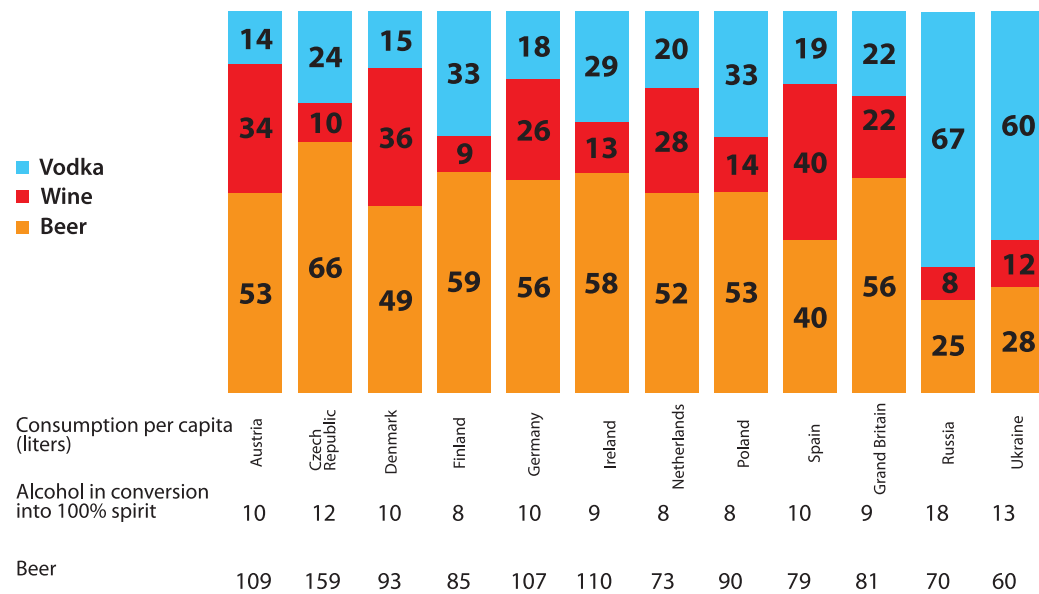
Beer consumption per capita

Year	2005	2006	2007	2008	2009	2010
Consumption per capita, liters	45	50	60	61	57	57

Source: in-house data of "Slavutich", Carlsberg Group

- The consumption of alcohol in Ukraine per capita per year includes: 28 liters of beer, 60 liters of vodka and 12 liters of wine. Those rates are almost identical to neighbouring Russia, but the share of vodka consumption there is much higher.

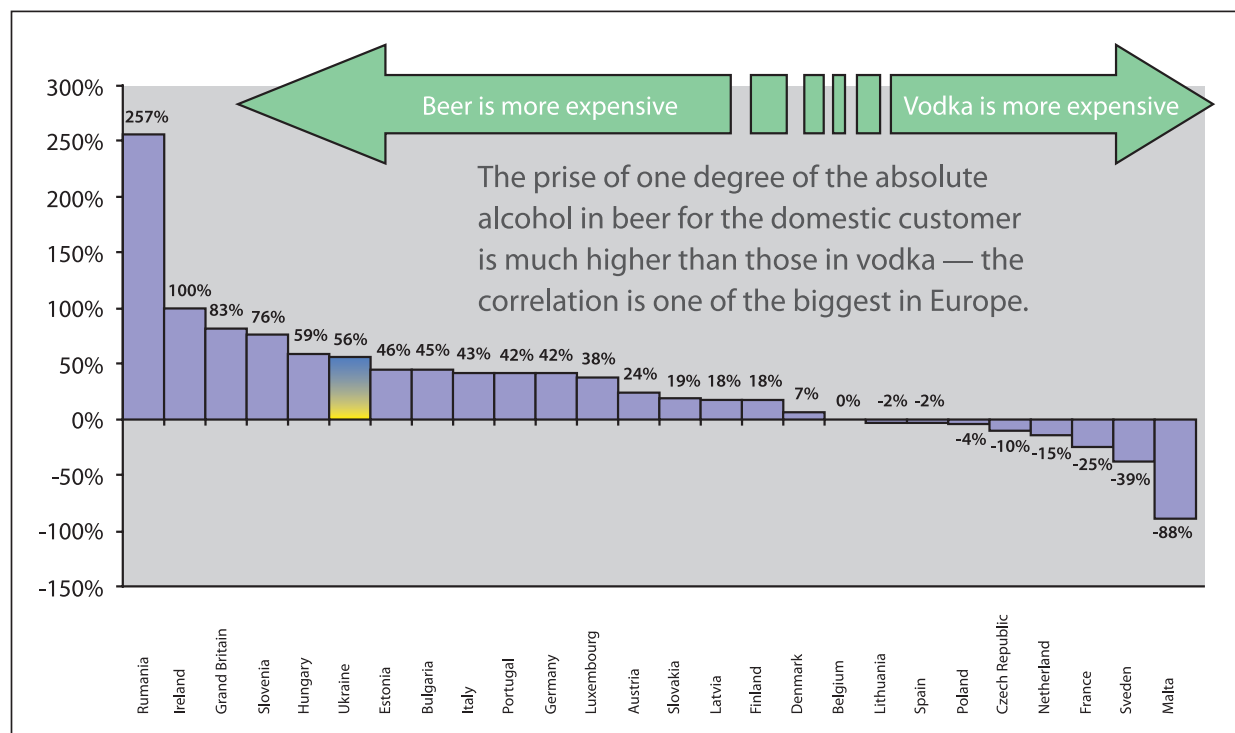
Structure of alcohol consumption, % of consumption per capita



Source: Euromonitor, Canadean, Carlsberg, Business Analytica

- The price of one degree of absolute alcohol in beer for the domestic customer is much higher than those in vodka – this correlation is one of the biggest in Europe.

Correlation of the price of one degree in beer to one degree in vodka, %



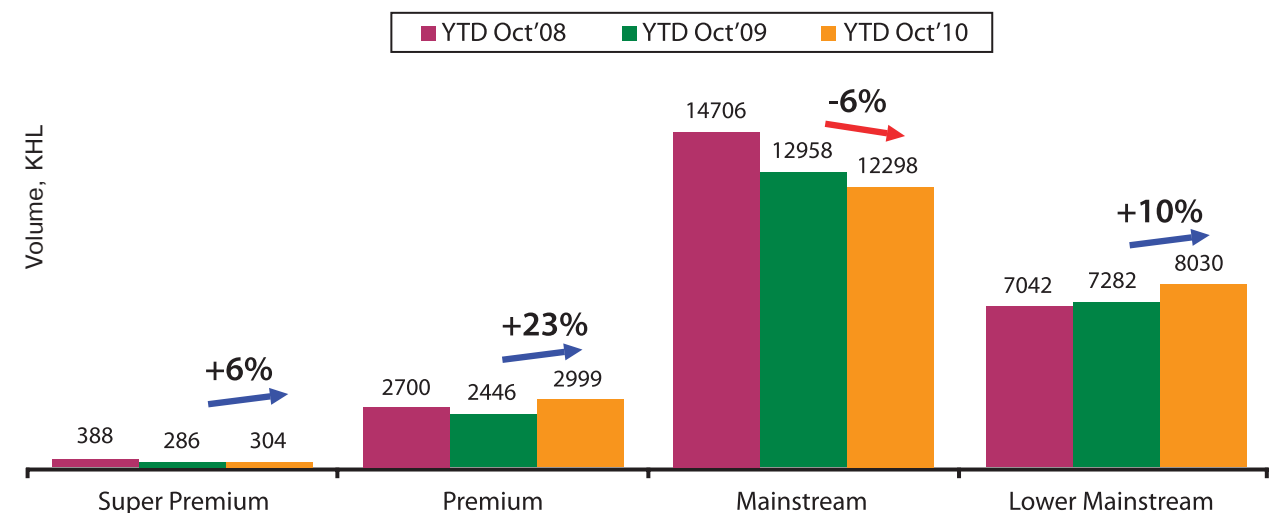
Source: IAS (Institute of alcohol studies: www.ias.gov.uk), World Health Organization

- The premium segment suffered more than any other and in spite of the improvement of the general economic situation in 2010, the negative trend remained. Also, starting from 2008 in Ukraine we are witnessing the obvious process of down trading – customers switching over to lower priced brands of beer in less

expensive packing but in 2010 a more positive trend is noted. According to in-house data of the “Slavutich” Carlsberg Group, the preferences of customers by the type of packing are the following: 40% – glass bottle, 7% – can, 11% – kegs, 42% – PET (plastic bottle).

Beer market volume by segments KHL

Mainstream is the only declining segment, but the declining tendency improving
Producers' shipments data (Sep'10)

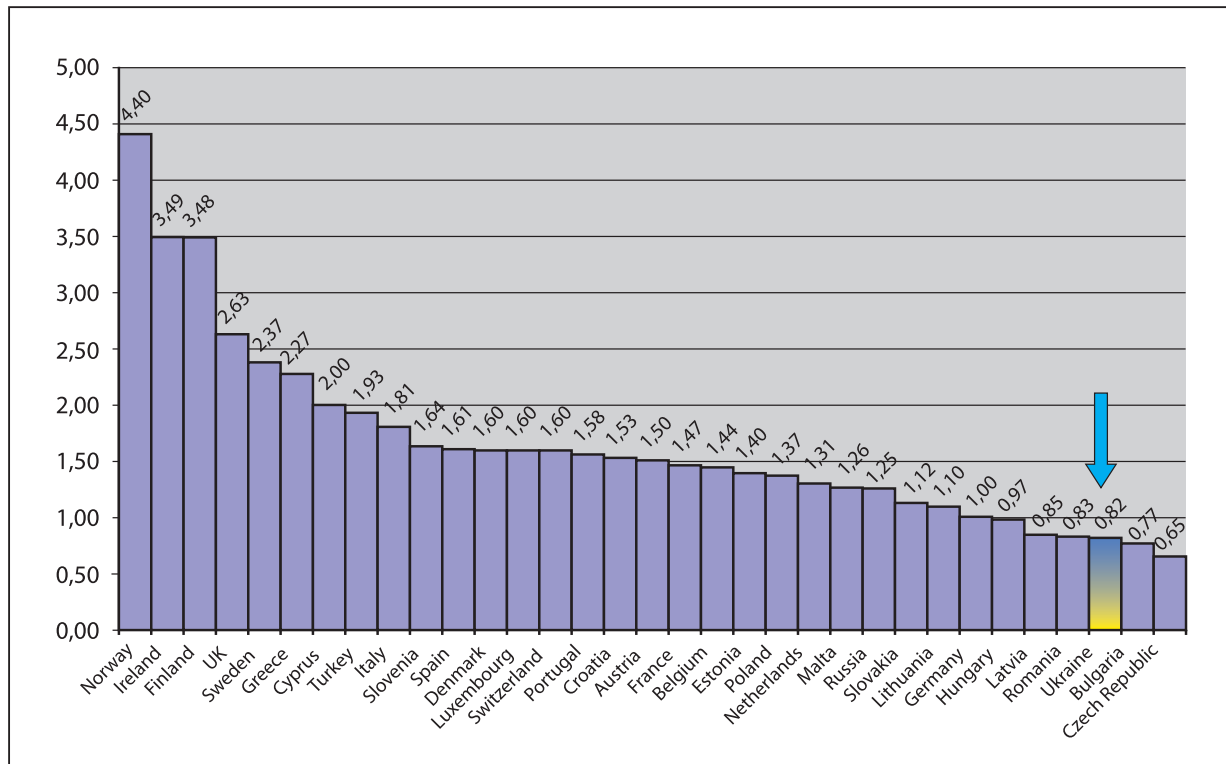


	YTD Oct'08	YTD Oct'09	YTD Oct'10
Super Premium	1,6%	1,2%	1,3%
Premium	10,9%	10,6%	12,7%
Mainstream	59,2%	56,4%	52,0%
Lower Mainstream	28,4%	31,7%	34,0%

Source: companies shipments (sales), ACNielsen retail data
Source: according to the shipment data of the companies

- In 2009 the share of the licensed segment also dropped significantly – it is declining at a greater rate than the market. This trend can be accounted for since licensed beer is a more expensive product due to royalty fees and tendency to be in the premium segment. But in 2010 we are witnessing a cardinal break of this tendency – the segment of licensed beer not only renewed its position of 2008, but has also extended its market share. It is related most of all to the willingness of people to buy products with higher quality while the economic circumstances are improving.
- In 2010 we saw insignificant price increase for beer – nearly +6%. The main reason for this increase – two-fold increase of excise duties for beer in July 2009, increase of excise in July 2010 (up 23.3% - from 0.60 to 0.74 UAH per liter), and in addition – the price increase for raw materials (including barley). But it must be noted that in Ukraine the beer price on the shelf is one of the lowest not only in Europe, but in all CIS countries.

Average retail beer prices in European countries



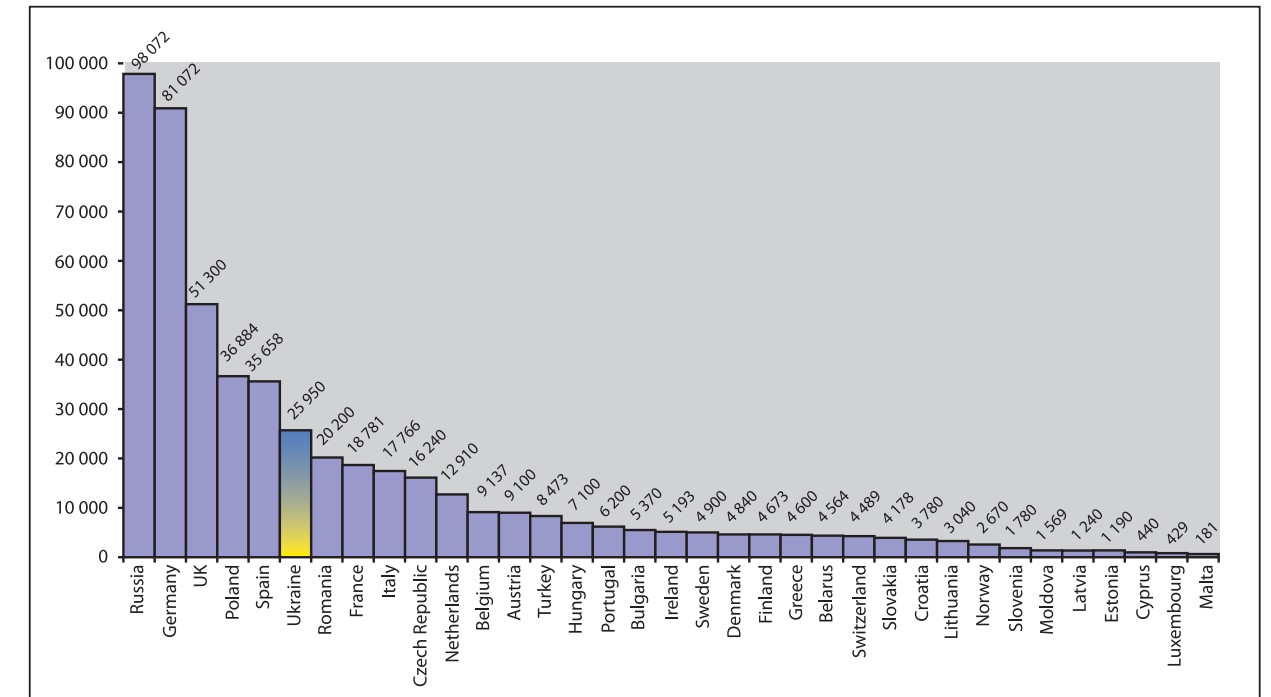
Source: Ernst&Young

- In 2010 the brewery sector was affected by the number of legislative restrictions. The government, for example, has increased the tax for water resources usage (surface and underground). The payment for using surface and underground water was up to 21.60 UAH/cubic meter and 25.20 UAH/cubic meter accordingly. Initial plan made provisions for the increase by 50 times. In such a case Ukraine would be Europe record breaker for the price of water. But in 2010 the rate was multiplied by 8 (by 5 – direct charge plus coefficient).
- Also in 2010 the Law of Ukraine #1824-IV dated January 21st, 2010 “On the alteration of some legislative acts of Ukraine dealing with the restriction of

beer and low-alcohol drinks’ sales and consumption” was adopted. The law prohibited consumption of beer (except non-alcoholic) as well as alcoholic and low-alcoholic drinks in public areas. But no changes in volumes of beer consumption are noted after the adoption of this law. These changes affected rather the area of its consumption. People moved from streets to cafes and restaurants, and that has a positive impact on the formation of the culture of beer consumption. And beer producers support such measures and laws in every possible way.

- In comparison with other European countries Ukraine take the sixth rate by beer sales volumes.

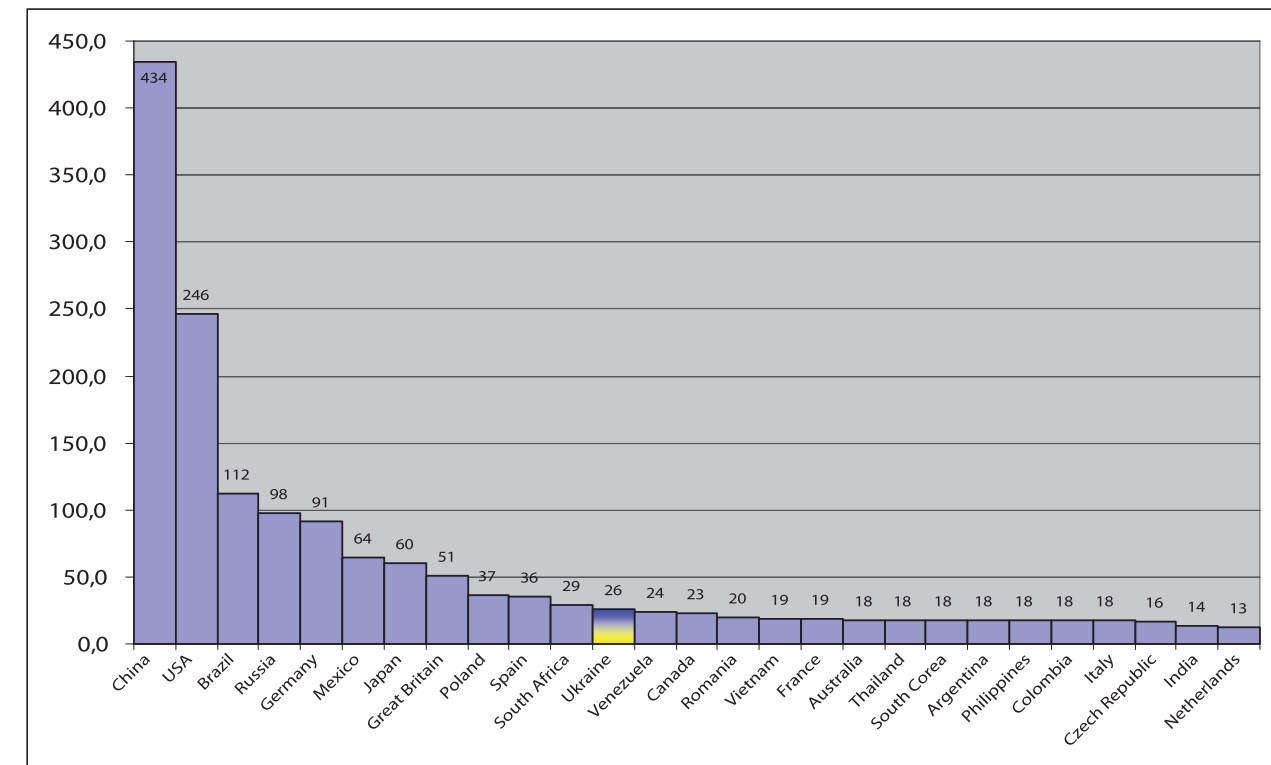
Beer market volumes in Europe in 2009, KHL



Source: Ernst&Young

1.4% of global beer volumes is sold in Ukraine

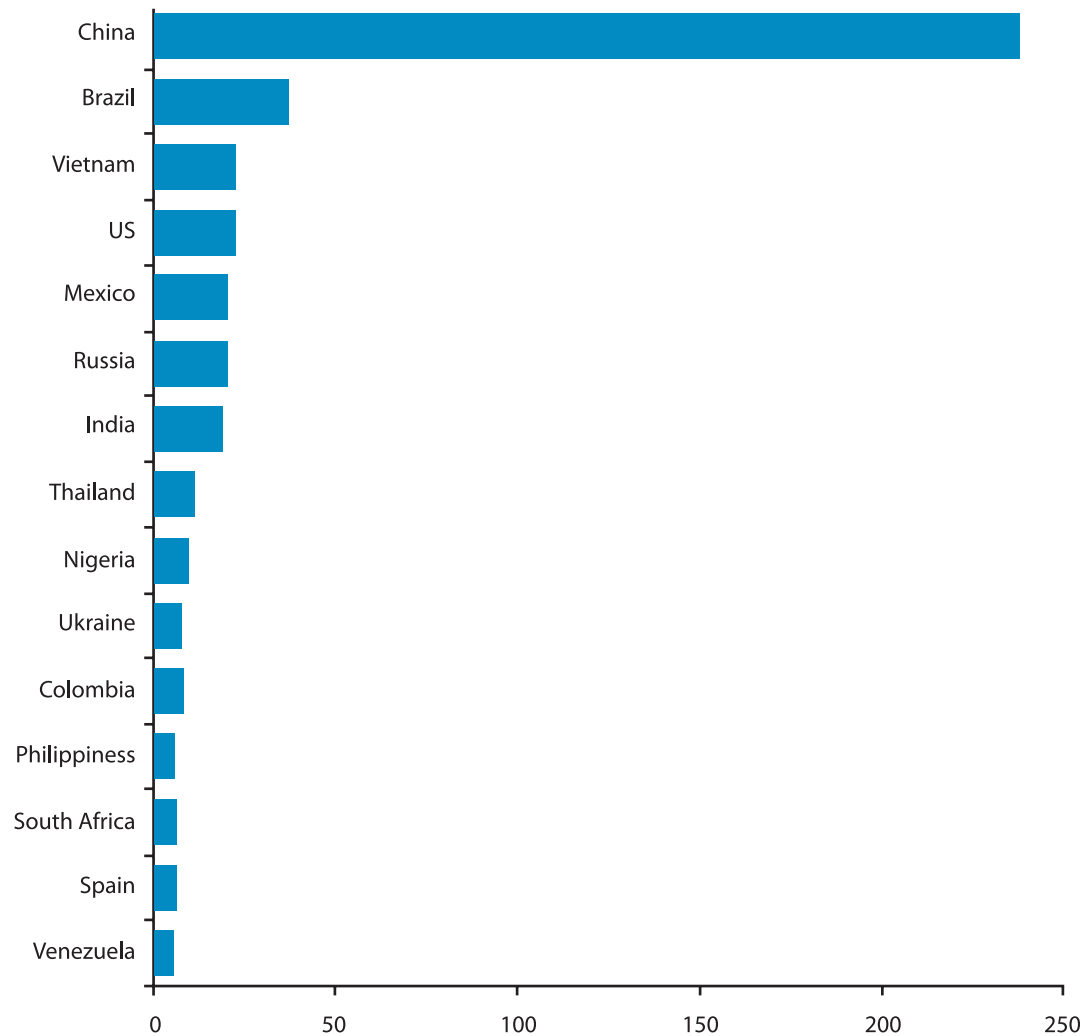
Beer market volumes in the world in 2009, KHL



Source: JP Morgan

JP Morgan had calculated the potential of beer market volumes in each country in the world. Ukraine takes 10th position in this research.

TOP-15 beer markets by incremental volume growth, 2009-2020



Source: Plato Logic

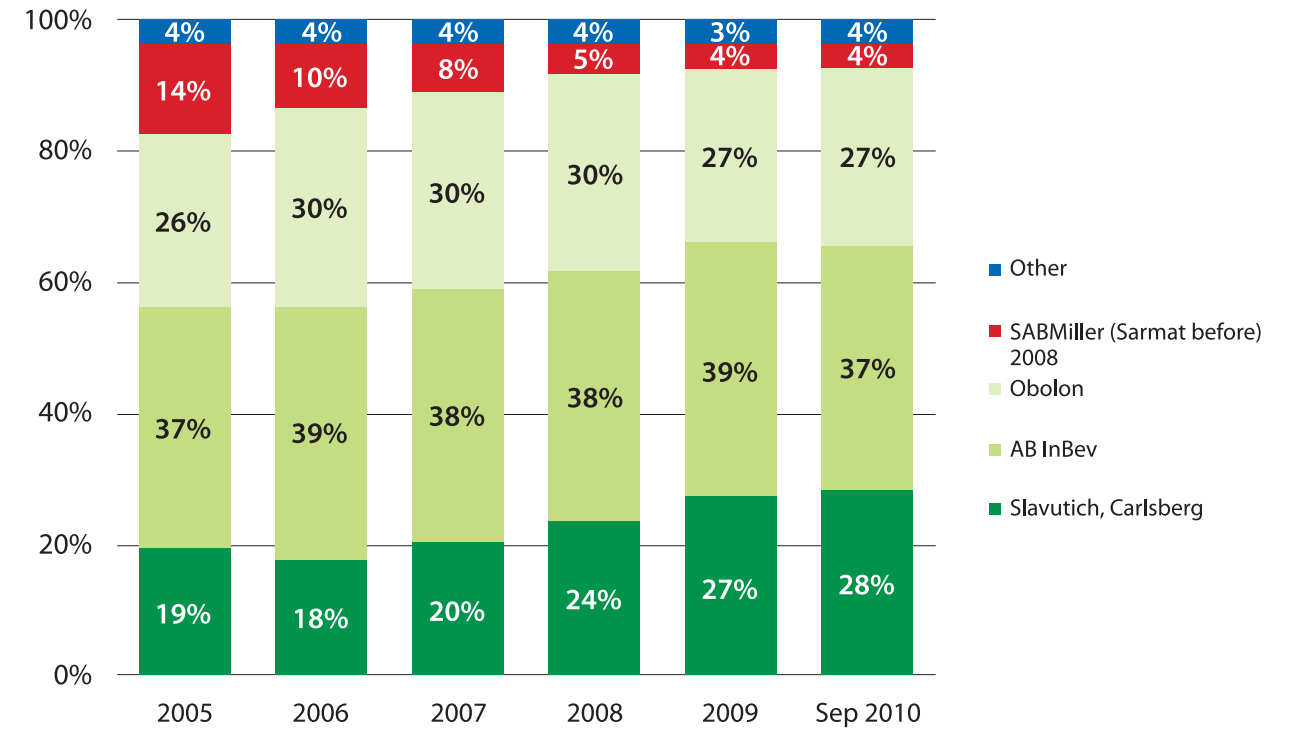
- Among the main players on the Ukrainian beer market there are three foreign companies working: AB InBev (1st place); “Slavutich”, Carlsberg Group (2nd place); SABMiller (4th place), and local company – “Obolon” (3rd place).

Distribution by the segments of the main beer market players

Segment	Share
Super Premium	1.3%
Premium	12.6%
Mainstream	52.4%
Low Mainstream	33.7%

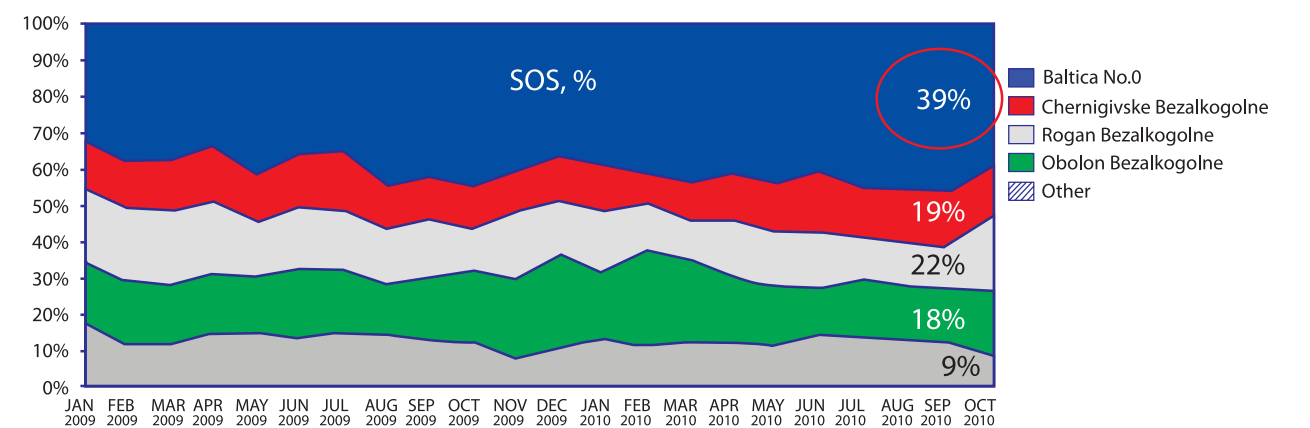
Source: CJSC “Ukrpivo”

Share of main producers on the Ukrainian beer market



Source: AC Nielsen

Ukraine alcohol-free beer market

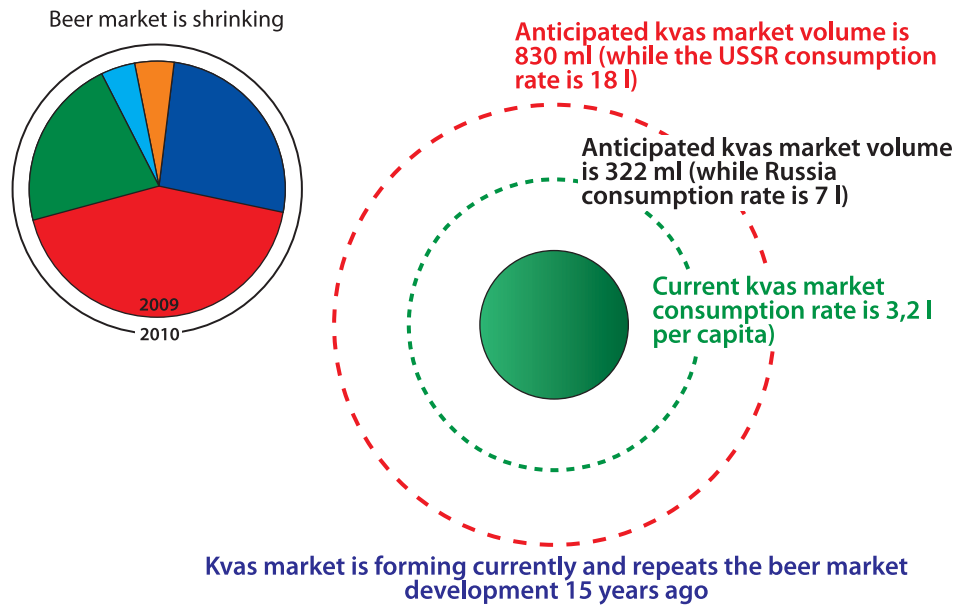


2. Survey of Ukraine kvas market

- The Kvas market in Ukraine is still taking shape and reflects the process of beer market development 15 years ago.
- The Kvas market keeps on developing, so there is room for all players. During the first half of 2010 kvas consumption has grown by 16%. Present volume of

kvas market – 150 millilitres. Estimated volume of the kvas market – 830 millilitres (basing on the amount of kvas consumption characteristic for Soviet Union – 18 litres per capita) or 322 millilitres (in case of kvas consumption on the level similar to Russia – 7 litres).

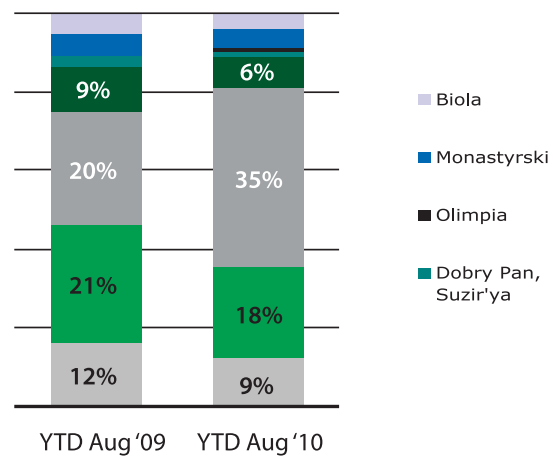
Kvas market potential



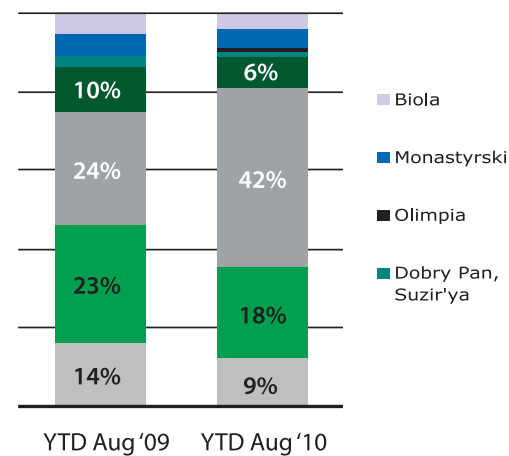
- This market is growing, in the first place, due to the demand for the naturalness of the product: kvas is a beverage of natural fermentation, production of which does not need preservatives, aromatises or substitutes. This is quite a natural product, made of 100% natural raw materials. This is the reason of the demand for this class in the whole.
- In 2008 a new product – “Kvas Taras” – made its appearance on the market (producer – “Slavutich”, Carlsberg Group); straight away it became the leader of the kvas market and in no time it was acclaimed both by experts and consumers.

