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COUNTRY PROFILE

UKRAINE AT A GLANCE 2014


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AGRICULTURAL SECTOR OVERVIEW

Agribusiness is the Ukrainian economy's leading sector. Ukraine's blue and yellow flag accurately depicts the unique part that agriculture plays in the national identity, showing a deep blue sky over shining yellow boundless fields of wheat and sunflower. Ukraine's agricultural potential is due to a combination of exceptional ecological, geographical, and historical factors. Experts foresee a 100 million ton grain production level in the not too distant future, versus the 45/60 million tons produced nowadays. Such a goal is realistic, but it requires a lot of investment, more stability in land resource use, better protection of investments, and more stable rules for importing and producing inputs.

Ukraine has the potential to be the world's leading grain basket

First of all, Ukraine has the lion's share of the best "black earth" soil in the world. Ukraine's famous "chernozem" accounts for more than 30% of all such soil in the world, well in front of Argentina in the southern hemisphere and Canada, Russia, and certain central European countries such as Rumania and Bulgaria in the northern. These soils, which can in some places be deeper than 1.5 meters, are extremely fertile due to their wide range of abundant nutrients, good water retention capacity, and stable structure. After the severe drought of the summer of 2012, Ukraine's grain harvest decreased by only 10% to 20%; in other countries, a majority of the crop would have been lost under such conditions.

	Million hectares
Ukraine land acreage	60
Agriocultural land	42,8
Arable land	32,5
Chernozem	60%

Another illustration of this soil's resistance to pressure is that the heavily mechanized Soviet agricultural industry did not destroy fertility. Nor has tremendous decrease in fertilizers use since Ukraine's independence led to miserable yields.

Ukraine's continental climate provides acceptable water resources, even if the south of the country is exposed to a real risk of severe drought once every five years and if there are late spring frosts that can damage winter crops and delay spring crop seeding. But these unfavorable climatic conditions can make Ukrainian traders more influential on the grain markets, as they can use the uncertainty of expected yields late in the season and growing volatility to their advantage.

The southern part of the country, along the Black Sea coast and through Kirovograd, is the most risky in which to grow cereals and has a limited yield potential for corn and sunflowers grown without irrigation. More than two million hectares of good soil was still under irrigation during the Soviet era in that part of the country, but very few of those irrigation networks have survived.

Ukraine's geographic position has made it the funnel end of a very large grain basin that also includes the extensive grain areas of Russia, Kazakhstan, and Belarus. Railway and river networks converge in Ukraine's Black Sea ports, the only ones in the region that are deep enough for heavy ships, notably Panamax ships. Odessa port and neighboring ports such as Illitchivsk or Youzhnyi are rapidly developing their loading capacities. River and sea barges can access these ports from either the Don River, which opens up the Russian hinterland, or from the Danube, which connects the Black Sea area with Central and Northern Europe. Ukraine intends to promote a new "silk road" thanks to its location at the very intersection of the main commercial roads to Asia, the Middle East, Africa, the Mediterranean Sea, and the Atlantic Ocean.

Agricultural structure and farmland use

Since the first privatization of agriculture in the 1990s, farming structures have gone through a considerable evolution, one that has produced the three types of farms existing at present. More than five million tiny farms using less than 20% of Ukraine's total farmland are producing 80% of Ukraine's milk and vegetables and its various fresh food products. Without credit or investment, and in spite of low prices, these basic units remain rather stable. Their evolution is determined only by the general laws of demography and by their influence on elections, given that they account for roughly 12 million voters. Private farms or agro enterprises account for a lot of profit and wealth. Most of them remain family enterprises, even after amassing up to 25,000 to 35,000 hectares of farmland. Economists believe that only with at least 500 hectares under good management can a private enterprise provide good revenues for a family. The optimum size seems to be around 3,000 hectares. At that size the farmer has a real chance to manage his crops, can use private credit resources, and can employ modern technology that leads to improved soil management and yields.

Agro holdings appeared after the 1998 financial crisis and helped restart production of food that was impossible to import after the devaluation of that time. Most of them are vertically integrated, producing poultry, sugar, or flour. In order to feed their cattle or their plants, such enterprises had to control crop production and to respect the crop rotation, which compelled them to try and acquire more land. They also opened their capital to foreign floating investors, sometimes with great success, and sometimes at the cost of bankruptcy. Since 2008, after several good agricultural years have demonstrated how large their potential is, they have increased their internal and external growth, taking over large amounts of land from private farms or from the state to create sizable "land banks." The largest holding is 600,000 hectares in size. These holdings need huge capital resources and certain of them are now preparing IPO's, as others did before the 2008 crisis.

Ukrainian agricultural structure

	Farms	Enterprises		Agroholdings	Total
		Small private family farms	**Private farming enterprises**		
Number of farms	5,250,000	33,050	9,540	80	5,300,000
Total area	6,180,000	2,651,000	18,456,000	5,200,000	32,500,000
Average size of one farm in hectares	1.2	80	1,935	75,000	
As % of total area	19%	8%	57%	16%	100%
Tendency	=	+ / -	-/- -	+	-

Agricultural land use is an ongoing issue in former Soviet countries. The privatization of the 1990s put forward the principle of the constitutional right to own, buy, and sell land just like "any other property." But at the same time the Rada adopted a moratorium on land sales. Many international institutions are advocating the moratorium's removal, but for many reasons successive governments have prolonged it. The most recent draft laws meant to lift the moratorium, in mid-2012, were removed from the Rada's agenda, as they were considered in the end unrealistic, controversial, and prone to lead to corruption.

Land lease prices have regularly increased from 3% of the standard official land plot sale price to 5%. To support local budgets, the Rada recently mandated an additional 2% tax. At the moment, the ability to sell farm land would help generate the money needed to modernize technology and logistics. Stabilizing the rights of land users via contracts for a minimum of 10 to 15 years would be an effective measure at the moment. Consolidation of land plots remains an important administrative issue. The moratorium has prevented the splitting of large plots of land ranging from 100 to 400 hectares into smaller fields and has thus helped create efficient conditions for the use of mechanization and modern agro technology.

Distribution of land leases, 1st trimester 2013

Number of contracts		Duration (years)		Average price	
4,741,000	Less than 4	From 4 to 5	From 6 to 10	More than 10	563.5
	218,000	1,863,700	2,000,000	659,000	
100 %	4.6 %	39.3 %	42.2 %	13.9 %	

Source: *The State Agency for Land Resources of Ukraine*

Crop production

The official agencies fixed the 2012 harvest at 46.2 million tons (after the grain was cleaned), which was 18.6% lower than the 2011 harvest. Wheat and barley particularly suffered from the severe summer drought: the wheat harvest declined by 29%, to 15.8 million tons, and barley by 24%, to 6.9 million tons. Only rye saw a better harvest (+17%), but that harvest produced only a small amount of grain (0.7 million tons). Corn amounted to roughly 21 million tons, thanks to technological and yield improvement.

Potatoes were more abundant (+4.1%, for 23.2 million tons). Vegetable production was more or less the same (+1.8%, for 10 million tons).

Farmers, whatever size they are, bet on the most profitable crops: corn, sunflowers, and soya. Smaller margins make the basic cereals less attractive, but they still hold an important share in total production as they are compulsory in crop rotations, well-adapted to climatic conditions, and able to support the extensive, conservative technologies that most farmers use, often as an alternative to intensive technologies that require much more working capital.

Corn and sunflower seeds are among the best crops for export, providing hard currency incomes and thus allowing producers to cover their needs via working capital or Capex loans at lower cost. Corn acreage and production are increasing and may continue to do so, as the average yield remains under 5.5t/ha. Sunflower production now comes to roughly 10 million tons; the yields are rather good and it is difficult to improve them quickly. The yields can be expected to increase up to the national crushing capacity, which has risen to 12 million tons, with a consequent downward pressure on prices paid to producers after the unrealistic peaks of the last two years.

Marketing year 2012 / 2013, Ukrainian cereal production

		Wheat	Barley	Corn	All cereals
Production	mt	15,761	6,935	20,922	46,183
	World ranking	9	5	7	10
	mt	12,000	5,000	8,000	26,579
Consumption	World ranking	10	6	14	18
Export	mt	6,200	2,500	13,000	21,710
	World ranking	9	4	4	7

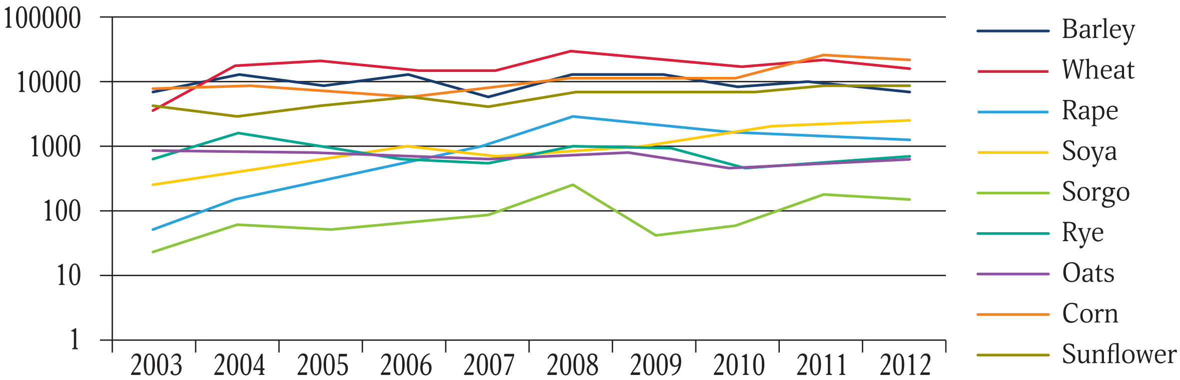
Source: *Ukrainian Grain Association*

There is no final information about the 2013 harvest as of the date of this writing, as corn has not yet been fully harvested. Corn acreage is rising (+6%), as is rape acreage (+80%).

The year 2013 has provided a large contrast with the previous year. Good climatic conditions during all vegetation cycles for winter as well as for spring crops gave farmers higher yields, pushing overall production to a record 60 million tons. Ukraine is thus once again rising in the classification of leading exporting countries, and has a chance to leave the European Union behind. At this writing, corn and sunflower had not yet been fully harvested, but experts were expecting from 25 to 28 million tons of corn and from 9.5 to 10 million tons of sunflower seeds.

Ukraine's insurance system remains poor, despite prominent IFC efforts to support modernization of the coverage of climatic and market risks. It has thus remained unable to temper farmers' reactions to market prices and help them stabilize their rotations.

Grain production, thousand tons



Production of main grain cultures in Ukraine, thousand tons

	Barley	Wheat	Rape	Soya	Sorgo	Rye	Oats	Corn	Sunflower
2003	6,833	3,599	50	231	24	624	940	6,875	4,254
2004	11,084	17,520	148	363	65	1,592	1,007	8,866	3,050
2005	8,975	18,699	284	612	54	1,054	790	7,166	4,706
2006	11,341	13,947	605	889	64	583	690	6,425	5,324
2007	5,980	13,937	1,047	722	78	562	544	7,421	4,174
2008	12,611	25,885	2,872	812	231	1,050	944	11,446	6,526
2009	11,833	20,886	1,873	1,043	41	953	730	10,486	6,364
2010	8,484	16,851	1,469	1,680	61	465	458	11,953	6,771
2011	9,097	22,323	1,437	2,264	176	578	505	22,837	8,670
2012	6,936	15,762	1,204	2,410	143	676	629	20,961	8,387

Source: *Ukrainian Grain Association*

Cultivated (sown) area in 2013

Crops		Area in thousand hectares			As % of total	
		2013	2013 vs. 2012		2013	2012
		Thousand ha	+ /_ thousand ha	%		
Food crops	**Total**	**7316,0**	**698,1**	**110,5**	**26,0**	**23,8**
	W & S wheat	6691,9	920,2	115,9	23,8	20,7
	Rye	285,7	–17,1	94,4	1,0	1,1
	Rice	24,2	–1,6	93,8	0,1	0,1
	Millet	97,8	–93,1	51,2	0,3	0,7
	Buckwheat	191,4	–109,0	63,7	0,7	1,1
	Beans	25,0	–1,3	95,1	0,1	0,1
Forage	**Total**	**8958,1**	**127,0**	**101,4**	**31,9**	**31,8**
	W & S Barley	3377,9	–47,4	98,6	12,0	12,3
	Corn	4913,3	287,9	106,2	17,5	16,7
	Oats	256,9	–52,8	83,0	0,9	1,1
	Oil and protein	258,3	–33,7	88,5	0,9	1,1
	Sorghum	150,6	–21,2	87,7	0,6	0,6
Crops for industry	**Total**	**7664,9**	**–189,2**	**97,6**	**27,3**	**28,2**
	Sunflower seeds	4833,9	–360,2	93,1	17,2	18,7
	Sugar beets	292,6	–165,8	63,8	1,0	1,6
	Soya	1366,1	–110,3	92,5	4,9	5,3
	W & S rape	1019,7	453,7	180,2	3,6	2,0
		2221,4	–253,5	89,8	7,9	8,9
Potatoes		1387,7	–52,1	96,4	4,9	5,2
Vegetables		482,1	–12,3	97,5	1,7	1,8
Total		**28115,0**	**313,7**	**101,1**	**100,0**	**100,0**