Share of main producers on Ukrainian kvas market

By volume



By value



Почесний спонсор Євро-чемпіонатів УЄФА з 1988 року

0% часу на чай, 100% футболу

6. HEALTHCARE

Sources: “Partnership for Successfully Competing in the Global Economy” (www.chamber.ua/competitiveness), State Statistics Committee of Ukraine, World Economic Forum, State Pharmacological Center of Ukraine, MORION, Proxima Research

Most of Ukraine’s healthcare system is state-owned and financed from the state and local budgets. The share that private clinics hold is growing but is yet insignificant (about 2-3% in the whole country and about 10% in large cities). The exception is the dentistry sector, where the share of private clinics (60%) exceeds the share of state-owned ones. However, the private sector cannot yet significantly influence the current overall situation in Ukraine’s healthcare sector.

Lack of reform in the healthcare system has led to its current state as the sector is characterized by poor management, lack of state financing, unfair distribution of resources, outdated medical equipment, low salaries, widespread bribery, and a low level of service quality, especially in rural areas.

At this point there is neither compulsory medical insurance nor reimbursement for medicines and medical devices in Ukraine, which results in a significant share of out-of-pocket financing in the healthcare system (up to 80%).

Obviously, given this situation, most of the experts the American Chamber of Commerce surveyed in February 2010 assessed the changes in the sector’s general situation as negative (66.7%). The rest of the respondents (33.3%) reported no changes.

Current negative demographic trends make the situation even more complicated. According to the World Economic Forum’s “Global Competitiveness Report 2009-2010,” Ukraine is ranked 92 out of 133 countries for the life expectancy indicator. In addition, Ukraine is among the countries with the most rapid natural population decline in Europe. According to State Statistics Committee data, Ukraine’s population is declining on average by 300,000 people annually; this has been the trend for

the last several years. In 2009 the surplus of deaths over births was 1.4 times. So-called “over-mortality” is yet another negative demographic trend: the mortality of men aged 25-44 exceeds that of women of the same age group by four times.

In order to address these problems, ensuring high quality, accessible and affordable medical services for all must become a priority goal for Ukraine’s government.

The government recently took some steps towards reforming healthcare. In February 2010 the Cabinet of Ministers approved the Resolution “On Certain Measures to Improve the Healthcare System.” The resolution 1) introduced institutional differentiation for the initial, second and third level of medical care provision; 2) improved financing of the healthcare sector; 3) instituted mandatory medical insurance; 4) established specialized hospitals. Before these measures are introduced at the national level, they will be piloted in Dnipropetrovsk and Vinnytsia oblasts.

These initiatives are critical for addressing current healthcare system problems. According to the results of the expert survey the Chamber conducted, the legal environment in the healthcare sector either changed for the worse over the past 11 months (from April 2009 through February 2010) or remained the same (44.4% and 44.4% of the respondents, respectively). Only 11.1% of the experts stated that there have been positive changes in the legal environment.

The Ukrainian medicine market is generally saturated. According to data of the State Pharmacological Center of Ukraine, there are 11,422 medicines registered on the Ukrainian market. Some 29.1% of them (or 3,321) are produced in Ukraine and 70.9% (or 8101) are produced abroad. Nearly 6,000 businesses that run over

20,000 drugstores sell medicines in Ukraine through wholesale and retail networks.

According to data from the MORION and Proxima Research companies, about a quarter of the Ukrainian medicine market belongs to Ukrainian pharmaceutical producers (24.8%). Among foreign producers the most active are producers from Germany (17.8%) and India (8.1%).

Table 1. Volume of sales of medicines through drugstores, 2007

Countries	% of market
Ukraine	24.8
Germany	17,8
India	8,1
France	6,4
Great Britain	4,6
Switzerland	4,2
Slovenia	4,2
USA	3,5
Hungary	3,4
Austria	3,3
TOTAL	100

Source: Pharmstandard analytical systems (MORION) and PharmXplorer (Proxima Research)

Almost all medicines produced in Ukraine are generic, while innovative medicines must be imported into Ukraine. However, intellectual property law in Ukraine, which is a WTO member and a party to the TRIPS agreement and a number of IPR-related international treaties, incorporates most internationally accepted rules and mechanisms of protection. Nevertheless, law enforcement and judicial protection of intellectual property rights remains insufficient, mostly owing to a lack of expertise on the part of law enforcement bodies and judges.

Overall, according to MORION and Proxima Research data, the Ukrainian medicine market totaled 16.7 billion hryvnias in 2009 (1.1 billion packages were sold), which is 27.5% more in money terms and 8.1% more in real terms than in 2008. In addition to the annual growth

in medicine consumption that the last several years saw, the flu outbreak at the end of 2009 and inflation, which drove up medicine prices, were responsible for last year’s rise.

The Berlin-Chemie/Menarini Group and Farmak were the leaders in sales in 2009.

Table 2. Top 30 companies in sales of medicine through drugstores in 2009 (in money terms)

Company	Rank
Berlin-Chemie/Menarini Group	1
Farmak	2
Sanofi-Aventis	3
Darnitsa	4
Nycomed	5
Arterium Corporation	6
Sandoz	7
KRKA	8
Servier	9
Gedeon Richter	10
Borschagovsky Pharmaceutical Plant	11
Bayer Consumer Care	12
GlaxoSmithKline	13
Zdorovje	14
Actavis Group	15
Boehringer Ingelheim	16
PRO-Farma	17
Bittner	18
Heel	19
Stada-Nizhfarm	20
Ratiopharm	21
Solvay Pharmaceuticals	22
Ranbaxy	23
Bionorica	24
Kyiv Vitamin Plant	25
Mili Healthcare	26
Zentiva	27
GlaxoSmithKline Consumer Healthcare	28
Interchem	29
Pliva	30

Source: Pharmstandard analytical systems (MORION) and PharmXplorer (Proxima Research)

Most of the healthcare sector experts (66.7%) stated that the regulatory environment for the sector did not change from April 2009 through February 2010. Some 22.2% assessed the changes in the regulatory environment as negative. Only 11.1% stated that the changes in the regulatory environment were positive.

The Ukrainian healthcare market (especially the market for medicines) is rapidly growing and is, therefore, attractive for investment. This is primarily due to the size of the market and the relatively low market entrance barriers. The majority of the experts (77.8%) plan to keep the same level of investment in the sector in 2010 as there was in 2009. Only 11.1% of the respondents expect to increase their investment in 2010; the same share (11.1%) stated that they plan to reduce their investment in 2010 as compared to 2009.

According to 44.4% of the experts, the competitiveness of the Ukrainian healthcare

sector weakened between April 2009 and February 2010 as compared to neighboring countries. The same share (44.4%) stated that competitiveness remained the same over the studied period. Only 11.1% of the experts reported a rise in the competitiveness of the Ukrainian healthcare sector over the past year.

Multi-centered clinical trials grew rapidly over the course of the several previous years in terms of the number of annually approved trials. They involved clinical sites and enrolled clinical trial subjects. Ukrainian legislation on clinical trials is in line with the ICH Guidelines, including the Good Clinical Practice requirements. Although clinical trials constitute an important driver of R&D activity and provide free access to innovative medicines for patients, conducting them in Ukraine is fraught with enormously complicated customs procedures, and importation of investigational medical products is not VAT exempted.

7. HOTELS

Hotel Business in Ukraine: Some Legal Aspects

by Dr. Oleksiy Feliv,
Partner,
BEITEN BURKHARDT
(Attorneys-at-Law)

BEITEN BURKHARDT

1. Development Preconditions

The main incentive of the hotel development during the last couple of years is Ukraine's participation in the European Football Championship, which is to be held in 2012. The preparation of Ukraine for this event seems to be of the highest priority for the current government. Already in 2007 the Ukrainian Parliament issued the Law "On Organization and Holding of the Final Part of the 2012 European Football Championship in Ukraine". According to the State Program developed in order to implement the aforesaid Law, it is planned to construct (reconstruct) around 37,569 rooms (wherefrom 20,763 in Kyiv). Pursuant to the requirements of the UEFA, 34 new or reconstructed hotels have to be finished by 2012.

It is worth noting that the hotel development is preconditioned not only by the desire to hold the European Football Championship in 2012 but also by some objective criteria. Currently, there are approximately two hotel rooms per one thousand inhabitants in Ukraine, whereas in the European Union this figure is estimated to be within the range of 14 -18 rooms.

2. Hotel development for 2012

One of the crucial issues of the hotel development is the approval procedure of the design documents, which, on the average, can take from six to eighteen months. Partially, the bureaucratic and financial burdens have been minimised by the preferences set forth in the Law "On Organization and Holding of the Final Part of the 2012 Eu-

ropean Football Championship in Ukraine". Once the building is included into the list of the objects to be developed for the football event in 2012, the developer would enjoy the following advantages:

- Responsible state bodies are obliged to consider on a first-priority basis and approve design documents necessary for construction;
- The compulsory state expertise of the design documents shall be also performed within the shortest period of time;
- The construction permit shall be issued within 20 days, once all necessary documents have been submitted;
- Developers are released from the obligatory infrastructure participation fee (for hotels can be up to 10% of the construction costs, for more information, please refer to the Brochure of BEITEN BURKHARDT "Real Estate Law in Ukraine", edition 2009).

Certain additional advantages relating to the priority land reservation for hotel projects are stipulated by the Land Code.

3. Tax Vacation

In July 2010 Ukrainian Parliament adopted the Law which foresees exemption of three to five star hotels from the corporate profit tax for the next ten years, under the condition, however, that the hotels are commissioned before September 1st, 2012. The tax vacation itself begins on January 1st, 2011, respectively allowing hotels to apply for the tax exemption. Subject to ex-

emption are rather wide understood hotel services which include so-called main services (hosting and food) as well as other services which are usually not included in the standard room price (SPA, Fitness etc.).

Judging from the wording of the respective provisions relating to the corporate profit tax exemption, specifically: "tax exemption for enterprises providing services in hotels of ...", one should conclude that the tax exemption shall not apply only in the instances when profit is received directly by the hotel owners; the aforesaid exemption should be also applicable with respect to the enterprises which in effect provide hotel services (e.g. under lease or property management agreements).

To mention is that the same provisions have been implemented in the new Tax Code, already adopted by the Ukrainian Parliament but still not signed by the President.

4. Certification

There is no special law in Ukraine governing the hotel businesses. The definition of the hotel is given in the Law "On Tourism", since the hotel business is considered to be a part of the tourist sector. According to this Law, the hotel is "an enterprise of any legal form and any ownership consisting of six or more rooms and providing hotel accommodation relating to a temporary stay with an obligatory servicing". Thus, "hotel service" means the enterprise's operations to host the consumer by providing a hotel room (place) for temporary stay and other hotel services.

Hotels are classified into five categories. The classification procedure is established by the Resolution of Government dated July 29th, 2009. The certification is to be performed by a committee formed out of the representatives of different state bodies. Assignment of the respective "star" to a hotel is formalized in the certificate having a term of validity not exceeding three

years; as to the hotels having their own certified quality management system, the term of validity of the aforesaid certificate may not exceed five years. The procedure of the star certification may not exceed 30 days. The certification requirements are stipulated by the State Standards "Hotel Services. Certification of Hotels", which have been in force since 2004.

Before a hotel is assigned the respective classification category, it has to undergo a compulsory state certification aimed at establishing the fact whether it complies with the applicable legal requirements and standards. The result of the compulsory certification shall be formalised due to issuance of the Compliance Certificate. The Compliance Certificate can be issued a maximum period of time comprising five years. The Compliance Certificate for hotels, which have their own quality management system, can be issued without validity limitation, subject, however, to maintenance of a valid certificate of the quality management system. The compulsory certification procedure may not exceed 60 days.

Certification of a hotel with the respective star category should be considered, of course, as non-compulsory. This was expressly stated in the previous edition of the Rules "On Compulsory Certification of Services Relating to the Temporary Stay". According to the new edition of the Rules dated June 17th, 2010, it is not completely clear whether the star certification shall be obligatory. The new wording was very likely affected by the fact that the government has to comply with the UEFA requirements relating to the certified three to five star hotels. Hence, it should be expected that the certification authority will perform the star certification at all times when it performs the compulsory certification. Given the fact that the aforesaid corporate profit tax vacation is linked to the classification of the hotel as three, four or five star hotel, the initiation of the aforesaid certification should be also in the interests of hotels.

5. Operation

Historically, the hotel operation was structured in Ukraine through a lease agreement (usually, for municipal or private hotels) or through a property management agreement (typical for the state owned hotels). Hence, operation agreements, based on which international operators are ready to enter the Ukrainian market, are rather an unknown legal tool for Ukrainian owners and developers. In spite of cultural differences and difficulties during the negotiations over the operation contracts, there are many legal peculiarities which make such negotiations and agreements even more stressful.

International operators almost unexceptionally insist on having their draft agreements; they have successfully tested them in different regions within different legal backgrounds. It is very common that such agreement is governed by the US or UK laws. Given the fact that the most provisions of an operator's agreement are set out rather as services, there should be no problem to agree on the choice of law, subject, however, to the fact that one of the parties (operator) is a foreign legal entity (not under the Ukrainian law). If the operator is acting through a legal entity established in Ukraine, the choice of the applicable law will be impossible, if the owner of the building is also a Ukrainian legal entity or an individual. Organisation of the hotel operation without having an established legal entity in Ukraine causes a number of practical difficulties mainly related to employment, tax and customs peculiarities. Should the operator just hold a representative office, the choice of law is again open, though, from a tax point

of view, however, this structure will be not the most advantageous.

Even if the choice of law is open, there may still be certain operation provisions which parties cannot simply take over to the operation agreement. This relates in particular to those provisions which can be interpreted as property management. The property management agreements have to comply with the applicable Civil Code provisions, especially about their form, which means notarisation and state registration. Under the Ukrainian international private law, the rights which undergo state registration shall be defined based on the law of the country, where the real estate is registered; this means that the property management agreements/provisions can be governed only by the Ukrainian law.

Unlike the choice of applicable law, arbitration clauses for the International Commercial Court (ICC) at the Ukrainian Chamber of Commerce and Industry may be validly agreed even if both parties are Ukrainian legal entities with one of them being a company with foreign investments. It should be emphasized that in the instances when both parties to the hotel operation agreement are Ukrainian legal entities, the choice of the international arbitration other than ICC at the Ukrainian Chamber of Commerce and Industry, will be not valid.

As a result, the imperative provisions of the international private law have significant influence on the structuring of the hotel operation activity in Ukraine as well as on the contents of standard operation agreements.

8. INFORMATION TECHNOLOGIES AND COMMUNICATION (ICT)

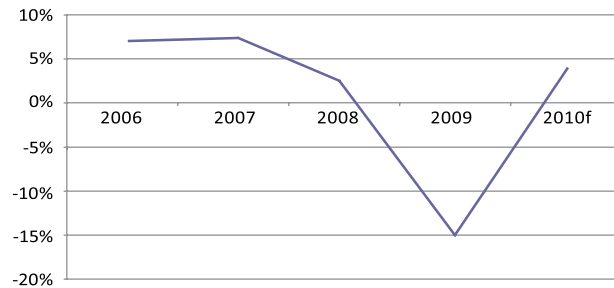
Ukrainian IT Market in 2010



1. General Overview

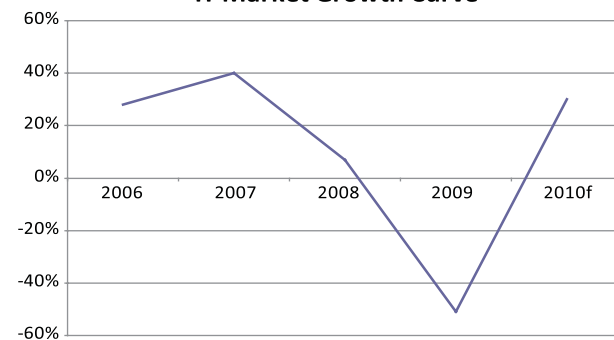
The year 2009 was a year of changes for Ukraine. The change of the President and the government justified the positive market expectations, while the gradual climb of the global economy out of the crisis spurred the growth of Ukraine's industry, and in particular, as a result of resumed demand in the world for Ukraine's stable exports – its metallurgy products.

GDP Growth, %



Year	2006	2007	2008	2009	2010f
GDP growth, %	7	7.3	2.1	-15	3.7

IT Market Growth Curve



Year	2006	2007	2008	2009	2010f
IT market growth trends, %	28	40	7	-51	30

Source: IDC

The government predicts a 3.7% growth in Ukraine's GDP in 2010 after the 15.1% plunge in 2009. The government also expects 4.5% economic growth in the country next year, a figure that coincides with the IMF's forecast.

The 2010 forecast voiced by the European Bank for Reconstruction and Development in late October for Ukraine's economy foresees even higher growth of 5%.

The employment rate has been growing the entire year. The official unemployment figure decreased from 1.9% at the beginning of the year to 1.5% in late September. The State Statistics Committee highlights almost 10% growth in the level of average salaries and wages in the country for the first nine months.

Traditionally, GDP growth has been an indicator of increased IT spending. Market operators say the second six months of 2010 show that the branch, just as the country as a whole, is making its way out of the crisis.

After a more than two-fold plunge in 2009, Ukraine's IT market promises to show 30% growth in 2010, according to IDC forecasts, totaling nearly US \$2 billion. Thus, in terms of growth, Ukraine will leave behind Russia, which expects a 20% market recovery, and the countries of Central and Eastern Europe, where growth is expected at 13% on average. However, the share of IT spending in the overall GDP structure will remain very low (approximately 1%).

The post-crisis recovery is yet to trigger significant changes in the IT market structure. Hardware remains the main IT spend-

ing item, exceeding 80% against 60% in developed countries.

The key reason behind such a hefty share of hardware in the spending structure is the volume of computers in the country, which remains rather small. There were only 13 PCs per 100 persons in 2009 in Ukraine. Such a significant growth in hardware sales in 2010 is also a result of the delayed demand that accumulated in the crisis year of 2009. In addition, the high level of copyright piracy (85%, according to Business Software Alliance) is holding back progress in the software development branch, and the lack of a state IT policy is the answer to the question of why the market of IT services has no stimuli.

In 2009, the supply of PCs to Ukraine decreased by 49% in quantitative terms, while the first six months of 2010 showed 43% growth here, which was primarily accounted for by notebook computers. This year, according to IDC, the supply of laptops will almost double (to approximately 1.2 million units) and their market share will exceed 60%.

Analysts predict that the full recovery of the IT market will take at least three years. It is also predicted that after the market becomes saturated with hardware, the software development segment will become a new driving force for it. In 2009, despite the disproportion in the spending structure, more than 30% of the 72,000 Ukrainians working in the IT industry were engaged in the software development segment. This share is poised to grow in the coming years, since software development centers are now increasingly popping up in smaller oblast centers, breaking the limits of a few large cities.

The way out of the crisis has proved the most difficult task for the market of corporate IT services. Large companies curtailed their IT budgets last year, and their interest in IT projects resumed only in the middle of 2010. New projects here are much smaller in terms of scale than in pre-crisis times,

and the competition among IT companies has tightened.

Many providers of IT services believe that the crisis should have helped Ukrainian companies optimize their consumption of IT technologies by reducing their spending on costly hardware and redirecting their focus to such services as virtualization and cloud computing. However, the conservative nature of Ukrainian businesses resulted in their IT spending reduced to almost zero in 2009, and in 2010 the companies again show much greater interest in hardware than in services.

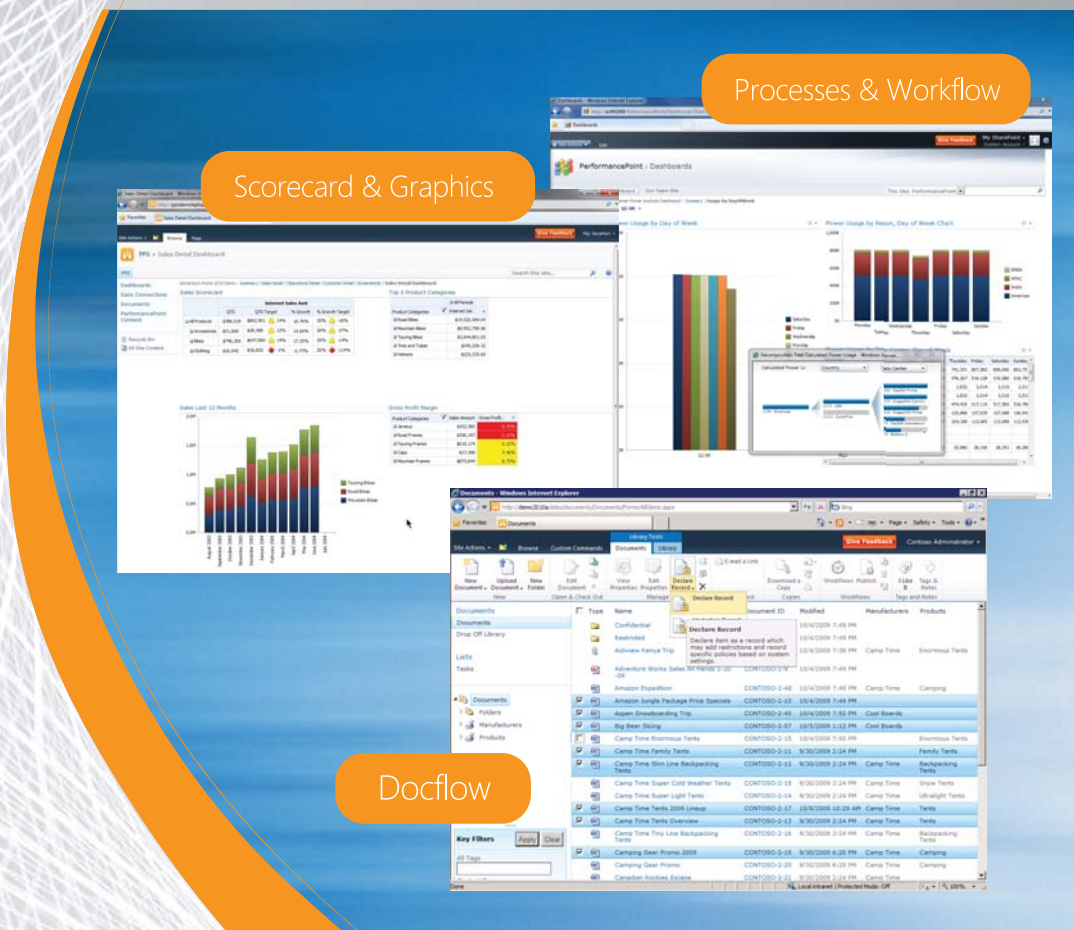
2. Key Market Trends

Despite the existing preponderance of hardware spending, the software development segment is seen as the most promising on Ukraine's IT market. Despite the crisis, incomes in the industry increased by 38% in US dollar terms in 2009, according to the IT Ukraine association. A major share of those incomes (80%) comes from exports, primarily outsourced software programming.

A considerable share of outsourcing services is a major trend of Ukraine's IT market. According to a study completed by A. T. Kearney, Ukraine is 42nd in the world in terms of IT outsourcing attractiveness, being the most attractive country in the region. The large share of outsourcing is also explained by the poor internal demand for IT services and software.

As a result, most Ukrainian software development centers are actually in the hands of foreign companies, providing services to the latter and thus making no contribution to the capitalization of the branch and generating no revenues for Ukraine's state budget.

A high software piracy level is a feature determining the present face of Ukraine's market to a great extent. Weak governmental support for the efforts to protect intellectual



Company Portal

Sites

SharePoint 2010 Sites provides a single infrastructure for all your business Web sites. Share documents with colleagues, manage projects with partners, and publish information to customers.

Composites

SharePoint 2010 Composites offers tools and components for creating do-it-yourself business solutions. Build no-code solutions to rapidly respond to business needs.

Insights

SharePoint 2010 Insights gives everyone access to the information in databases, reports, and business applications. Help people locate the information they need to make good decisions.



Communities

SharePoint 2010 Communities delivers great collaboration tools — and a single platform to manage them. Make it easy for people to share ideas and work together the way they want.

Content

SharePoint 2010 Content makes content management easy. Set up compliance measures «behind the scenes» — with features like document types, retention policies, and automatic content sorting — and then let people work naturally in Microsoft Office.

Search

SharePoint 2010 Search cuts through the clutter. A unique combination of relevance, refinement, and social cues helps people find the information and contacts they need to get their jobs done.

property rights results in the fact that the software development for domestic users is actually a high business risk. The developers of one of Ukraine's most successful software products – the computer game S.T.A.L.K.E.R. – derive most of their profits from sales abroad, whereas in Ukraine, the company is struggling to end the illegal distribution of copies of its product.

The near future promises an intensified fight with copyright violators and increased support for this fight on the part of the government. In particular, after his November meeting with Microsoft's CEO Steve Ballmer, Borys Kolesnikov, deputy prime minister in charge of the preparation for Euro-2012, promised to finalize the transition of all government bodies to legal and licensed software in 5-6 months.

Lowering the copyright piracy level in the country is a matter of critical importance not only for the IT branch but also for Ukraine's economy as a whole. According to IDC, a 10% drop in the copyright piracy level in the next couple of years promises additional GDP growth of US \$755 million and US \$116 million in tax proceeds. If the piracy level goes down by 10% in four years, the country's GDP will go up by US \$586 million and tax proceeds by US \$88 million.

The intensified attention of the government to the IT branch is also evidenced by the intentions to complete the deployment of electronic government systems in the immediate future. The transition to a new level of IT usage in governmental institutions will improve the government's communication with citizens, facilitate access to governmental information resources for legal entities, and allow government bodies to implement and switch to electronic document flow.

The dashing spread of the Internet is another factor fueling the development of the IT industry in Ukraine. According to GfK Ukraine, in 2009 the number of regular Internet users in the country increased by 37% to 8.25 million people. A study by

InMind shows that in the third quarter of 2010, Internet access services were provided to 8.7 millions of Ukrainians over the age of 15 or to approximately 19% of the country's population. At the same time, 11.8 million residents of Ukraine access the Web at least once a week, and 12.9 millions, once a month.

This dynamic boosts the popularity of various Internet services, stimulating the web development segment. The ongoing growth of the Internet bodes the further growth of cloud computing. On the other hand, the growth in data transmission rates and the advance of broadband Internet access encourages copyright piracy, as users prefer trading illegal copies of movies and software applications. The popularity of file sharing sites and p2p networks put a serious load on the networks of Internet providers, making them consider their participation in fighting the spread of pirated content.

In 2010, Microsoft remains one of the major driving forces behind the advance of Ukraine's software development segment. The company's ecosystem includes software vendors servicing the software they produce and developers of software applications for Microsoft's operating systems – all together making up more than half of Ukraine's IT community. The Company takes it as its duty to support this ecosystem, discussing with the government issues of critical significance for the branch and encouraging investments in Ukraine's IT industry.

3. IT Services

The segment of IT services has been seriously affected in the crisis period. According to market operators, its incomes decreased almost twofold in 2009. At the same time, regardless of good pre-crisis dynamics, the share of this segment in the market structure remained very insignificant. Many expected that the economic downturn would strengthen service providers against the backdrop of hardware vendors due to the desire of businesses to optimize their IT

spending. But despite being quite logical, these forecasts have not come true.

Faced with the need to cut spending, Ukrainian companies mostly reduced their IT spending rather than implementing modern business analysis systems. As the economy turned to recovery, IT departments rushed to upgrade their outdated hardware, once again ignoring optimization solutions.

The demand for IT consulting was noticed in the most competitive branches of Ukraine's economy – retail and logistics. In particular, the significant shrinkage of retail chains' product ranges created the need for the efficient management of goods on the shelves, warehouse stocks, and relations with vendors, as well as the need to predict the market situation and consumer preferences.

On the whole, the internal demand for IT services started to revive in the second six months of 2010. Yet the amount of most projects in this sector rarely exceeds US \$1 million. It is therefore too early to speak of market recovery here.

In the meantime, the interest of Western companies in Ukrainian outsourcing centers providing IT services remains strong. One example is the opening of a software development and support center of Barclays Capital Bank in the Kyiv office of EPAMSystems and a Kyiv software development center of Saxo Bank, a Danish investment bank.

4. Software Development

Despite the crisis, the software development segment kept on progressing in 2009-2010. According to the IT Ukraine association, its volume grew in 2009 by 38% primarily due to outsourced programming. The economic recession made Western companies look for less expensive ways to develop software and to resort more often to process outsourcing, a trend that played into the hands of Ukraine's industry. According to the association, the number of people engaged in software development more than doubled in 2009, increasing up to approximately 40,000 persons. In 2010, 50% growth is expected here again.



Net salaries of Ukrainian software programmers in US dollars
Source: www.developers.org.ua

Nov 2009	Dec 2009	Jan 2010	Feb 2010	Mar 2010	April 2010	May 2010	June 2010	July 2010	Aug 2010	Sept 2010	Oct 2010
1300	1380	1230	1250	1350	1300	1500	1380	1337	1500	1200	1300

The share of outsourcing in the software development segment has fluctuated between 80 and 85% in recent years, according to various sources. The remaining share is occupied primarily by Web application development and isolated projects creating software products of their own. This proportion is a result of small salaries of Ukrainian programmers as compared with their Western

counterparts and a high level of software piracy that makes the software production for the domestic market unprofitable.

One success story in the software development area is Viewdle, a company that has drawn US \$10 million in investments in 2010 from the world's largest household electronics retailer BestBuy, the US telecommunica-

tions operator Qualcomm, and BlackBerry partnership foundation. The investments have been targeted at the launch of new consumer products based on a multiplatform system of face recognition on photos and video developed by Ukrainian specialists.

However, such projects generating substantial rewards for their authors are still very rare in Ukraine. Lacking in possibilities and resources to unfold their potential, Ukrainian programmers have no other option but to take lower-paying jobs in outsourcing companies where they are bound to create discrete portions of source codes, having no idea of the end product. This creates the risk of involuntary involvement in global cyber crime. For example, a company called Innovative Marketing Ukraine was closed in Kyiv in 2009 for making computer viruses for an international group of swindlers. Many employees of that company did not regard their work as illegal because Ukraine had no holistic approach toward the fight against such illegal activities.

The fight against software piracy, governmental support for the software development branch, and the involvement of Ukrainian specialists in global projects could seriously improve the market situation, raise the reputation of domestic software programmers in the world, and prevent criminalization of their work.

Microsoft is a company that supports Ukrainian programmers. There are hundreds of them developing software for the company.

5. Education

The President of Ukraine announced 2011 as a year of innovations. The country is trying to overcome its technological backwardness to make the national economy more competitive. The IT sphere requires innovative approaches as well. The ongoing consumption of new hardware should be replaced with the consumption of services, and Ukrainian software specialists should abandon outsourced programming and start developing their own intellectual products.

These reforms require another approach to the consumption of innovations and intellectual property, which can be formulated as "not only to consume but also to produce."

Ukraine has a long-standing reputation of a country with a developed research and education base. 6% of the world's physicists and mathematicians work in Ukraine. According to the World Economic Forum, the country used to hold 32nd place in the world in terms of education quality in mathematics and natural sciences.

The growing demand for IT specialists in recent years has made these professions popular with prospective students. However, despite the growth in the number of IT graduates, the quality of their education is insufficient, as there is a noticeable gap between the knowledge and skills acquired in institutions of higher learning and those required by the industry. This fact has prompted many IT companies to establish partnership relations with leading universities, offering students additional knowledge and an opportunity to apply them in practice.

However, the preparation of IT specialists is only one facet of the process of creating a resource potential for the information society of the future. Ukraine also needs to raise the digital awareness of the population. Although providing fundamental knowledge to pupils, the high school system that exists in the country now fails to provide the skills required today. As a result, most Ukrainian school children learn the Internet by experience of by just trying it, knowing nothing about such perils as cyber crime, child pornography, and frauds.

The education system should be modernized in three basic areas: content, tools, and infrastructure. The first area includes school curricula, as well as courses and training classes for teachers and students. Work in this area is required to expand knowledge of children and oftentimes their teachers about the IT world. A good example here is Microsoft's program, "Programming for Kids", which uses a sim-

plified programming language and an interactive format to teach children the programming basics. Microsoft has set up a social network for communicating with teachers and exchanging information about the academic process and teaching methodology.

Yet another contribution of the company toward the cause of raising digital awareness of the population, particularly in the regions of Ukraine, is the project "Open World of Information Technologies" IDEA (Information Dissemination and Equal Access), a joint undertaking of Microsoft and PH International. The goal of the project is to expand the access of people to acquiring, disseminating, and using information as the most important precondition for all-around personal development, as well as training in modern information technologies and improving technical skills of socially unprotected population categories to improve the quality of their lives.

The economic downturn of 2009 provoked the highest leap in the unemployment rate for all the years of Ukrainian independence. Computer literacy and information handling skills is not an advantage of a job seeker any more – it is now a standard requirement. Having 15 training centers in Ukraine, IDEA offers training classes primarily to people in a difficult financial and social situation – the unemployed, disabled, victims of human trafficking and violence, elderly people, and socially unprotected youth, helping them to acquire the knowledge and skills required for employment in the modern information society. As of today, more than 76,000 people have already taken advantage of this pro-

gram. Microsoft has invested US \$720,000 in this project in three years.

The other two areas of primary importance in which the national education system requires modernization are tools and infrastructure. Major IT companies such as Microsoft and Intel have already spent years supplying Ukrainians schools with personal computers. The next important step in this direction is to provide Internet access to schools and other educational institutions to allow them to connect to global knowledge bases, exchange information, and use various services based on cloud computing. Today many realize the need to invest in this area, and there are already a few projects of communications operators providing Internet access to schools. In addition, one of the items on the list of priority national projects approved by the President of Ukraine is the project of a national wireless communication network to be set up to provide Internet access to schools, which also includes 1.5 million netbooks to be granted for school children.

The improvement of Ukraine's education system to support the development of the nation's potential is a cause of not only specific educational institutions, companies, or even the Ministry of Education. Only joint efforts involving the government, business, and non-governmental organizations can help bring up a generation of Ukrainians who are comfortable in the ocean of modern digital technologies and able to unfold the potential of Ukraine, creating a new economy of development and innovations.

Research: Internet shopping in Ukraine

For the last few years we've seen fast growth in the popularity of different Internet resources among Ukrainians. The Internet has become a powerful channel for accessing

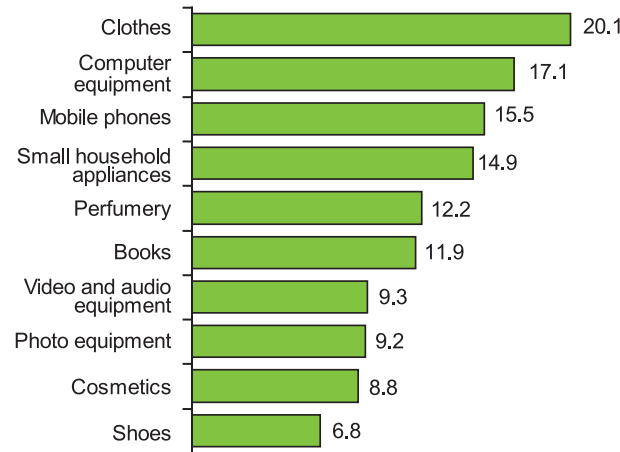
Ukrainian consumers, just as it has for accessing consumers all over the world. In developed markets Internet shopping has long been an integral part of daily life. In Ukraine,



however, Internet shopping is now in the development stage. This is despite that more than 80% of Ukrainian Internet users already have Internet shopping experience, according to UMG International research.

Some 3260 permanent Internet users aged 15 to 54 were surveyed. The research covered all five Ukrainian regions (Northern, Southern, Eastern, Western, and Central). Special attention was paid to Kiev.

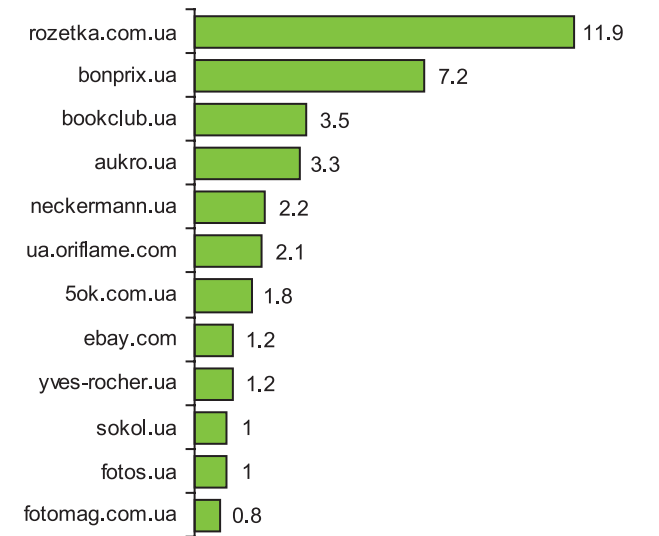
Internet shoppers' demands are quite diversified. Clothes, mobile phones, computers, small home appliances, perfumes, and books are the items that Ukrainians most frequently purchase through the Internet. Food, food-



Percentage of purchased items through the Internet

stuffs, alcohol, and soft drinks are not popular Internet shopping items at the moment.

The most popular Internet shops in general are as follows:



Percentage of Internet users who purchased items via the above resources

As for categories of goods, we should note that leading Internet shops are available for almost all of them. Among Internet shops dealing in **clothes**, for example, *bonprix.ua* is the unprecedented leader. In **small household and audio/video appliances, mobile phones, computers, and photo equipment** the sole leader is *rozetka.com.ua*. Among Internet **book** stores *bookclub.ua* is the leader, followed by *petrovka.ua*. For **perfumery**, *ua.oriflame.com* ranks first. In **cosmetics** a distinct leader is lacking, with the breakdown between key market players not exceeding 3.5%.

Top 10 goods categories	Dec 2009	Jan 2010
	Internet store	% of respondents within category who purchased items through shop
Clothes	bonprix.ua	53.5
Computers	rozetka.com.ua	40.3
Small household appliances	rozetka.com.ua	22.1
Audio/video appliances	rozetka.com.ua	32.9
Mobile phones	rozetka.com.ua	41.2
Photo equipment	rozetka.com.ua	39.2
Books	bookclub.ua	53.9



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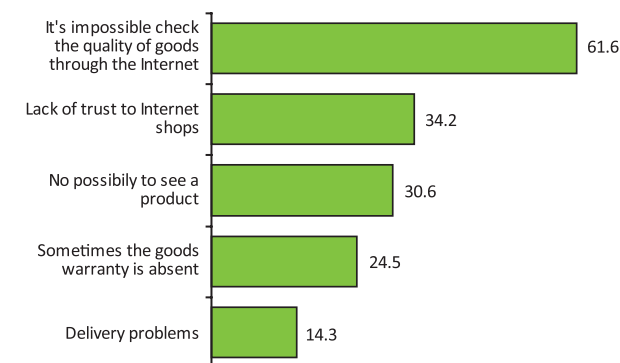
Perfumery	ua.oriflame.com	12.6
	aromat.kiev.ua	7.7
	yves-rocher.ua	4.9
	marykay.ua	3.2
	parfum.net.ua	3
Cosmetics	ua.oriflame.com	19.4
	yves-rocher.ua	16
	avon.ua	14.8
	marykay.ua	7.6
	makeup.com.ua	5.8
	greenmama.ua	5.6

Internet shopping limiting factors.

Among the main factors that limit Ukrainians from buying goods through Internet stores are:

- lack of possibility to check the quality of goods purchased (61.6%);
- lack of trust in Internet stores (34.2%)
- lack of possibility to see the goods purchased (30.6%);
- absence of goods warranties (24.5%);
- delivery problems (14.3%).

Delivery problems are more critical in the West (where they mostly have to do with duration of the delivery process) and the North of Ukraine (where many possible shoppers live outside of delivery zones).



Factors that make consumers reject Internet stores

Internet shopping geography.

Kiev and the Northern region are Ukraine's most active regions for Internet shopping. The Eastern and Western regions are the least active.

Gender categories and age profile.

Male and female category differences proved to be traditional. "Purely male" goods involve auto-related equipment and computer equipment; female consumers buy clothes, children's goods, cosmetics, and books through the Internet. Perfumery, mobile phones, small home appliances, and sporting goods are equally popular among both females and males.

In general, the most popular goods categories (clothes, mobile phones, computers, small home appliances, and books) are evenly popular in all age groups. Age differences revealed themselves in some other segments. Home appliances are most frequently purchased online by the 25-34 age group. The major customers for cameras and photo accessories are young consumers, while older consumers (35-54 years old) are much less interested in that category. The digital media segment evinces the opposite situation. The accessibility of

interactive resources with open access has kept young people away from buying CDs

and DVDs, while middle-aged and older consumers remain active in this segment.

Telecom Market Overview and Mobile Number Portability

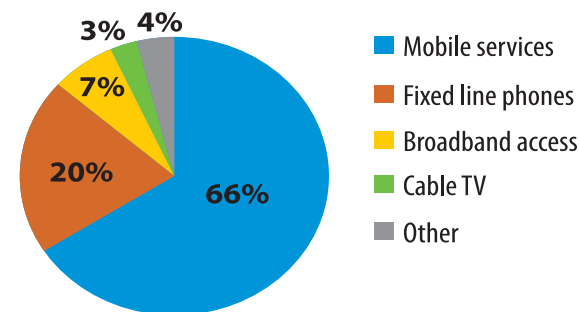


In crisis year of 2009 telecommunications was one of the least affected sectors of the Ukrainian economy. While revenues in some segments of the telecom market went down, internet access market showed two-digit growth. Telecom services penetration among the Ukrainian population continued to grow.

- In H1'2010 Ukrainian telecom market increased by 2.7% compared to H1'2009. We expect that in 2010 telecommunication services market will recover from economy cool down in 2008-2009. However, market still suffers from the devaluation of national currency in 2008, when average exchange rate for USD has rapidly fallen for 60% (from 5 UAH/USD to 8 UAH/USD).

In 2010 the situation is even better. Telecom market is growing again as mobile communications returned to growth path, and internet penetration reached 34% by November 2010² giving push to providers' revenues.

Structure of Ukrainian Telecom in 2009.

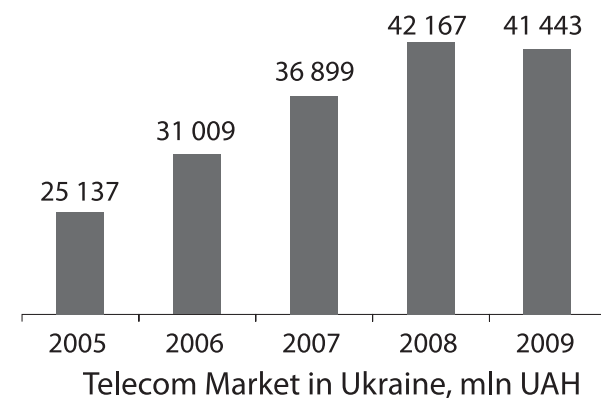


Source: SSCU data

General market overview

- In 2009 total size of the Ukrainian market of telecommunication services reached 41.44 billion UAH³. Due to the depression that deeply impacted the Ukrainian economy, telecommunication market declined by 2% compared to year 2008.

Telecommunication market size in Ukraine, UAH mln, 2005-2009.



Source: SSCU data

² GfK Ukraine nationally representative survey data.
³ According to State Statistics Committee of Ukraine (SSCU)

- Mobile communication is the largest segment of telecom market. In year 2009 its share was approximately 66% with total revenues of 28.48 billion UAH.
- Internet access is a segment of telecom market with the highest growth rate. In 2009 Internet access market size was twice as much as in year 2007.

Mobile communication market

- There are 7 national mobile carriers in Ukraine, which operate 3 different network technologies: GSM 900-1800 (Kyivstar, MTS, Astelit), CDMA-800 (CDMA Ukraine, Intertelecom, People. Net), CDMA-450 (MTS mobile broadband), UMTS-2100 (Ukrtelecom).



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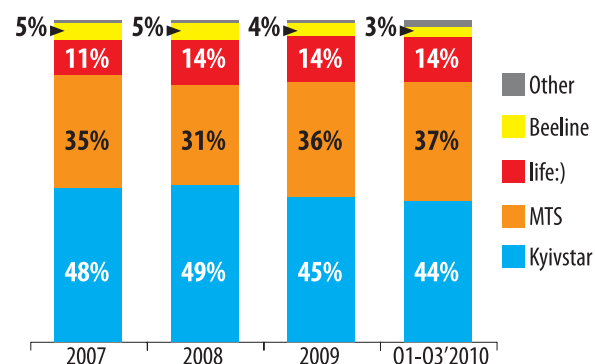
- Unlimited calls in life:) network
- Best cost calls to other mobile operators in Ukraine and abroad
- Without connection fee



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Індивідуальні мобільні рішення

Market share by active subscribers, 2007-2010



Source: GfK Ukraine survey data

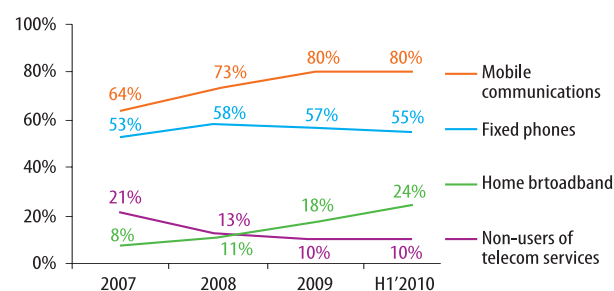
- Currently there are 56.6 millions of active SIM cards in Ukraine, with nominal penetration around 120%⁴. 80% of Ukrainians older 16 years old declare to use mobile services permanently in Q3'2010⁵.
- In 2009 Ukrainians cut down expenses on mobile communication because of the impact of financial crisis. In 2008 average declared expenses on mobile services were 50 UAH per month compared to only 39 UAH in 2009⁶. Nominal ARPU calculated by active SIM-cards is around \$4.
- In 2010 main mobile operators did little investment in mobile networks development, because licenses for 3G UMTS 2100 networks were still unavailable, and network coverage and capacity was enough for existing services. Ukrtelecom – the only 3G UMTS operator – developed its network in a slow pace.
- Main news in the segment in 2010 was in M&A field. In late 2009 main shareholders of Kyivstar – Telenor (Norway) and Altimo (Russia) announced a merger of their Ukrainian assets – Kyivstar GSM, Ukrainian Radiosystems and Golden Telecom (Beeline Ukraine), and establishing new management company Vimpelcom (NYSE: VIP) with headquarters in Amsterdam. In 2010 Antimonopoly committee of Ukraine officially allowed this

merger. On November 16th, 2010 it was announced that brand Beeline would disappear from the Ukrainian market, and Vimpelcom will continue developing only Kyivstar and djuice brands. Beeline's GSM mobile, fixed-line and FTTB broadband access networks will be integrated into Kyivstar's infrastructure.

Internet access market

- In 2009 Internet access market reached size of 2.9 billion UAH⁷ that is 38% more compared to previous year.
- Ukrainian internet access market faced a dynamic growth within last years - home broadband penetration increased from 8% in 2007 up to 24% in 2010⁸. Average annual growth rate is still 30% and we don't expect change in this trend within next 2-3 years.
- During last years Internet access and especially mobile Internet became the main driver that stimulated growth of the whole telecommunication market. During 2009-2010 all mobile operators focused on this segment of services and launched a wide choice of offers. Nevertheless, Ukrainian Internet access market is still highly fragmented with a large share of small local Internet providers, especially in large cities.
- Ukrtelecom is the largest Internet provider in Ukraine. In Q2'2010 its subscriber's base was 993 thousands of users⁹.

Usage of Telecom services in Ukraine in 2007-1H'2010



Source: GfK Ukraine survey data

⁴ According to iKS-Consulting monthly report
⁵ GfK Ukraine nationally representative survey data.
⁶ GfK Ukraine nationally representative survey data.

⁷ According to SSCU.
⁸ GfK Ukraine nationally representative survey data.
⁹ According to iKS-Consulting.

Market share of Internet providers in Ukraine in 2010

Provider	Market share
Ukrtelecom	34.40%
Kyivstar	7.2%
MTS	6.1%
Volia	5.9%
life:)	3.5%
VEGA	3.0%
People.Net	2.9%
Beeline	2.2%
Intertelecom	2.2%
TeNet	1.5%
IP Net	1.3%
Triolan	1.1%
Other	28.8%

Source: GfK Ukraine survey data

- In future, with developing 3G and 4G mobile networks this will cause heavy competition between cable FTTx providers and mobile operators. In 2009 two new companies launched mobile WiMAX networks 802.16e in Ukraine. Intelcom, owned by Arabian investment holding Vtel, runs WiMAX network in 2.3-2.5 GHz that operates in Kyiv and Kharkiv, and FreshTel, owned by Intel Capital and Icon Private Equity, develops network in 3.4-3.6 GHz. Mobile WiMAX allows to offer mobile broadband access with speed up to 20 Mbps.
- However, we expect that only providing major GSM operators with UMTS licenses will give real impetus to mobile broadband development in Ukraine.

Fixed-line phones

- Despite the significant growth of internet access market and stabilization in the mobile services market, there is a clear trend of decline on fixed phone market.

- In 2009 total revenue of fixed-line phone operators was at 8.8 billion UAH¹⁰. It is still the second largest segment in Ukrainian telecom business. Nevertheless, this market suffers from an advantageous substitute – mobile phones. Since year 2007, when it reached a peak of 9.7 billion UAH, it demonstrates a negative dynamics by declining 5% per year.
- This trend is also observed in 2010. In first half 2010 this market segment has already decreased by 2.2% y-o-y.
- Ukrtelecom is a main operator for fixed line phones. Its market share is over 90% in the segment of fixed telephony.
- Ukrainian customers abandon from using fixed line phones. Two years ago fixed line penetration reached the peak at 58%¹¹ and now is decreasing at a slow pace. In H1'2010 fixed line phone penetration was only 55%, and continues to decline.
- Announced privatization of state owned Ukrtelecom that should take place on December 28, 2010 could significantly change Ukrainian telecommunication market. Ukrtelecom was established in 1993 on the base of state owned telecommunication assets. Now this company has a monopoly position of fixed line phones market with around 9.5 million of subscribers, approximately 1 million of ADSL users, which is around 50% of broadband market, and owns the only 3G UMTS network in Ukraine that is used by 500 thousand subscribers. In addition Ukrtelecom has widely developed core fiber network with direct connections in Western Europe and Russia. So, future privatization on Ukrtelecom will cause a serious impact on market environment in Ukraine.

Sector outlook

- Ukraine still has a lot of opportunities in telecom sector, mostly concentrated in internet access market.

¹⁰ According to SSCU.
¹¹ GfK Ukraine nationally representative survey data.

Broadband market is supply-driven, and competition is fierce only in high-storey residential areas of large cities. High share of those claiming that low-speed GPRS/EDGE mobile internet is their main means of internet access shows that broadband infrastructure is very underdeveloped.

- There is an expectation that 2011 will show significant growth on telecom market that will be mostly concentrated in internet access segment. However, its pace will be very dependent on regulatory policies that could either push or curb mobile broadband development in Ukraine.
- Another key regulation that will influence telecom market in 2011 is expected implementation of mobile number portability (MNP). It will increase competition on mobile communications market, opening new opportunities for mobile subscribers.

Changes in regulation of Ukrainian telecommunication market in 2010

On June 24th, 2010 AMCU passed one of the most important regulations on the Ukrainian telecommunication market since 2003, when Calling Party Pays approach was introduced. AMCU officially claimed all 8 mobile operators of all networks standards to be monopolists on the market of termination of calls on their networks. Basically, this means that interconnection rate between all networks should be set not by a mobile operator itself, but by National Commission of Regulation of Communications (NCRC).

Regulation of interconnection rate is among the most significant problems of the Ukrainian telecommunication market. Before this decision mobile operators could unilaterally set termination rate, which was set at 0.5 UAH per minute by two incumbent operators. This worked as market entry barriers for challenger operators and was a reason for permanent conflicts between mobile operators.

As call termination rate became regulated, in October 2010 NCRC has set new unified rates for operators' interconnection. For PSTN networks call termination rate was set as 0.25 UAH per minute and for mobile networks — 0.36 UAH per minute. This decision will have positive impact on Ukrainian telecommunication market by creating equal opportunities for all mobile operators and stimulating competition, as well as preventing conflicts between market players.

However, there are still a lot of regulatory challenges on the Ukrainian telecommunication market. For now, main mobile operators still couldn't receive licenses for UMTS 2100 that negatively affects mobile operators' service development and a choice of mobile Internet offers available for Ukrainian customers. 3G tender is expected in 2011 but there is still high uncertainty related to this decision. The transparent procedure will move the whole telecommunications market forward. That is why cooperation of all the parties involved (mobile operators, legislative bodies, telecommunication equipment providers, etc) is vital.

There are other European and international regulation best practices that are yet to be adopted in Ukraine: radio frequency licensing policy in Ukraine created deeply fragmented radio spectrum that is dispersed between different mobile operators. Currently, mobile operators support an idea of radio frequencies refarming and technological neutrality. This will allow mobile operators to develop new mobile technologies, such as 3G and 4G on already licensed radio frequencies, make an exchange of radio bands for network optimization, and upgrade current mobile networks to latest technologies such as UMTS-900 and LTE (Long Term Evolution networks).

Mobile number portability is another challenge and opportunity to improve market environment and intensify competition between mobile operators. MNP is a tech-

nology that enables mobile phone users to retain their mobile numbers when changing from one mobile network to another.

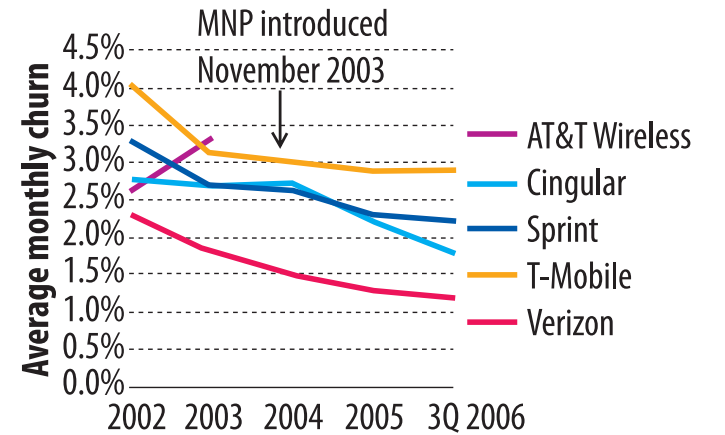
On September 6th, 2006 draft law #2047 "On Amendments to the Law of Ukraine "On Telecommunication" regarding the expansion of the list of services was registered in Verkhovna Rada. This legislative act triggered the process of MNP introduction in Ukraine. On June 7th, 2007 amendments to the Law "On Telecommunication" were accepted by Parliament in the first reading. Unfortunately, further readings were not conducted. However, anticipating MNP introduction, in 2007 Ukrainian Center of Radio Frequencies (UCRF) established a "Consortium of numbers support". This Consortium was authorized for mobile number portability management in Ukraine.

Finally, the process was brought out of a stalemate in 2010. On July 1st, 2010 Verkhovna Rada has passed amendments to the Law of Ukraine "On Telecommunication" that created legislative basis for MNP in Ukraine. According to the Law, MNP should be implemented within 6 months after the Law is divulgated, i.e. in January 2011.

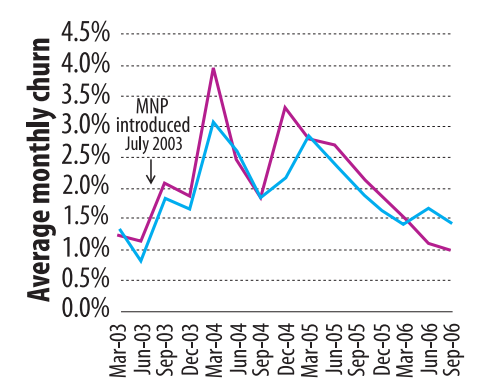
There are two different types of realization of MNP. First type is based mainly on sophisticated mechanism of calls forwarding from donor mobile network. Alternative way requires a creation of special database with all national mobile phone numbers. For now the market expects the second type with central coordination database to be launched in Ukraine. UCRF consortium is expected to operate this database.

International experience of MNP implementation has wide range of different cases. MNP was firstly launched in Singapore on April 1st, 1997 and is available in United States since late 2003. Currently, MNP is an obligatory service for telecom operators in all EU member countries.

Mobile subscribers churn before and after MNP introduction in the United States



Mobile subscribers churn before and after MNP introduction in Finland



In United Kingdom and Netherlands only 7% of subscribers used MNP since it was launched in 2009. In Australia since 2001 28% of mobile subscribers tried MNP and changed their mobile operator. However, in Finland since July 2003 54% of mobile subscribers migrated from mobile operator to another and retained their phone number. Analysis shows that terms and conditions of MNP as well as market competition level have significant influence of churn after the introduction of MNP.

The market expects that after MNP implementation in Ukraine churn rates will significantly increase. On individual market overwhelming share of prepaid subscriptions will help it as most of subscribers have no contract obligations. On corporate market MNP will remove one of the largest barriers to switch mobile operator—fear that number change will result in lost of potential business. We predict

that MNP introduction will result in price competition during the first six months, especially on the corporate market and

increased accent of operators on the customer care which bring additional value to the end users.

Convergence as the Engine of Progress

by **Oleg Balaban, Head of Convergence Services**
Department MTS Ukraine



Familiar to everybody today contemporary telecommunications sphere is a relatively new business. Indeed, the history of mobile communications and the Internet counts just few decades. In the 70-80th years of the past century cellular communication was used only for networks that served first wireless phones in cars. No one could imagine then that just in few decades portable mobile phone will be in the pocket of every person. The world's first telephone dial up connection was committed in 1990. Nowadays almost every big city in the world is enveloped in a fiber network that allows data transfer at speeds of 100 Mbps and faster.

Mobile operators and Internet providers began competing aggressively with companies providing fixed telephone services. All of them were basically doing the same — providing communication services — but in different ways. Consumers choice, as a rule, depended on the price. But people also preferred new types of telecommunications and services, as they were more convenient and handy for information transfer. This continued until three diverse and once dissimilar communications — fixed line, mobile and Internet-access — gradually began to converge.

For example, in the early 2000's cellular networks subscribers began using high-speed mobile access to the global network. At this time European operators started to receive licenses for third generation communication (3G). Fixed telephony was slowly developing as well, although not as rapidly as wireless services. It became possible to send text

messages and arrange video conferences using a fixed phone, etc.

Clear convergence trend in contemporary communications and interpenetration of diverse technologies will become stronger in the coming years and will inevitably lead to new services and consumers devices. For example, new, pretty unusual at first glance devices — tablet computers — started to appear at the market. They are a cross between computers and mobile phones. There is no telling that it was most recent invention — Swedish Ericsson released a “pad” prototype in the early 2000s. But at that time access to Internet was not yet as widely spread and available as today and was provided mainly on the basis of wire technologies. No one could even think of convergence with wireless networks, it just didn't exist. Scandinavian gimmicks turned out somewhat premature and therefore didn't find understanding. While Apple CEO Steve Jobs seems to have a special talent for guessing about new devices well-timed for the market and highly demanded with consumers. Both iPhone and iPad set the tone in the consumer devices market.

Rapid the World Wide Web development pushes not only users' devices to move towards each other, but also services people using the devices for. Today people do not feel much difference between web-pages loaded on a smartphone or a desk-top. Fixed telephony is moving to IP-telephony. These days subscribers tend to make calls through Skype-like programs instead of using their fixed-line phones.

Prepared by:



It is not difficult to predict further convergence of different types of telecommunication services. Main obstacle on the way of merge mobile and fixed networks services — are the technology shortcomings. At the moment possibilities of data transmission in fiber networks are several times bigger than in wireless networks. Launches of high-speed LTE (4G) networks in some countries (Sweden, Norway, USA) give reason to hope that gap between wire and wireless services will be bridged in the near future. LTE Advanced laboratory tests demonstrate data transfer speed exceeding 1 Gbps. This shows that difference in data services provided in mobile and fixed networks will hardly be felt soon. Data transport will also be common for all technologies. Modern All-IP-based trunk transport networks will allow to deliver any information and content to computers, mobile phones or TV.

Accordingly, consumer devices of the future will be optimized for unified access. Obviously, their frame and design will mostly depend not on voice any longer but on video and multimedia content transfer.

Operators, who will soon connect all subscribers to all possible services, will compete by means of quality of services and their diversity. Price wars will cease to be the major competition weapon.

Companies will try to provide to subscribers as many innovative telecommunication services as possible at most attractive terms. Special price proposals will become possible thanks to integrated transport and billing systems used by operators for the whole scope of wire and wireless services. In addition, companies will be able to develop innovative niche services, not yet demanded on a massive scale, but attractive to most advanced consumers. Subscribers will also get a number of advantages, major of which — one bill for all services at most attractive price instead of separate bills for mobile and fixed telephony, Internet, TV. The main effect of convergence — benefits for both consumers and the market.

The era of global convergence have not yet come to Ukraine. Mainly due to the fact that the market has not yet taken final shape, although is very close to this. A decade ago two big companies — MTS (formerly UMC) and Kyivstar — formed the basis of a new mobile communications market in Ukraine. As the number of mobile subscribers grew fees for mobile services went down. More people preferred mobile telephony to fixed services. Competition became stronger in 2004-2005 after two more GSM-companies — Astelit (life:)) and URS (TM Beeline) entered the market.

By 2010 mobile operators formed their market shares. Their total annual turnover exceeded 25 billion hryvnias. Once biggest fixed operator Ukrtelecom lost leadership and profits in a number of areas in telephony. At the same time, the state operator succeeded in developing fixed Internet access services, switched about 1 million subscribers to its network. Until recently, only one Ukrainian provider could compete with Ukrtelecom in the fixed internet access market — Volia, largest cable TV operator in the country. But it suspended expansion to the regions last year, Volia strongly lagged behind the state-owned company. Leaders of the Ukrainian telecom market try to provide the full scope of services to private clients. For example, MTS apart from mobile voice services provides mobile internet access in its second and third generation networks. The company has biggest in Ukraine 3G coverage — more than 200 cities overall.

Most rapidly fixed-to-mobile convergence (FMC) is developing in the corporate market. MTS is an unquestionable leader in this area. It serves about 60% of all corporate clients in the country and started to develop FMC corporate services, including mobile services, Internet and fixed telephony, still in 2003. FMC-solutions are more in demand by big corporations. By experience a company with 100 mobile and 20 fixed numbers is more likely to be interested in a private business network for all its fixed and mobile numbers. Or, for instance, preferential



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fees for calls from fixed to mobile phones and vice versa. According to expert estimates big businesses can save up to 25-30% of their communication bill monthly due to FMC solutions.

As for the Ukrainian mass market, converged solutions are just emerging there. People will be able to experience benefits from convergence to the full extent only after Internet + TV + phone in one package becomes common practice. Obviously this time is not far off.

In addition to telecom convergence interaction between different markets and industries emerges. Most interesting processes will take place at the junction of industries, in adjacent and related areas. For example,

data transfer and billing telecom solutions can be useful in energy industry. MTS has implemented integrated data transfer solutions for big power generating companies. In Nordic countries a possibility of power lines monitoring system on the basis of telecom networks is being discussed. Introduction of such system will allow to control peak electricity consumption by households. Perhaps the most interesting converged solutions will emerge in the field of machinery. More and more industries start using the so-called M2M services — Machine-to-Machine connection. In the coming five years telecommunication operators are planning to switch on billions machines throughout the world to their networks in order to control their use, increase efficiency and reduce energy consumption.