Source: *State Statistics Service of Ukraine*

Winter crops in 2013 (million hectares) and variation versus 2012 in %

Total	Cereals	Wheat	Barley	Colza	Rye
9,2	8,1	6,7	1,1	1,03	0,3
–2,5 %	–3,5 %	–0,2 %	–19,5 %	+7,2 %	–4,3 %

Source: *Ministry of Agrarian Policy and Food*

Harvest and use of soya, million tons

	2011 / 2012	2012 / 2013	2013 / 2014 forecast
Ukrainian consumption	800	910	1,055
Export	1,340	1,330	1,580
Oil	482	600	7,580

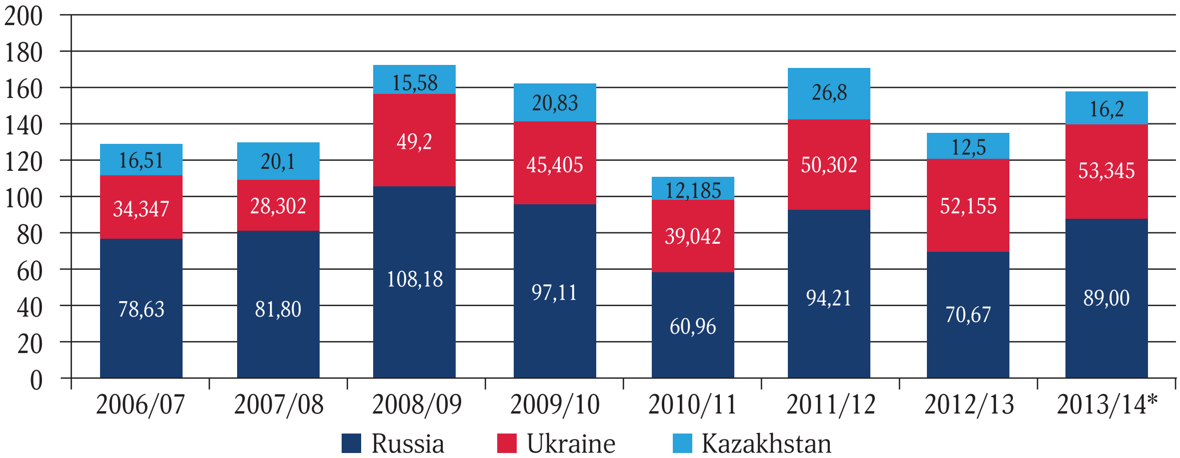
Source: *APK Inform*

Crop production as of August 2013

	2011	2012	2013
Total harvest, million tons	56,7	46,2	57 to 60
Incomes from export, USD	13	18	> 22
IDE, billion USD	0,77	0,8	3

Source: *State Statistics Service of Ukraine*

Forecast of grain production, million tons



Source: *UkragroConsult*

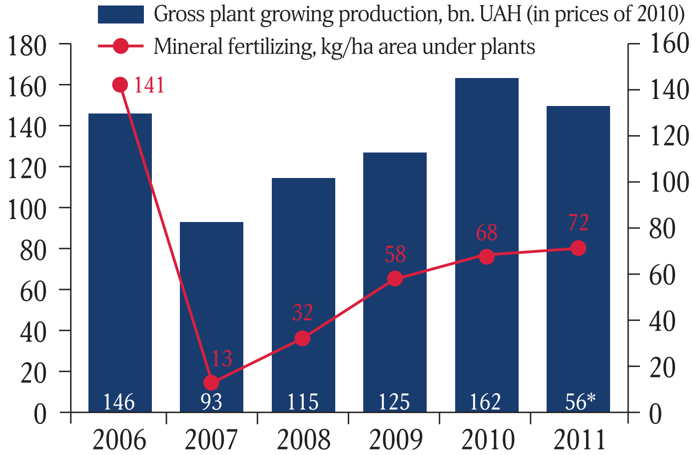
Ukrainian agricultural technology depends on farm size:

- Small farms are very conservative. They use their own seeds and scarcely ever buy new ones; they employ low mechanization, if any mechanization, and use mainly organic fertilizers generated by their own private small husbandry.
- Large holdings, on the contrary, mainly use minimum till and other low cost technologies, requiring more capital investment. They have learned from worldwide experience, mainly that of the US and South America, how to achieve high yields at minimum production cost. They use high-quality selected and certified seeds and have adapted crop protection and rational fertilization methods. Most of them have recruited highly qualified agronomists to manage their crops and agro strategy.
- Mid-sized farms are implementing both extensive and intensive technologies, according to their financial capacities. Their average yields reflect the balance between these two technological levels. Large modernized farms achieve very high yields: from 8 to 12 tons of corn per hectare, from 5 to 7 tons of wheat per hectare, and over 2.8 tons of sunflower seed per hectare. Average yields are still rather low, however, at less than 3 tons per hectare for wheat and 2.5 tons per hectare for barley.

These yields could double if access to inputs were easier and more stable. Though Ukraine was admitted to the OECD seed scheme and to ISTA in 2008, the seed certification and crop protection rules remain complex and hazardous. Ukraine's 40,000 professional farms need to invest in machinery, but they do not really benefit from state support. They are doing their best to improve their technologies with facilities provided by large companies, retailers, and a few supportive banks.

Nevertheless, experts do believe that 100 million tons is quite a realistic goal for Ukrainian agriculture if clear rules are established towards stabilizing land lease and if the rules for importing seeds and crop protection chemicals are clarified.

Ratio of production to use of fertilisers



The blue rectangles represent crop production value in billion UAH (as of 2000). The red line shows the level of NPK fertiliser (kg/ha).

The low level in 2010 reflects the 2008 crisis. The soft decline of gross production in 2012 is due to a summer drought that was particularly severe for cereals (except for corn and sorghum).

Fruit and vegetables

	1990	1995	2000	2005	2006	2007	2008	2009	2010	2011	2012
Apples		1046	648	720	536	755	719	853	897	954	1298
Grapes	836	457	514	443	301	360	415	469	390	522	456

Sugar market in Ukraine, in thousand tons

Marketing year		**2009 / 2010**	**2010 / 2011**	**2011 / 2012**	**2012 / 2013**
Production	total	1,510	1,830	2,330	2,200
	From sugar beet	1,270	1,550	2,330	2,200
	From sugar cane	240	280	0	0
Consumption		1,750	1,800	1,850	1,880
White sugar	Export	1,2	0,6	163	100
	Import	87,2	49,1	9,2	1

Six big groups cover 53% of sugar output. The number of sugar plants is intended to decline and the top four players could cover 50% of production in upcoming years.

Source: *Ukrainian Agro Business Club from the State Statistics Service of Ukraine*

Export

Ukraine produces at least twice as much in grains and oil seeds as the population can consume. Half of commodities production goes to export; this export makes up a quarter of all Ukrainian export. Rising exports make agriculture the country's leading economic sector. But Ukraine has to improve its logistics and apply the rule of law if it is to realize its potential. Two years ago an agreement supported by the European Business Association, the American Chamber of Commerce in Ukraine, and the European Bank for Reconstruction and Development was signed by the Ministry of Agriculture and Food and various professional associations to facilitate monitoring of exports without administrative restrictions like quotas or other limitations of the sort that have been imposed four times in recent years. Nevertheless, certification of grains and elevators and monitoring of contracts still require improvement in line with WTO rules; there must be no state monopoly, as the State Service for Exchanges and the Guaranty Fund sometimes propose there be.

Logistics require considerable improvement. A possible 5,000 to 6,000 new railcars are needed to speed grain transfer to the ports. Ukrzaliznytya, the national railway company, is incapable of making investments but intends to maintain its monopoly. Traders thus have to use more trucks, which contributes to road deterioration and creates traffic jams at port elevators. In spite of considerable private sector investment to boost seaport loading capacities to 30 million tons a year, new facilities still need to be built to meet bigger harvest sizes and export volumes. Transhipment capacities must be doubled and wharf areas deepened in order to service Panamax ships for quick loading.

The new seaport development scheme is proceeding on the right track, involving both the specialization of infrastructure and the expansion of railways and motorways. The lack of dryers is particularly obvious after this year's good harvest. Most of the country's 750 inland elevators are outdated, requiring significant rebuilding so that they load and unload more quickly. They also require more efficient quality monitoring. Attention must also be paid to grain conservation inside elevators.

Farmers have limited chances to hedge their sales using futures and derivatives, even though the CBOT has created new contracts for the Black Sea grain market. Compensation schemes for paying margin calls suffer from the country's very tight currency control, so that only companies with subsidiaries abroad can use these tools. The correlations between FOB prices in Ukraine and world prices on the CBOT or Euronext are rather good, and prove that Ukrainian farmers can benefit from financial markets to improve and stabilize their sales.

Most traders have to deal with permanent VAT refunding limitations and delays. Repayment of state bonds is, as in previous years, uncertain, while the VAT rate should be linked to the agricultural export tariff included in the WTO agreement (10.66% versus the current 20%). This situation also has a negative impact on the prices paid to farmers and fails to stimulate private companies to invest.

Import and export

	All industries		Agriculture			
	Export	Import	Export		Import	
	Billions USD	Billions USD	% of total	Billions USD	% of total	Mds USD
2011	82.2	88.8	18.8	15.44	7.8	6.93
2012	82.3	91.4	26.0	21.40	8.9	8.14

Source: *State Statistics Service of Ukraine*

Cereals export: 2012–2013 MY, in million tons

Wheat		Barley	Corn	Other	Total
Total	Milling wheat				
6.8	5.9	2.1	13.5	1.3	22.82

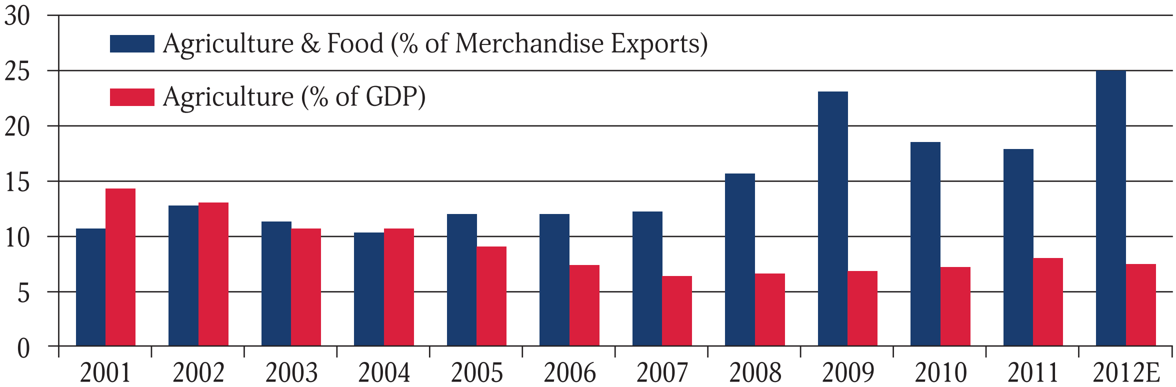
Source: *Ministry of Agrarian Policy and Food*

Grains sources and use: wheat, corn, barley, sorghum, oats, rye, millet, and other mixed grains

	Beginning stocks	Harvest	Imports	Domestic use	Exports	Ending stocks
2011/2012	5.5	56.0	0.1	30.3	23.0	8.2
2012/2013	8.2	45.6	0.0	26.6	22.6	4.5
2013/2014	4.5	59.2	0.1	29.0	28.8	6.1

Source: *International Grain Council September 2013*

Agriculture as share of exports, GDP



Source: *Dragon Capital*

Black Sea and Azov Sea traffic in million tons (2010)

Russia	Ukraine	Rumania	Bulgaria	Georgia	Turkey	Total
172,9	155,6	45,9	27,2	22,3	22,3	446
38,8 %	34,9 %	10,3 %	6,1 %	5,0 %	5,0 %	100 %

Specialization of Ukrainian seaports

Specialization	Seaports
Hydrocarbon	Odessa, Feodossia
Chemicals in bulk	Youzhnyi
Steel, metal, coal	Marioupol, Odessa, Illitchivsk, Youzhnyi, Kertch
Grains: cereals and oil	Odessa, Kherson, Mykolayiv
Containers	Odessa, Illitchivsk
Passengers	Odessa, Sebastopol, Yalta

Source: *Cabinet of Ministers N ° 548 , 11 July 2013*

Grain exports as of June and July 2013

Crop	Wheat	Barley	Corn	Total
Million tons	1,5	1,15	0,56	3,23

Source: *Ministry of Agrarian Policy and Food*

Correlation between FOB Ukrainian contracts and CME futures

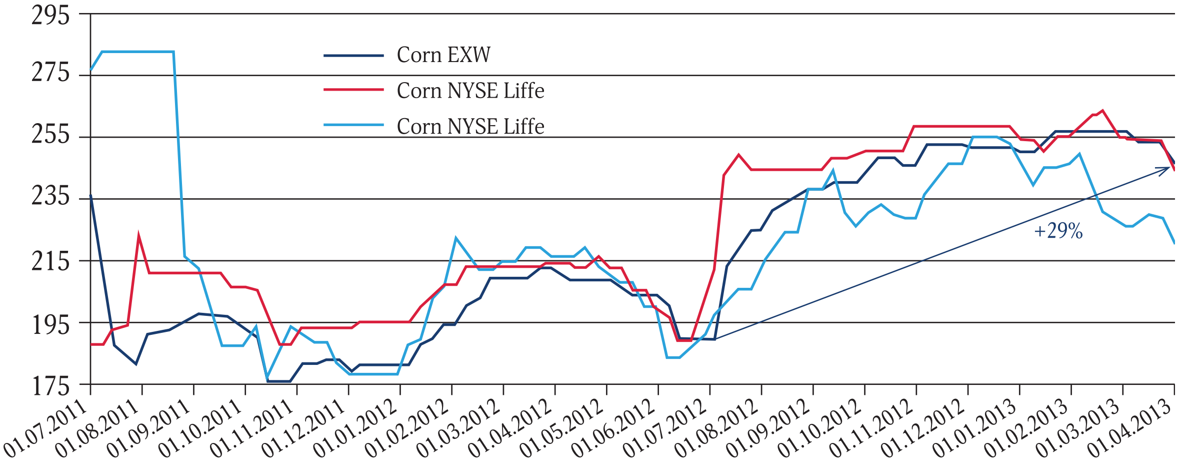
Marketing year	Wheat	Corn	Sunflower oil	Soya
2005 / 2006	0,55	0,61	0,72	-0,05
2006 / 2007	0,63	0,58	0,72	0,67
2007 / 2008	0,65	0,82	0,91	0,87
2008 / 2009	0,59	0,64	0,59	0,74
2009 / 2010	0,77	0,25	0,09	0,26
2010 / 2011	0,88	0,89	0,47	0,55
2011 / 2012	0,56	0,80	0,67	0,96
2012 / 2013	0,87	0,90	0,74	0,92

Source: *INTL, FCStone Inc.*

Corn NYSE Liffe – Corn EXW elevator South District

Correlation 6 months: 75%

Domestic price, EXW, USD/MT



Husbandry

Husbandry is performed mainly by household farms. They produce 80% of the milk and perhaps half of the fresh meat consumed by local families. There has been progress in pork production, but Ukraine still has to import 500,000 tons of meat from European countries and Brazil. Beef consumption is very low and beef prices are similar, if not lower, than pork prices.

The most dramatic decrease has been in milk collection, even though industry is facing growing demand. A lack of raw material, 50% of which is produced by households, is the origin of the high prices, especially in wintertime, when collection declines as "babushkas" (grandmothers) are unable to feed their single cows. The slow decline in the number of milk cows has not yet been compensated for by private farms. Indeed, the largest agro companies have more interest in selling crops than they do in breeding cattle, even though they would see very attractive prices (twice those that households get) if they could offer higher quality milk and cut down on seasonality problems.

Husbandry in 2012 in thousand tons

		2012	December 2012	December 2012 in %		Year 2012 as % of 2011
				of November 2012	of December 2011	
Beef	Fresh and refrigerated	55,1	4,5	98,2	100,4	97,9
	Deep freeze	14,3	1,0	63,1	85,9	90,3
Pork	Fresh and refrigerated	171	16,4	115,7	98,5	92,9
	Deep freeze	7,0	0,6	113,9	76,2	86,1
Poultry	Fresh and refrigerated	750	62,2	100,8	105,1	102,7
	Deep freeze	86,1	9,4	82,1	162,0	106,4
Prepared meat		285	24,9	106,2	103,7	100,4
Milk		909	66,6	94,5	100,4	106,0
Butter		88,2	5,7	109,2	122,6	115,7
Cheese	Fresh	53,2	5,2	94,8	106,4	89,2
	Hard and fat	78,6	6,8	98,8	114,0	104,4
	Fermented	166	11,9	89,0	89,1	92,4

Source: *State Statistics Service of Ukraine*

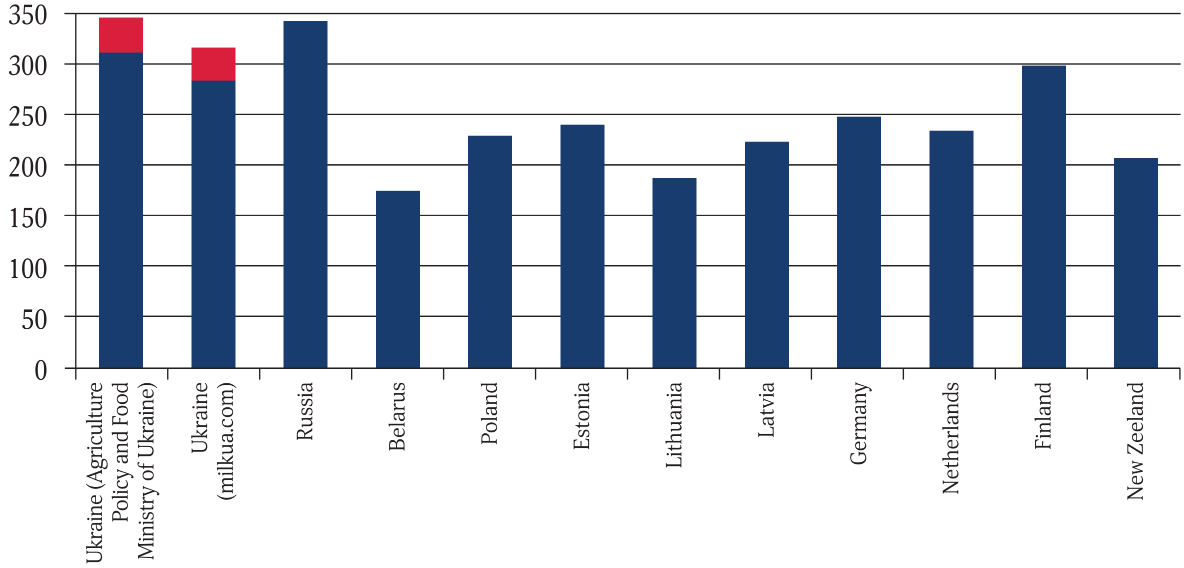
Evolution of cattle as of February 1, 2013

	Cattle		Pigs	Goats and sheep	Poultry
	Total	Milk cows			
Millions of heads	4,7	2,56	7,6	1,78	206,4
% as of February 1, 2012	+ 4,5 %	–1,1 %	+ 3,7 %	–0,4 %	+ 7,8 %

Source: *State Statistics Service of Ukraine*

Price for raw milk in Ukraine is higher than in other countries.

Average price per ton of milk (3,4 percent of fat, 3.0 percent of protein) in Euros including VAT (2012)

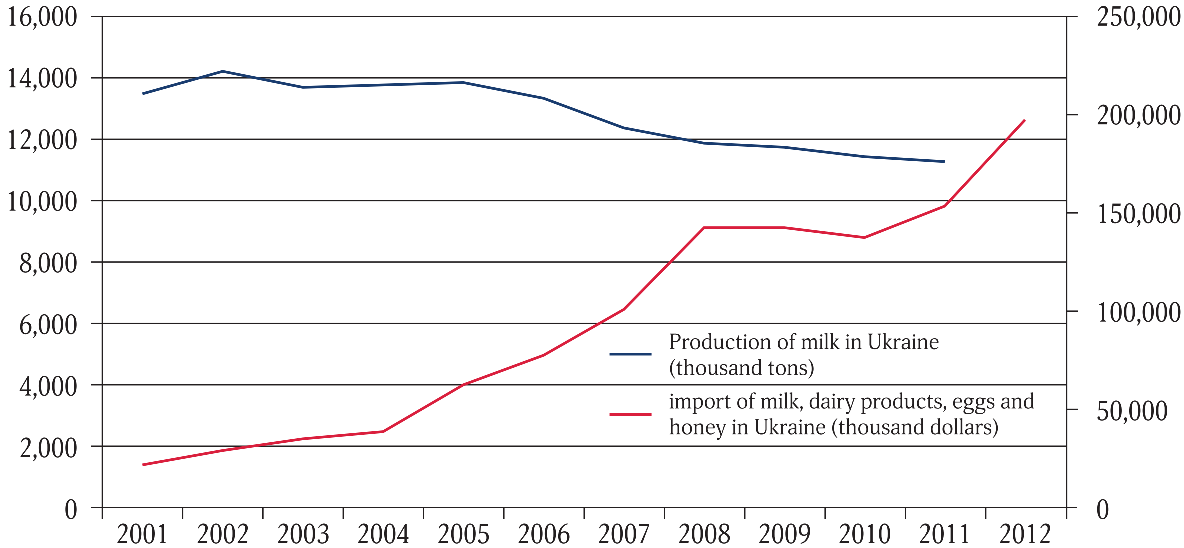


Source: *milkua.com, Ministry of Agrarian Policy and Food of Ukraine*

Average price for milk raw material (first semester)

Year	**2009**	**2010**	**2011**	**2012**	**2013**
UAH / t	1,825	2,745	2,793	2,715	3,554

Production and import of milk in Ukraine, thousand tons, thousand USD



Source: *State statistics, UN Comtrade database*

Milk output in Ukraine

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012
Households	11,2	11,1	10,8	10,1	9,7	9,4	9,0	8,8	8,8
Dairy farms	2,5	2,6	2,5	2,2	2,1	2,2	2,2	2,3	2,5
Rotal	13,7	13,7	13,3	12,3	11,8	11,6	11,2	11,1	11,3

Source: *State Statistics Service of Ukraine*

Food processing

Ukrainian agriculture mainly produces commodities. Nevertheless certain sections of the food industry represent splendid success stories. Vertical integration in poultry, pork, and confectionary is providing spectacular growth on the Ukrainian market. Some holdings have already won large market shares, combining competitiveness with adherence to international food safety standards. These enterprises have demonstrated that western standards aren't only a source of consumer safety, but also a tool for modernization and growth. These enterprises largely inspired the new law on food quality and food security that incorporates European principles, transferring responsibility to producers and retailers. Food processing remains a sector in which development can produce added value.

Food industry energy consumption is twice as much in Ukraine as it is in the West, using, for example, more than 40 cubic meters of gas per single ton of sugar. But certain groups are sometimes doing even better than western companies thanks to their commitment to sustainability, using manures and various sub-products as alternative energy sources. These innovative companies — in meat production, sugar, and sunflower seed crushing, primarily — are going to become more competitive and find their ways on the world markets.

Retail is developing fast among both Western and Ukrainian groups and represents a source of development for specialized farms that provide vegetables, salads, and fruits. New shopping malls and hypermarkets are attracting growing numbers of consumers and enjoy more public confidence than do more traditional retailers and even the government services.

Production of drinks in 2012 in million decaliters and in percent

		Year 2012		December 2012		
			in % of 2011		in % of November 2012	in % of December 2012
Cognac and brandy		4,6	99,0	0,7	113,9	101,4
Vodka (horilka)		33,8	101,6	3,3	96,8	109,0
Liqueurs		11,5	95,5	1,0	101,2	99,4
Beer		300	98,5	19,2	99,7	82,5
Mineral waters	still	34,0	112,5	2,4	89,1	92,3
	fizzy	92,6	98,1	5,1	91,8	76,0
Non-alcoholic drinks		143	100,1	8,5	102,2	90,1

Source: *State Statistics Service of Ukraine*

Yearly electricity consumption in billions of KWh

	2012		2011		Variation 2012 vs. 2011	
		as % of total		as % of total	value	in %
Industry	70,8	47,0	73	48,4	–2,2	–3 %
Food and feed	4,7	3,1	4,6	3,1	+0,05	+1,1 %
Metal industries	37	24,5	37,7	25,0	–0,75	–2 %
Agriculture	3,8	2,5	3,5	2,4	+0,27	+7,8 %
Heating and public services	18,3	12,3	18,5	12,2	0,2	+1,2 %
Housekeepers	40,3	26,7	38,5	25,5	+1,8	+4,7 %
Total consumption	150,77	100	150,75	100	–0,02	0

Source: *Ministry of Energy and Coal Industry of Ukraine*

Investment and finances

Financing the agro sector is a key issue in Ukraine, where average loan interest rates range from 17% to 23% p.a. Hard currency loans are less expensive, but only exporters have the right to apply for them.

The working capital needs of large and professional companies are more or less covered by the banking system, but medium-sized and small farms have considerable difficulties in obtaining enough credit and are therefore obliged to limit their expectations about increasing yields. There's a lack of capital investment for modernization and reconstruction, in both farming itself and for farming-related infrastructure. The Agrarian Confederation estimates that up to USD 70 billion is required for these purposes. The 2008 financial crisis put a brake on IPOs, but the most dynamic enterprises still obtain resources for floating capital shares from international investment funds.

Ukraine's agricultural industry is very attractive to countries facing large food deficits, either because of poor climatic conditions, such as certain Middle East countries, or as the result of strong demographic growth, such as China. The Bank of China and the Ukrainian State Grain Corporation have signed an agreement according to which China will invest USD 1.5 billion in Ukraine's agro sector from 2013 to 2017.

State support of agriculture is limited, coming to an estimated USD 15 per hectare per year, but the OECD equivalent subsidy nevertheless remains negative, meaning that agriculture is subsidising consumption with state-regulated prices for bread and other basic food products. The lack of an efficient market regulation system increases farmer sensitivity to ExWorks price variations and keeps them from making long-term investments. Increasing stability for farmers is thus a priority for developing investment and increasing output to its full potential.