9. INVESTMENT POLICY

Financial risks associated with investments in Ukrainian companies



A foreign investor that intends to invest in Ukrainian companies or to buy a stake in a Ukrainian company (further: to invest) will meet the following financial risks associated with Ukrainian business:

1. Maintaining of accounting records and preparation of financial statements are based on Ukrainian GAAP. However Ukrainian GAAP were implemented based on IFRS conceptual framework, some differences exist. The differences relate to bookkeeping of certain transactions as well as to applicable bookkeeping practices. Ukrainian companies keep their records not after the transactions were completed but after receiving documents that support the transaction (so called “source document” principle). Such bookkeeping practice is a heritage of tax accounting and does not match with faithful representation principle of IFRS. As a result, accounting records made based on local GAAP do not reflect the substance of business activity. Consequently, during the analysis of financial performance and financial position of a Target company, vague trends that even management cannot explain arise. So there is a risk of making wrong investment decision based on inadequate financial information.

Where the company’s financial statements are prepared following local practices on the basis of “primary/supporting document” principle, special adjustments are required to use financial statements for investment decision making. Consequently, during financial Due Diligence procedures, adjustments related to local bookkeeping practices should be made to align financial information with IFRS conceptual framework.

2. The next peculiarity of financial accounting based on Ukrainian GAAP concerns accruals. Ukrainian companies seldom perform accruals regarding transactions carried out with no supporting documents. Thus, the information about the actual liabilities of the company is not always represented in the statement of financial position. That is why there is a risk of incomplete representation of current liabilities in financial statements.

It is worth mentioning that there is a program of transition to IFRS in Ukraine (insurance companies, banks and public companies will be obliged to prepare financial statements according to IFRS since 2011).

3. Separate tax accounting. Unlike the common world practices, tax reporting in Ukraine is not in any way connected to financial accounting. Tax base is calculated based on the “first event” principle (so the basic principle of accounting – accrual basis is not applied in tax accounting). Thus, to ensure that tax base (corporate income tax and VAT) is estimated correctly, a special tax audit must be performed. During the assessment of tax risks even audited financial statements are not useful.

It is also worth mentioning that from the January 1st, 2011, the new Tax Code is expected to be effective, which will fundamentally change the tax system of Ukraine and bring together the tax and financial accounting (the data of financial accounting will be accepted as a basis for determination of tax base).

4. Tax evasion and use of optimization schemes. Tax evasion is widespread among Ukrainian companies. However, unlike the

world practice of tax planning through the use of jurisdictions with a low tax rate, Ukrainian business uses other methods, based on dummy transactions. Dummy transactions influence not only data of tax accounting but also distort the data of financial accounting. That is why during the financial Due Diligence procedures, the financial data need to be adjusted to eliminate any “optimization” transactions, which have nothing in common with the company’s business activities.

The other side of using the Ukrainian methods of tax optimization is incomplete representation of income and expenses. The major portion of income and expenses related to business activities are not represented in accounting records, and therefore in financial statements, therefore distorting the financial performance. That is why additional expenses may be incurred subsequent to the investment made, which were not taken into account during the investment decision making, which will significantly impair the effectiveness of the investment. Unrecorded Income might not be subsequently stated in financial accounting records, since business partners refuse to change the worked out format of business relationships. Such income cannot be neither represented in financial statements, nor confirmed by the auditors’ report, which significantly reduces the investment attractiveness of a company and its ability to raise financial resources on favorable terms.

5. The peculiarities of management accounting. Because of the practice of intensified tax optimization, financial statements do not reflect the actual financial performance and are not suitable for pre-investment analysis (it is not always possible to adjust all “optimization” transactions). In such case management accounting may be helpful, which is used in local practice not only to make management decisions, but also as an alternative for financial reporting. However, management accounting also has certain features that must be taken into consid-

eration during pre-investment analysis, which significantly influence the investment decision making. First of all, Ukrainian companies mostly keep management accounts using the cash method of accounting. It means that the basic principle of financial accounting – the accrual basis is not applied. Moreover, income and expenses comprise also indirect taxes, VAT in particular. That is why management accounts cannot even partly replace financial statements in terms of obtaining reliable financial information, since management accounting data do not even correspond to the basic principles of financial accounting. It is also worth mentioning that management accounting generally does not contain the full financial reporting package: usually only a statement of cash flows is prepared; and since the accrual basis is not used, both income statement and analogue of statement of financial position are not available. That is why management accounting is not suitable for making a reasonable investment decision, because it contains no data on the company’s financial performance and cost effectiveness.

However, if an investor still made a decision to use the management accounts during the pre-investment analysis, then information about the income and expenses must be adjusted for VAT amounts. The company should also present the analogues of income statement and statement of financial position. In respect of the adjustments to income and expenses regarding VAT, it should be mentioned that it is a rather laborious task. In Ukraine there are special tax treatments for the non-VAT payers. That is why the adjustment procedures may require analysis of almost every transaction separately.

Therefore, using the management accounting data for the purposes of investment decision making without additional adjustments is subject to the risk of distortion of financial information and hence making “overoptimistic” decision, which may substantially reduce the investment effectiveness.

6. Unrecorded liabilities regarding founders' pledges. Since all the above factors do not allow to use the financial statements as a basis for making an investment and credit decision, it is a common practice in Ukraine to pledge the property from other companies as collateral to guaranty founders/shareholders liability for credit relations with banks. Thus, it is probable that the company's property is pledged as collateral for credit liabilities of other company of the founder (these obligations have no relation to the business activities of the company). Such liabilities are very tricky, since they are not disclosed in financial statements (but only in off-balance-sheet accounts). It is quite difficult to identify such liabilities, if they are not stated in the off-balance-sheet accounts in violation of the financial accounting requirements. It creates the risk of both additional financial losses and the loss of company's property after making the investment.

7. The procedures of administrative or court appeal of accrued additional tax liabilities and penalty provisions. According to Ukrainian tax legislation, in case a company does not agree with accrued additional tax liabilities and penalty provisions, it has the right to initiate administrative or court appeal. During the appeal procedures, accrued tax liability is considered as non-agreed and is not to be represented either in tax reporting or financial statements. Accordingly, there are some serious risks of financial losses. Such risks can be minimized if the acts of tax

audits and the company's correspondence with tax authorities are substantively examined during Due Diligence procedures.

It should be mentioned, that according to the certain interpretations of new Tax Code, the tax authorities can exercise the right of tax pledge even during the period of administrative or court appeal.

8. Internal controls. Usually the internal control system in Ukrainian companies is under development. Internal audit services are seldom in place, and the company's business activities are strictly controlled by the founder. That is why a potential investor will have to strive for establishment of internal control system and to prevention from possible loss of assets and outflow of financial recourses.

All these and other factors, related to generally accepted business and accounting practices in Ukraine, bear considerable financial risks for a potential investor who is not aware of the peculiarities of Ukrainian business environment. At the same time, most financial risks can be prevented or minimized if they were identified during Due Diligence procedures.

Moreover, such risks should be considered during the negotiations regarding the investment, drafted in the investment agreement company's sales and purchase agreement, and also during the valuation of a Target Company.

10. LABOR AND EMPLOYMENT

Resolution of Individual Labor Disputes: a Comparative Analysis of the Draft Labor Code and the Code of Labor Laws of Ukraine

VASIL KISIL & PARTNERS
ATTORNEYS & COUNSELLORS AT LAW

by Oksana Voynarovska, Counsellor with Vasil Kisil & Partners Law Firm

The procedure for the resolution of individual labor disputes is regulated by Chapter XV of Code of Labor Laws of Ukraine # 322-VIII dated December 10th, 1971, as amended (the "CLLU"). Draft Labor Code # 1108 dated December 10th, 2009 (the "Draft Labor Code"), which was submitted to the Verkhovna Rada of Ukraine for consideration in the second reading, contains Volume IX devoted to individual labor disputes.

Definition and Subject Matter of Individual Labor Dispute

Applicable labor laws do not define the concept of an individual labor dispute. As the Draft Labor Code defines this term, an individual labor dispute means differences between an employer and an employee in relation to executing, performing, amending or terminating an employment agreement as well as complying with labor laws. A tentative list of differences which may constitute the subject matter of an individual labor dispute is provided in Article 425 of the Draft Labor Code. In particular, the subject matter of an individual labor dispute may include differences regarding establishing and changing working conditions, complying with labor laws, collective agreements, a collective bargaining or employment agreement, and any other agreements between an employer and an employee.

Bodies Authorized to Consider Individual Labor Disputes

In accordance with the CLLU, labor disputes shall be considered by courts and

Labor Disputes Commissions (the "LDC"). The LDC is a mandatory primary authority to consider labor disputes, which deals with all categories of disputes, other than those falling within the exclusive competence of courts (Article 224 of the CLLU). However, according to Article 124 of the Constitution of Ukraine, justice in Ukraine shall be administered exclusively by courts. Therefore, upon the adoption of the Constitution of Ukraine in 1996, the parties may refer any labor disputes directly to courts without previously submitting them to the LDC.

The list of labor disputes, which may be settled by the LDC, is not limited by the Draft Labor Code as opposed to the currently effective CLLU. In this connection, the Draft Labor Code contains an unclear provision stating that the courts shall consider individual labor disputes upon application of an employee if the disputes are not to be considered by the LDC.

In addition, the LDC's legal status has been drastically changed: from the [mandatory] primary authority to consider individual labor disputes, the LDC has been transformed into a conciliation authority to be set up to "settle individual labor disputes by finding mutually acceptable solutions and conciliating parties to such disputes." In accordance with the Draft Labor Code, court shall be the only authority competent to consider individual labor disputes while the LDC shall perform conciliation functions only.

Settlement of Labor Disputes by the LDC

As provided by the Draft Labor Code, the LDC may be set up at all companies, regardless of their staff number, by agreement between an employer and a trade union representative. It should be reminded that the effective labor legislation stipulates that the LDC may be set up only at those companies where the total staff number is at least 15 people.

The Draft Labor Code has changed the procedure for setting up the LDC. Thus, according to Article 429, employees and an employer shall be equally represented at the LDC, while, as specified in the CLLU, the number of employees represented at the LDC shall be at least a half of the LDC's members. The number of LDC's members shall be determined by mutual consent between an employer and a trade union representative.

It should be highlighted that, pursuant to the Draft Labor Code, an employer shall nominate its representatives to the LDC by issuing its order while the employees' representatives to the LDC shall be elected by the general meeting of the labor collective or by a primary trade union organization.

Similarly to the effective CLLU, the Draft Labor Code obliges the employer to provide the **organizational and technical** support to the LDC.

According to Article 225 of the CLLU, an employee may apply to the LDC within three months after he/she has or should have found out about the infringement of his/her right and, in the case of salary disputes, an employee shall not be limited in time. It should be stressed that the LDC may restore the set period of time if such period of time is not met for valid reason. The Draft Labor Code does not set the time period for applying to the LDC. Thus, an employee may apply to the LDC for the protection of his/her rights within any time whatsoever.

At the same time, according to Article 431 of the Draft Labor Code, before applying to the LDC, an employee should first apply directly to his/her employer (provided that the existing differences between the employee and the employer have not been settled within two weeks).

In accordance with the effective CLLU, an LDC's meeting shall be valid only if attended by at least two thirds of the LDC's elected members. According to Article 433 of the Draft Labor Code, an LDC's meeting shall be valid only if attended by at least one-half of the LDC's members.

As provided by the Draft Labor Code, the period of time for LDC to consider individual labor disputes has not been changed and is 10 [presumably calendar] days; if a dispute is complicated, the LDC shall be authorized to extend this term but no more than to 15 calendar days.

As contemplated by the Draft Labor Code, the LDC shall take its decision upon consent of all commission members participating in a session, but not by a majority vote of all members present thereat as it is provided by the effective CLLU. Should at least one LDC's member disagree with the decision proposed to be rendered, such decision shall be deemed to be failed (part one, Article 435 of the Draft Labor Code). Since the LDC's objective shall be to conciliate the parties to the labor dispute, the LDC's decisions may not be adopted by a simple majority vote. Thus, reaching a consensus between all commission members is a pre-requisite for taking a decision, which will enable to ensure high level of voluntary performance of the LDC's decisions.

If the LDC's decisions are not performed on a voluntary basis, the applicable labor legislation provides for the enforcement of such decisions. Thus, according to Article 230 of the CLLU, if an owner or its authorized agency fails to perform the LDC's decision within the prescribed period, the LDC shall issue a certificate to an employee, which certificate shall have the effect of a writ of execu-

tion. The LDC's decision shall be enforced on the basis of such certificate submitted to the state enforcement service no later than three months of its issuance date.

In accordance with Article 438 of the Draft Labor Code, the LDC's decisions shall be binding upon the parties to an individual labor dispute and shall be performed by an employer on a voluntary basis within the period prescribed by such decisions. Thus, the Draft Labor Code provides only for a voluntary performance of the LDC's decisions by an employer.

At the same time, necessary amendments have not been made to the Law of Ukraine "On Enforcement Proceedings" and, thus, if such Draft Labor Code is adopted, the LDC's certificate shall continue to be an enforcement document. Only an employee shall have the right to appeal against the LDC's decision in accordance with the Draft Labor Code of Ukraine (as opposed to the currently effective CLLU). The latter may be treated as an additional argument in favor of a point about an exclusively voluntary procedure for performance of the LDC's decisions in the Draft Labor Code. In other words, the reason why an employer is deprived of a right to appeal against the LDC's decisions is because such decisions are not subject to enforcement.

Individual Labor Dispute Resolution Procedure

Under the Draft Labor Code, the general limitation period for individual labor disputes has been extended from three months to three years. The limitation period for filing a statement of claim for illegal dismissal has not changed and remains set at one month. The Draft Labor Code provides the same limitation period for filing claims regarding transfer to another job or unlawful denial of employment. Meanwhile, it is a positive thing, in our opinion, that the Draft Labor Code states specifically that limitation period will not apply only to claims for payment of accrued but delayed wages and salaries,

and not to any claims originated from remuneration for labor (part 2 of Article 440 of the Draft Labor Code).

Just like the current labor laws, the Draft Labor Code exempts employees from payment of state duties and court costs.

The Draft Labor Code does not limit the paid period of forced absence in a situation where an employee is illegally dismissed. Thus, an employer will have to pay an employee his or her average wage or salary for the entire period of forced absence (or a difference in earnings for a lower-paid job period) should the respective court proceedings end in favor of the plaintiff. It should be mentioned in this context that part 2 of Article 235 of the CLLU provides that for illegally dismissing an employee, the employer must pay such employee his or her average wage or salary for the period of forced absence or a difference in his or her earnings for a lower-paid job period, but not more than for one year (except when the case has been pending for more than one year through no fault of the employee). Meanwhile, under the existing court practice, courts often rule that employees should be paid their average earnings for entire period of forced absence without any period limitation.

In contrast to the current CLLU, the Draft Labor Code does not provide for the employer's obligation to pay dismissed employees their average earnings for the entire period of delay in the return of their work record books. Meanwhile, a work record book is one of the necessary documents that need to be provided by an employee when entering a new job. An employee is thus unable to secure employment in line with the requirements of applicable laws due to his previous employer's wrongful failure to duly return his or her work record book.

Like the current CLLU, the Draft Labor Code provides that if respective final judgment are delayed for a dismissed employee through the employer's fault or if the employer fails

to timely comply with a judgment to reinstate a dismissed employee in his or her job, the employer must pay such employee his or her average earnings for the entire period of delayed judgments (clause 3 of Article 127 of the Draft Labor Code).

Like the current CLLU, the Draft Labor Code provides for the financial liability of a company's officer for damages caused to an employee by illegal dismissal or illegal transfer to another position (payment of the employee's average earnings for the period of forced absence or for the period of a lower-paid job).

It should be noted in this context that the Prosecutor General's Office of Ukraine has recently launched an initiative to impose a greater liability on the officers for gross violations of labor laws, including for illegal dismissals. Thus, in November 2010, the Prosecutor General of Ukraine addressed the President of Ukraine seeking to submit the draft law authored by the Prosecutor General's Office of Ukraine for consideration by the Verkhovna Rada of Ukraine. This draft law provides that any dismissal of an employee for personal motives and any other gross violation of labor laws will be punishable with a fine of up to UAH 8,500 or with imprisonment for up to two years.

Just like the current CLLU, the Draft Labor Code provides that employers may be under an obligation to compensate their employees for moral damages.

A totally new provision of the Draft Labor Code in the context of labor dispute resolution is set out in part 3 of Article 442 of the Draft Labor Code. It provides that *"further to a motion by the employer and subject to consent from the employee, the court may, rather than re-instate such employee in his or her job, decide that such employee should be paid a compensation in the amount to be agreed between the parties, but in any event at least in the amount of his or her average earnings for a period of 12 months"*. Therefore, this provision allows a settlement agreement between the parties with respect to some claims and a judgment with respect to the other claims. In our opinion, however, it will be rather difficult to apply this provision in practice from a procedural standpoint.

Under the Draft Labor Code, just like under the current CLLU, a judgment to re-instate an employee, who has been illegally dismissed or moved to another job, is subject to immediate execution. The Draft Labor Code also prohibits reversal of judgments issued in labor disputes, except when the reversed judgment is based on false information or forged documents provided by the plaintiff.

Labor Disputes: Proposed Legislative Amendments

	CLLU	Draft Labor Code
LDCs		
Legal status	Jurisdictional authority	Conciliation authority
Establishment requirements	Companies with a total staff of at least 15 employees	All companies, regardless of their staff numbers
The number of the employer's and the employees' representatives in Labor Disputes Commissions	At least half of the members should be the employees' representatives	Equal number
Limitation periods for applying to Labor Disputes Commissions	3 months	Not prescribed

Quorum	At least 2/3 of the representatives	At least 1/2 of the representatives
Time frames for hearing a labor dispute	10 days of the filing date of the application	10 days of the filing date of the application
Decision-making procedures of Labor Disputes Commissions	A majority of votes	Upon consent of all commission members
Opportunities for challenging commission decisions in court	Commission decisions can be challenged both by the employer and the employee	Commission decisions can be challenged only by employees
Procedure for the performance of commission decisions by the employer	Both voluntary and enforced performance	Voluntary performance
Courts		
An employee's obligation to pay state duties and court costs	No	No
Limitation period under labor disputes	3 months	3 years
Limitation period for claims regarding dismissal	1 month	1 month
Limitation period for claims regarding transition to another job, denial of employment	3 months	1 month
A judgment to re-instate an employee in his or her job or move an employee to another job is subject to immediate execution	Yes	Yes
Reversal of a judgment	Forbidden, with several exceptions	Forbidden, with several exceptions
Employer's Liability		
Compensation for the period of forced absence	The employee's average earnings for the entire period of forced absence, but not more than for one year	The employee's average earnings for the entire period of forced absence
Compensation for failure to return the work record book to a dismissed employee	The employee's average earnings for the entire period of delay	No
Compensation for failure to make timely final judgments with a dismissed employee	The employee's average earnings for the entire period of delay	The employee's average earnings for the entire period of delay
Compensation for a delay in the execution of a judgment to re-instate an employee in his or her job	The employee's average earnings for the entire period of delay	The employee's average earnings for the entire period of delay
Compensation for moral damages caused to employees	Yes	Yes

The recruitment market: summing up the results for the year

In 2010, the labor market overcame its crisis. During the year we saw new foreign companies enter the Ukrainian market and open new offices (particularly in the FMCG and B2B segments). Mass reductions and lay-offs were a thing of the past. Most companies formed new development strategies based on the current market situation. In order to meet challenges and implement future plans they needed high-class professionals.

As far as went the major market recruiting trends in 2010, recruitment agencies were very active, especially when compared with the period from the end of 2008 and through 2009. Most orders mainly came from the FMCG market. Companies from the B2B segment contacted agencies very carefully. Pharmaceutical industry entities consistently cooperate with us in the same way they did before the crisis. Many banks have finally started to recruit through agencies, although generally they tried to search for personnel on their own. In the fourth quarter of 2010, however, banks opened recruiting tenders. This means that they are ready to restore pre-crisis levels of active interaction with agencies next year.

Demand structure

Natalia Lukyanenko, head of the B2C department and senior consultant with the recruiting company Brain Source International, notes that in the first quarter of 2010 the number of resumes far exceeded the number of vacancies. "In the third quarter of 2010," Natalia says, "activity among candidates decreased and the number of CVs decreased by 20%. This was a function, first of all, of the holiday period and candidates' desire to start job searches and 'new lives' in the fall. Conversely, employer

BRAIN▲SOURCE INTERNATIONAL

activity increased. Companies continued to work steadily and thrive throughout the year. Some companies prepared for an autumn market revival beforehand, opening vacancies in advance so that employees began work in late summer or early autumn."

It is worth noting that there were vacancies for top managers in 2010 in both the B2B and B2C markets. In addition, primary among the positions that started to gain popularity this year were marketing vacancies (brand managers, trade marketing specialists). Vacancies for HR managers/directors were in second place, as were those for narrowly focused professionals in the banking sector. These positions were reduced during the crisis, but in 2010 companies again began to fill those posts.

Still, just as last year, FMCG specialists and different categories of IT professionals were in demand. For comparison, in the same period in 2008 companies were mostly looking for professionals from finance (banks and insurance and investment companies), the construction sector, and manufacturing.

Industry focus

In the crisis period companies reduced budgets, a trend that extended to personnel departments. Companies were forced to lay off HR professionals, so many managers and HR directors had to be universal workers, which significantly increased the range of their functions. Unfortunately, this year few companies changed this situation. However, as we already noted above, HR positions finally started to become available. Companies reduced costs on personnel searches through recruitment agencies. Today, however, the number of orders at recruitment agencies and the costs of their

services have almost returned to pre-crisis levels. This trend will no doubt continue in 2011. A number of recruitment agencies, however, mostly those that are not members of major networks, are still working for minimum rates because they have no other competitive advantages.

The question of motivation, loyalty, and retention of key employees given minimal budgets was also important for companies in 2010.

Closer to the end of 2010 companies began to conduct personnel evaluations. Olga Beshka, a human resources management consultant from Brain Source International, notes in particular the following: "After the evaluation companies realized they need to change their methods of motivation. The new motivation system in the next year had to be structured around a business strategy. But due to a volatile economic and political situation, companies have been and will be disinclined to set long-term goals. Therefore, early next year, as in the second half of 2010, a half-year motivation system will prevail. Regardless of this, companies should work on improving productivity. This can be used in a performance management system, where there is a clear description of

goals (both short and long-term) and control of achievement and feedback on the part of a manager. There must be a clearly established dialogue between a manager and an employee. The variable portion of a salary, one of the main components of motivation systems today, will be tied closely to an employee's willingness and attempts to accomplish pre-planned results. The second component will be non-material motivation. Its purpose is to increase an employee's interest in his work, which will be reflected in an increase of productivity and consequently of company profits. However, in addition to a formal approach that uses non-financial motivation to increase profits only, managers will also use it to raise corporate spirit and improve employees' self-assessments."

Nostalgia about the pre-crisis period should be a thing of the past. We all have to realize that we now face new conditions and that to be successful we need to put in more effort than we did before. We must define approaches that are needed here and now.

Flexibility, creativity, innovation: these help us stand out from the crowd, and today they require even more dedication if the maximum results are to be achieved.

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This service arose because of a growing need for companies to be more flexible and to support their own processes with a temporary labor force. In Ukraine staff leasing was born at the end of the 1990s in addition to agencies offering staff search and selection services. Up to now many agencies have offered it as an additional ser-

¹ Staff leasing — this terminology is widely used in Europe.

Is it profitable to recruit temporary staff?

Temporary staff gives a customer at least seven advantages, while the temporary employee gets at least one.

Without unneeded words

Temporary staff service (staff leasing¹) means providing a client with employees without their being permanently registered as members of the client's regular office staff.

vice. Presently, however, many of them are offering staff leasing as one of their main specializations. Historically this service has been known in Ukraine as “staff leasing,” but there is a more accurate name for it: professional employer services². This is a much broader service, as it means two different types of service:

- “staff leasing” means that a contractor provides a client with its own staff or searches for and selects candidates according to customer requirements.
- “outstaffing” differs from leasing in that personnel that works for a customer is officially registered as part of the contractor’s regular staff but actually continues to work for the customer’s company.

These works are executed according to an agreement on rendering services between a customer and company-contractor.

According to recent research by the world’s top HR companies, such as Hewitt Associates, one of the main trends on the world job market is overinflated expectations on the part of employees about employers. Today is clearly the time to change the term from the utilitarian “staff leasing,” which is more applicable to non-human resources, to “professional employer.” The term “professional employer” puts the accent more on workers, which is more consonant with the actual HR strategies of strong companies.

Using that term makes the meaning of the service more obvious, and it is clear what the service consists of. Service is ordered simultaneously by two parties: the enterprise that orders and pays for it and the temporary employee that is registered as contract staff. The company-contractor (a legal entity and professional employer) must provide an identical client-oriented approach for a company-client and temporary employee at all stages of service.

² “Professional employer organization” is also used in the abbreviation “PEO.”

The best employer

A “Best Employers” research project for Central and East Europe, conducted by Hewitt Associates (“Best Employer” research), shows that for the first time in history Ukrainian companies have entered the ranks of the top 30 best employers of Central and Eastern Europe. The research indicates that Ukrainian companies have showed that as economic indicators improve, so does the risk of losing talented employees. Also, the level of employee attraction grew, and companies used it as a good competitive advantage on the market.

Various people are needed

What types of temporary staffers exist?

As a rule, companies divide temporary staff into two categories:

- a) Low-skilled employees, so-called blue-collar workers;
- b) Various types of managers, so-called white collar workers.

Blue-collar workers are temporary staffing’s pioneers, given the specifics of the flow of goods and services in a modern economy. Success comes to companies that can find another effective method of increasing the speed of circulation of goods, tightly connecting it with upsurges in consumer activity. To react immediately to demand fluctuations, companies have implemented the practice of signing contracts to provide temporary workers periodically. Such flexibility is sought in many industries and is not rare on the Ukrainian market. For example, supermarkets sign contracts to obtain additional personnel for days off and holidays; airlines need temporary staffers during summer vacations and agriculture needs staffers to sell their products during the harvest season.

Temporary staffing on the Ukrainian market looks like this:

- production (large factories and so on that use blue-collar workers) — 54.5%
- offices and representative offices of western companies (white-collar workers) — 27.3%
- services (blue-collar workers) — 18.2%

Killing seven rabbits

Our experience with rendering professional employer service and monitoring demand and supply shows that the popularity of this service remains low among Ukrainian management teams. Even if they order this service, clients would rather seek employees with low qualifications. The switch towards using blue-collar workers is not completely casual. The matter is simply that, when they sign contracts with professional employers, Ukrainian companies focus on the benefits of hiring temporary staff when they desperately need to fulfill additional tasks. Western companies search first of all for a party to which to transmit the responsibility for these employees and the work they do.

As a whole, attracting a partner that provides temporary staffers brings new possibilities, which gives an enterprise at least seven benefits. They cannot be obtained via independent search, selection, employment, and administration of temporary employees.

So what benefits have Ukrainian business not yet gained?

- The ability to react rapidly to changing a business climate via an ability to increase and reduce temporary labor force volumes.
- Guarantees that business processes will not freeze in unexpected situations (due to lack of staff or other issues)
- Transparency: working with a professional employer is the most transparent way to address such matters; everything is done in accordance with the law.
- The ability to reduce and optimize department quantity (the accounting, HR,

IT, legal, and labor protection departments) according to the actual volume of business. This is done by transferring certain of these departments’ tasks to a professional employer.

Staff leasing gives a company the chance to use its labor force more flexibly. A company can have the exact number of employees it needs to perform the actual amount of work.

- Maintaining a company’s image by minimizing risks of lawsuits from personnel and risks connected with labor protection.
- Optimizing the skilled labor pool by selecting for the permanent labor pool the best specialists that the contractor provides (with an unlimited trial period). At the same time, the client can concentrate on its own staff development.
- Improving financial and economic indexes, such as: increasing employees’ income by diminishing the quantity of workers and redistributing expenses (salary-payment of services). This is important for companies that are planning to attract investment capital via IPOs.

Changes begin

Because of these benefits the demand for temporary staff is increasing in the business world. Demand for white-collar workers is thus also increasing. It is no secret that in countries with developed economies agencies specializing in leasing white-collar workers are common.

As a rule, white-collar workers come as a temporary staff most frequently in four cases:

- As administrative personnel (during vacations or periods of illness)
- To fill very narrow professional niches; they are invited for company projects for between a month and a year (SAP specialists are an example of this group);
- As top managers of international companies in cases of their dynamic rotation to different countries of the world;

- As employees of foreign companies without official representative offices in a country or sometimes as employees of official representative offices when companies can have only limited staffs.

ployer gets an official salary from a stable company. Additionally, a temporary employee is recommended to various projects at all of the professional employer's client companies.

A professional employer can often give a temporary staffer work that is practically permanent. White-collar workers thus understand the advantages of being selected for a professional employer's staff pool. A freelancer employed by a professional em-

A professional employer service is attractive not only to the client, but also to the temporary employee. It should not be surprising if some day the employee suggests this variant of employment to a future employer.

11. LEASING



Leasing Market: Overview and Trends

During 2010 new leasing business increased in comparison with 2009 for more than 100%. Thus we expect volume of new leasing contracts more than 4 billion UAH. In 2011 the leasing market will continue to grow with same dynamics. Such tendency will be caused by new positive changes in taxation of leasing operations and growing interest to leasing from banking groups (leasing operations are more secured than bank loans, after crisis reaction). Car leasing got stronger position in 2010 – the penetration rate increased to 2,5% in comparison with 2,1% in 2009. Month by month leasing companies increased their sales and reached more than 600 vehicles\ month (penetration rate 5%) at the end of the year. In 2011 we expect further increasing of importance of leasing for car sales up to 7% penetration in total sales.

During 2009-2010 quantity of lease market participants significantly decreased. For example on the car leasing market at the end of the year there are 13 lease companies, most of them owned by international financial groups, and just four companies operate in segment of car leasing with full service. To be competitive in 2011 companies will need to develop product line with new services which can bring added value to client's business, such as fleet management solutions, special programs for used fleet replacement with new cars etc.

Euro Leasing operates as one-stop shop provider of transport leasing and connected services with one invoice for the whole range of the products that client can use very easily in planning and budgeting. Euro Leasing offers special solutions such as:

- operational and financial leasing of all vehicles needed for business: passenger cars, LCVs, trucks;
- unique Fleet-online product – fleet ma-

agement with web access to the client's fleet database, the powerful tool for organizing the fleet's efficient operation and possibility to get the useful information online. In present market conditions, when optimization of business processes and expenditures proves to be one of the most pressing issues in business, this product is called upon to optimize and to improve the operations of large corporate fleets, which in turn increases their competitiveness. The basis of the Fleet-online is developed the data information system reflecting all cases about fleet activity, providing detailed reports about road accidents (incl. pictures), regular maintenance and repairs, mileage and fuel consumption as well for each car as for the whole fleet;

- unique multi-chain fuel card which accumulates services of five top fuel operators: Shell, LUKOIL, WOG, TNK, Parallel and thus covers all the territory of the country. Every customer can obtain online reports of fuel consumption as well as paper statement;
- additional services with ability to create individual service packages in accordance with customer needs: replacement cars, pick-up and delivery of the vehicle, seasonal replacement and storage of tires, driver services, technical support all over Ukraine, etc.;
- brokerage in transport insurance services (CASKO, TPL, PAI) for the customers with own fleets on beneficial conditions (similar with Euro Leasing fleet insurance conditions).

We expect that next year car leasing market volume will reach 24,000 cars. And in car leasing with services segment overall fleet will reach 11,000 cars at the end of 2011.

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Medeya Uridiya,
Euro Leasing account manager



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12. LEGAL SYSTEM OVERVIEW

Joint stock company law



Before the Law of Ukraine “On Joint Stock Companies” passed on September 17th, 2008, activities of Ukrainian joint stock companies were regulated by a separate section of the Law “On Business Associations,” which was adopted in 1991 (provisions of that law are still effective for limited liability companies, supplementary liability companies, partnerships, and limited liability partnerships). The Law “On Business Associations” contains numerous gaps and ill-conceived norms. Its shortcomings have had an especially negative effect on joint stock companies, since the legal framework of a joint stock company, which envisages the greatest degree of separation of ownership and control, sets much higher requirements for the reasonability, complexity, and balance of norms and mechanisms, in order to ensure effective management and reliable protection of shareholder rights.

However, the joint stock company legal model stipulated by the Law “On Business Associations” was primitive and inherited the shortcomings of the Soviet system of administration at “socialist enterprises.” This system had been based on non-legal methods (party and administrative control) and had proven totally unsuitable for market economy conditions. The main drawbacks of the Law were its establishment of “management tyranny” and regulation of shareholder relations on the winner-take-all principle.