Minimum and maximum prices MY 2013–2014, in UAH/t

Crop	Milling wheat group A			Milling wheat group B			Rye		
Class	1	2	3	4	5	6	1	2	
Minimum price	2,021	1,841	1,736	1,667	1,480	1,437	1,601	1,525	1,453
Maximum price	2,470	2,250	2,122	2,037	1,809	1,756	1,957	1,864	1,776

Crop	Corn				Barley			Peas	
Class	sup	food	milling	basic	1	2	3	1	2
Minimum price	1,683	1,586	1,532	1,453	–	–	–	3,858	3,530
Maximum price	2,057	1,938	1,872	1,806	2,108	1,955	1,916	–	–

Crop	Oats			Millet		Buckwheat
Class	1	2	3	1	1	
Minimum price	–	–	–	–	–	–
Maximum price	3,227	2,958	2,689	3,362	3,056	4,217

Product	Powder milk	Butter	Sugar
Minimum price	–	–	5,613
Maximum price	25,344	44,310	7,735

Price evolution in January 2013

	Retail prices	Production prices	Food products				
			Rape	Vegetables	Cereals and bread	Sugar, fish	Domestic heating
Vs. December 2012	+0,2 %	+0,3 %	+0,3 %	+0,7 %	0,3 %	–0,8 %	+1,6 %
Vs. January 2012	–0,2 %	+1,5 %					

Source: *State Statistics Service of Ukraine*

Profitability of various productions

	Crops	Cereals	Sunflower seeds	Rape	Sugar beet	Potatoes	Pork	Fruits	Milk	Poultry meat	Beef
2011	32,3	26,1	57,0	32,1	36,5	17,7	–3,7	38,8	18,5	–6,8	–24,8
2012	21,9	14,8	45,1	20,6	15,9	–21,4	2,3	52,5	2,3	–6,0	–29,5
Variation %	–32,2	–43,3	–22,1	–35,8	–56,4	–220	+135	+35,3	–87,6	+11,8	+18,9

Source: *State Statistics Service of Ukraine*

Loans for agricultural companies in Ukrainian banks, in billion UAH

June		Seven first months	
2013	2012	2013	2012
5,0	3,7	36,1	27

Source: *National Bank of Ukraine*

Investments in the Ukrainian agricultural sector

Year	2007	2008	2009	2010	2011	2012
mUAH	9519	16890	9382	12231	18183	20092
% of previous year	130,2	177,4	55,5	130,4	148,7	110,5

Source: *State Statistics Service of Ukraine*

Direct foreign investment in the Ukrainian agricultural sector

Year	2007	2008	2009	2010	2011	2012
mUSD	557	813	793	834	813	941
% of previous year	137,9	146,0	97,5	105,2	97,5	115,7

Source: *DerjKomStat*

Projects of the State Grain Corporation of Ukraine (GPZKU) supported by China in mUSD

Projects	2013	2014	2015	2016	2017	Total
Crop protection chemicals	30	30	60	75	80	275
Mineral fertilizers	50	50	65	70	70	305
Machinery	–	5	15	20	15	5
Seeds	50	50	75	85	90	345
Construction of a fertilizer plant	35	35	–	–	–	70
Construction of a plant for crop protection chemicals	30	40	–	–	–	70
Wholesale market organization	30	25	45	50	65	195
Support to alternative energy sources	10	5	–	–	–	15
Construction of seaport elevators	65	60	40	–	–	165
Total	**300**	**300**	**300**	**300**	**300**	**1500**

Source: *Ministry of Finance of Ukraine*

Conclusion

Ukraine is already a leading commodity-producing country. The Black Sea market is dominated by Ukraine, the leading provider of grains and oil seeds among CIS countries. Russia, Kazakhstan, and Ukraine have for years been discussing the creation of a pool of Black Sea exporting countries, but the discussions were difficult, as Ukraine intended to sign the Agreement for Association with European Union while the Russian Federation intends to include Ukraine in its Eurasian Customs Union.

Ukraine's population is only slightly declining, so national consumption will remain almost stable. As a consequence, every increase in output is dedicated to export. In spite of difficulties and of occasional harassment by the government, Ukraine's agricultural sector offers real opportunities for companies. The country needs machinery, genetic technology, crop protection technology, elevators, transport facilities, research, know-how, and, above all, access to world markets, in line with the fact that it has held WTO membership since 2008.

2 BANKING & FINANCIAL SERVICES

BANKING SECTOR, ANTI-MONEY LAUNDERING SET-UP AND CURRENCY CONTROL REGIME

Overview

As of October 1, 2013 Ukraine had 181 active banks (while Russia had around 900 and Poland had around 80).

Total banking system assets as of October 1, 2013 were UAH 1.234 billion (USD 154 billion). They grew by 9.5% YTD, or by UAH 106 billion, and the system remains moderately concentrated: approximately the top 50 banks possess about 87% of total assets and capital. Indeed, the top 10 banks slightly increased their share over the year, breaking the 50% mark (which had held stable over the past three to five years) by growing to 51.8% as of the middle of 2013. Concentration is still at a lower level than in the EU zone and in neighboring Eastern Europe. Recent market trends according to which several banking groups have withdrawn capital and locally-owned banks have gotten bigger should increase the concentration ratio of the domestic banking system in the medium-term future.

Banks continued changing the structure of their assets in 2013, with an increasing share of loans in local currency. Corporate loans led banking loan portfolio growth this year. Banks also continued expanding their assets by purchasing government bonds, with the stock of bonds growing by 31% YoY. Ukrainian private banks were the most active in expanding their assets over the last 12 months. They did this not only through organic growth (by producing new loans, that is) but also by acquiring the assets of some of the Western banks that left Ukraine or reduced their loan portfolios.

Rank by	Total Assets	Date	in Mio USD	**Shaded > 12%	
Assets	**Bank Name**	**1/1/2013**	**7/1/2013**	**+/-, % p. a.**	**+/-, Mio USD**
	Total	**141,021**	**149,407**	12%	8,386
1	Privatbank	21,572	23,886	21%	2,314
2	Oshadbank	10,759	11,963	22%	1,205
3	Ukreximbank	11,003	11,463	8%	406
4	Delta	3,734	5,957	119%	2,224
5	Raiffeisenbank Aval	5,967	5,621	-12%	-346
6	Ukrsotsbank	4,858	4,797	-2%	-61
7	Prominvestbank	5,169	4,671	-19%	-498
8	Sberbank of Russia	3,381	4,094	42%	713
9	First Ukr. Intl. Bank	3,532	4,059	30%	527
10	Alfa-Bank Ukraine	3,201	3,707	32%	506
11	VTB Bank (Ukraine)	4,280	3,694	-27%	-587
12	Nadra	3,464	3,486	1%	22
13	Ukrsibbank	3,239	3,425	11%	186
14	Finance and Credit	2,821	2,954	9%	133
15	Ukrgazbank	2,627	2,604	-2%	-23

16	OTP Bank	2,542	2,492	-4%	-49
17	Brokbusinessbank	2,118	2,259	13%	141
18	VAB Bank	1,662	2,028	44%	366
19	Credit Agricole Bank	1,648	1,611	-5%	-38
20	Pivdenny	1,253	1,375	20%	122
	Legend:	*Ukrainian state Bank*		*CIS & Venture Bank*	
		Western-owned Bank		*Ukrainian Private Bank*	

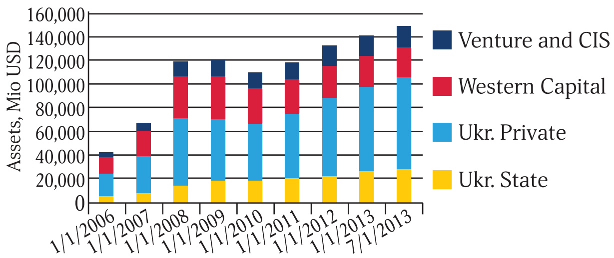
Total Assets

Interim data

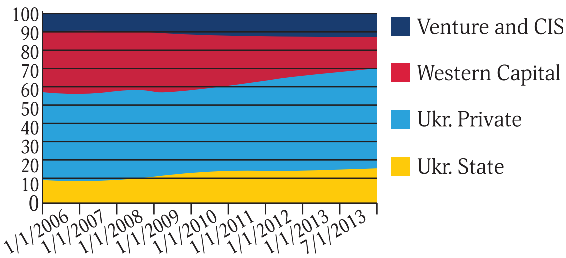
Total Assets, Mio UAH	Date								
Group by Ownership	**1/1/2006**	**1/1/2007**	**1/1/2008**	**1/1/2009**	**1/1/2010**	**1/1/2011**	**1/1/2012**	**1/1/2013**	**7/1/2013**
1. Ukr. State	25,595	40,088	71,643	139,103	149,733	159,599	179,103	206,819	219,453
2. Ukr. Private	97,741	155,099	289,165	400,932	377,264	433,484	524,956	571,251	628,252
3. Western Capital	69,214	113,490	179,971	285,070	244,698	236,335	218,627	208,747	203,817
4. Vanture and CIS	21,328	31,503	58,617	100,981	101,755	112,665	131,586	140,362	142,689
Total	**213,878**	**340,179**	**599,396**	**926,086**	**873,450**	**942,084**	**1,054,272**	**1,127,179**	**1,194,211**
+/-, %		*59,1%*	*76,2%*	*54,5%*	*45,7%*	*7,9%*	*11,9%*	*6,9%*	*5,9%*
Share of Western Banks:	*32,4%*	*33,4%*	*30,0%*	*30,8%*	*28,0%*	*25,1%*	*20,7%*	*18,5%*	*17,1%*
Total Assets, Mio USD									
1. Ukr. State	5,068	7,938	14,187	18,065	18,752	20,046	22,417	25,875	27,456
2. Ukr. Private	19,355	30,713	57,260	52,069	47,247	54,446	65,704	71,469	78,600
3. Western Capital	13,706	22,473	35,638	37,022	30,645	29,684	27,364	26,116	25,499
4. Venture and CIS	4,223	6,238	11,607	13,114	12,743	14,151	16,469	17,561	17,852
Total	**42,352**	**67,362**	**118,692**	**120,271**	**109,386**	**118,327**	**131,954**	**141,021**	**149,407**

Share	**Y-to-D**	
%	*%*	***Mio UAH eq.***
18,4	6,1	**12,634**
52,6	10,0	**57,001**
17,1	-2,4	**-4,930**
11,9	1,7	**2,327**
100,0	**5,9**	**67,032**

Ukrainian Banking System Assets Evolution



Ukrainian Banks Ownership Groups by Total Bank



Ukrainian state and private owners together control 71% of assets, up from 66% in January 2012. Foreign banking groups reduced their share to 29%. Only Western banks have substantially downsized their activity, while Russian banks have kept their share in assets flat at 12% over the last 1.5 years.

Historical background

The Ukrainian state has historically owned Oschadbank (the State Savings Bank of Ukraine) and the universal/commercial Ukreximbank. The latter was a part of the USSR's Vnesheconombank and focuses on export/import operations and on facilitating relations between the Ukrainian government and international financial institutions.

Three more banks were bailed out by the government to calm the crisis waves in 2008. RODOVID BANK was supposed to be instrumental in bad debt management. The strategy for the further re-privatization of Ukrgasbank and Bank Kyiv is being discussed by the government and the regulator.

The first wave of Western banks arrived in Ukraine in the 1990s: Credit Agricole (at that time under the Credit Lyonnais brand), ING, Citibank, Raiffeisen Bank Aval, and HVB arrived to service companies from OECD countries. ProCredit Bank started in 2001 as Microfinance Bank.

After the Orange Revolution in 2004 foreign banks were again interested in Ukraine, as a country with 45 million people and an under-developed consumer banking market. SEB, Raiffeisen, Erste Bank, BNPP, Credit Agricole, OTP, Swedbank, Commerzbank, Intesa Sanpaolo, and Unicredit bought banks with nationwide networks.

2007 and 2008 saw the massive arrival of banks from regional and neighboring countries — “followers” with a business model similar to that of the Western banks mentioned above. This business model involved concentrating on cheap external funding for the development of consumer, car, and mortgage lending. Second-tier banks like Universalbank (EFG Eurobank Ergasias), Piraeus Bank, Astra Bank, Marfin Bank (Greece), Bank of Cyprus (Cyprus), Credit Europe Bank, Credit West Bank (Turkey), and BG Bank (Georgia) also established their presences in Ukraine.

Russian banks were selective in their path to Ukraine. Although they were all firm in following a strategy of supporting client business outside Russia, each bank entered the market in a specific way. Alfa-Bank has been demonstrating successful organic growth since the 1990s. In 2004 VTB Bank bought Bank Mriya, which serviced many businesses involved in trade with Russia. Sberbank of Russia was given authorization to start corporate banking in 2007 and only later got approval to enter the retail sector. VEB, a Russian state-owned bank, entered the Ukrainian market when the crisis of trust and liquidity at the end of 2008 was testing the viability of Prominvestbank (which was № 6 at that moment) and of the banking system in general. A capital injection and a credit lifeline helped to save and even improve Prominvestbank’s standing.