That the executive body could be hired and fired exclusively by the general meeting granted managers a high degree of independence from shareholders, who couldn't exercise effective control over them. In addition, the mechanism for dismissing dishonest managers required from shareholders

excessive efforts at collective action (holding a meeting, coordinating positions, adhering to procedures, processing the decision) and took a long time (a 45-day notice was required to hold a general meeting). All this made replacing the management a complicated, expensive, and risky business. Dishonest managers had more than plenty of time and opportunities to disrupt the meeting, blackmail different groups of shareholders, or strip assets from a company. Another legacy of the Soviet legal system, with its ultra-positivist approaches, was the fetish of adherence to the form and procedures of appointment (or dismissal) of management, with complete disregard for the problems of responsibility personification (evaluation of the substance of managers' activities, assessment of motives in decision-making and of results achieved, and bringing to responsibility those guilty of cynical violation of shareholders' rights).

The winner-take-all principle provides a controlling shareholder (or the person that managed to gain temporary control over the majority of shareholder votes on general meeting) with the possibility of staffing a company's governing bodies only with persons loyal to him, while the rest of the shareholders are deprived even of a theoretical possibility to gain representation on the supervisory board or executive body. This enabled the person who has usurped control to run the company single-handed, reducing its activities to his or her own interests while the interests of all other shareholders are cynically ignored. In those circumstances, the controlling shareholder is usually engaged in asset stripping (if he is not sure of keeping control) or builds a system for skimming profits through related party transactions

executed on conditions unfavorable for the company. Profit skimming schemes based on related party transactions with entities connected to a controlling shareholder benefit the controlling shareholder by allowing minimization of tax payments and avoidance of paying a fair share of profits to other shareholders.

The Law “On Joint Stock Companies” of September 17th, 2008 should be regarded as a compromise between big Ukrainian capital, represented primarily by business empires (built as groups of joint stock companies) and the Securities and Stock Market State Commission (SSMSC), a special state authority in whose competence lays the regulation of the securities market and which has become the main addressee of numerous complaints by small shareholders concerning violation of their rights. While big Ukrainian capital planned to considerably improve its image in the eyes of foreign investors and to attract substantial foreign investments through the Ukrainian stock market (which demonstrated striking growth rates for a long time), the SSMSC tried to use that opportunity to solve what it considered the most critical problems the market was suffering from. However, in view of the financial crisis and mistakes made in the course of drafting, neither party reached its goals.

The formula for effective regulation of a joint stock corporation is to ensure the reliable protection of the interests of small shareholders (investors) while finding a balance for the issuers’ expenses for these purposes. The new Law offers investors only certain tools, however important, and does not ensure reliable protection. Meanwhile, the issuers’ situation is substantially deteriorated because additional unjustified requirements are imposed on them, some of which have no regulatory sense but require substantial expenditures. Despite this the Law “On Joint Stock Companies” could be considered an important step in improving the legal theory and practice of Ukraine’s corporate legislation.

Among the most important achievements of the Law “On Joint Stock Companies” the following should be mentioned:

- Improvement of principles for structuring joint stock company governing bodies and division of their powers. The supervisory board of a joint stock company has become an important center of decision-making, including important managerial decisions. This is expected to put an end to “management tyranny” and to compensate managers’ advantages in the sphere of information about a company’s situation. Now managers must support the supervisory board’s awareness of different spheres of company activities, since consistency of actions by the executive body and the supervisory board depends on that.
- Granting the supervisory board the right to appoint and dismiss members of the executive body (sub-paragraph 8, paragraph 2, Article 52) made it possible to finally minimize the risk of management’s getting beyond the control of the shareholders and conflicts between management and the board. The only significant drawback in defining the competences of company bodies is the lack of proper regulation of possible conflicts between the overall (unlimited) competence of the shareholder’s general meeting that, in accordance with the law, may discuss and take decisions on any matter (paragraph 1, Article 33), and decisions by the supervisory board on matters that are within its exclusive competence (paragraph 2, Article 52).
- An important step towards improvement of the situation regarding protection of minority shareholders’ rights is the introduction of mechanisms for cumulative voting for the election of the supervisory board. Mandatory use of cumulative voting mechanisms for the election of the supervisory boards of public companies (paragraph 3, Article 53) grants minority shareholders the possibility to elect their representatives to the company board

and in that way gain access to important information about company activities.

- A clearly defined mechanism for granting shareholders pre-emptive rights to purchase additionally issued stock in proportion to their shares in the company’s capital (Article 27) will enable minority shareholders to protect themselves against attempts to dilute their shares in the company’s capital.
- Possibilities for manipulation during convocation and holding of shareholders’ general meetings are now much narrower. Shareholders must be notified about the time and place of the meeting in due time and must receive sufficient information about items on the agenda, with proposed draft decisions enclosed. It is prohibited to discuss and take decisions on matters that were not mentioned on the agenda, and, by decision of the general meeting, the whole procedure, including the vote count, may be recorded (in audio or video form). The ballot voting requirement will make it possible to verify the correctness of the vote counting if doubts emerge.
- The mechanism for obligating a joint stock company to buy out its shares offered for redemption from those shareholders who voted against certain important decisions at the general meeting (Article 68) (appraisal rights) can be regarded as a powerful tool to protect minority shareholders. It is meant to deter controlling shareholders from violation of minority shareholders’ rights under the threat of investment withdrawal. It is difficult to overestimate the importance of this norm. The lack of a liquid market for the shares of most Ukrainian joint stock companies has deprived investors of even the theoretical possibility of “voting with their feet” in response to violations of their rights.

Other norms and mechanisms that protect investors’ rights in most cases have internal defects, which either preclude their use or

significantly reduce their regulatory effect. This concerns norms on related party transactions (transactions with conflict of interests) (Article 71), mechanisms to determine the market value of property (Article 7), and provisions relating to the responsibility of company officers (Articles 63, 72); on regulation of takeover (Section XI); and on requirements for auditor independence (paragraph 3, Article 75). Although those rules are ineffective and do not ensure a regulatory effect, they could be considered theoretically as grounds for the future development of sound concepts, as they indicate the right path to follow.

Unfortunately, the Law contains some provisions that demonstrate the danger of seeking simple solutions for complicated problems and of fighting consequences while ignoring their causes.

The lack of attractive instruments on the Ukrainian securities market, the result of the inability of most joint stock companies to meet minimally acceptable standards for market listing, as well as their managers’ reluctance to disclose information, cannot be rectified by obliging all public corporations to get and maintain listings for their shares on at least one stock exchange (paragraph 1, Article 24). Rough administrative pressure cannot change that the key factor in an issuer’s decision to obtain and maintain the listing is its choice to meet strict requirements (on significant expenses) in exchange for the possibility of attracting significant investment from the stock market (which for most Ukrainian companies is totally unrealistic). The absurdity of compulsory listing has become apparent to all, but this norm has caused panic among the top managements and major shareholders of many joint stock companies. They now fear everything related to stock markets and exchanges.

A ban on the sale of public joint stock company shares on the over the counter market (paragraph 1, Article 24) was a completely unsuccessful solution to the problem of lack of control over the OTC circulation of stock.

The ban cannot prevent agreements about sales of large blocks of shares outside the market, but significantly increased risks during small-scale transactions and produced an adverse affect on the attractiveness of shares as an investment instrument.

The demand for the calculation of shareholder votes needed for the approval of a decision by a qualified majority not on the basis of shareholders present at the general meeting, but on the basis of the total number of issued shares (paragraph 5, Article 42), can be explained only as an attempt to reinforce minority shareholder protection. But these good intentions caused huge problems. Making amendments to the company's charter will require the presence of shareholders representing at least 75% of issued shares (if all of them vote for it), while many Ukrainian companies currently face problems reaching the 60% quorum threshold required for a meeting to be recognized as valid (the latter is caused in part by minority shareholders' lack of interest due to their powerlessness). However, instead of protecting minority shareholders, that provision will force majority shareholders to increase their blocks and dilute minority shareholders simply to avoid decision making paralysis.

The requirement to send mail to shareholders with a description of the enclosure and a delivery notice (sub-paragraph 14, paragraph 1, Article 2) was also intended to protect minority shareholders and prevent management abuses. However, compliance with this requirement threatens with bankruptcy even companies with a low degree of equity dispersal.

The mistakes made are so apparent that it is surprising that the draft law aimed at their rectification, # 6216, "On Amendments in the Law of Ukraine 'On Joint Stock Companies,'" has not yet been adopted.

This draft law, however, does not correct all the errors that pose a threat to the existence of joint stock companies and the stock market.

An apparent threat to small shareholders and to the stock market is posed by the provisions in paragraph 2 of Article 20 of the Law concerning existence of stock exclusively in book-entry (electronic) form. That regulation is connected with the SSM-SC's intention to radically reform the existing system of securities accounting and registration of ownership rights due to its inconsistency with the minimally acceptable criteria of time needed to complete a transaction and keep it safe. That decision can hardly be regarded as reasonable and effective. The matter is that the Ukrainian system of depositary accounting has long been in a state of abeyance. It is technically unable to serve the stock of a large number of issuers. Apart from that, payment for depositary accounting services will be made at the investors' expense. That system is unacceptable for small investors, since the costs of depositary services could quickly destroy the value of small blocks of shares and the circulation of stock will be inhibited by high risks and a lack of legal clarity.

It is difficult to justify the legislators' decision to change the names of joint stock companies from "closed" to "private" and from "open" to "public." This will not only require changes to the names of all joint stock companies, but also entail significant costs for securing of new licenses, permits, certificates, etc. Multiplied by over 30,000 joint stock companies, the cost of that procedure could reach hundreds of millions or even billions of hryvnias in terms of unproductive expenditures. Draft law # 6216's proposals for financing this re-registration from the state budget will obviously not find approval due to the large state budget deficit.

Nor does the draft law solve the problem of the extremely inadequate wording of provisions concerning its entry into force. This makes inclusion of joint stock companies into the scope of the Law conditional on certain company actions (amending its charter and changing the name of its type) that the majority of joint stock companies cannot do because of technical limitations

and lack of motivation. That flawed approach entails serious conflicts related to the simultaneous action of two legal acts within the same area of regulation and the uncertainty of the law's timely application. There are also legal consequences for joint stock companies that fail to bring their statutes in consistency with the new law after the expiration of the approved period of transition (two years).

In addition to correcting obvious technical errors, draft law # 6216 also envisages changes of a conceptual nature and is aimed at removing restrictions on company management and on the extraction of management results by controlling shareholders. This includes a proposal to establish a system of automatic payment of dividends on preferred shares, similar to bonds. This norm contains the threat of the creation of legal channels to extract company profits and establish lifetime bondage for the company. Proposals about the possibilities of applying labor law to regulate relations between members of the supervisory board (directors) and the company, the possibility of election of legal entities as members of the supervisory board, the subordination of a supervisory board member to the shareholder who elected (appointed) him, the removal of references to the possibility that a shareholder can appeal to court against an official whose actions harmed the company, and removal of contracts concluded with persons connected with managers or large shareholders from the scope of regulation of related party transactions – all these elements represent a step back into the past. They also destroy the rather fragile legal foundation – if not one that provides protection, then at least with respect to investors and their interests.

It is not difficult to understand that the Law "On Joint Stock Companies" was adopted to enable attracting investments. But the financial crisis, the lack of an adequate system of corporate governance, and problems with the institutional environment of the stock market have deferred any prospects

to generate significant foreign investments for an indefinite period of time, and draft law # 6216 is just one step in the restoration of unrestricted domination by controlling shareholders. However, compromise between a state regulator and big Ukrainian capital only will have a negative result for the Ukrainian economy. Absence of adequate legal protection of investors' rights (especially portfolio investors) will make Ukraine an outsider in the competition for investment resources on the international financial markets. In addition, the majority of Ukrainian joint stock companies, which are de facto one-person corporations, will transform into limited-liability companies and the Ukrainian stock market will quietly perish.

To prevent such a scenario, the Ukrainian government should understand that the Ukrainian economy needs investment, both foreign and domestic. Reallocation and re-investment of extracted profits are not sufficient for the technological upgrading and organization of competitive production of sophisticated goods. The one-person corporation model objectively tends to simplify the organizational structure and primitivize manufacturing processes. It suppresses internal competition within the company, converting it into intrigues for the grace of the "monarch" (controlling shareholder) and into a fight to demonstrate personal loyalty rather than professional qualities. Ukraine will get the right amount of quality investments only by convincing investors (particularly portfolio investors) that their rights are secure from the perspective of both decision making and getting a fair share of profits (dividends). A country interested in attracting investment and fostering economic growth must protect the rights of investors (small shareholders) as an unconditional priority if corporate law is to develop.

All investors are interested in legal mechanisms that will allow them to control management effectively, to dismiss dishonest or incompetent managers quickly, to block suspicious transactions at the stage of their conclusion, to punish dishonest managers

and to recover from them compensation for losses caused by their wrongful acts. All that is impossible, or very problematic, if a relationship between managers and the corporation is governed by labor law which is naturally aimed at protecting the interests of the weaker party (an employee), who is in a less advantageous position than the employer and is sensitive to pressure. In the case of managers the situation is the opposite. Managers have an advantage in obtaining and disseminating information; they control resources, give orders to company employees, and have ample possibilities to put pressure on employees, officials, and shareholders. Labor law grants dishonest managers various possibilities to slow down or undermine the dismissal procedure, preserve their chances of their reinstatement in office (!), and prevent claims based on the liability of managers and attempts to recover damages caused by management dishonesty or negligence. This violates the fundamental principles of responsibility under civil law: compensation for damages incurred by the affected party, and depriving the offenders of opportunities to consume the benefits that came from wrongdoing.

Ukrainian lawmakers must realize that the model of the one-person company dominated by the controlling shareholder is incompatible with attracting investments. Typically, investments are associated with the transfer of control over investor's assets to an investment recipient in exchange for a fair share of revenues generated by the use of invested assets. The largest amount of direct and portfolio investments in the global economy comes from investors who do not claim to gain full control over the recipient company. Those are strategic investors that are interested in sharing technologies and resources with local partners in exchange for a fair share of the profits; small investors wishing to invest their temporary surplus funds; and institutional investors that invest huge amounts of money, but are bound with commitments of diversification and liquidity. For such investors, it is insufficient to hear verbal statements by man-

agers or controlling shareholders that their interests will be respected, while the reality offers glaring evidence to the contrary; they require reliable legislative guarantees. The system for the protection of their rights is based on denial of the principle of making equal the company's interests and those of the controlling shareholder and a clear priority is given to the company's interests over the interests of its individual shareholders. Legal presumption is established to the effect that the company's own interest is to gain the maximum profits from its activities, and shareholder interests are guaranteed by the fact that only the general meeting may determine how to use the profits that the company generated.

The effectiveness of this principle is ensured by the mechanism of the fiduciary duties of company officers (managers and supervisory board members), who must act honestly and professionally, putting the interests of the company above their own. If a conflict of interest has emerged, an officer must report it and withdraw from any influence on the decision. Compliance with this requirement is ensured by the official's duty to inform the company about all persons with whom the officer shares family ties or financial interests. Such information is publicly available, which makes it possible for shareholders and other persons to check if an official has violated his duty to disclose a conflict of interest in a suspicious transaction.

Fiduciary duties include the following:

- the duty to act with reasonable care, skill, and diligence in the best interests of the company (under which the rapid sale of assets for a song cannot be explained).
- the duty to avoid conflicts of interest, and in case there are conflicts of interest, immediately to inform the company about the fact (this should stop the widespread practice of profit skimming and asset stripping by dishonest managers or shareholders);

- the duty not to accept any benefits (rewards) from third parties (shareholders, counterparties) for performance (non-performance) of functions related to the company (this should stop the widespread practices of individual shareholders maintaining individual directors and the bribing of company officials by other persons).

The effectiveness with which officers perform their fiduciary duties is ensured by unlimited liability for violating them and by the mechanism of the derivative lawsuit, the essence of which is that any shareholder may file a claim on behalf of the company against an officer for violation of his fiduciary duties. In fact, high litigation expenses naturally limit derivative lawsuits by small individual investors, but the presence in the national legislation of a derivative lawsuit mechanism is an important factor for foreign strategic and portfolio investors in making decisions to invest in a particular country.

The Law "On Joint Stock Companies," however, does not contain such a category as company interests that are separate from the controlling shareholder's interests. Despite providing minority shareholders with the right to elect their representatives to the supervisory board, the Law claims that supervisory board members are dependent on the shareholders that ensured their election (paragraph 1, Article 53), which in fact turns the board into a puppet body. Apart from that, the possibility that the company can enter "gratuitous" agreements with members of the supervisory board, anchored in the Law, gives the controlling shareholder legal opportunities to harass and discriminate against minority-elected board members, and also tools to maintain the dependence of board members elected by the controlling shareholder through control over the sources of their incomes. These relations have nothing in common with the fundamental principles of corporate governance and thus pose great risks for almost all parties, including the controlling shareholder himself. The mechanism of the derivative

lawsuit contained in the Law (paragraph 2 in Article 72) for certain reasons applies only to those cases of related party transactions in which all stock (shares) of a legal entity with which a contract has been concluded belong to the offender (or its affiliates). Therefore, the lawsuit's effectiveness is undermined by shareholders' limited access to information about the company's commercial activity (counterparts), as well as by the complexity of the process of identification and of finding evidence that proves the existence of legal connections between the offending officer and the counterpart entity. At the same time, in order to excuse himself from responsibility, the accused officer has only to prove the fact that some interest present in the capital of the counterpart entity belongs at least to one person with whom the officer has no proven connection (in an offshore company's case, proving that connection will be almost impossible).

An important mechanism that protects investors against expropriation of their investments is the mechanism for the regulation of transactions with related parties. The essence of this mechanism is to neutralize the impact of the person with a conflict of interest on negotiation and conclusion of a contract between the company and a person connected to the company's officer. That does not mean a complete ban on concluding such contracts, which many shareholders in Ukrainian companies are afraid of, but it makes it possible to ensure that such transactions are made on terms acceptable to the company. The law stipulates detailed procedures for entering into transactions with related parties that are generally consistent with international practice but that have certain national specificities. Some of those Ukrainian features include the lack of a mechanism for preventive disclosure of information about the company officers' affiliated persons; that there is no responsibility for breaching the duty to report a conflict of interest; that there are virtually no legal implications for a person who benefitted from the conclusion of a transaction characterized by violations; that the law

does not deprive the controlling shareholder of his voting rights at the shareholders' general meetings that make decisions on transactions (which guarantees a controlling shareholder the chance to push through a decision about concluding a transaction on any terms).

All this raises serious doubts about the sincerity of Ukrainian lawmakers' intentions to ensure effective protection of investors' funds from their misappropriation through transactions with related persons. These doubts are only amplified by reviewing provisions of draft law # 6216, which proposes to remove the derivative lawsuit mechanism (despite all of its inefficiency) from the text of the Law and actually exclude from the scope of application of Article 71 the larger part of dubious transactions. It narrows the definition of "related party" to a person who occupies a post in the executive body of the counterpart entity, receives a fee from the counterpart, or is the acquirer of property. This will make it possible for controlling shareholders or dishonest managers to enter transactions in an unrestricted manner.

If eliminating these shortcomings in the Law towards improving corporate governance and ensuring effective rules for regulating transactions with related parties is sufficient to meet the minimum requirements that strategic investors (the major technology suppliers) demand of the legal framework of a Ukrainian joint stock company, then the specific features of portfolio investments (which provide the greatest amounts of financial resources) make portfolio investors more demanding. They require the introduction of more complex and sophisticated protection mechanisms into legislation.

The majority of small and portfolio investors have neither the expertise nor the resources to examine and analyze an issuer's financial statements. Moreover, their access to information about the financial and economic activities of the issuer should be limited. For that reason, they must be confident in the correctness of the information that the is-

ssuer's statements contain. This, in its turn, requires the objectivity and independence of the auditors who will make conclusions, as well as ensuring their responsibility for any errors made. For that purpose, the law must stipulate much stricter requirements for auditors' independence and, as is done in many developed countries, require that audit firms exist exclusively in partnership form (which will expose the personal assets of auditors to liability).

An essential component of the proper protection of minority shareholders and modern corporate governance is the legal concept of the "independent director," which is absent from Ukrainian legislation. Independent directors must form a majority on supervisory board committees, which should have exclusive competence on such issues as selection of candidates for the board, determining managers' remuneration, selection of external auditors, and control over the internal audit system.

It is necessary to mention the proper regulation of takeover procedures, which has nothing in common with the practice widespread in Ukraine today of criminal seizures of enterprises or unlawful capturing of control. Indeed, due to the excessive concentration of property in Ukraine today, acquisitions in the classic sense of the phenomenon (a change of the controlling shareholder as the result of an invader's acquisition of a larger package from minority shareholders on the stock market) are impossible. But capital market development requires engaging a large number of small investors, and those will require guarantees of fair distribution of premium for control.

Without introduction of these mechanisms, therefore, Ukrainian joint stock companies cannot expect an influx of large investments by foreign small and portfolio investors into the Ukrainian market and Ukrainian joint stock companies. Also, in entering the local stock market, any serious foreign investor will calculate the exit situation and pay attention to market capacity and to the

existence of a large proportion of local investors that can absorb securities from liquidated investment. In other words, a stock market development strategy based solely on foreign investors is unpromising; only the growth in the local investors' share will lead to a proportional increase in foreign investment.

It should be noted that the law still contains a rather significant number of provisions that require changes in both company management optimization and significant reduction in issuers' unnecessary and unproductive expenditures. The costs the companies bear to comply with unreasonable requirements and procedures are the profits that shareholders will not receive. These costs decrease the attractiveness of the Ukrainian stock market as an investment instrument and deteriorate Ukrainian joint stock companies' competitiveness on international markets. For example, it is possible to greatly reduce the number of general meetings (abandoning the mandatory founders' meeting); to significantly reduce the costs of notification of shareholders (by setting specific dates for receiving proposals from shareholders and by making it possible to receive messages in electronic form); to reduce the costs of organizing the general meeting by instituting voting by mail; and to accelerate and reduce the cost of issuing new shares through a pledged share mechanism. All those rather simple mechanisms can significantly reduce issuers' expenses and create more comfortable conditions for investors.

For Ukrainian corporate legislation, the Law "On Joint Stock Companies" has truly been a significant step forward and laid the foundation for modernizing the legal joint stock company framework in a way consistent with internationally recognized models.

The Law "On Joint Stock Companies" cannot be regarded as an instrument that ensures Ukraine's transition from a country in which there dominates an "expropriation" model of the corporation, characterized by the unlimited domination of one person, to-

wards an "investment" model that ensures due protection of investors and the agreement of different groups of shareholders' interests. This is partially explained by legal inertia and conservatism, partially by a lack of understanding of the collective nature of a corporation, and partially by large shareholders' unwillingness to restrict their ability to manipulate joint stock companies and their assets in an unlimited way. Preservation of the "expropriation" model leaves Ukrainian joint stock companies no chances to compete for foreign investment with Turkish, Malaysian, Vietnamese, Indian, and Mongolian companies.

The Law "On Joint Stock Companies" considerably worsens conditions for joint stock companies and prospects for stock market development by making excessive and sometimes unreasonable demands on issuers that may push the most promising issuers (companies with dispersed capital) to make actions beyond the realm of the economic. Weak legislative decisions, amplified by panic among issuers, have led to numerous cases in which joint stock companies have changed their legal form. This has been accompanied by large-scale violations of shareholders' rights and entailed numerous mistakes, contradictions, and conflicts.

It is difficult to understand the position that the Ukrainian Parliament has taken. It does not seem in a hurry to correct errors that pose a serious threat to national economic development; at the same time, it is obviously preserving a situation in which there is great potential for negative impact on the macroeconomic situation.

Any attempts by certain individuals to present the Law "On Joint Stock Companies" to foreign investors as an instrument that has radically changed the rules of the game in the Ukrainian corporate sector and that ensures reliable protection of investors' rights may result in those investors' bitter disappointment. They may also noticeably harm Ukraine's reputation, poor enough as it is, as a recipient for foreign investments.

Competition Law. Use of Restrictive Covenants in Commercial Contracts

By Anna Putintseva, Oleksandra Soloviova, Attorneys, Chadbourne & Parke LLP

General

When negotiating commercial agreements, careful consideration should be given to the imposition of various restraints on the activities of the contacting parties influencing production, sale or purchase of goods or services on the Ukrainian market, as such restraints may be classified by the Antimonopoly Committee of Ukraine (the “**AMC**”) as anti-competitive concerted actions, which are generally prohibited to be carried out by the parties without prior approval of the AMC (the “**AMC Approval**”).

There are broad categories of agreements where the restrictive covenants are generally used: agreements on sale and purchase of shares and assets, employment contracts, shareholder agreements, distribution, licensing and supply contracts, etc. The examples of restrictive covenants include, inter alia, the following: non-compete and non-solicitation clauses (typical restraints in sale of business agreements), exclusivity and market sharing arrangements (mostly used in distribution and supply contracts), restrictive covenants aimed to preserve confidential information and trade secrets (used in employment and sale of business agreements).

Such restrictive covenants, even though they may constitute concerted actions, are not always deemed anticompetitive concerted actions and may be performed without obtaining AMC Approval under certain conditions. Therefore, it is very important to carefully consider each restraint intended by the contracting parties to be included into the agreement to make sure it is in line with the requirements imposed by the Ukrainian competition law.

CHADBOURNE
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Concerted Actions under Ukrainian Law

According to the Law of Ukraine “On Protection of Economic Competition”, dated January 11th, 2001 (the “**Competition Law**”), concerted arrangements are defined as agreements or any other concerted competitive behavior or omission by business entities, including legal and natural persons. In addition, establishment of a business entity or an association is deemed a concerted arrangement of its founders, if such establishment results or may result in coordination of competition among (i) the founders; and/or (ii) the founders and the newly established legal entity.

The Competition Law provides for a non-exclusive list of actions defined as anti-competitive concerted actions, among which are: (i) *price regulation*; (ii) *restriction of production, goods’ market activity, technical development, investments or control over them*; (iii) *sharing of markets or sources of supply by a territory, range of goods, volume of sales, customers, sellers or consumers or other criteria*; (iv) *distortion of tenders and auctions*; (v) *removal from or restriction to the market of other market players*; (vi) *applying varying terms to similar agreements placing business entities into unfavorable competition conditions*; (vii) *entering into agreements imposing additional commitments on the parties not relating to the subject-matter of the agreement*; (viii) *significant restriction of competitiveness of other market players without any legitimate reasons*. Furthermore, the AMC may, at its discretion, qualify other similar actions (or omissions) as anti-competitive concerted actions, if such actions result in or may lead to the prevention, elimination or restriction of competition.

Thus, pursuant to the Competition Law, if the restrictive covenants constitute any of the actions listed above or other similar actions, the contracting parties may perform them only upon obtaining prior AMC Approval, which shall be issued upon the parties presenting sufficient evidence to the AMC that the restrictive covenants will not result in and may not lead to the prevention, elimination or restriction of competition on the involved market or its significant part.

Exemptions Available to Concerted Actions’ Participants

According to the Competition Law certain concerted actions are exempt from the requirement of obtaining AMC Approval. Generally, the following aspects have to be carefully considered when analyzing whether the contracting parties’ actions may fall within any of the exemptions: (i) market share(s) of the concerted actions’ participants (which include the contracting parties themselves, as well as entities controlled by them and controlling them) on a respective market; (ii) combined volume of assets and sales of the participants of concerted actions; (iii) existence of direct and indirect control among the participants.

Regulation # 27-p “On the Standard Requirements to Concerted Actions of Business Entities for General Exemptions from Obtaining the AMC Approval” dated February 12th, 2002 (the “**Regulation # 27-p**”) provides the following exemptions depending on the market shares of the contracting parties and types of the concerted actions.

1. **De-minimis exemption:** where the aggregate market share of the concerted actions’ participants does not exceed 5% on any involved market;
2. **Market share exemptions:** where the aggregate market share of the participants of horizontal and combined concerted actions is less than 15% and of vertical and conglomerate concerted actions is less than 20% on any involved market, provid-

ed, however, the following financial thresholds are not exceeded: (i) €12 million of assets and/or sales by concerted actions’ participants in aggregate worldwide; and (ii) €1 million of assets and sales per at least two participants each worldwide; and (iii) €1 million of assets and sales by at least one participant in Ukraine.

Both de-minimis and market share exemptions are not applicable, however, with respect to the following horizontal or combined concerted actions: (i) *price fixing*; (ii) *restriction, including termination, of production, sale or purchase of goods*; (iii) *sharing of markets or sources of supply by a territory, range of goods, volume of sales, customers, sellers or consumers or other criteria*; (iv) *distortion of tenders and auctions*. Thus, in all listed cases the contracting parties are required to apply for prior AMC Approval before engaging in the respective concerted behavior.

The Competition Law also envisages other exemptions to the requirement of obtaining AMC Approval. These include certain concerted arrangements related to: (i) supply and use of goods; (ii) intellectual property rights; and (iii) actions by small and medium-sized business. According to the Competition Law, the listed concerted arrangements may be performed under certain conditions without obtaining AMC Approval, if such actions do not significantly reduce competition, restrict access to the market or cause economically unjustifiable price increase or goods deficiency.

If the exemptions provided by the Competition Law and Regulation # 27-p may not be applicable, the contracting parties are entitled to avoid obtaining AMC Approval also in the case of the “specialized” concerted actions, governed by Regulation No. 880-p “On the Standard Requirements to Concerted Actions of Business Entities on Specialization of Production Permitting such Concerted Actions without Obtaining AMC Approval” dated December 11th, 2008 (the “**Regulation # 880-p**”). Thus, concerted actions with respect to specialization are defined as *hori-*



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Legal System Overview

zontal concerted actions of business entities aiming at consolidation of their efforts and resources on production (sale) of certain goods, which results in improvement of production, purchase or sale of goods, provided such actions do not lead to significant restriction of competition on the market or its substantial part. If the latter condition is met, concerted actions on specialization do not require obtaining AMC Approval, provided that the contracting parties undertake only certain obligations (listed in Regulation No. 880-p) when engaging in concerted behavior. In addition, Regulation No. 880-p sets forth a number of exceptions from the "specialized" concerted actions' exemption, among which, inter alia, are the following: occupying by concerted actions' participant of the monopoly position (more than 35%) or occupying of more than 25% of a certain market by a single business entity; more than 50% by a group consisting of not more than 2 business entities; and more than 70% by a group consisting of not more than 4 business entities, in which case the exemption will not apply.

Applying for AMC Approval

If none of the exemptions are accessible to the concerted actions' participants, the only possibility to legitimate anti-competitive concerted arrangements is to obtain prior AMC Approval. For the purpose of obtaining of AMC Approval, the contracting parties shall prepare and file with the AMC a joint application accompanied by various documents.

In the application the contracting parties shall describe the intended concerted actions, their impact on the relevant market(s), including on actual and potential competitors, consumers, market sharing, etc. In addition, arguments must be provided supporting the fact that the concerted actions will contribute to (i) *improvement of production, purchase and sale of goods*; (ii) *technological and economic development*; (iii) *development of small or medium-sized business*; (iv) *optimization of export or import of goods*; (v) *development and application of uniform technical terms or standards for*

goods; (vi) *efficiency of production, etc.*

Pursuant to the Competition Law, the AMC may authorize anti-competitive concerted actions, if the concerted actions' participants provide sufficient evidence of the above listed positive effects. If the contracting parties fail to provide strong arguments in favor of the intended concerted actions, the AMC is required to deny the issuance of its Approval. The AMC, however, before issuing a denial, may notify respective applicants and allow them to submit additional supporting information and/or documentation proving that benefits of the concerted actions will offset the negative effects thereof.

The overall review procedure for obtaining AMC Approval can take up to 3,5 months, and the state processing fee is €230. As a general rule, the AMC Approval is valid for one year. The applicants, however, may request for a longer period (e.g., the term of a contract), in which case, it will be in discretion of the AMC to issue its Approval either for a requested period or for another period determined upon the results of the review.

Applying for a Preliminary Conclusion

Alternatively, the contracting parties may also apply to the AMC requesting its preliminary conclusion regarding the qualification of the proposed restrictive covenants as concerted actions. Such application is not mandatory, but may be helpful in guiding the parties on the necessity of obtaining AMC Approval before engaging in concerted behavior. To obtain a preliminary conclusion of the AMC, the contracting parties must file substantially the same package of documents which is filed for obtaining of AMC Approval. Preliminary conclusions are issued within 1 month, and the state processing fee is €107. If the AMC, however, comes to a conclusion that its Approval is required to permit the proposed restrictive covenants, the contracting parties must file again all the docu-

ments with the AMC with the request for obtaining AMC Approval.

Liability

According to the Competition Law, anti-competitive concerted actions carried out without obtaining of prior AMC Approval, if such Approval was required, are expressly defined as a violation of the Ukrainian antimonopoly law.

Prior to imposing of any fines, the AMC is required to carefully investigate each particular case and collect sufficient evidence that the competition on the involved market or its substantial part is significantly reduced as a result of carrying out of the concerted actions established by the contact.

The AMC is entitled to impose a fine in the amount of up to 10% of the combined annual revenue of the breaching entity's group for the last reporting year. The violation is deemed to be committed starting from the date of a contract. If the profit resulted from the concerted actions envisaged by a contact exceeds 10% of the combined group's revenue, an additional fine may be applied in the amount not exceeding a triple amount of unlawfully earned profit.

Recent Competition Overview (Law and Practice)

By Maria Nizhnik, Counsellor, Serhiy Denisenko, Associate, Vasil Kisel & Partners

The Antimonopoly Committee of Ukraine (the "AMC") is currently one of the most transparent and open-minded state agencies of Ukraine, available for a dialogue with business community. Just over the last several years, a significant step forward has been made by the Committee in terms of its more intensive participation in economic processes of the state, position of the Committee's representatives on problematic issues of the applicable legislation and practice, as well as reasoning

In addition, the AMC may reconsider its decision on issuing AMC Approval within five years following the date of the Approval if the AMC permitted the concerted actions on the basis of inadequate information provided by the contracting parties. In this case, a fine in the amount of up to 1% of the combined revenue of the breaching party's group for the last reporting year is imposed.

Conclusion

Although various types of restrictive covenants commonly used in commercial contracts may constitute anti-competitive concerted actions under Ukrainian law, they do not always negatively impact competition. Instead, frequently, concerted arrangements lead to facilitation of competition by improvement of production and sale techniques, optimization of trade practices, development of uniform technical terms and standards for goods.

However, in order to ensure that each particular restrictive covenant is carried out in line with the Ukrainian law, one has to correctly classify it, apply available exemptions and, if necessary, validate it through obtaining of AMC Approval.

and transparency of the Committee's decisions.

The main objectives of the AMC are the following:

- control over economic concentration and concerted actions;
- control over the prevention and termination of anticompetitive concerted actions and termination of the abuse of monopoly (domain) position;

- control over the prevention and termination of unfair competition; and
- ensuring control and protection of the competition in public procurements.

1. AMC's Current Practices

Merger clearance

When starting the business in Ukraine, a foreign investor should first and foremost consider certain peculiarities of local merger control.

Notwithstanding the business community's initiative to amend the legislation and its support by the AMC, once again it must be stressed that the effective financial thresholds for merger control clearance (attaining which acquisition of 25% of shares / participation interests / votes, acquisition of companies' assets, establishment of an entity by two or more parties require merger control approval) are still low compared to other jurisdictions. No changes into applicable legislation have been made yet in this respect.

Practically, this means that a number of transactions which either do not have or have a little effect on competition in Ukraine, including foreign-to-foreign transactions, technically fall under the merger control legislation and, thus, require prior merger clearance.

Recent trends show that the Committee is increasingly focused on revealing historical breaches, such as verification of compliance with the merger control legislation when forming a corporate group structure as well as insertion of certain business divisions or business units. This practice is supported by the cases recently investigated by the Committee, in particular, the case against major financial and industrial group in connection with the acquisition of a telecommunication business without obtaining prior approval by the AMC, as well as imposition

of fines on a leading household appliances and electronics company in Ukraine.

AMC case related practices

The cases related to the anticompetitive concerted actions have seen a significant increase in numbers. As a result, the penalties imposed by the AMC based on the results of respective investigations have increased as well. However it would, be fair to state that, amounts of penalties imposed by the AMC, involving the abuse of the monopoly (dominant) position are in the absolute lead. The top 3 fines imposed by AMC were on companies that deal on the market of oil products

Furthermore, most of the discovered anti-competitive concerted actions and abuses of monopoly position were associated with the pricing abuses (establishment of prices on such level which would not exist in case of significant market competition).

The distinguished cases investigated by the AMC primarily dealt with a fuel and energy market, telecommunications, medicines, cable television, grain storage and transportation.

Concerted actions in fuel and energy as well as pharmaceutical sectors

The mentioned markets are among the most socially sensitive areas. Thus, the AMC pays considerable attention to the competition compliance issues in these areas. Consequently, business entities operating in the aforementioned markets appear to be most frequently involved in the cases related to competition legislation violations.

The key issue in these sectors is price-regulation approach taken by the market players in relation to their products. Considering the dynamic nature and information transparency of the oil and pharmacy markets, the market players are often fixing their prices at similar level, which potentially

may give a rise to competition compliance concerns.

Such cases are often treated by the Antimonopoly Committee as anticompetitive concerted actions by the market players. In 2005 Article 6 of the Economic Competition Act was amended by clause 3, which since then had become the most applicable provision in the enforcement practice of the AMC. The AMC apply clause 3 of the Article 6 of the Economic Competition Act, mostly to prove the occurrence of price fixing on a market.

Under clause 3 of Article 6 of the Economic Competition Act “anticompetitive concerted actions are those similar actions (omissions) performed by the entrepreneurs on the product market, which have resulted or may result in prevention, elimination or restriction of competition where analysis of the respective market conditions evidences the lack of objective reasons for such actions (omissions).” Thus, to qualify the behavior of market players as violations of clause 3 of Article 6 of the Economic Competition Act both criteria shall be satisfied, namely: (i) lack of objective reasons for such actions and, (ii) negative effect (potential effect) on Ukrainian competition.

However, as opposed to the enforcement practice adopted by the EU competition authorities, the AMC bases its approach on a presumption that similar behavior of market players by itself represents a concerted practice, (without necessity to establish the second condition – existence or lack of objective reasons for taking respective actions). Therefore, the burden to overrule the existence of concerted actions is on market players.

Therefore, proving evidences of the existence of respective objective conditions both at the stage of case investigation by the AMC and at the stage of the appeal in court is a rather painstaking process, which requires extensive expertise and practical experience of dealing with similar cases both in the AMC and in court.

Telecommunications and Unfair Competition

The main problem in this area was market players` approach to the advertising of their own products and services. In particular, the advertisement of the so-called zero rates and provision by market players of the information on compulsory withholdings and payments in a shortened or hidden format, were treated by the Committee as a misleading advertisement.

By applying Article 15 of the Law of Ukraine “On Protection against Unfair Competition,” which contains a provision that “*dissemination of misleading information shall mean the provision by entrepreneurs, directly or through any other person, to one or several persons or an indefinite number of persons, including in advertising of incomplete, inaccurate, unreliable information, in particular, as a result of a selected method of statement, concealment of certain facts or inaccurate wording that affected or may affect the intention of those persons to purchase (order) or dispose of (sell, supply, perform, provide) products, works, and services of such business entity*” the AMC recommended market players to bring their activities in line with the applicable legislation.

Further to the Committee’s recommendations, major market players developed and adopted the Code of conduct for telecommunications service operators and providers of advertising of mobile communications services, which was also approved by the AMC. The Code sets out requirements for indoor and outdoor printing, radio, TV and Internet advertisements for mobile services.

Therefore, some matters that potentially give rise to competition concerns are jointly resolved by market players and the AMC at the stage of the Committee’s recommendations rather than case investigation and potential penalties imposition.

Applicable practices evidence that some 90% of unfair competition cases currently

investigated by the Committee involve violations under Article 15 of the Law of Ukraine “On Protection Against Unfair Competition” associated with the dissemination of misleading information.

Financial sector a concerted actions or an abuse of dominant position?

Problems in this sector are currently associated with loan agreements signed between banks and their borrowers establishing for the requirement that insurance agreements under respective loan agreements should only be signed by the bank’s clients with insurance companies designated or accredited by the bank.

In the AMC’s opinion, this may lead to a selective character of the insurers accreditation procedures applied by the banks. Following this practice a large majority of insurance companies may be unfairly restricted in their access to a certain category of their consumers.

The Committee initiated an investigation into the practices of banks forcing certain insurance companies to their clients. During this investigation, the AMC provided five major banks in lending sector with its recommendations to review the banks’ accreditation procedures, in particular in view of the negative impact of such procedures on competition on the insurance services market.

Such practices can be qualified by the AMC as violation of the Economic Competition Act in the form of anti-competitive concerted actions and/or an abuse of monopoly position. Respective practices may accordingly be subject to penalties of up to 10 % of the turnover from such entity’s (i.e. group of companies) worldwide sales as of the last financial year.

Following recommendations issued by the AMC the banks reported on their compliance with such recommendations.

Meanwhile, the AMC continues to monitor the situation with the bank’s applicable procedures on accreditation of insurance companies. Thus, the AMC addressed a letter to the National Bank of Ukraine to inform all banks of possible consequences for non-transparent accreditation of insurers and unreasonable refuse in access to the respective services market.

The Antimonopoly Committee is now investigating the banks’ practices on forcing certain insurance companies to their clients both in the context of possible monopoly abuse of a certain group of banks and in the context of possible concerted actions of insurance companies and banks.

2. Recent Legislative Changes

One of the landmark achievements in competition law was the adoption on June 1, 2010 of the new Law “On Public Procurements”. This law creates a solid foundation for building a transparent, non-discriminatory and effective public procurement system in Ukraine.

The adoption of the Law “On Public Procurements” proves that Ukraine continues its progress towards harmonization of domestic public procurement laws with EU laws and WTO requirements.

The Law provides that public procurement procedures can be appealed to the Antimonopoly Committee of Ukraine. As of today, certain procedures are already in place for challenging the public procurement process.

Nearly half of the appeals challenge documents that need to be submitted for participation in a tender (in particular, in the context of discriminatory requirements established by tender customers such as availability of previous experience in public procurement contracts execution by potential bidders, special technical requirements, etc.). Other part of appeals covers procedural violations, in particular those involving the time frames and procedures for making

procurement announcements as well as public communication of the procurement results, etc.

The following competition law changes can be expected as soon as next year:

- Assigning jurisdiction over cases involving the Antimonopoly Committee of Ukraine. The current practice shows that such cases are resolved both by commercial and administrative courts. The proposed changes will assign the exclusive jurisdiction over these cases to commercial courts.
- Approving amendments to the Economic Competition Act, which are now being prepared for a second reading in the Parliament and which provide for an increase of the current financial threshold for merger control clearance (in case of acquisition of 25% of shares / participation interests / votes or joint establishment of a business entity by two or more persons).
- Amending the Economic Competition Act to increase fourfold the fines that may be imposed by the AMC's territorial branches.

- Amending the Administrative Offences Code of Ukraine to authorize AMC bodies to hear administrative cases and impose fines for (i) obstructing officers of the AMC or its territorial branches *in act of their duty*, or (ii) failing to comply with a decision of the AMC's body, or (iii) failing to comply with the procedure established for provision of reply on the AMC information requests.
- Approving the amendments to the Criminal Code of Ukraine, which have been prepared for a second reading in the Parliament and which establish criminal liability for bid rigging during auctions or tenders as well as for forcing into anti-competitive concerted actions prohibited by the competition legislation.

Some changes in economic competition laws are also expected in connection with the undertakings assumed by Ukraine for the purposes of signing a free trade zone agreement with the EU. However, signing of the respective agreement is most-likely to be a long-term prospect for Ukraine.

13. MEDIA OVERVIEW

Ukrainian media overview 2010

The Ukrainian media sector experienced a second consecutive tough year in 2010 as advertising revenues remained at a premium as the post-crisis recovery got underway. Many of the country's leading advertising sectors dried up completed in 2009 as the worst of the crisis combined with a period of political uncertainty, and this situation has only gradually improved in 2010. TV has benefited the most from the slight improvement in the commercial media market, with print media continuing to suffer. One of the strongest emerging channels in 2010 was Rinat Akhmetov's football channel, which continues to expand its reach as it taps into the huge potential of Ukraine's domestic Premier League. Following the presidential elections, the TV sector experienced changes at Ukraine's state TV channel, with Lebanese born Kyiv media figure Walid Harfouch becoming Vice President of the nation's only fully state-owned national TV channel as part of a wholesale changing of the guard at the helm of Ukraine's flagship media outlet. Harfouch, who has been active throughout the Kyiv media sector since the early 1990s, took Ukrainian citizenship in 2005. Since arriving at First National Channel he has overseen considerable image changes and a major personnel overhaul, with the national state channel receiving a ratings boost as a result of its repositioning. In late 2010 it was announced that in the New Year Savik Shuster will be bringing his popular debate-style programming to First National Channel – a coup for the country's formerly moribund national channel and an indication of the prominent position which



the channel sees for itself on the Ukrainian media landscape. Elsewhere in the TV sector the main controversy of the year was a court ruling stripping two Ukrainian channels of a number of their regional broadcasting licenses. This decision to reverse an earlier ruling awarding Kanal 5 and TVi frequencies provoked negative commentary from EU figures and was a key factor behind Ukraine's falling International Press Freedom Index rating for 2010, with the country dropping from 89th to 131st in the annual Reporters Without Borders survey.

In the Ukrainian print sector it was a hard year of closures and sellouts as the market failed to persuade many core advertising segments to return to print. The crisis period of 2008-09 had led many Ukrainian companies, particularly in the lifestyle, recreation and services sectors, to actively seek alternatives to their previous marketing strategies involving relatively expensive print advertising. This has led to a considerable growth in the range of outdoor advertising client bases but first and foremost it has driven a boom in the email marketing sector, with hundreds of daily messages for dachas, restaurants, tours, financial services and for email marketing itself now infesting Ukrainian inboxes. Print media titles to go out of business in 2010 included the iconic Kyiv weekly events bible Afisha, which had been published since 2001 by American-born Kyiv media mogul Jed Sunden, the man behind Kyiv Post newspaper and Korrespondent magazine. Prior to closure, Afisha magazine was widely regarded as one of the most authoritative style barometers of what was hot in the Ukrainian capital and its disappearance from the market was seen by many as a particularly ominous omen. This award-winning publication was one of the most high-profile victims of the credit crunch impact, and had

also reportedly been badly hit by changes to regulations severely limiting the scope of liquor and cigarette advertising in the print media which came into effect in 2010. Also in Ukraine's previously buoyant recreation and lifestyle sector, Timeout called time out in 2010 after what was a brief few years on the Ukrainian market. Another title to close was GlavRed, a Ukrainian language magazine which was regarded by many as an important voice for the opposition and for alternative viewpoints in general. Beyond Kyiv, Lviv's English language magazine Lviv Today remained the country's only English language regional publication and it continued to expand in 2010 as the city pushed forward with its tourism promotion campaign and preparations for Euro 2012. The magazine added a Ukrainian language section in 2010 to cater to the large local audience which the glossy publication had already attracted. Also in the Ukrainian En-

glish language media sector, the Kyiv Post in 2010 introduced online Russian and Ukrainian language versions of their English language materials in an attempt to boost their market reach and consolidate the publication's reputation as one of the country's leading independent news sources.

On the Ukrainian internet, the biggest climber of the year was probably the Segodnya newspaper's online presence, which has been improved in line with the paper's general modernization. Segodnya remains the country's best-read daily and offers different editions in a number of regions including Kyiv and Donetsk to cater for local tastes. In 2010 the online political sphere continued to maintain the high dynamic of recent years, with the leaders still the Ukrainska Pravda and Korrespondent websites – both of which have been relatively dominant for the past four years.

14. REAL ESTATE MARKET

Investment Market

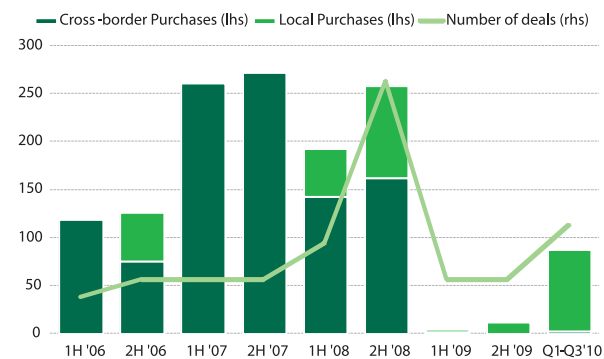
Trends and Tendencies

- Investment activity gathered pace in 2010 but remained below historical average, even though average deal size tripled
- As throughout 2009, foreigners shunned the local marketplace, with turnover driven almost entirely by local players
- Ascertaining the level of yields in the current market environment remains problematic, but we have lowered our estimations by 100 basis points for all segments, in view of general decline of Ukraine country's risks

Turnover

Total property investment turnover (net of debt settlements and development deals) by the end of September 2010 amounted to ca. \$87 million in 6 transactions, almost five times as much as in the whole of 2009.

Property Investment Volume (USD, million) and Number of Deals



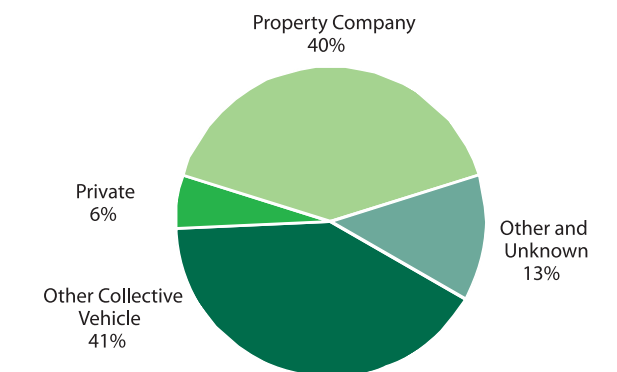
Source: CB Richard Ellis

Note: local investment market is extremely small and opaque, so CBRE data on investment volumes does not claim exhaustiveness and is subject to constant revisions. Calculation methodologies were changed in 2008 to take account of share deals. Previously, only asset transactions were recorded.

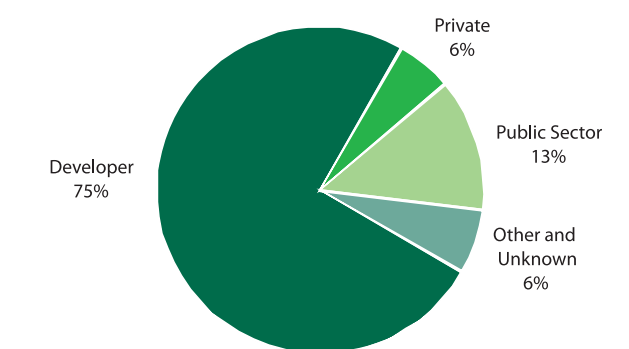
Buyers and Vendors

The recent growth in investment turnover is mainly the result of activity by domestic buyers. Cross-border buyers stayed inactive for the same old reasons of risk aversion.

Purchaser Activity by Purchaser Type (January-September, 2010)



Vendor Activity by Vendor Type (January-September, 2010)



Source: CB Richard Ellis

By remaining focused on defensive product — i.e. prime buildings with strong covenants and minimal voids in cash flow projections — international investors essentially have nothing to choose from. Their tight buying parameters mean that they remain outside of “transactional territory” — i.e. the market for opportunistic, development-like investments such as unfinished constructions and for value-add,

second tier products such as inferior properties with potentially upgradeable capacities – where most deals are taking place today and which local players have been successfully exploring.

The mismatch between the demand and supply is equally ensured by surprisingly resilient vendors, whose positions were strengthened as a result of banks' unwillingness to foreclose on properties secured against NPLs. Thus, developers and property companies remained the primary vendors of real estate.

Also notable, was the emergence of State Property Fund as an active seller. Although the government has been auctioning off its surplus property assets for years, it was not until recently that it sold some of its most decent (yet not completely professional) properties such as Tsum (Central Department Store) and Bratislava hotel. Precarious finances combined with the high share of state ownership (estimated at 37% of GDP including social infrastructure) means that

the government could remain an important player on real estate investment market in the future, as privatizations become an importance source of deficit financing.

Capital Values

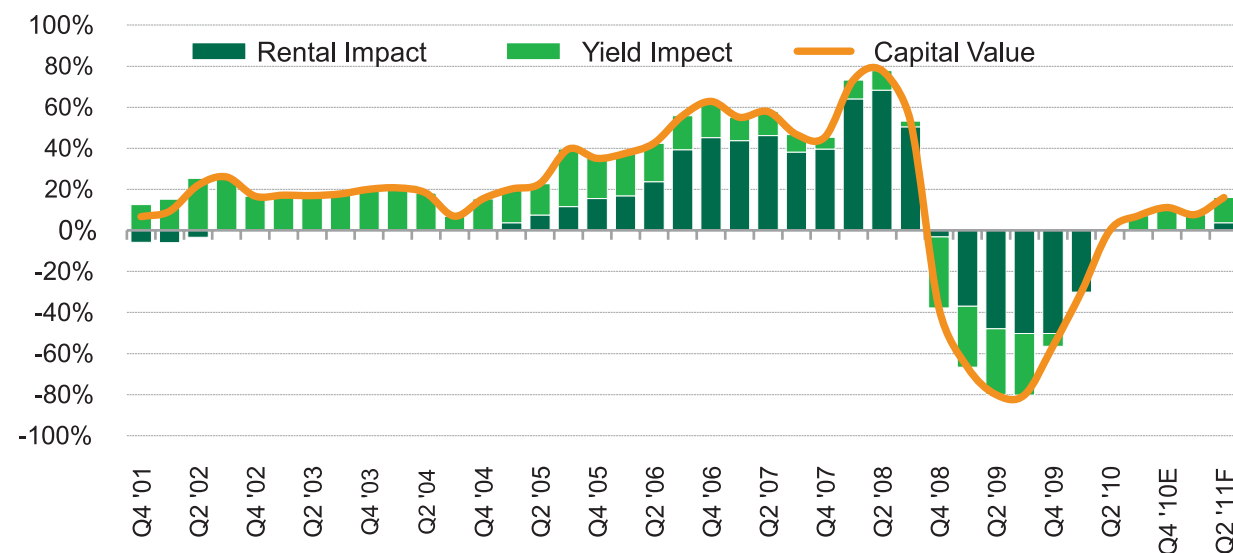
At the height of the crisis – when cash was king and cost-cutting became the norm – rising yields and falling rents pushed capital values deep into the red. By Q4 2009 Kyiv prime capital values were on average 72% below their peak levels recorded in H1 2008. Values started to level off in 2010 thanks to favorable base effects and sentiment-driven compression in yields.

Occupier market situation in each segment is different, but it is clear that rental rates are no longer having a negative impact on valuations. Indeed, in prime offices the prospect for rents has recently brightened and current outlook is for prime capital growth to turn positive in y-o-y terms by October with possible acceleration in H1 2011 (see graph).

Kyiv prime yields have been highly synchronized across all CRE sectors because of the universal factors that drive them. Whereas during the crisis the key upward factor has been tightened liquidity, a major cause for declining yields today is predominantly sentimental. As the global commotion has receded, Ukraine's country risks

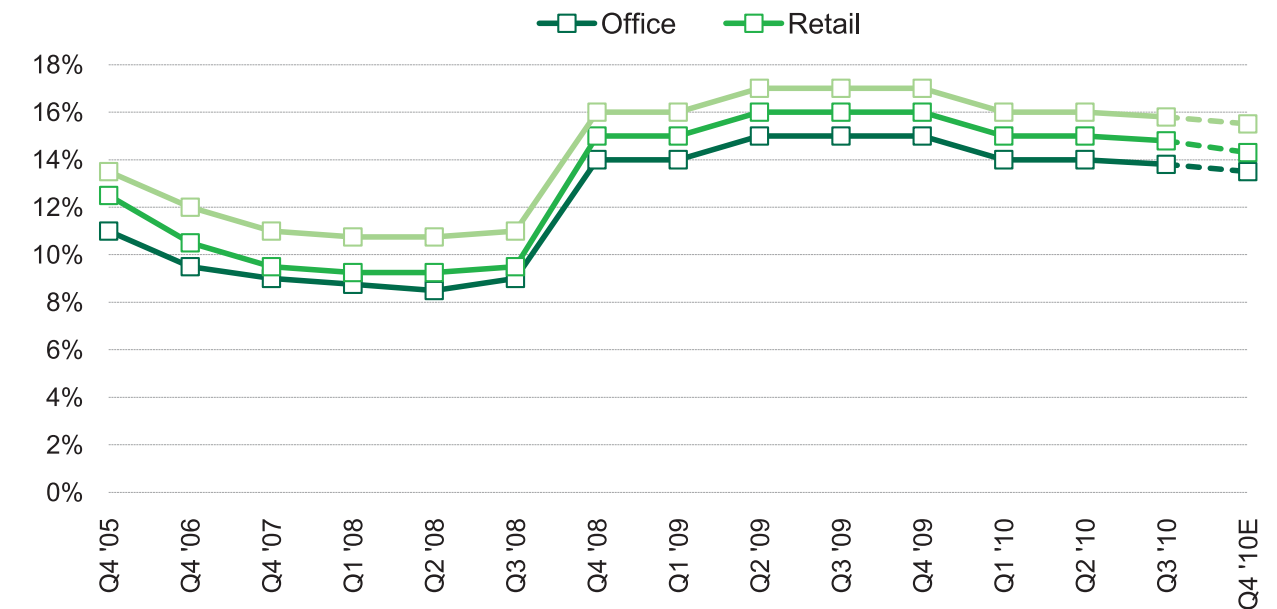
have lessened. Despite this increased confidence, there is still a lack of transaction evidence available, and in the absence of reliable benchmarks pricing is still being compromised. It should be noted, therefore, that yields currently serve as an indication only and are not based on any relevant transactions.

Prime Capital Value Growth – Office Market (% change, y-o-y)



E – Estimation
F – Forecast
Source: CB Richard Ellis

Kyiv Prime Yields



E – Estimation
Source: CB Richard Ellis

Outlook

Looking forward, we are certain that prime yields will trend downwards. Given the lack of prime product and the fact that the majority of investors are showing strong willingness to transact only in the top tier of the market, upward pressure on prices is increasing. The trajectory for capital values outside of prime segment is less clear. Secondary rents are likely to remain flat for an extended period of time, and yields will continue to reflect the elevated risk of short-term movements in the occupier markets.

The most likely outcome is for the market to slowly drift away from the distressed state it is in today towards a more comfortable pe-

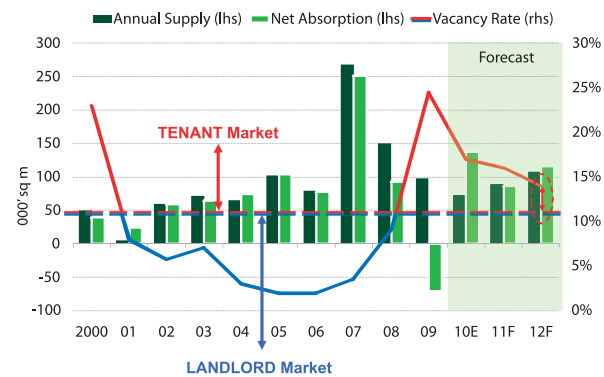
riod of freer lending and stronger occupier market. It is unlikely to be a debt-driven recovery, however, with leverage-backed deals being rare and cash-rich investors dominating purchasers' lot. Cross-border investors are expected to steer clear of Ukraine, but mostly for benign reasons of lack of quality product, rather than for plain risk avoidance. Provided investors do not relax their criteria and banks continue holding onto to the repossessed collaterals, the number of transactions will be restricted, a fact that will contribute to the anemic pace of market recovery. We, therefore, forecast a protracted period of slow sentiment-driven growth of capital values until market fundamentals (distinct for each segment) will clear the way for an upward trend in rental values.

Office Market

Fundamentals

Overall, the outlook on the occupier market is definitely brightening. Corporate sentiment is clearly improving, as businesses feel that the cycle is leaving the danger zone of a recession and is moving into a period of moderate growth. Many relocations from grey (unaccounted) space took place in 2010, so net absorption is likely to be higher than annual development completions, and vacancy is therefore expected to decline noticeably. Later in 2011-2012, as new space enters the market and relocation boost to absorption peters out, vacancy will stay unchanged or fall only marginally.

New Supply, Net Absorption and Vacancy Rate: Past and Future

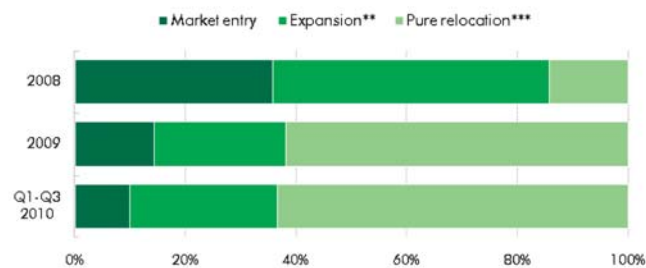


E – Estimation
F – Forecast
Source: CB Richard Ellis

Demand

Occupier market grew stronger throughout 2010. Demand remains active again but is still primarily fuelled by tenants looking to upgrade rather than to expand. Moving offices within competitive space has been especially noticeable in prime segment, where premises – particularly of large area – are already in short supply.

Take-up by motivation*



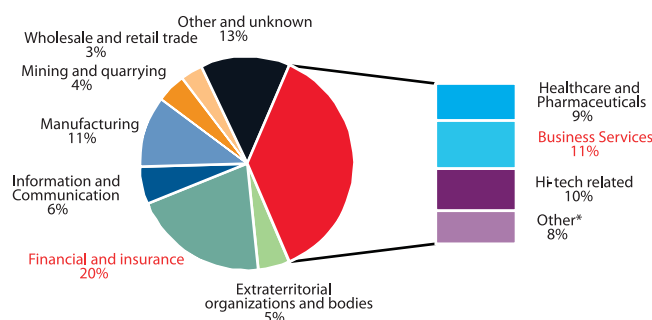
* – share of transactions, not volume; including sub-leases
** – with or without relocation
*** – net of expansion (with or without contraction and/or consolidation)

Source: CB Richard Ellis

The latest preliminary results for known take-up suggest that both financial and business services firms are once again playing an active role on the occupier market. Their combined share of deals has risen to 31% for nine months to the end of September.

Although most drastic cutbacks are definitely in the past, we believe that the demand for office space on part of most occupiers will continue to be limited to relocation requirements for cost saving and quality improvement purposes at least until the end of 2010.

Take-up by Industry, Q1-Q3 2010



* – mostly mass-media and advertising firms

Source: CB Richard Ellis

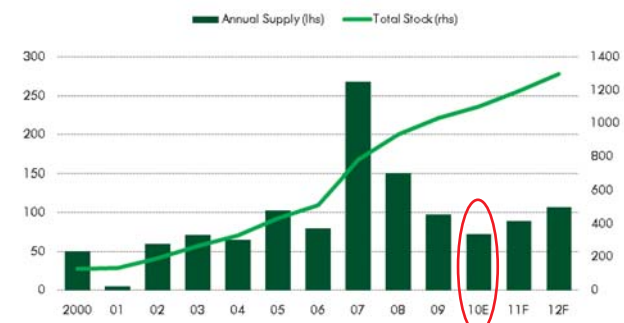
Supply

By the end of September, with the new additions of 2010 (ca. 69,000 sq m) the total competitive stock has reached 1,100,000 sq m. By the end of 2010 we expect completion of some more premises (7,000 sq m).

The quality of 2010-2011 future completions, however, is lagging behind international standards, ensuring that prime real estate remains in short supply.

In H1 2010, we forecasted that development completions would slow down considerably in 2012. In H2 2010, construction works on a few sites were resumed on the back of gradually recovering economy and alleviated situation in the banking sector. Thus, we have adjusted our 2012 forecast accordingly. In 2012 development completions of class A premises are expected to grow.

Kyiv Annual Development Completions and Total Competitive Stock ('000 sq m)



E – Estimation
F – Forecast

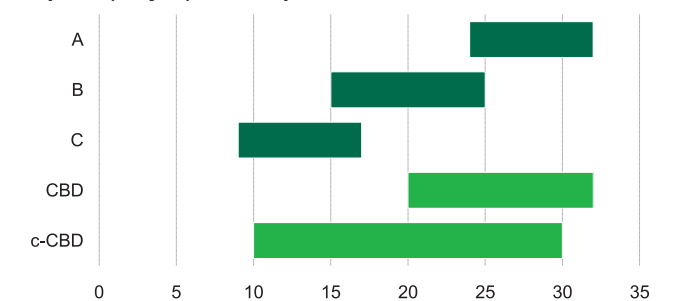
Source: CB Richard Ellis

Rents and Vacancy

Average prime rents remained flat at \$28/sq m/month during 3 quarters of 2010. By the end of 2009 prime USD rents were down 67% from their peak in Q3 2008. The fall in UAH equivalent has been less dramatic – 47% from the peak in Q3 2008¹. Clearly, the bottom has been reached and the fundamentals as well as details of recent deals are pointing that further declines (in at least

UAH terms) are unlikely. Imminent rental growth, however, should not be expected either, as additional deliveries in the mid of 2011 will feed vacancy, keeping rentals in check. Slight increases in prime rents, however, are very real, given that vacancy here is almost two times below market average. Indeed, because only a few (if any) class A buildings will be delivered to the market over 2010-2011, we expect the gap between prime and secondary rents to widen.