The sector thus saw just one big failure of a bank in the “traditional” top 20 group — Ukrprombank, which fell victim to chaotic government measures to protect the interests of private depositors (their accounts were transferred to RODOVID BANK and the bank’s business model was broken).

2011 saw the resolution of the most burning issue in the banking sector — the future of the biggest bank in NBU receivership. Bank Nadra got a powerful private investor, Dmitry Firtash, owner of businesses in the gas and energy, agriculture, and chemical industries.

The year 2012 was marked by the decisions of several Western banks to scale down or quit the banking business in Ukraine. Swedbank and SEB sold their retail networks, Commerzbank found a buyer for its subsidiary Bank Forum, and Societe Generale quit its ProFin Bank in Ukraine. These losses might be linked in part to the difficult global strategic standings of the subject banks and the need to focus on domestic and strong regional markets. The Ukrainian business sphere, although reinvigorated by the 2012 UEFA European Championship, remains complicated, depends on export industries, and is characterized by political uncertainty.

The end of 2012 was marked by the merger of two Credit Agricole subsidiaries in Ukraine — Credit Agricole CIB and CREDIT AGRICOLE BANK — into one entity, CREDIT AGRICOLE BANK.

In 2013 Western-owned banks did not abandon their intentions to quit Ukraine or to reduce their presences here. Erste Bank and Swedbank finalized deals to sell their Ukrainian assets in the middle of the year. Some other banks still intend to sell their assets as well.

Ukrainian Banks — Subsidiaries of Banking Groups from OECD Countries and Cyprus

Data as of:	01.07.2013 1 USD =			7.993	UAH				Data in Mio USD
Rank by Assets	**Rank Change**	**Bank Name**	**Country**	**Rank by Profit**	**Total Assets**	**Due to Banks**	**Accounts Corporates**	**Accounts Individuals**	**Net P&L**
5	—	Raiffeisenbank Aval	AT	0	5 621	707	1 500	2 098	2
6	0	Ukrsotsbank	IT	5	4 798	1 307	815	1 531	1
13	-1	Ukrsibbank	FR	4	3 425	28	910	1 328	7
16	0	OTP Bank	HU	4	2 492	13	438	711	- 5
19	0	CREDIT AGRICOLE BANK	FR	1	1 611	151	663	502	36
24	—	ING Bank Ukraine	NL	2	1 213	409	561	1	- 8
27	3	Universal	GR	3	947	233	86	327	- 11
36	-	Citibank Ukraine	US	1	770	21	597	3	1
39	-8	UniCredit Bank Ukraine	IT	2	653	246	137	118	22
41	—	Pravex	IT	22	625	20	114	315	- 2
47	3	Platinum Bank	US	4	556	0	87	364	3
49	-4	Kredobank Ukraine	PL	21	520	45	117	240	- 24
60	-2	Piraeus Bank ICB	GR	21	384	114	25	117	0
61	-13	Marfin Bank	CY	10	367	21	119	145	18
65	—	Bank of Cyprus (Ukraine)	CY	17	324	130	19	79	- 6
69	2	Procredit Bank	DE	3	302	0	58	166	1
70	3	Idea Bank	PL	8	301	29	39	188	4
83	-8	Deutsche Bank DBU	DE	3	227	0	197	0	1
86	8	Credit Europe Bank	TR	1	221	90	12	2	1
118	-16	SEB Bank	SE	7	90	40	16	0	3
148	0	CreditWest Bank	TR	5	54	12	16	5	2
		Grand Total			**25 501**	**3 616**	**6 526**	**8 240**	**46**

Assets evolution

Ukrainian Banking System – Loans Portfolio

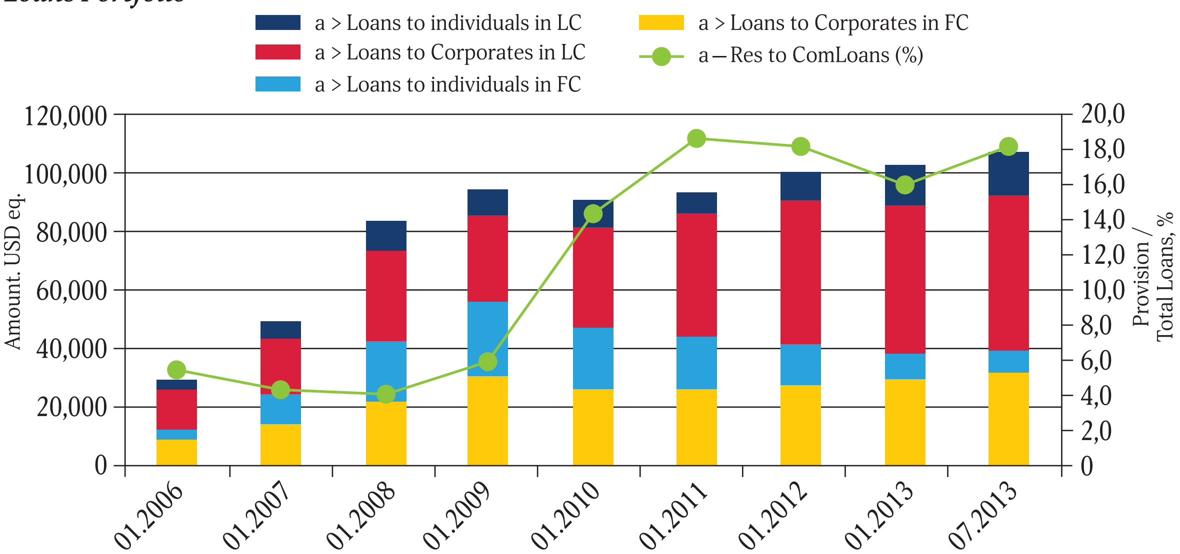
Clients & Currency Structure

Date of report:	08.11.13									Internim data
Date:		01.01.06	01.01.07	01.01.08	01.01.09	01.01.10	01.01.11	01.01.12	01.01.13	01.07.13
UAH per 1 USD		5.05	5.05	5.05	7.7	7.985	7.9617	7.9897	7.993	7.993

	Units	01-2006	01-2007	01-2008	01-2009	01-2010	01-2011	01-2012	01-2013	07-2013
Total Clients' Loams	**Mio UAH**	**142,277**	**245,523**	**430,052**	**741,816**	**726,296**	**750,536**	**813,864**	**826,486**	**849,128**
Total Clients' Deposits	**Mio UAH**	**147,094**	**202,929**	**318,389**	**436,727**	**349,636**	**439,446**	**524,909**	**597,631**	**650,421**
Total Loans / Total Deposits	%	97%	121%	135%	170%	208%	171%	155%	138%	131%
FC Part of Clients' Loans	**Mio USD**	**12,305**	**24,047**	**42,191**	**56,336**	**47,352**	**44,334**	**41,578**	**38,519**	**39,417**
FC Part of Clients' Deposits	**Mio USD**	**9,034**	**13,892**	**17,795**	**20,460**	**22,064**	**24,553**	**29,052**	**33,971**	**34,172**
FC Loans / FC Deposits	%	136%	173%	237%	275%	215%	181%	143%	113%	115%

Total Loans to Corporates	**Mio USD**	**21,608**	**33,221**	**54,737**	**61,423**	**61,267**	**67,893**	**76,400**	**80,407**	**83,958**
Growth rate (Y-to-D)	%		53,7%	64,8%	12,2%	11,9%	10,8%	12,5%	5,2%	9,9%
– FC Share Loans to Corporates	%	39%	42%	41%	50%	42%	39%	36%	37%	37%
Total Loans to Individuals	**Mio USD**	**6,565**	**15,397**	**30,422**	**34,916**	**29,291**	**25,852**	**24,756**	**22,995**	**23,253**
Growth rate (Y-to-D)	%		134,5%	97,6%	14,8%	-3,7%	-11,7%	-4,2%	-7,1%	-6,1%
– FC Share Loans to Individuals	%	60%	65%	65%	74%	73%	70%	57%	40%	36%
Total Loans to Fis + Securities	**Mio USD**	**7,838**	**11,128**	**21,597**	**16,876**	**9,385**	**15,352**	**17,776**	**15,095**	**20,589**
Growth rate (Y-to-D)	%		42,0%	94,1%	-21,9%	-56,5%	63,6%	15,8%	-15,1%	15,8%
Loans Loss Provision	**Mio USD**	**-1,811**	**-2,556**	**-3,891**	**-6,136**	**-14,170**	**-18,606**	**-19,681**	**-17,597**	**-17,511**
– as of Total Commercial Loans	%	5,5	4,7	4.0	5,7	14,8	18,6	18,2	16,0	18,1

Loans Portfolio



In 2013, Ukraine's banking sector saw modest loan portfolio growth. The overall ~6% increase in loans during H1 2013 was mainly underpinned by business activity in the corporate sector, representing 80% of banks' commercial loans. However, the 2012–2013 figures reveal a lack of resources for stimulating further growth, as loan dynamics have lost their momentum since the end of 2012, reflecting lower investment demand (after the 2012 UEFA European Championship). Loans to private individuals in local currency have experienced rapid growth, but the ongoing downtrend in foreign currency lending to the population blunted the effect and the total volume of loans to this client segment remained almost unchanged. NBU monetary policy has not changed much, so banks are left without direct or indirect support in their credit expansion.

A significant reduction in the growth rate came after a boom and bust period: in the three pre-crisis years total bank assets grew from +/- USD 42 billion (December 2005) to USD 120 billion (December 2008). There was growth of 300% overall (in USD), with the peak coming in October 2008 — USD 155 billion (just before the UAH devaluation). Commercial loans grew even faster between 2006 and 2009: loans in UAH grew 3.7 times; and loans in foreign currencies grew 4.6 times, from USD 12 billion in January 2006 to USD 60 billion in October 2008.

Devaluation of the local currency from ~UAH 5 per USD 1 in 2005–2008 to ~UAH 8 per USD 1 in 4Q 2008 had a major impact on the economic environment in Ukraine.

Major loan portfolio development in 2009–2013

- UAH-denominated loan totals went up, driven by massive state support to state companies and banks, replacement of foreign currency loans with UAH-denominated ones, and growth of local business ahead of Euro 2012: +16.5% in 2009, +10.5% in 2010, +21.6% in 2011, +8.4% in 2012 and +8.5% over 9M2013.
- Foreign currency loans, if accounted in USD equivalents, showed slides of -18.9% in 2009, -8.0% in 2010, -3.9% in 2011, and -7.3% in 2012. Foreign currency loans ceased their decline at the end of 2012 and showed moderate growth in 2013. This indicates a stabilization of demand for foreign currency loans, mainly from companies involved in external trade operations.
- After corrections in 2009–2010 (-18% and -1% respectively) loans to individuals in local currency became popular again with consumers and retail banks: +34% in 2011 and +19% in 2012. The trend continues this year, reaching 16.7% over 9M 2013. The segment of short-term credit to private individuals has been spotted by many banks and massive advertising was followed by the advent of a variety of products.
- Corporate loans in UAH grew vigorously during the post-crisis years: +27% in 2009, +13% in 2010, +19% in 2011. Growth is not so strong this year as it was in 2012. But it's still solid (+6.4%over 9M13), taking into consideration the absence of a strong factor that was present in 2012 (i.e. EURO-2012) as well as growing political concerns. The main directions of expansion are the agriculture and food-processing businesses and production of selected import-replacement consumer goods.

Overall, commercial loans in USD terms increased slightly since the big drop caused by the crisis and since the local currency was devalued at the end of 2008. Loans have been massively prolonged when borrowers have been incapable of repaying them during the current market slide, or else they've been restructured in exchange for partial repayment. Some foreign currency loans to individuals, upon the advice and with the support of the National Bank of Ukraine, have been converted into the local currency to ease the burden of interest payments.

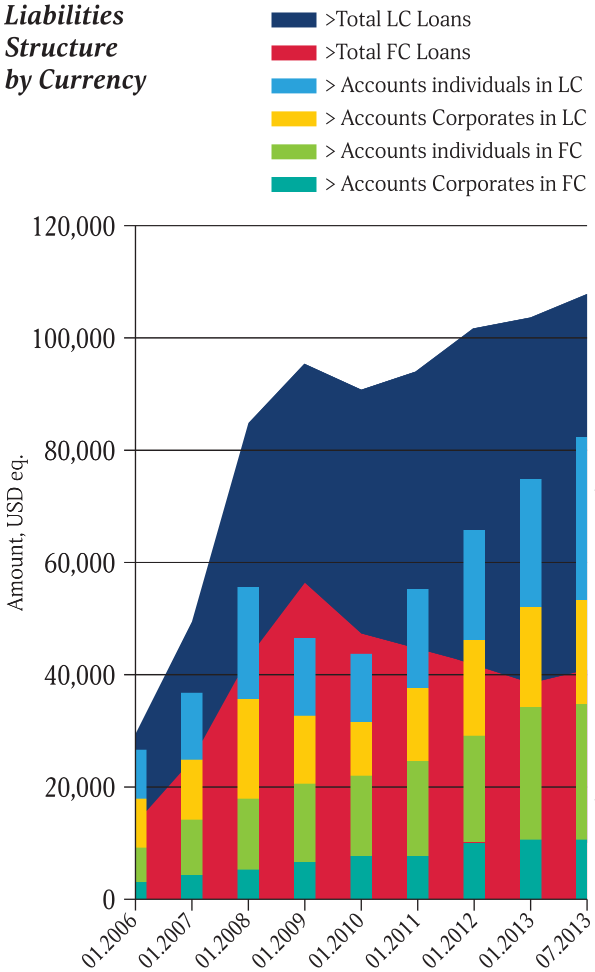
Lending is weak, as banks still have to provision their assets, the economy is not showing the expected recovery, and the legal environment remains uncomfortable for lenders. In 2009–2012, however, loans to individuals almost stabilized around USD 23 billion, while starting this year loans have been seeing renewed growth. Hence the decrease in foreign currency loans was fully covered by the UAH credit portfolio's recovery. Banks have not lent in foreign currencies to households since the 2008 crisis.