Kyiv Office Rental Range as of Q3 2010 (USD/sq m/month)



CBD – central business district
c-CBD – close CBD

Source: CB Richard Ellis

In H1 2010, vacancy rate went down on the back of few development completions and continued strong relocation drift in the occupier market. By the end of Q3 2010, average market vacancy rate increased to 19.8% (+1.7 pp q-o-q). Despite the fact that demand is healthy, it is not expansionary, and relocation trend has its limits, thereby two office schemes which were delivered onto the market in Q3 2010 remain largely tenantless. As there are no large schemes to be completed in Q4 2010, we expect vacancy rate to decline slightly by the end of 2010.

Outlook

The presently unfavorable supply-demand disequilibrium does not spell disaster, yet it does mean that rental growth across the market is some time away. Given how fundamentally undersupplied in quality Kyiv offices were before the crisis, prime segment was always bound to be in a much

¹ At quarterly average official exchange rate.

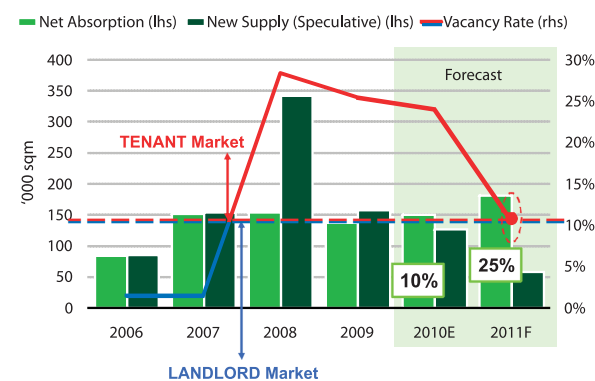
better shape than the market overall. Rental growth in best properties is, therefore, real and close, provided exchange rate stays broadly unchanged. Late 2010 is the time when landlords of prime buildings have begun to demand higher payments. The rest of the market will need to wait longer, until at least 2012. Indeed, one of the most obvious aftermaths of the recession has been a partial decoupling of prime space from "the rest" of the market.

Decreasing vacancy rate in prime segment and forecasted deficit of development completions of class A buildings over 2010-2011 period are factors which will drive prime rents upward.

Warehouse Market

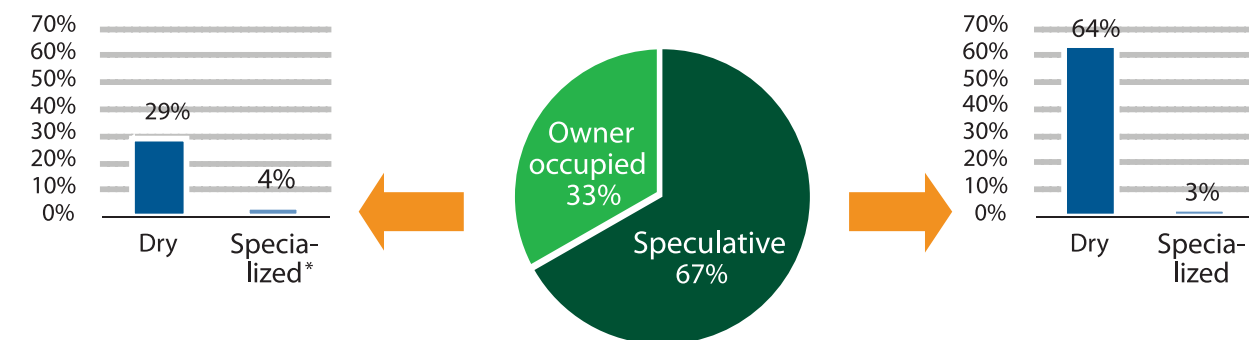
Fundamentals

New Supply, Net Absorption and Vacancy Rate: Past and Future



E – Estimation F – Forecast

Source: CB Richard Ellis



* - excludes premises within production units and unprofessional (low-quality) schemes, old industrial refrigerators, storage facilities, etc.

Source: CB Richard Ellis

The supply-demand misbalance with net absorption consistently falling behind development completions, has been the recurrent feature of Kyiv warehouse market for almost two years. Specifically, in late 2008 vacancy went through the roof, hitting an all-time record of 28% as a result of record volumes of new supply entering the market (ca. 400,000 sq m) at a time when demand was severely dented by economic crisis. From Q2 2009, vacancy started to decrease slowly, but still remains in high double-digits (25%). The presently high level of vacancy coupled with slow pace of new supply points to the still weak demand for professional warehouse space. Gradual economic recovery is not yet reflected in the activity of key warehouse users. Today leasing activity in the warehouse market is the lowest among other commercial real estate segments.

Demand

In terms of demand structure, the market saw the continuation of 2009 trends, as only those companies who maintained their positions during the crisis stayed active. Their demand was primarily driven by upgrades and, to a lesser degree, by expansions. Such companies as Raben and Kuehne + Nagel were active on the logistics side, while among retailers there were Auchan, ATB, Novus, Eldorado and Nova Liniya.

Supply

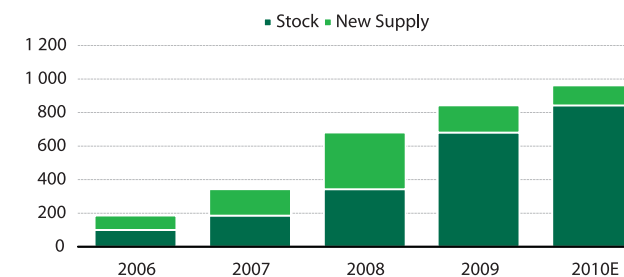
Stock Structure by Type Total Supply: 1,344,000 sq m

By the end of September 2010, total professional warehouse came to the following:

- total supply – 1,344,000 sq m (new supply – 65,000 sq m);
- total speculative supply – in excess of 900,000 sq m (new supply – 61,000 sq m).

As of today, total speculative stock includes all for-rent premises in both owner-occupied schemes are those offered to the open market.

Annual Development Completions and Total Speculative Stock ('000 sq m)



E – Estimation

Source: CB Richard Ellis

Rents and Vacancy

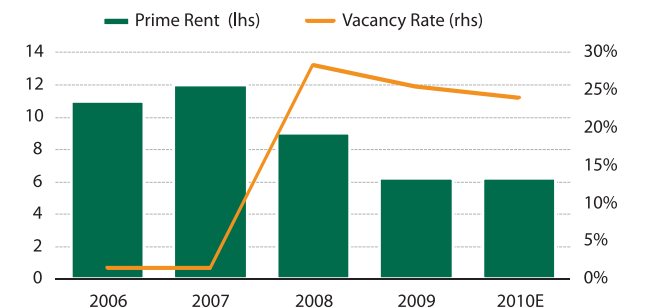
Rental rates currently stand at \$5.5-6.5/sq m/month (triple net), unchanged from Q4 2009 and on the back of very limited demand their growth prospects are weak despite significantly reduced pipeline. From Q3 2008 prime rents declined by 43% in USD terms and by 7% in local currency.

By the end of September, average market vacancy rate has comprised ca. 25%. Indeed, the share of vacant space in the newly delivered properties can be as high as 100%. Furthermore, the space that was initially planned for owner-occupation, but that is now offered to the open market intensifies competition for tenants and has an extra negative impact on vacancy.

All in all, landlords are still willing to compromise, keeping anchor tenants by means of more flexible terms and allocating rented space at own expense. For instance, whereas before the crisis landlords could foist

office premises and mezzanine regardless of tenant's needs, today they no longer do that, allowing tenants to refrain. Besides, landlords are ready to lease warehousing space in smaller units.

Prime Rent and Vacancy Rate



E – Estimation

Source: CB Richard Ellis

Outlook

Market activity will revitalize once internal demand gets better. For now it is rising only gradually (from a very depressed level) and is still far from booming. A rather large share of warehouse space will, therefore, stay vacant. Development starts, on their part, can only resume once the market leaves recovery phase behind and moves onto a more solid growth period.

Rents will remain unchanged in the mid-term due to excess vacant space and the delivery of new space before the year end. If rental rates are to grow, the market must be balanced with no more than 8-10% of vacant space. Rental growth is, therefore, impossible with today's vacancy rate of 25%.

New supply in 2011 is forecast to be the lowest for the last five years, which will help bring vacancy down quite considerably. Should the economy stay on track, existing premises will be gradually absorbed in 2011 and misbalance of supply and demand will start to correct itself on the back of sluggish development completions and bolder take-up.

Vacancy rate could go down to 10% by 2012 only on condition that net absorption

risers by 10% in 2010 and by further 25% in 2011 (provided new supply in 2010 and 2011 will be 120,000 and 60,000 sq m of warehouse space, respectively). On such optimistic assumption, no rental growth can be expected until H2 2012.

Hotel Market

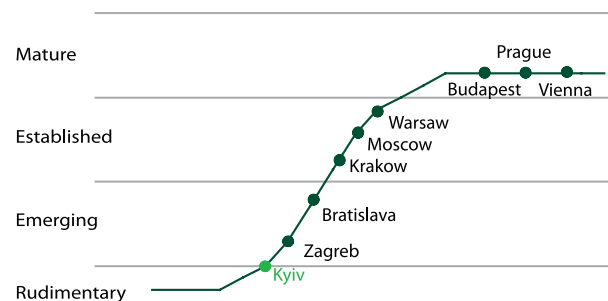
Main trends

- Resilience of the hotel segment during crisis due to acute deficit of quality supply
- Revitalization of the market in 1H 2010 with resumption of construction works on some major projects
- Governmental support and alleviation of tax burden for hotel developers
- Increase in tourist inflows
- Increasing occupancy of top quality hotels, reaching 60% by the year end
- ADR declining nevertheless Kyiv remains one of the most expensive cities in terms of accommodation cost

Supply

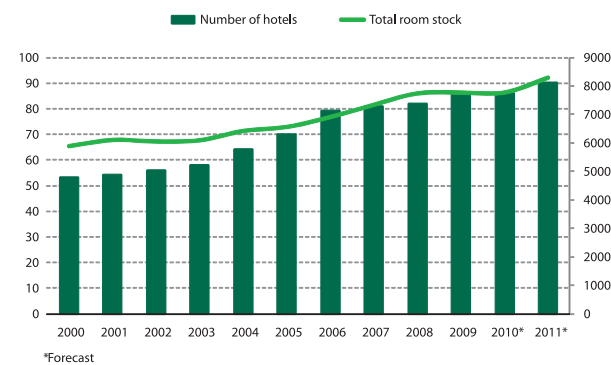
By the end of Q3 2010 total number of hotels in Kyiv amounted to 86 offering more than 7,500 rooms of different quality. After almost 10 years of constant but slow growth Kyiv hotel market witnessed no new hotel schemes in 2010 as a result of low construction activity during the crisis.

Hotel market positioning in CEE



Source: CB Richard Ellis

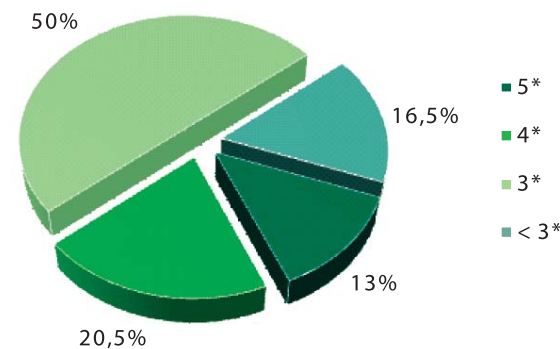
Kyiv hotel stock



Source: Kyiv Statistics Office, CB Richard Ellis

Hotels of low categories still dominate the market, while the share of 5* hotels is the smallest – 13% of total stock. Top-segment hotels corresponding to 5* category are represented only by 4 properties: Opera, Premier Palace, Hyatt Regency, and InterContinental.

Room structure by hotel category, 2010



Source: Kyiv Statistics Committee, CB Richard Ellis

Currently there are only 3 international hotel groups operating in Kyiv: Global Hyatt Corporation (Hyatt Regency 5*), InterContinental Hotels Group (Intercontinental 5*) and Rezidor Hotel Group (Radisson Blue 4*). For 2011-2013 several international hotel chains announced their plans of entering the Kyiv market. Among them Fairmont Hotels & Resorts (Fairmont 5*), Accor (Sofitel 5* and Ibis 3*), Hilton International (Hilton 5*), Starwood Hotels and Resorts Worldwide (Sheraton 5*), Marriott Hotels & Resorts (The Ritz-Carlton 5*).

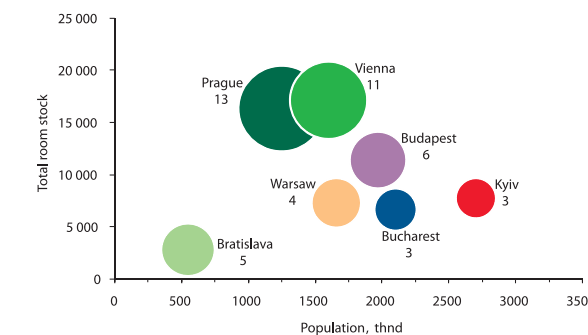
According to the Kyiv city officials, in 2011 there will be 8 hotel openings which should

add 1,453 more rooms to total stock. In addition there are 8 other hotels at different stages of construction but with a much lower probability of timely delivery. However, taking into account current state of construction on sites, we expect opening of only 4 hotels by the end of 2011, among which the long-awaited Fairmont Grand Hotel Kyiv (5*) and Ibis (3*).

In 2010 some developers resumed construction activity on a number of projects which were halted previously due to the recent financial downturn. In particular, developers of Hilton and Swissotel managed to find financing for their projects, while Sofitel announced the start of construction of the hotel in Kyiv for early 2011.

Overall, hotel provision rate in Kyiv remains at an extremely low level. At the end of 2010 in Kyiv there were 3 rooms per 1,000 residents, while in case of European capitals the average indicator ranges between 5 and 10 rooms per every thousand of local residents.

CEE hotel provision, rooms/thousand population, 2009



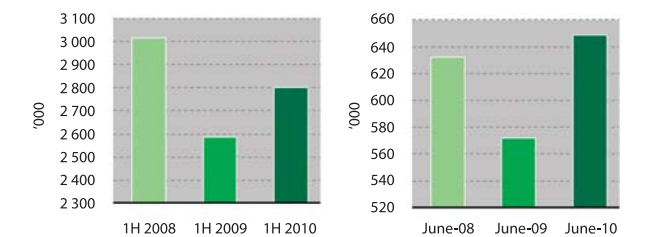
Source: CB Richard Ellis Hotels

Demand

Following a decade of consecutive positive tourist flow dynamics, in 2009 Kyiv saw the decline in the number of accommodated tourists for the first time since 2000. By the results of 2009, Kyiv hotels hosted about 960,000 tourists, a 20% decrease compared with 2008. But from the beginning of 2010 situation started to improve. In H1 2010 Boryspil International Airport reported

a 10% increase (y-o-y) in number of its passengers following last year's 15% decline.

Number of passengers in Kyiv Boryspil Airport

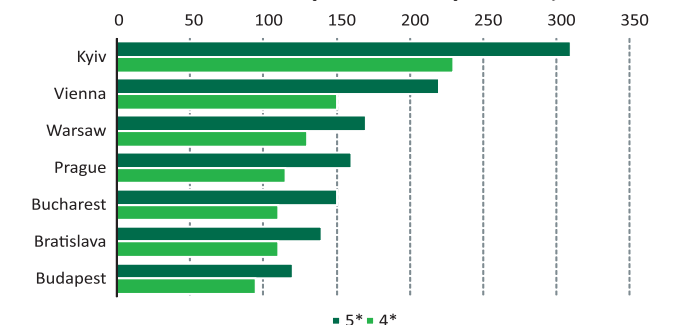


Source: Kyiv International Airport Boryspil

Improving tourist arrivals resulted in rising hotel occupancy rates in 2010. This indicator for upscale hotels was increasing throughout 2010 and currently reached 60%, however, it is still far from the average yearly figure of 70-80% observed on the market before the economic turmoil. In 2010 occupancy rate for midscale hotels ranged from 20% to 70% depending on the quality of the property. Such a wide range can be explained by a drastic difference in the quality of hotel stock in Kyiv.

Rates. Rack rates in Kyiv hotels fell on average by 15-20% in USD terms since Q3 2008. However, in Hryvnia terms, rack rates in UAH stayed approximately at the same level.

Standard room rates (rack-rates) in CEE, Euro



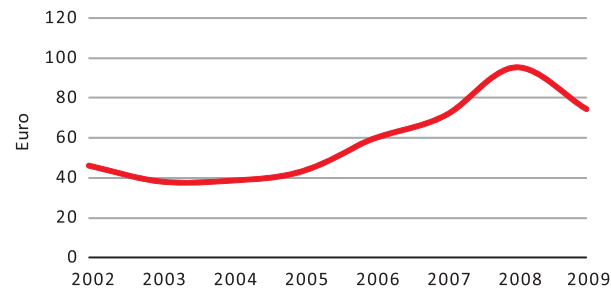
Source: CB Richard Ellis, 2010

Rack rates in quality hotels in Kyiv are often twice as high as in most of CEE capitals. However, in 2010 more than previously, Kyiv hotels were actively introducing various discounts on their rack rates which caused ADR (Average Daily Rate) to continue the declining trend of 2009. Since the begin-

ning of the year ADR in upscale hotels fell by almost 20%, reaching the level of 200-230 USD per night. Nevertheless, Kyiv re-

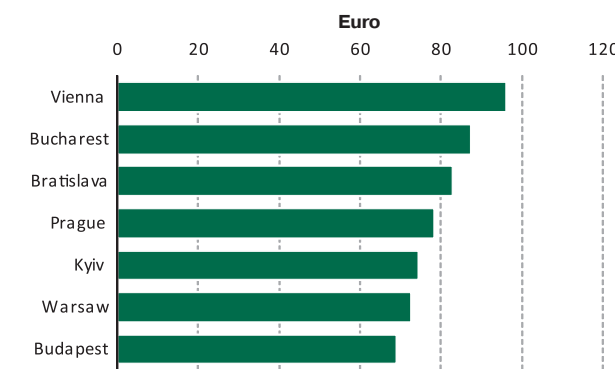
mains one of the most expensive CEE cities in terms of accommodation cost.

ADR in Kyiv (market average)



Source: Kyiv Statistics Office, CB Richard Ellis

ADR in CEE, 2009 (market average)



Source: CB Richard Ellis

Forecast

- New supply in 2011-2012 is forecast to be the highest since 2000
- Major international operators to enter Kyiv hotel market in the upcoming years

- Demand is likely to continue the growing trend albeit at a moderate pace in the short-term
- With ADR still declining, rates are unlikely to grow in the short to middle term taking into account significant expected new supply in the top segment of the market.

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15. TAXATION

Ukraine: New Year with the Brand New Tax Code

by Slava Vlasov, Partner, PwC Ukraine



Early in December 2010 the Ukrainian Tax Code was signed by President Yanukovich and officially published. On January 1st, 2011, this document – which has sparked heated debates in the Parliament and drawn healthy criticism from the international business community as well as small domestic businesses – will become law, with the following exceptions:

- Profits tax chapter, one of the most debatable, will come into effect on April 1st, 2011;
- Real estate tax for individuals will be introduced from 2012;
- New transfer pricing rules will come into effect in 2012, and
- Taxation of interest income earned by individuals from deposits is deferred until 2015.

The logical question is whether this brand new Tax Code is a good or bad thing for international businesses that operate in Ukraine or have Ukraine in mind for potential expansion.

Earlier in 2010, in the days following the presidential elections in Ukraine, the new Ukrainian Government publicly declared its intention to reform the tax system. In light of this declaration, it was, in our professional view, a good thing for both Ukraine and Ukrainian and international businesses, to have codified tax rules that would replace the hundreds of currently existing laws, regulations and interpretations, which are in many cases inconsistent with one another.

Does this really mean the end of the tax reforms to which Ukraine has been committed? No, in fact, this probably means only the start

of these reforms. It matters a great deal for the business community what the Tax Code looks like now, but no less important is what will happen with the implementation and changes of this document in the first couple of years after its enactment. Much will depend not only on the new rules of law, but on the approach that the Ukrainian authorities will take in monitoring the impact of the changes on business and adjusting the new rules in a way that makes the Ukrainian economy attractive to new foreign investment.

PwC Ukraine was actively involved in discussions of the proposed new tax rules, concerns of the international business community and their suggestions on ways forward with the Ukrainian Government and Parliament. Based on these discussions, we would like to offer the foreign business community the following food for thought.

KEY POINTS OF THE NEW TAX CODE AND ITS IMPACT ON UKRAINIAN BUSINESSES

The Ukrainian Government presents the new Tax Code as a very progressive document that, among other measures, reduces the rates of major taxes (Corporate Profits Tax and VAT), eliminates a number of small but burdensome local taxes that currently exist in particular regions or towns of Ukraine, unifies statutory and tax accounting rules and simplifies the VAT recovery procedures, the latter of which is currently a major tax issue for exporters in Ukraine.

It should be noted, however, that the tax rates are not the major tax issue for Ukraine; they are quite comparable with other European tax rates. Tax administration is the real issue, given that Ukraine is currently ranked

by PwC, World Bank and IFC as one of the least attractive countries when it comes to ease of paying taxes.

Initially, Ukrainian business was shocked by the version of the draft Tax Code, passed by the Ukrainian Parliament in the first reading in June 2010, which was largely based on the assumption that a taxpayer is always wrong and guilty. Inconsistent compilation of existing tax laws with significant revision of rules for tax audits, tax assessments and appeals against them in the favour of the tax authorities, in combination with the proposal to give the tax office almost unlimited powers to control business and collect taxes at own discretion, were the reasons why business said a clear “no” to that document. The business community expressed a clear view to the authorities that that version of the Tax Code would never ease doing business in Ukraine.

Now, reading the Code, we are glad to say that the voice of business was heard by the authorities. Most disputable and arrogant administrative rules were taken out of the draft and the following key principles were introduced into the Code:

- **Unification and simplification of tax rules.** The terminology of the document is much more consistent than the one in the original draft. The first steps are taken toward unifying statutory financial and tax accounting, which eases the lives of accountants and finance personnel.

Currently multinational corporations keep three sets of accounts in Ukraine: IFRS, statutory financial and statutory tax. Unification of the last two is clearly a positive factor. Examples of unification include same rules for recognition of revenues and costs, same depreciation rates and same approach to recognition of exchange rate differences, allowance of accelerated depreciation of machinery, equipment and transport vehicles.

Still, many other things need to be done in this area after the enactment of the

Tax Code, i.e. unification of statutory accounting rules with the international financial reporting standards, simplification of the procedures to prepare the tax returns, etc.

The Code has also reflected the concept of stability of tax rules, i.e. at least 6 months prior notice to business is required to introduce any future significant changes in this document.

In addition, the Code contains a “conflict of interest” clause, stating that if tax rules are inconsistent, they should be interpreted in favour of a taxpayer.

- **Simplification of tax administration.** As mentioned above, tax administration rules are, at least, no worse than the current rules. In addition, the authorities have agreed to introduce less frequent and more simplified tax reporting for relatively small businesses.

This is only the first step in the improvement of tax administration in Ukraine. What goes beyond the Tax Code is the qualitative improvement of tax audits. The tax authorities must understand the industries they are auditing, market trends and the financial indicators of these industries at a particular point of time, so that the tax audits are focused on the identification and understanding of deviations from these trends and indications for a particular taxpayer, as well as discussing their rationale with the taxpayer prior to tax assessment.

Another positive example of the improvement of tax administration is the introduction of a single personal income tax rate for both Ukrainian tax residents and non-residents alike. Currently, non-residents are subject to tax at a double rate and to establish Ukrainian tax residency is a long and burdensome process, requiring lots of time and effort for both individuals and their employers.

We would separately like to mention that the Tax Code has introduced the con-

cept of “automatic” VAT refund, which is one of the key tax issues for exporters in Ukraine. In the last several years Ukraine has consistently failed to refund VAT to business in cash. The procedure for the refund introduced by the Code is very straightforward; it allows transparent businesses to get cash from the Government in a few weeks, compared to months and years of waiting which has been the case to date. However, for this new rule to work, the Government still has to develop an electronic register for all VAT invoices in the country and make this register work efficiently. This is no easy task and may take time to complete.

- **Mutual responsibilities of businesses and the Government in the tax sphere.** Given that the Ukrainian tax system is still developing, tax penalties on bona fide companies should be fair. International businesses are glad that the Government heard their concerns on this issue and significantly reduced tax penalties in the Tax Code.

Another positive change is that the Government has agreed to be financially liable for late refund of VAT. Late payment interest payable by the Government is introduced for each day of delay of the refund.

Given that the Tax Code is a brand new document that was made a law less than a month before the start of new fiscal year, it will give very little time to businesses to adopt to the changes, i.e. read the document, adjust accounting policies and procedures, make necessary changes into accounting software and reorganize tax-compliance and tax-planning functions. The authorities have agreed to set a “grace period” of 6 months after the introduction of the Tax Code. A nominal penalty of 1 Ukrainian Hryvna will apply to tax violations committed during this period. In addition, for corporate profits tax, no penalties will apply during second and third quarters of 2011.

IMPACT OF THE CODE ON FOREIGN INVESTMENT INTO UKRAINE

The proposed improvements of the tax rules will clearly lead to a reduction of state budget revenues in the short term. It is our understanding that in trying to compensate for this, the Ukrainian authorities have introduced in the Tax Code several significant limitations for businesses that negatively impact foreign investors in Ukraine. They include, for example:

- Prohibition for businesses, except for those operating in IT area, to deduct costs of goods, works and services purchased from individual entrepreneurs that pay Unified Tax;
- Limitations for business to deduct royalties, consulting, advertising, marketing and engineering fees payable to non-residents, unless such non-residents create permanent establishments in Ukraine and tax the above fees in Ukraine;
- Absence of costs for promotion of goods, works, services and trademarks in the list of tax deductible expenses. While this list is not closed, absence of direct indication of the tax deductibility of these costs in the Tax Code may lead to tax disputes;
- Non – deductibility of VAT payable by new businesses at start-up phase. New businesses that invest in, for example, manufacturing facilities, are not recognized as VAT payers until they make first sale, and thus are not able to recover VAT paid on construction works, purchased equipment, etc
- Unfair VAT treatment of several industries, for example grain traders, auditors, consultants, accountants, lawyers, software developers. Operations of these industries will not be subject to VAT. As a result, VAT that these businesses pay to their suppliers becomes extra cost for them.

We understand that the Government’s rationale for these limitations is to prevent tax schemes used by non-transparent businesses in order to reduce their Ukrainian tax liabilities. Transparent international businesses fully support this intention, but the format of the limitations is unacceptable to them.

Take services payable to non-residents for example. Recharge of group costs as a service fee is a generally accepted business practice for multinational groups. It is aimed at the allocation of relevant costs to the entities that obtain economic benefits from services, and therefore tax deductibility of such fees should be economically justified. While the Government has heard the voice of business and rejected the original idea to completely prohibit tax deduction of such fees, limitations introduced by the Tax Code are still not good for investment image of Ukraine in the eyes of foreign investors. As a result, further foreign investments in Ukraine may not be attractive for international businesses compared to opportunities in neighbouring countries. In addition, Ukrainian subsidiaries of international businesses will compensate their additional tax costs (corporate profits tax, VAT, excise tax if applicable) via increases in the prices of their goods, works and services in Ukraine. As a result, Ukrainian consumers will suffer from higher prices on high quality products.

The Ukrainian authorities need to further revisit this and other rules that discriminate against international businesses. In our view, the best way to balance the interests of both the Government and businesses is

to follow best international practices. For example, it is well known that no developed countries prohibit the deduction of service fees payable to foreign suppliers. As a rule, service fees payable to unrelated foreign suppliers are fully tax deductible. When such payments are made to a related party, other countries allow tax deduction to the extent that the payments do not exceed the level of similar payments to unrelated parties (the “arm’s-length” principle). Other countries have developed their transfer pricing legislation that defines “arms-length” and Ukraine should introduce the same rules and apply them consistently.

A final aspect worth mentioning when discussing the new Tax Code is that it does not offer any specific tax incentives for foreign investments. While the incentives as such should not be a decisive factor for an investor to make a decision to invest or not, they may serve to differentiate Ukraine from neighbouring countries in the eyes of a particular investor. We believe that Ukraine need to revisit its approach to stimulating foreign investment activity.

To conclude this short summary of the Tax Code, it is important that the Ukrainian authorities are prepared to stay in active dialogue with the business community on any issues that businesses experience after the enactment of the Code and further amend this document to stimulate business activities in Ukraine. Therefore, businesses should not miss their chance to voice their issues and concerns during this dialogue.

VAT refund in Ukraine: before and after January 1st, 2011

By Anna Iakubenko, Attorney, Chadbourne & Parke LLP

In Ukraine, obtaining a VAT refund from the state is a well-known problem. Mostly, it affects export-oriented enterprises. A withdrawal of money from businesses negatively

affects their financial positions and reduces the attractiveness of the sector for investors. The problem is caused, in particular, by the effective legislation regulating the VAT

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refund procedure which is far from perfect.

On December 2nd, 2010, Ukraine adopted its first Tax Code that came into force on January 1st, 2011. Among other important problems, which the Tax Code was called to resolve, the authorities also included a simplification of the VAT refund procedure.

This article reviews the status of the VAT refund problem at the end of 2010, as well as how the Tax Code's provisions impact this problem starting from January 1st, 2011.

A VAT refund before January 1st, 2011

Until January 1st, 2011, the law of Ukraine "On the Value Added Tax" dated April 3rd, 1997, # 168 (hereinafter – the "VAT Law") regulated taxation with VAT in Ukraine.

According to the VAT Law, a VAT payable to/receivable from the state had to be generally calculated as an output VAT (which was assessed on sales) less an input VAT (which was paid in relation to purchases). If such calculation resulted in a negative amount for two consecutive months, a taxpayer was entitled to claim a VAT refund¹. The amount subject to a refund had to be computed as a portion of such negative amount, which was actually paid by a taxpayer to suppliers in previous months.

According to the VAT Law, a taxpayer was not entitled to claim the refund in the following particular instances²:

- (i) If a taxpayer was registered for VAT purposes for less than 12 months before the month for which it filed a claim. Mostly, this provision negatively impacted developers and newly created export-oriented companies.
- (ii) If the amount of VAT-able sales was less than the amount of a claimed VAT refund. However, this restriction did not apply to a refund in respect of fixed as-

sets acquisition or construction.
(iii) If a taxpayer did not conduct any activity during the previous 12 months³.

If a taxpayer was not entitled to the refund, the accumulated input VAT had to be carried forward for setting off against its future VAT liabilities.

If a taxpayer decided to claim a refund, it had to declare such decision in a VAT return for a respective month and attach export customs declarations (supporting the fact of export) to the return. Within five days after filing the return, a taxpayer had to submit its copy (stamped by the tax authorities) to the state treasury⁴.

The tax authorities had to verify the amounts declared for refunding and provide a confirmation to the treasury. Based on such confirmation, the treasury had to remit money to the taxpayer. According to the VAT Law⁵, the maximum duration of the above-mentioned VAT refund procedure was 70 calendar days, including:

- (i) 60 calendar days for conducting statutory tax audit(s),
- (ii) five calendar days for providing the tax authorities' confirmation to the state treasury, and
- (iii) five calendar days for remitting money to the taxpayer's bank account.

Generally, the VAT Law provided relatively clear procedures for a VAT refund. However, it resulted in numerous complications in practice.

The tax authorities often failed to comply with the above-mentioned time frames, did not provide the confirmations to the treasury and significantly delayed the refunds. The tax authorities claimed that there were taxpayers that acted in bad faith and artificially created negative differences between output and input VAT in order to get money from the state in an illegal way. Such fraud

could take place if one or more suppliers in a supply chain did not pay VAT due to the state, but the taxpayer, which was later in such chain, had formal rights to obtain a refund from the state. To prevent fraud, the tax authorities conducted inspections of all suppliers in a chain up to the producer/importer of goods. However, such inspections could take up to several years. At that, Ukrainian law did not provide for any liability for the state for untimely VAT refunds.