Rating agencies and international financial organizations report that more than 35% of loans have been restructured. However, the NPL ratio as measured by the NBU kept falling in 2013, reaching 8.7% as of the end of September. Banks have been selling their loan portfolios to SPVs to improve the reported quality of their loans. Another way to get rid of heavily provisioned assets has been to sell a selected portion of a portfolio to a collection company.

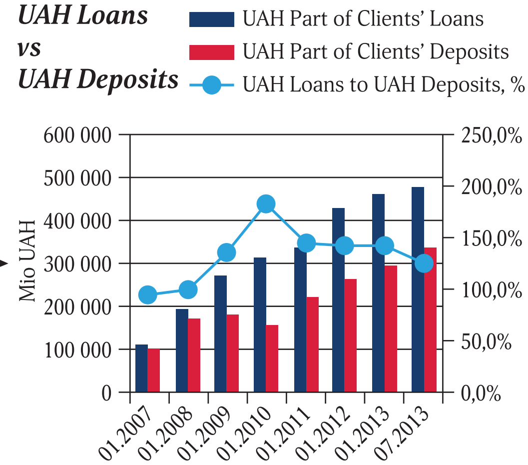
Non-performing loans are a major problem for the banking system, for all bank categories. Reserves accumulated by banks are building up quickly: from 4% of loan portfolios in October 2008 to 18.2% at the end of 2011. They started sliding downwards in 2012–2013 (16%).

In 2010–2012 banks put an excess of funds into the securities market, in which the stake held by banks has grown almost three times: from USD 4.8 billion (UAH 38.6 billion) at the end of 2009 to USD 16 billion (UAH 128 billion) by the middle of 2013. Securities are concentrated among the top 20 banks, and in fact three state-owned banks hold 40% of government securities. Only around 15% belongs to private Ukrainian banks.

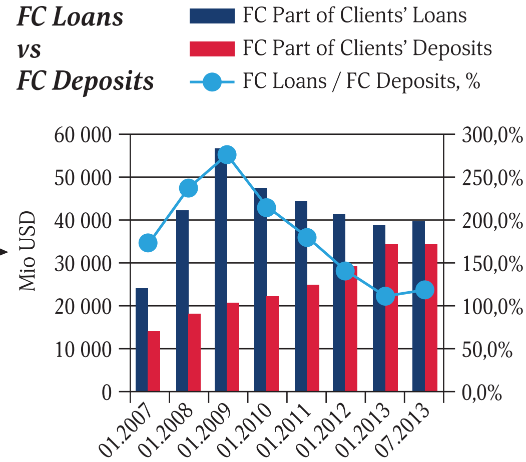
Liabilities Structure by Currency



UAH Loans vs UAH Deposits



FC Loans vs FC Deposits

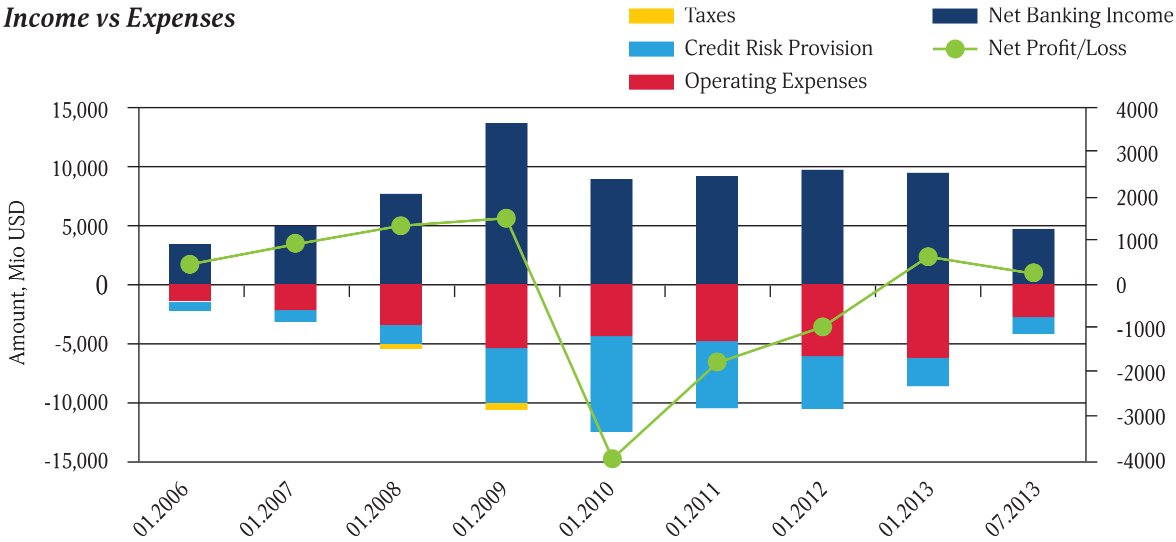


Since funding from abroad was interrupted by the crisis and since the situation has become no easier over the last three years, Ukrainian banks have refocused on domestic deposits. By raising rates and marketing new short-term and bonus products, banks have achieved a visible stabilization of funding in UAH and foreign currencies attracted from private individuals and corporate clients. The banks have kept and even increased their deposit base since January 1, 2009 as follows:

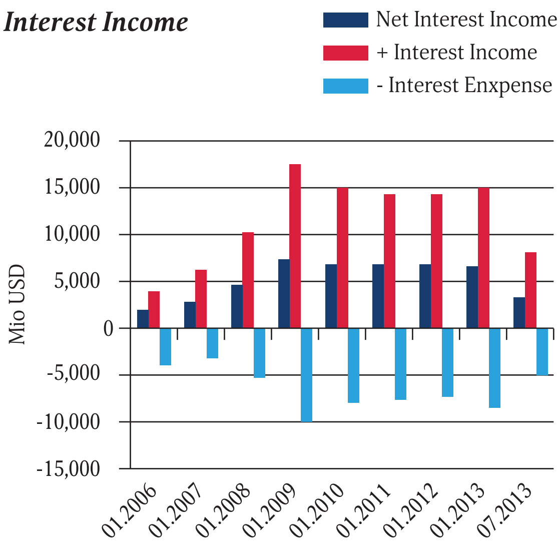
- Population deposits grew up by USD 25.8 billion to reach USD 53 billion (UAH 425 billion) as of the end of September 2013; that amount was equally split between foreign currencies and UAH.
- During the same period corporate accounts saw a dramatic drop from USD 28 billion to USD 17 billion in 2009, and then a recovery to USD 26.8 billion in 2011. Since 2012 a squeeze has started again (to USD 27 billion or UAH 217 billion as of the end of September 2013).
- It should be noted that around two thirds of corporate accounts involve "at-sight" money, while private individuals are motivated by banks to place at least short-term deposits (one-month to one-year). Such deposits make up >75% of the money kept with banks.
- The bank loan to deposit ratio is improving: it was 2.19 at the end of 2009 and 1.33 as of the end of September 2013. Foreign currency to foreign currency deposits were almost equal, at 1.23, in 2013.
- Foreign currency borrowings from banks abroad decreased from USD 42 billion to USD 34 billion over 2009 and then dropped to USD 21 billion, Western-owned banks being the biggest beneficiaries of the funding.

Capital increase has been a big concern for banks. After an urgent "emergency" capital infusion of UAH 35 billion in 2009, the banks continued the pace in 2010 by adding UAH 27 billion in 2010 and a further UAH 22 billion in 2011. Nevertheless, banks are adequately capitalized today.

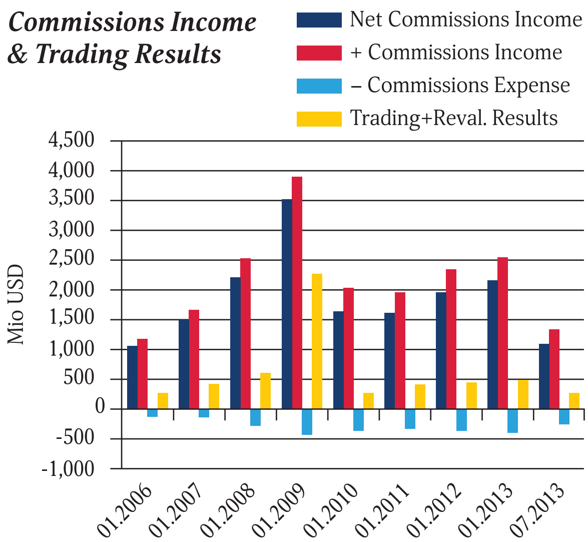
Income vs Expenses



Interest Income



Commissions Income & Trading Results



Net banking income was stable in 2009–2012: ~USD 9 billion. The figure for 1H 2013 shows that net income will be almost the same for the whole year (USD 4.7 billion for the first half).

The share of interest income in NBI has been declining since 2011, reaching 67% in 2013.

At the same time, commission income is increasing its share. It reached almost 23% in 2013.

The operating expenses up-shift over 2009–2012 may be capped in 2013 thanks to cost and staff expense control. Administrative and staff expenses were USD 4.9 billion in 2010, USD 6.3 billion in 2011, and USD6.3 billion in 2012. They should hopefully be lower in 2013. Nevertheless the cost-to-income ratio deteriorated from 52% in 2009 to around 66% in 2012. It reduced slightly in 1H 2013 to 64%.

The net result is pointing to marginal profit in 2013: loan loss provisions produced less pressure on earnings, finally decreasing in 2013 (forecast) to USD 2.5 billion. Compare that to USD 4.4 billion in 2011 or USD 8.2 billion in 2009, the hardest year.

Market regulator

The National Bank of Ukraine (NBU), with more than 11,000 employees, has been regulating banking activity since 1991. Banks are subject to very significant constraints in their day to day activities, and report "everything." The banking sector, and particularly that portion of it that is not western-owned, faces such challenges as fragmentation, including the presence of many small banks (which have to comply only with a minimum regulative capital requirement of UAH 120 million), capital adequacy issues, insider loans, tax games, and insufficient provisioning.

The change in the political landscape in 2010 also led to a change in the NBU's management team. Thanks to IMF support, certain positive changes took place: NBU independence was reinforced (a challenging task), the obligation to reveal beneficiary owners was established (in December 2011), and the necessity of focusing more on inflation management and less on the "peg" between the UAH and the USD was stressed (although the peg is unfortunately still being maintained). In addition, the capacity to transmit foreign exchange risk to economic sectors thanks to the development of forwards became possible in mid-2011, although in a very restrictive way.

Conclusion

The Ukrainian banking sector remains halfway between stabilization and growth. Anti-crisis measures are still effective, like the sale of 50% of foreign currency proceeds as mandated by the regulator to keep the UAH/USD rate manageable. At the same time, sources of growth depend solely on the Ukrainian economy, which is too dependent on growth in Europe and emerging markets and on key export/import partners.

Profitability is limited by the overall law of business efficiency. Non-performing loans, as well as restructured loans, still account for +/- 30–40% of gross loans. At the same time, UAH currency funding became more accessible in 2013 after the NBU took steps to ease monetary policy. The policy should prevent interest rates from a sharp hike in Q413, thus inducing banks to accelerate loan provision to the economy.

Banks showed their resilience in the 2008 crisis and have received the required capital. Their capitalization is today adequate, so there exist no additional risks in the medium-term future.

Retail loans and loans to agriculture should be the main driving force for banking system growth in 2013.

Western banks in Ukraine have continued decreasing their relative presence, falling from one third to one fifth of the market over the last 3.5 years. The trend should continue in the medium-term future.

2014 will once again be a challenging year for banks in Ukraine, one in which the global and national business environments will demand that they take quick, precise measures.

The anti-money laundering set-up in Ukraine

Anti-money laundering measures are regulated by the Law "On Prevention and Counteraction to Legalization (Laundering) of the Proceeds from Crime" of May 18, 2010, №2258-VI (hereinafter the Law). Bank activity is regulated by NBU Regulation №189 "On Financial Monitoring Execution by Banks," approved by NBU Resolution №22 of January 31, 2011 and registered with the Ministry of Justice of Ukraine on April 7, 2011 (hereinafter the Resolution).

According to the Law, any acts related to proceeds (property) received as the result of the commission of a crime aimed at concealing the origins of these proceeds (property), or any assistance to a person who is an accomplice to this crime, is to be understood as laundering.

The Law excludes tax crimes from the list of crimes that are subject to it. Laundering in Ukraine is understood to relate to prostitution, terrorism, drug and arms sales, and other crimes. But the authorities are also inclined to include tax crimes in this group.