If the authorities failed to confirm payment of VAT by any of the suppliers in a chain (because of a real non-payment, or a supplier's refusal to provide requested information), then they refused to confirm the amount claimed by a taxpayer for a refund. Such situations led to numerous disputes between the taxpayers and the tax authorities.

When considering such disputes, the courts tried to find a balance between two sides: on one side, a taxpayer could not be liable for breach of law by a third party (its supplier); on another side, a duly completed VAT invoice could not be a ground for obtaining a refund if the tax authorities proved that information contained in it was false. During the last two years, the courts tended to consider each dispute relating to such issues on an individual basis. They tended to analyze whether a taxpayer acted in good faith, and did not restrict themselves solely by analysis of formal legislative provisions (which were rather controversial). In particular, the courts paid attention to the following issues:

- (i) whether a business transaction really took place, or it was fake,
- (ii) whether a taxpayer had a business purpose, or solely intended to gain tax benefits,
- (iii) whether a taxpayer could be aware of the supplier's illegal actions (tax evasion), and
- (iv) whether all supporting documents were in place and duly completed⁶.

Unfortunately, successful winning of a VAT case in a court did not mean an immediate receipt of a refund by a taxpayer. According

⁶ Informational letter of the Higher Administrative Court of Ukraine dated July 20, 2010, No. 1112/11/13-10.

to the VAT Law, the tax authorities had to provide a conclusion to the state treasury within five days after receiving the court ruling for remitting money to a taxpayer. The tax authorities often delayed the submission of such conclusions. This resulted in further delays of the refunds to taxpayers.

The authorities declared that the above problems with VAT refunding had to be addressed by the Tax Code of Ukraine.

A VAT refund after January 1st, 2011

Starting from January 1st, 2011, taxation with VAT is regulated by the Tax Code of Ukraine dated December 2nd, 2010, # 2755 (hereinafter – the "Tax Code").

Mostly, the Tax Code did not amend the principles of the VAT refund calculation; however, it introduced a number of changes in the VAT refund procedure. The most important changes are as follows⁷:

- (i) A taxpayer is entitled to obtain a VAT refund in the following instances in addition to the previously existed:
 - If a taxpayer was registered for VAT purposes for less than 12 months before the month for which it filed a VAT refund claim, and such refund relates to fixed assets acquisition or construction, then a taxpayer shall be entitled to a refund. Therefore, the developers' problem regarding an impossibility to obtain a refund during the first year of their business may be resolved.
 - If a taxpayer did not conduct any VAT-able sales during the previous 12 months, but reported any input VAT, it shall be entitled to claim a refund⁸.
- (ii) A taxpayer is not required to file a copy of the VAT return (claiming a refund) to the state treasury any more.
- (iii) A penalty for an overstatement of a VAT refund, which is claimed and not received by a taxpayer, was introduced. Such penalty equals 25%/50%/75% of the amount of such overstatement for the first/second/third and later cases, respectively,

⁷ Article 200, Article 123.1 of the Tax Code.

⁸ Also, the tax authorities do not continue to be entitled to cancel a VAT registration of such taxpayer.

which occur during a 3-year period. In our view, such penalty has no economic grounds because a taxpayer does not obtain any money from the state at the stage of filing a claim for a refund.

(iv) A general electronic register of VAT invoices was introduced. Such register is expected to simplify the procedure by which the tax authorities control taxpayers acting in bad faith, and reduce the number of counter inspections of the taxpayers' suppliers.

(v) In addition to a standard VAT refund procedure, an automatic procedure was introduced. Under the new procedure, obtaining a refund should take 26 calendar days, including:

- 20 days for conducting an audit by the tax authorities,
- three days for confirming the amount of the refund by the tax authorities to the state treasury, and
- three days for remitting money by the treasury to a taxpayer.

To benefit from such automatic refund, a taxpayer must meet numerous criteria (in particular, conduct sales taxable at 0% VAT rate), and the amount of the claim must be confirmed by the tax authorities as a result of their audit(s).

(vi) If a taxpayer meets certain criteria, which have to be established by the Cabinet of Ministers of Ukraine, during a 36-month period, it shall be considered to have a positive tax history. For such category of

taxpayers, the maximum duration of the refund procedure shall be five calendar days after January 1st, 2014.

(vii) The state is obliged to pay interest for each day of the delay of a refund. The annual interest shall be computed as 120% of the discount rate established by the National Bank of Ukraine.

Unfortunately, the Tax Code (similarly to Ukrainian legislation for the last three years) does not provide for alternative non-cash mechanisms of VAT refunding. Such mechanisms could potentially be the issuance of VAT promissory notes for imported goods, offset of the VAT refund receivables against taxes due to the state, etc. Summarizing the above, the Tax Code made a number of positive changes which are called to simplify and quicken the VAT refund procedure, including introduction of an interest penalty for an untimely refund.

Conclusions

The difficulties in obtaining a VAT refund are an obstacle for investing in the export-oriented Ukrainian businesses. The first Tax Code of Ukraine is called to address this problem by simplifying the VAT refund procedure, introducing an electronic administration of VAT invoices and establishing a liability of the state for untimely refunds. Practice shall demonstrate whether the new procedures appear to be efficient and improve the investment attractiveness of Ukraine.

Investing in distressed loans in Ukraine: certain legal, tax and regulatory considerations



The global economic crisis gave new meaning to the concept of the "distressed investor". This kind of investor is willing to risk its capital by acquiring assets that are low-priced due to the crisis, with the hope of selling them at a gain when business normalizes.

The Ukrainian banking and financial sectors, hit hard by the crisis, naturally offer a lot of opportunities for distressed investing.

The rapid fall in the quality of loan portfolios and growing provisions created incentives for Ukrainian banks to get rid of their distressed assets. Recent changes in the tax legislation facilitated this course of action. In particular, Laws of Ukraine dated June 23rd, 2009 #1533 and dated July 24th, 2009 #1617 specifically allowed Ukrainian banks to deduct (discount) losses incurred upon selling a loan portfolio. This cleared the way

for banks to sell distressed loans to third party investors.

Now many banks are tendering for sale their retail unsecured consumer loan portfolios and their auto loan and mortgage portfolios in foreign or local currencies. Low asking prices should be attractive for potential investors. But apart from purely business considerations (the pricing of the assets and the expected profitability) the interested investor should think about designing a robust legal and tax structure with which to make the investment and repatriate the expected profits from Ukraine.

It is to be expected in the Ukrainian legal and regulatory environment that investors will face significant impediments caused by underdeveloped and fluctuating legislation. Certain civilized structuring solutions will become unreasonably distorted or be difficult to achieve.

There are several basic structures that an interested investor can consider for structuring acquisitions of distressed loan portfolios from Ukrainian banks:

- a foreign special purchase company (non-resident SPV);
- a Ukrainian financial company that can provide factoring services (factoring company);
- a Ukrainian venture fund.

Each of these structures implies that an investor establishes a vehicle (a company or a non-corporate entity such as a venture fund) in a chosen jurisdiction and enters into an agreement with a bank in Ukraine to purchase the loans. On the basis of this agreement the investor's vehicle becomes a new creditor under the loan agreements and receives all rights to collect outstanding loan principal, accrued interest and commission fees and other payments from the borrowers in Ukraine.

Below we discuss in more detail some of the structuring considerations relevant to the options we have mentioned.

Non-resident SPV

The non-resident SPV is the most obvious choice for a foreign investor. It creates an opportunity to repatriate all distressed loan proceeds from Ukraine to a jurisdiction with low or no taxation.

Selecting the foreign jurisdiction for the location of the SPV is important, as it is driven by tax considerations (i.e., the withholding tax rate on payments the Ukrainian borrowers will remit to the new creditor, the possibility of benefiting from double tax treaty exemptions, taxation of inbound and outbound financing flows in the hands of the SPV, etc.). Some jurisdictions may (under certain conditions) consider profit that the SPV realizes to be of a capital nature for tax purposes and thus exempt it from corporate profit tax. Cyprus is often ranked first among the jurisdictions usually shortlisted by investors.

Unfortunately, the tax benefits that a non-resident SPV structure could potentially provide are overshadowed by regulatory impediments. In particular, under National Bank of Ukraine (NBU) regulations, each loan assigned to a foreign company must be registered with the NBU. The registration is handled by regional NBU departments and is generally not burdensome. However, it is important to note that the obligation to register the assigned loan lies with the borrower (an individual or a corporation). The new creditor (the non-resident SPV) is not entitled to file a registration application on behalf of the borrower, unless the borrower issues power of attorney to the new creditor.

An impediment to the transfer of loan proceeds from Ukraine could arise if the borrower is unwilling to cooperate and assist with the registration of the loan. The NBU's regulations prohibit banks from servicing payments abroad on loan agreements (including assigned loan agreements) that are not duly registered with the NBU. Therefore, if the borrower refuses to register the

loan, the non-resident SPV will most likely be unable to extract foreign currency proceeds from Ukraine.

Currency control regulations may also hinder transferring loans denominated in Ukrainian currency to the non-resident SPV. Ukrainian currency (UAH) is not freely convertible, and the non-resident company is restricted in terms of repatriating its proceeds from Ukraine.

The combination of these regulatory impediments effectively means that the non-resident SPV structure may work if the investor is contemplating purchasing a limited number of large corporate loans in a foreign currency. In that case completing the currency control procedures (registering the loans with the NBU) should not be too burdensome. For loan portfolios consisting of a large number of individual loans other structures may need to be used, because arranging for the registration of each individual loan may be unfeasible in practice.

Ukrainian factoring company

The Ukrainian company that the investor establishes in Ukraine to purchase loan portfolios will likely be required to obtain financial institution status due to the following reasons.

The Civil Code of Ukraine qualifies factoring as financing provided in exchange for assignment of a monetary obligation and for a fee (the definition has recently been clarified by the State Commission of Ukraine for Regulation of the Financial Services Markets (the Financial Services Commission). In particular, it qualifies a discount to the debt value as a factor's fee. Factoring is mentioned among those financial services that require the service provider's registration as a financial institution. Financial institutions should provide financial services on an exclusive basis.

To obtain financial institution status, the Ukrainian company should be included in

the State Register of Financial Institutions of Ukraine. The Financial Services Commission maintains this register.

To conduct factoring operations, the SPV may be recorded in the register as a "financial company," which is a separate type of financial institution according to the Commission's regulations. To be included in the register, the company must comply with a number of Financial Services Commission requirements.

Overall, it is not that difficult to create and register a financial company, which is evidenced by the fact that there are dozens of such companies in Ukraine. The disadvantages of the factoring company structure, however, lie in the taxation treatment of its operations.

A factoring company is subject to all applicable Ukrainian taxes, including the corporate profit tax. For tax purposes the factoring company should define a taxable result for each loan purchased as a difference between proceeds collected on the loan and the cost of purchasing the loan. Importantly, the tax law imposes restrictions on netting losses and gains between different loans. If it incurs losses on one loan, the company is unable to deduct the losses against gains realized on other loans or against taxable profit from other operations. This could significantly increase the effective tax rate of the company.

There are also gray areas and uncertainties in a Ukrainian factoring company's tax regime. It is not clear if the factoring company should continue accruing interest income in its tax books on the loans purchased. If the loans are denominated in foreign currencies, the factoring company may be required to revalue the loan principal and overdue interest in its books and recognize FX gains (or losses) in the tax return. It is important to understand that the likelihood of actually collecting such accrued (unrealized) income in full is very much doubtful in circumstances when the loan is long overdue and is

purchased at a big discount. Recognizing such accrued income in the company's tax books may therefore increase its effective tax rate even further.

For these reasons, from a tax perspective an alternative structure deserves consideration. According to that structure, the loan portfolio is assigned to a Ukrainian venture fund operated by an asset management company. A venture fund is not subject to corporate profit tax on any proceeds from its assets. Tax-free repatriation of profits from the venture fund can also be arranged. We discuss this structure below.

Another complication with the Ukrainian factoring company's structure arises in the area of currency control operations. Under Ukrainian law any financial institution must obtain a general license from the National Bank of Ukraine to perform currency transactions. A factoring company is a financial institution under the Ukrainian law. It must therefore obtain a general license from the NBU to perform currency transactions if it is going to collect proceeds on loans in foreign currencies.

As a way to side-step this requirement, the factoring company may engage a Ukrainian bank to act as servicer on the purchased loan portfolio. That bank will convert foreign currency proceeds on the NPLs into Ukrainian currency (UAH) and will credit UAH proceeds to the factoring company's bank account. The factoring company will thus receive only UAH proceeds.

Based on the foregoing, an argument can be made that the asset management company is not required to receive a general license from the NBU because it will not receive any foreign currency in its bank account.

At the same time, the law defines a currency transaction as, among other things, any "assignment of debt receivable denominated in a foreign currency." On this basis, the proposed assignment of the foreign cur-

rency loans to the factoring company may be regarded as a stand-alone "currency transaction." Following the literal interpretation of the law, the factoring company is required to obtain a general license from the NBU to perform this currency transaction. Interested investors should obtain a clarification from the NBU about this issue prior to entering into the proposed transaction.

Ukrainian venture fund structure

A venture fund has no legal entity status and represents a contractual mutual investment vehicle (assembly of assets) jointly owned by the fund's investors and managed by the asset management company (AMC). All transactions with the venture fund's assets are carried out by the AMC, which is a legal entity acting under a license issued by the Ukrainian Commission on Securities and the Stock Market (SEC).

Upon obtaining a license from the SEC to manage mutual investment funds, the AMC should get registered as a financial institution¹ and should comply with financial services regulations².

An obvious advantage of the venture fund is its tax efficiency. According to Ukrainian law, only corporate entities and individuals are recognized as taxpayers. The venture fund itself does not qualify as a taxpayer.

All transactions with venture fund assets are carried out by the AMC, which has the status of a corporate profit tax payer on a general basis. The AMC manages the venture fund's assets not on its own behalf but on behalf of and for the benefit of third parties

¹ Para. 14 of Chapter III of the Licensing terms of activity on managing assets of institutional investors, approved by the Resolution of the SEC # 341 dated May 26th, 2006, as amended.

² Para. 1.11 of the Order of forming and maintaining the state register of financial institutions providing financial services on the securities market, approved by the Resolution of the SEC # 296 dated July 14th, 2004.

– the investors. The AMC should therefore not account for transactions with the venture fund's assets in its own tax returns.

As the result, all gains and losses that the venture fund realizes on its assets (purchased loans) are not taxable (deductible). For this reason the venture fund should not suffer from restrictions on netting gains and losses on the loans purchased – restrictions that apply to a factoring company.

Taxation may also be avoided at the stage when profits are repatriated from the venture fund. Dividends paid by Ukrainian companies are normally subject to advance corporate profit tax of 25%. However, for venture funds (and other mutual investments funds) an exemption applies. If the venture fund's investors are non-resident persons, they can, on the basis of applicable double tax treaties, obtain an exemption from Ukrainian withholding tax on dividends and capital gains received from investment into the fund. Finally, many foreign jurisdictions would treat income from investments into the venture fund as income of a capital nature and not subject it to profit tax.

Is that too good to be true, the potential investor may ask? Are there any hidden pitfalls? Of course there are.

Acquiring a debt portfolio for cash consideration at a discount should qualify as a factoring service that the AMC has provided to the originator of the loans. There is a list of financial services that financial institutions may not combine. According to it, asset management services (i.e., the AMC's managing of the venture fund) may not be combined with any other financial service (e.g., factoring), unless otherwise is established by the law. The law does not provide an exemption for factoring services. On this basis, one may argue that the AMC may not provide factoring services and that, therefore, the venture fund's acquisition of the loan portfolios is not in compliance with

the law. The issue may be clarified with the Financial Services Commission.

The venture fund structure is unfortunately affected by the same currency control issues that are relevant for the Ukrainian factoring company. The AMC, as a financial institution, may need to receive a general currency license from the NBU to purchase loans in foreign currencies.

As the above indicates, if compared against each other none of these options appears to be a clear winner. One option offers great tax benefits and advantages to the investor but is troublesome from a regulatory perspective. Another option is simple and straightforward, but results in higher taxation costs. As a result, the investor must perform a feasibility study to identify the option that best suits present interests in each particular case.

The range of issues that could arise when structuring this kind of deal is far wider than we were able to discuss above. These include specific legal issues (banking secrecy requirements, risks connected with litigation and enforcement in progress, dealing with collateral, operating foreclosed assets, etc.), practical implementations aspects, commercial benefits, etc.

Interested investors should also remember that for all structures we have discussed above, there are plenty of international tax issues to consider. The investor should choose a proper jurisdiction for the holding company that will own shares in the SPV – a jurisdiction that will allow it to avoid Ukrainian withholding taxes on dividends and capital gains. A careful choice of the financing structure for the SPV is also important.

**The article by Igor Chufarov, Tax & Law Senior Manager with Ernst & Young, was published on International Tax Review online on June 24th, 2010.*

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16. TRANSPORT AND LOGISTICS

Automobiles market review in 2010

by "Trade house-NIKO", official distributor of Mitsubishi Motors in Ukraine, Belarus and Moldova.

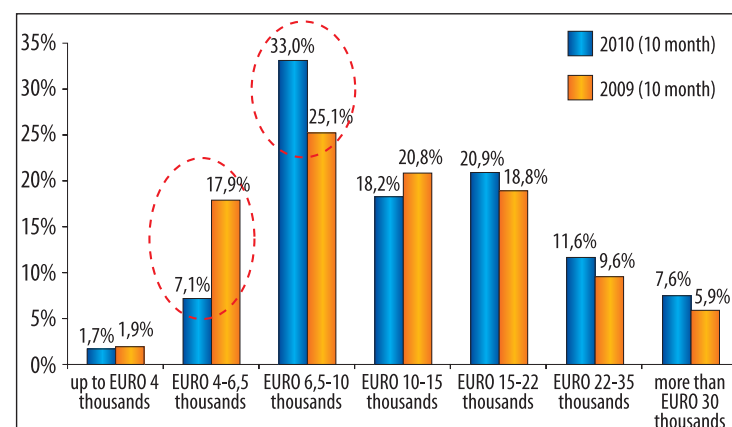
The general downturn of the new automobiles market in Ukraine is caused by total clearance sale of warehouses in 2009 as well as price-rising adjustment policy implemented by the majority of market operators in 2010 in terms of 2010 manufactured automobiles. Nevertheless, if we consider the dynamics of the latter half of the year, it is 10% higher than sales in the same period of 2009. These figures as well as the fact that the percentage of automobiles sold on credit grows monthly, inspires optimism in importers and dealers. Indeed, in 2009 only 5% of automobiles were sold on credit, while this October the rate was more than 12%.

The optimistic sales forecast by the end of this year is the recurrence of sales results in 2009 (nearly 160 thousand cars). Positive dynamics of the latter half of the year together with increase of automobile crediting are the reason to feel glad, and someday we will say that the Ukrainian automotive market began to restore in the second half of 2010 after a crisis lasting for one year and a half.

Based on the results of 10 months of 2010, a considerable growth in 6.5 – 10 thousand EUR price segment was marked, against to the same period of 2009 (33% against 25.1%) and reduction of 4-6.5 thousand EUR price segment.

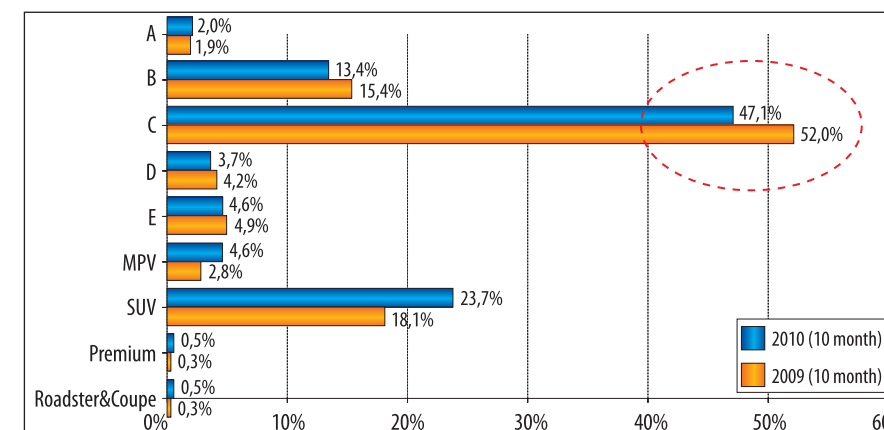


Structure of new automobiles' market up to price segments



	2010 (10 months)		2009 (10 months)	
up to EURO 4 thousands	2147	1,7%	2651	1,9%
EURO 4-6,5 thousands	9049	7,1%	24867	17,9%
EURO 6,5-10 thousands	42359	33,0%	34920	25,1%
EURO 10-15 thousands	23295	18,2%	28944	20,8%
EURO 15-22 thousands	26810	20,9%	26116	18,8%
EURO 22-35 thousands	14898	11,6%	13335	9,6%
more than EURO 30 thousands	9687	7,6%	8183	5,9%
	128245		139016	

Structure of new automobiles' market up to classes



	2010 (10 months)		2009 (10 months)	
A	2569	2,0%	2700	1,9%
B	17173	13,4%	21437	15,4%
C	60346	47,1%	72357	52,0%
D	4757	3,7%	5779	4,2%
E	5866	4,6%	6832	4,9%
MPV	5917	4,6%	3917	2,8%
SUV	30361	23,7%	25180	18,1%
Premium	677	0,5%	368	0,3%
Roadster&Coupe	579	0,5%	446	0,3%
	128245		139016	

Another trend is that in Ukraine, like in Europe, SUV category percentage is steadily increasing as well as the share of C category is decreasing.

This would allow the Ukrainian importer not only to have a required amount of automobiles for the country at its disposal avoiding considerable limitations (quote), but to draw up automobiles specifications based on the preferences of Ukrainian consumers. The recent agreement signed for 5 years testifies the high level of trust of the world-known manufacturer in the Ukrainian partner. This unparalleled agreement was preceded by successful history of establishment and development of Mitsubishi Motors brand in Ukraine: Mitsubishi automobiles became leaders of the country's automotive market. Only over the last 6 years more than 100 000 Mitsubishi cars were sold through the authorized dealerships network of the importing company. Moreover, 'Trade house-NIKO' company was recognized as the major importer of Mitsubishi Motors in Europe.

In 2010 'Trade house-NIKO' company has made several extremely important steps towards potential consumers of Mitsubishi automobiles. In particular, at the end of September a distribution agreement was concluded for 5 years between the Ukrainian importer and the manufacturer. It is worth mentioning that in 2008, taking into consideration the results of Mitsubishi Motors brand development in Ukraine, MMC made a strategic decision to make the market of Ukraine independent from the European office, forming it as an individual world market subordinating directly to the Head Office of the company in Tokyo (Japan).



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MMC does not conceal that the market of Ukraine is of high priority and perspective for the Japanese corporation.

The most important result of the new agreement is switching to a new service schedule of 15 000 km for automobiles starting from the model range of 2010. Furthermore, from the beginning of 2010 the authorized

dealership Mitsubishi Motors network in Ukraine cut prices for the range of parts - from 12.5% to 42%. Thus, total reduction of value of all basic services for 100 000 km warranty will account for nearly 25-30% for customers. Moreover, the company presented 2 new automobiles, ASX and Pajero Sport, as well as the updated Outlander XL and L200.

Logistics shows growth - results of UVK's marketing research of Ukraine's 3PL market



The logistics market of Ukraine is one of the most attractive domestic sectors for investment. Prerequisites for this are created by business activities of logistics operators and unique geographical position of Ukraine. Four out of ten international transport corridors go through the territory of the country; there is an access to the sea with unfrozen ports, infrastructure for international flights.

of the market, reporting to tax authorities, data on purchases / lease of vehicles, warehouse real estate, machinery, etc.

In Ukrainian logistics, operations related to transport logistics dominate structurally - 89%, storage services - 8%, freight forwarding services - 2%, supply chain management - just 1%.

3PL Market in Ukraine — Players and Structure

Most logistics companies entered the market in 2005-2008, when logistics in Ukraine was promising and rapidly developing. UVK - Ukrainian logistics leader - started its business in 2001, meeting the logistical requirements of a large trade association.

3PL Market in Ukraine — Trends of 2010

The interest of customers to receiving integrated services from one contractor - a 3PL principle - is a market trend that emerged in Ukraine about 5 years ago. In 2010, it not only retained its relevance, but also gained influence. The representatives of large international companies, the traditional customers in the present market, are added by those who started thinking about the need to cut costs by refusing to maintain their own logistics infrastructure after the crisis.

There are 16 professional logistics operators today. 12 of them work exclusively in the 'dry' logistics, 4 - offer services of 'cold chain' logistics - for products that require special temperature compliance.

UVK's experts estimate the 3PL market volume in Ukraine in 1.5-2 billion UAH with an error of 25%. This inaccuracy is caused by necessity of taking into account the contradictory information from different sources: applications of companies-participants

Since early 2010, the number of tenders increased significantly. Key vendors (suppliers) of consumer electronics decided to move to so-called "on-shore" business model, according to which imported commodities are imported and cleared by vendor's local office and all logistics flows are handled by a professional 3PL-partner.



17. TRAVEL AND TOURISM

Ukraine tourism is one of the fastest growing branches of the state economy. In Soviet Union times tourism was not even a branch of the State economy. It was just a neglected part of “the sphere of services”. For a considerable length of time, foreign tourists were allowed to come to officially designated “open” cities only.

Today tourism in Ukraine has been recognized as an important economic factor. For example the income from one foreign tourist in Ukraine equals income from exporting nine tons of Ukrainian coal.

Tourism serves as a major source of currency for 38% of countries in the world. Emerging economics have been at the heart of the tourism industry’s remarkable expansion over the past 30 years. Looking at international TV channels and magazines we see huge promotional investments by countries like Croatia, Macedonia, Hungary, Poland, Georgia and even Azerbaijan advertising themselves as the next generation of tourist destinations. Ukraine seems to be stumbling behind.

Inbound tourism can make a great contribution to a nation’s economy.

Tourism to Ukraine has yet to be really well marketed or well developed. Despite this, Ukraine and Kiev in particular have much to offer tourists.

Ukraine is a diverse and fascinating country, and Kiev is one of the great cities of Europe.

Kiev is a vibrant, historic and relaxed city which can and should quickly become as popular for tourists as Prague and Budapest.

Ukraine has excellent geography, climatic conditions and scenic nature. From the Black Sea and the Crimea in the South to the historical and archaeological monuments

of Kyivan Rus epoch (IX - XII centuries) in the North. Excavations of ancient towns dating from the 5th century B.C. as well as the magnificent fortresses built in the 14th-15th centuries by Italians from Genoa, are located in Crimea. From the Carpathian Mountains in the West to the wild prairies and Skythian barrows in the East. The Carpathian Mountains offer great skiing and snowboarding opportunities. Many regions of Ukraine have saved their ethnic originality, offering tourists great opportunity to get acquainted with national culture, songs, dances and cuisine. More than 600 museums introduce the most outstanding facts and personalities of Ukrainian history and culture.

As we start telling this to the world and inviting more people to visit, more people will discover and enjoy our country, its capital and its charming hospitality.

According to State border guard service of Ukraine in the 1st quarter of 2010 around 3.5 million foreign tourists visited Ukraine, which is 5% lower compared to the same period last year.

Structure of inbound tourist traffic based on motivation

Business trip	164 thousand people	5 % of overall traffic
Arranged tourism	104,2 thousand people	3 % of overall traffic
Individual tourism	3,3 mln. people	92 % of overall traffic

Structure of inbound tourist traffic based on the countries of origin

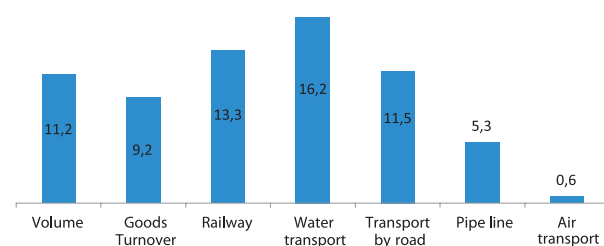
CIS	2,3 mln. people	63 % of overall traffic
EU	1,2 mln. people	35 % of overall traffic
Other countries	0,3 mln. people	2 % of overall traffic

The logistics activities in regional markets, such as Odessa, Dnipropetrovsk and Donetsk increased. Experts of UVK assume that the 3PL-logistics market will in near future increase at a very quick rate in these and other regions. At the same time, competition between 3PL-providers will intensify in the capital.

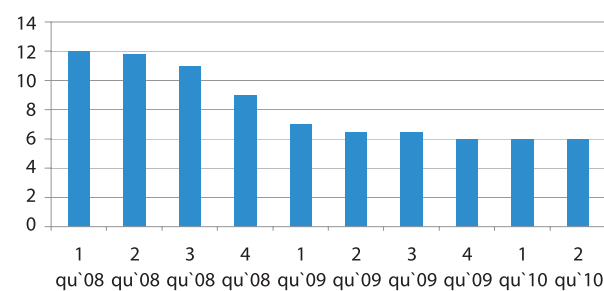
Russian and western logistics companies continue to look at the Ukrainian market as good-potential, though with care. In 2010, several Russian companies announced a soon entry into the Ukrainian market, while representatives of international logistics operators have tried to expand the regional network.

Statistics of 2009-2010 shows growth in freight transport (Fig. 1) and a slight increase in demand for storage services - 3-5%, which experts associate with the growth of retail sales. The cost of renting warehouse property in the past few years has decreased on average by more than 40% (Fig. 2). Today the vacancy rate in the market of professional storage facilities near Kyiv is 25%.

Percentage of increase of statistics data of transportations, January-August 2010, comparing to the same period in 2009



Warehouse lease rate level, USD per sq. m per month, triple net



3PL market in Ukraine — Outsourcing model efficiency as a major factor for further growth

The main reason for growth in the 3PL market turnover in 2010, despite bankruptcy and change of management in several logistics operators simultaneously, is transition of a number of companies to outsource of non-core business functions, including logistics.

The outsourcing model has proved its efficiency in the domestic business environment, but the overall proportion of outsourcing in the Ukrainian logistics remains low – several times less than in Europe and the USA. The UVK specialists expect this model to be applied oftener and oftener in the coming years.

3PL Market in Ukraine — Forecasts

In the opinion of the UVK specialists, the following forecasts are urgent for the Ukrainian logistics market:

- Tendencies of redistribution of clients in favor of large and medium-sized logistics companies, cognizant of local business specifics, will intensify;
- Requirements to the service level will increase;
- Personalized and EDI services will develop;
- Demand for integrated solutions will increase, leading to unification of forwarders and warehouse operators, expanding the scope of their activities;
- Stabilization in Ukraine’s logistics market with growth rates 6 - 9% year on year;
- Contract logistics has growth prospects for the next 3-5 years

Ukraine must compete for tourists and the added value they can bring to our economy. An important step was taken when Ukraine abolished its visa regime for many countries, including the EU, the United States, Canada, Switzerland and Japan.

Unfortunately, development and sustenance of Ukraine's infrastructure has been somewhat neglected by the government and left to private business interests.

Approaching EURO-2012 Government officials became more proactive in bringing international hotel chains and construction companies into the country in a bid to improve Ukraine's accommodation infrastructure. Meanwhile, new airport facilities and soccer stadiums are being rapidly constructed to meet UEFA deadlines and market requirements.

But boosting infrastructure development for EURO-2012 is not enough. Three weeks of intensive tourist traffic will soon leave half-empty hotels and recreation zones if Ukraine doesn't find a way to maintain stable inbound tourist traffic.

Another issue that has to be resolved in the nearest future is effective cooperation of central and local government with pri-

ivate business efforts in developing tourism. Cultivation and support of Ukraine's cultural heritage, state museums, national parks and theatres is a crucial factor in attracting foreign tourists, generating of international and local tourist traffic. Such improvements are only possible if the government encourages the involvement of private businesses. The government could use not only private investments but also private business management experience, creativity and problem solving practices.

UIA recognizes the importance of tourism as a powerful driver for the Ukrainian economy and has been a leader in promoting tourism to Ukraine.

In 2009 UIA set up a joint venture company "PANORAMA TOURS" to stimulate inbound traffic to Ukraine. It concentrates on selling inbound packages to Ukraine from all the countries to which the airline operates. UIA and Panorama Tours are actively promoting Ukraine and offering attractive tourism packages including flights, hotels, transfers and tour guides.

We believe that most service businesses will also be interested in contributing their assets and services into developing Ukraine's tourist attractions and traffic.