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

The following entities are involved in/are subjects of initial financial monitoring:

- banks, insurance (re-insurance) 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 participants in the securities market;
- asset management companies;
- postal service operators and other institutions carrying out financial transactions of fund transfers;
- branches and subsidiaries of foreign business entities rendering financial services on the territory of Ukraine;
- business entities rendering intermediary services in the process of real estate purchase and sale transactions;
- business entities involved in trading in precious metals, precious stones, and related goods for cash when the amount of these transactions equals to or exceeds UAH 150,000 or the equivalent in foreign currencies;
- business entities conducting lotteries and games of chance, including casinos and electronic (virtual) casinos;

- notaries, law firms, auditors, audit companies, and private entrepreneurs rendering accounting services; economic agents rendering legal services;
- private entrepreneurs and legal entities performing financial transactions with goods (rendering services, performing works) for cash if the amount of the transactions equals or exceeds UAH 150,000 or its equivalent in foreign currencies;
- other legal entities that are not listed as financial institutions but that render certain financial services.

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

- The National Bank of Ukraine
- The Ministry of Finance of Ukraine
- The Ministry of Justice of Ukraine
- The Ministry of Transport and Communication of Ukraine
- The Ministry of the Economy of Ukraine
- The State Stock Market and Securities Commission of Ukraine;
- The State Commission for Regulation of the Financial Services Markets of Ukraine;
- The State Service for Financial Monitoring of Ukraine (hereinafter SSFMU).

The SSFMU is a central executive power body the head of which is appointed by the Cabinet of Ministers. The SSFMU's activity is governed and coordinated by the Cabinet of Ministers via the Minister of Finance.

The following financial transactions are subject to compulsory 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 business entities conducting lotteries and games of chance the threshold is UAH 13,000 or its equivalent in foreign currencies) and if this financial transaction has one or more of the specific features stipulated in Article 15 of the Law, i.e. if certain objective criteria are met. When both conditions are fulfilled, reporting to the SSFMU is compulsory. For instance, all insurance-related incomings or payments above UAH 150,000 must be reported.

The following financial transactions are subject to internal monitoring:

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

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

Business entities rendering intermediary services during the execution of real estate purchase and sale transactions have to perform internal financial monitoring if the amount of the transactions equals or exceeds UAH 400,000 or its equivalent in foreign currencies.

Reporting to the SSFMU on a financial transaction subject to internal financial monitoring happens as the result of an assessment by the reporting institution and is based on defined subjective criteria.

The SSFMU has the right to suspend, for up to five business days, all debit transactions in customer accounts if there are suspicions that the customer's transactions are related to money laundering.

Subjects of the initial level of financial monitoring should "know their customers" and should be able to prove it. Their files should contain evidence that their customers (legal entities, individuals, banks, and other financial institutions) have been identified according to the identification rules defined by the Law and by the Resolution, if banks are in question. The identification rules require identification of the ultimate/beneficial owners ("controllers" >=50% ownership), shareholders ("holders of significant participation" >=10% ownership), and managers/authorized persons. The identification rules also prescribe identifying non-resident politically exposed persons (PEP) among the group of customers.

Banks that are subjects of the initial level of financial monitoring are obliged to classify their customers on the basis of how likely they are to perform money laundering transactions. This classification has to be performed in accordance with the requirements of the Resolution, taking into consideration the criteria defined by the SSFMU. The Resolution also requires that banks classify customers by their reputation.

Pursuant to the Resolution, banks should maintain electronic KYC forms ("anketas") of the prescribed format in Ukrainian on a mandatory basis. These "anketas" are to be stored and must contain all the historical data pertaining to banks' relationships with customers. Information about customer risk levels and customer reputation must be indicated in the customers' "anketas."

The Resolution also requests that, each quarter, banks analyze customer transactions as to their correspondence with customers' financial standing and activity. The results of these analyses must be recorded in customers' "anketas."

The Resolution obliges banks to make their internal documents pertaining to financial monitoring (programs, rules, standing orders, etc.) consistent with the Resolution.

The Law and the Resolution also cover activities related to "terrorism." Subjects of the initial level of financial monitoring are required to prevent for up to two days a financial transaction if a participant or a beneficiary of the transaction is on the list of terrorists provided by the SSFMU. The SSFMU has the right to extend this period to up to 12 business days.

The Law and the Resolution in many aspects respect international AML practices (for instance, in the extension of the list of entities that are subjects of the initial level of financial monitoring, in the identification of PEP, and in customer risk-based classification). But they substantially increase the volume of transactions subject to compulsory financial monitoring and to mandatory reporting to the SSFMU. They also increase the volume of work related to customer identification and maintenance of customer "anketas."

* * *

After more than 10 years of implementation, Ukraine's anti-money laundering protocols have resulted in about seven million transactions being reported to the SSFMU by subjects of the initial level of financial monitoring.

For three quarters of 2013, 692,836 transactions were reported to the SSFMU. Out of these, 673,638 (97%) transactions were reported by banks. In addition, 464,680 (69%) reported transactions were subject to compulsory financial monitoring.

Of the 442,695 reports that the SSFMU received for H1 2013, only 403 dossiers were sent to Ukrainian law enforcement bodies.

In H1 2013 239 new criminal cases were initiated. They were based on 38 dossiers sent by the SSFMU to Ukrainian law enforcement bodies. In addition, 144 dossiers sent by the SSFMU to Ukrainian law enforcement bodies were used in 147 already-open criminal cases. The courts considered 142 criminal cases out of this group.

Within the framework of criminal proceedings, where consolidated materials are used, property (funds) for a total of UAH 85.64 million was distrained;

- The total value of seized property (funds) came to UAH 3.4 million;
- The losses reimbursed at the pre-trial investigation stage (reimbursed voluntarily) came to UAH 2.99 million.

Currency control

Ukraine's currency control system is strict and complicated, regulated by many laws and regulatory acts of the National Bank of Ukraine (NBU).

The main purpose of currency control is to prevent illegal export or import of valuables and goods; illegal services; and illegal transfer of funds abroad. It applies to the foreign economic transactions of bank customers, such as those involving payments for goods and services during commercial deals; loans from non-residents; and investment operations. Banks verify if residents are respecting the settlement terms that Ukrainian legislation sets for export and import operations.

Banks also control the current non-commercial foreign currency transactions of private individuals (residents and non-residents alike).

Private individuals

1. **Incomings in foreign currencies of the 1st group of the NBU Classifier and in Russian rubles in favor of private individuals (residents and non-residents of Ukraine) from abroad:**

The NBU's Resolution № 453 dd. 14.11.2013 introduced mandatory sale of incomings from abroad in the currencies of the 1st group of the NBU Classifier and in Russian rubles (the currency classifiers can be found on the official NBU website, www.bank.gov.ua) in favor of private individual residents and non-residents of Ukraine.

According to the Resolution, if total incomings in favor of a private individual at the servicing bank (such as foreign currency incomings into current accounts or card accounts; or incomings that come without an account having been opened and via international payment systems like Western Union or Moneygram) exceed UAH 150,000 per calendar month, the bank sells the extra amount on a mandatory basis in the absence of payment instructions from the client.

The following incomings are not subject to 50% mandatory sale and are to be fully credited without sale:

- Incomings in favor of diplomats, employees of embassies and consular establishments, and international organizations who are non-residents or do not reside permanently in Ukraine and are accredited by the Ministry of Foreign Affairs of Ukraine.

The Ukrainian bank credits a UAH equivalent after currency sale to a private individual's UAH current account at that bank. If there is no UAH current account, the bank keeps the UAH equivalent in the transit account. During the beneficiary's first visit, the bank opens an account and then credits a UAH amount to it.

2. **Incomings in foreign currency in favor of private individuals (residents and non-residents of Ukraine) within Ukraine:**

The NBU's new Resolution № 365 dd. 16.09.2013 introduced 100% mandatory sale of incomings in favor of private individuals.

The following incomings are not subject to mandatory sale and are to be fully credited in foreign currency without sale:

- Incomings in favor of diplomats, employees of embassies and consular establishments, and international organizations who are non-residents or do not permanently reside in Ukraine and are accredited by the Ministry of Foreign Affairs of Ukraine.
- Transfer of personal funds to another account or a cash deposit to a current account by the owner of the funds or by a person acting based on a power of attorney (the power of attorney has to be notarized or completed at the bank in the presence of a bank employee).
- Transfers under heritance or gift agreements. A notary has to attest such an agreement regardless of the amount.
- Funds that were returned because they had previously been paid in excess or by mistake.
- Interest accrued and credited to a current or deposit account.
- Transactions with government bonds.

Please be advised that salary or other income transfers in favor of non-residents of Ukraine are also subject to mandatory sale. Legal entities and representative offices of non-residents can thus pay salaries and other income to their non-resident employees in the following way:

- In foreign currency, by crediting the amount in question to the account in hryvnia after mandatory currency sale on the Interbank Foreign Exchange Market. Afterwards, a non-resident individual can purchase foreign currency himself or herself only for its further repatriation to his/her accounts abroad.
- Legal entities and representative offices of non-residents can pay salary or other income to their non-resident employees in cash in foreign currency (via withdrawal of their own funds from corporate current accounts or after purchasing currency). A non-resident individual deposits cash in his/her account in a foreign currency upon providing a certificate (to be issued by the employer) proving its source. This certificate indicates the name of the employer, the name of the non-resident, the salary/bonus amount, the income payment period, and other information.
- In UAH in cash or by making a transfer to a non-resident's current account in UAH.

The Ukrainian bank credits a UAH equivalent after currency sale to a private individual's UAH current account at that bank. If there is no UAH current account, the bank keeps the UAH equivalent in the transit account. During the beneficiary's first visit, the bank opens an account and then credits a UAH amount to it.

3. **Settlements between private individuals (residents and non-residents) and legal entities and between private individuals in amounts exceeding 150,000 UAH are executed in noncash form only.**

The following NBU currency control requirements concerning the operations of private individuals (residents and non-residents) remain unchanged:

- Residents and non-residents may export and/or import without declaration the equivalent of EUR 10,000. An amount exceeding the equivalent of EUR 10,000 should be accompanied with a written declaration and a confirmation from the bank proving that the funds were withdrawn from the private individual's account. The bank's certificate is valid for 30 calendar days from the day of issue.

- Private individuals must present their identification documents during cash exchange operations.
- A non-resident of Ukraine can purchase cash foreign currency in reverse: he/she must provide the bank with proof that he or she sold cash foreign currency in the past.
- Private individuals can transfer abroad up to UAH 15,000 in a foreign currency equivalent per banking day without opening an account. Non-residents of Ukraine must provide the bank with a certificate confirming the source of the transferred funds; residents of Ukraine do not need to present such a certificate if they comply with the limit.
- Any incoming transfer into the current account of a private individual at a Ukrainian servicing bank should be accompanied by clear information about the purpose of the transfer.

Legal entities, representative offices of non-residents, and private entrepreneurs

The NBU's new Resolution # 453 dd. 14.11.2013 sets new rules for mandatory sale of incoming payments in foreign currencies of the 1st group of the NBU Classifier and in Russian rubles (the currency classifiers, again, can be found on the official NBU website, www.bank.gov.ua).

The following are subject to 50% mandatory sale on the Ukrainian currency market:

- Any incoming in favor of legal entities and private entrepreneurs, including:
- loans from non-residents, except for state-covered loans and loans from international organizations of which Ukraine is a member;
- contributions to statutory funds;
- redemption of payments from non-residents even if they were paid from their own funds or loans in foreign currency taken from a servicing Ukrainian bank.
- Ukrainian residents' commission income according to commission agreements.
- any incoming payments in favor of permanent establishments of non-residents in Ukraine ("P" type accounts).

Subject to 100% mandatory sale on the Ukrainian currency market:

- Payments, returned by non-residents as a result of the non-fulfilment of an agreement with a resident of Ukraine, that the resident previously purchased on the Ukrainian currency market.

Not subject to mandatory sale on the Ukrainian currency market:

- Incoming payments in favor of diplomatic representative offices.
- Incomings in favor of an international organization provided that the organization's status is confirmed by an intergovernmental agreement.

The following currency regulation requirements remain unchanged:

- settlements between residents and non-residents under export and import transactions must take place within 90 days.
- a resident legal entity can purchase foreign currency from a single Ukrainian bank chosen by the client.
- Purchased foreign currency should be transferred for the purposes indicated in the application for the purchase within 10 banking days.
- Payments for goods (including currency purchase and 90-day control) should be executed using the electronic customs declaration form available in the Electronic Register of Customs Declarations; the NBU sends this form to the servicing bank.
- All payments for services (including royalties) exceeding EUR 100,000 are subject to additional price relevance certification by the state entity Derzhzovnishinform.
- Cross-border loans are subject to obligatory registration with the NBU.
- The obligatory documents for capital market divestments including dividend payments are the following: an investment agreement and a document proving that the investment took place.
- If a non-resident sells shares or if a divestment was originally made in kind and the proceeds are to be repatriated, an "estimation certificate" issued by a licensed Ukrainian appraiser is required.

Conclusion

The Ukrainian banking sector remains halfway between stabilization and growth. Anti-crisis measures are still effective, like the sale of 50% of foreign currency proceeds as mandated by the regulator to keep the UAH/USD rate manageable. At the same time, sources of growth depend solely on the Ukrainian economy, which is too dependent on growth in Europe and emerging markets and on key export/import partners.

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2014 will once again be a challenging year for banks in Ukraine, one in which the global and national business environments will demand that they take quick, precise measures.

THE CAR MARKET: A BANKER'S VIEW

Auto finance is today an integral part of the automobile business. The car loan market is directly linked to the automobile market's development, and car sales depend on the well-being of the financial industry. The penetration of financial services is exceptionally high in developed countries. Ninety-nine percent of new car sales in the USA, for example, are financed using various types of debt instruments, while in Western Europe between 65% and 76% of cars are bought on credit. Car financing is becoming more common in emerging markets, as well, in line with robust car sales growth. In the first half of 2008 over 40% of new car sales in Ukraine were financed by local banks. But the financial crisis damaged this trend, closing off local banks' access to international capital markets and stopping car lending in its tracks. Recovery started only in the second half of 2009, when the recovery stabilized. Whereas banks financed 10% of cars in 2010, they financed 19% of them in 9M 2013. After the 2009 collapse the Ukrainian car market demonstrated modest recovery, growing 22,4% y/y in 2011 and 14,5% y/y in 2012. The Ukrainian market, however, still has great potential, given that Ukraine has the lowest motorization level (173 cars per thousand people) among European countries. In Russia there are 271 cars per thousand people and in Poland there are 571. The Ukrainian auto market is still in the early stage of its recovery, so there should be growth in both car sales and auto finance.

The Ukrainian car financing market in 2013

The Ukrainian car financing market is characterized by classical banking products, leasing, and OEM (original equipment manufacturer) captive financing. Bank loans constitute more than 80% of the total automotive finance market. The dominance of bank loans is a general trend for emerging markets, while OEM captive financing is more characteristic of developed countries. In addition to car loans, finance and operating leasing are widely popular in developed markets. In Ukraine, however, leasing makes up only an estimated 2,5% of total car sales. The OEM captive segment is represented by a limited number of players, with Porsche Leasing dominating in the niche.

Banks

In January-September of 2013 19,2% of cars were purchased on credit. The strongest month for the market was April, with 5,409 disbursed car loans. The April results have to do with the upsurge of sales before special customs duties for imported cars were introduced. Growing car sales before the introduction of utilization fees stimulated another boost in car loans in July. In July the number of car loans grew by 29% m/m to 4,059; in August it grew by 14% m/m to 4,614. The inflated comparative base resulted in a decline in disbursed loans of 17,4% m/m, to 3,810 in September 2013.

UniCredit Bank

- market leader in the car loan market with a market share of 18,5%

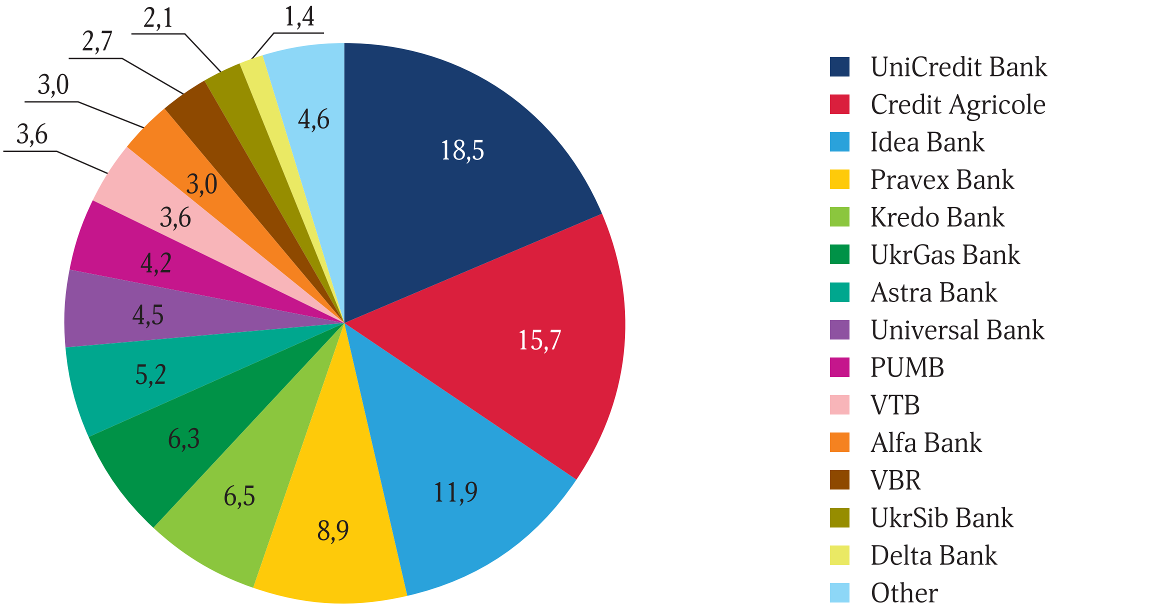
CRÉDIT AGRICOLE CORPORATE & INVESTMENT BANK

- market player in the car loan market with a market share of 15,7%

IdeaBank

- market player in the car loan market with a market share of 11,9%

Ranking of banks by number of car loans in January-September 2013



Source: *Banks*

Development of car loan interest rates

The evolution of interest rates

In 2007 car loan interest rates in Ukraine ranged between 12% and18% in UAH and between 13,4–13,6% in USD due to ample liquidity on the local financial market. In 2009 interest rates skyrocketed to 28%–30% in UAH, stabilizing at 23%-25% in 2010. In 2011–2012 the average cost of car loans varied from 19% to 22% due to volatile market liquidity. At the time of this writing the effective interest rates on car loans offered by local banks were varying between 13% and19% depending on the maturity of the loan and type of car.

New foreign cars

According to Prostobank Consulting, the average real interest rate for purchase of a new foreign car decreased by 1,4–1,7 percentage points from June 2013 to October 2013. According to Natalia Butkova, Head of Partner Relations Department at UniCredit Bank, interest rates in the car market tend to be stable in 4Q, ahead of the Christmas holidays.

Maturity	**Average effective rate,%**	**Δ % effective rate October to June 2013**	**Number of financing banks**
1 year	13,06	-1,59	36
2 years	14,22	-1,60	35
3 years	15,39	-1,62	35
4 years	16,29	-1,64	35
5 years	16,16	-1,70	35
6 years	16,16	-1,68	24
7 years	16,12	-1,37	23

Source: *Prostobank Consulting*

New domestic cars

Loans for domestic cars are more expensive than loans for foreign cars due to lower car quality and faster depreciation of collateral.

The fall in interest rates was less dramatic here than it was in the foreign car segment.

Maturity	**Average effective rate,%**	**Δ % effective rate October to June 2013**	**Number of financing banks**
1 year	18,06	-0,28	35
2 years	18,58	-0,30	34
3 years	18,95	-0,21	34
4 years	19,15	-0,15	29

5 years	18,84	-0,34	29
6 years	18,13	-0,89	13
7 years	18,14	-0,97	12

Source: *Prostobank Consulting*

Partnership programs: making financing cheaper

Of the top 50 Ukrainian banks, only 14 provide joint auto financing in conjunction with OEMs and dealers. Partnership financing products involve such brands as Honda, Toyota, Volkswagen, Ford, ZAZ, Geely, Chevrolet, and Mitsubishi. According to Prostobank Consulting, 70 of 87 partnership programs on the market provide financing at less than 13%, which is significantly below the average market rate. Usually dealers compensate for low interest rates. Cheaper financing makes car loans more attractive for consumers and increases dealers' car sales.

Leasing

In 2012 11,000 cars were financed through leasing (including operational and financial leasing), coming to 4,6% of total new car sales in Ukraine. The corporate segment has traditionally prevailed among car lease customers. In 2012, however, local market players achieved a breakthrough in terms of adapting the market for retail clients. As a result, the share of new cars sold to private clients through leasing companies grew from 0,3% to 2,5%. According to Leaseurope Automotive, the number of leased cars grew by 20% y/y in 2012 in Ukraine.

OEM captive financing

OEM captive financing is the major route that car financing takes in developed countries, as opposed to in emerging markets, where commercial banks prevail as the main channel of financing. In Ukraine the main OEM captive financing player is Porsche Leasing.

According to KMPG the development of OEM financing is subject to market maturity in general.

Market entry criteria for OEM captive players

	Criteria	Importance	Signal for Ukraine
OEM's market positions	Critical sales volume of OEM	Very important	Dependent on OEM
	Wholesale function is owned by the OEM	Very important	Dependent on OEM
Regulatory framework	Reasonable legal framework	Very important	Low
	Convenient regulatory framework	Preferable	Medium
Economic conditions	Well-developed financial market that allows for fundraising	Important	Low
	Availability of financial instruments with which to hedge interest rate and currency risk	Important	Low
	Market transparency as the result of availability of credit information	Important	Medium
	Customer acceptance of auto financing and leasing	Preferable	High

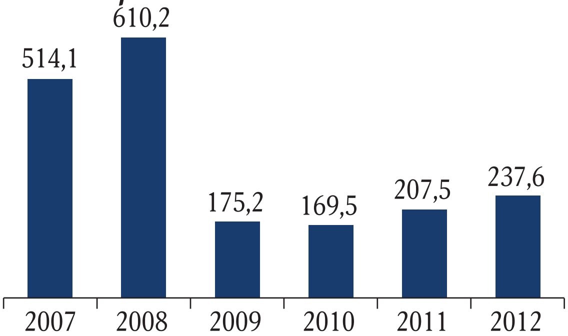
Source: *KPMG*

Low fundraising capabilities, a nontransparent legal framework, and a small market prevent wide development of OEM captive financing in Ukraine. Commercial banks with diversified business portfolios and stronger risk management are better adapted for lending in Ukraine, so the banking route will prevail in car financing in Ukraine in the upcoming years.

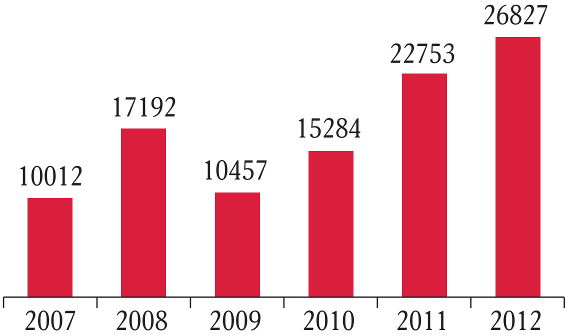
Ukraine's car market: key statistics

In 2003–2008 the Ukrainian car market demonstrated average annual growth of 22,4% by number of sold new cars. This was due to Ukrainians' growing purchasing power, backed by expansion of retail lending in the country. In 2008 car sales reached a peak of 610,200 new cars, with Ukraine taking the #7 ranking in Europe in this respect. After the crisis, car sales dropped more than 70% y/y in 2009, for the worst decline in car sales among European countries. In 2011–2012 the Ukrainian car market demonstrated modest recovery, growing by 22,4% and 14,5% y/y.

Number of new cars sold, thousend pieces



Volume of new and used cars and motorcycle sales, million UAH



Source: *UkrAvtoprom, Ukrainian Statistics Service.*

Car sales by brand in 2010–2012 (number of cars)

#	Brand	2010	2011	2012	Δ 2012,%
1	HYUNDAI	14,643	21,829	22,868	4,8%
2	VAZ	25,908	28,436	19,718	-30,7%
3	ZAZ	14,966	19,529	18,124	-7,2%
4	KIA	7,445	9,307	16,111	73,1%
5	VOLKSWAGEN	5,013	10,099	15,786	56,3%
6	TOYOTA	10,685	12,906	15,710	21,7%
7	SKODA	7,916	10,596	13,948	31,6%
8	RENAULT	8,157	11,478	13,567	18,2%
9	NISSAN	5,778	9,245	12,609	36,4%
10	GEELY	4,249	6,449	12,099	87,6%
	Total	169,540	207,453	237,602	14,5%

Source: *Ukrautoprom*

Hyundai currently dominates the market in terms of sales, having displaced VAZ from its leadership positions in 2012. A 30,7% decline in sales made VAZ the biggest loser in 2012, as it shut down production of popular old models, even as its new models lack competitive advantages in terms of either quality or price as compared to VAZ's low cost peers.

Today Chinese brands are demonstrating the fastest growth on the market, with Geely leading the pack. In 2012 Geely increased its sales by 87,6% y/y entering the ranks of the top 10 brands by total sales in Ukraine.

Car sales by brand in January-September 2013

#	Brand	9M 2012	9M 2013	Δ 9M 2013	Δ 2012,%
1	HYUNDAI	16,674	14856	-10,9%	4,8%
2	ZAZ	13,196	12889	-2,3%	-30,7%
3	GEELY	8,224	11813	43,6%	-7,2%
4	TOYOTA	11,531	11371	-1,4%	73,1%
5	KIA	11,867	10953	-7,7%	56,3%
6	VOLKSWAGEN	11,329	10469	-7,6%	21,7%
7	NISSAN	8,913	8933	0,2%	31,6%
8	SKODA	9,996	8722	-12,7%	18,2%
9	RENAULT	9,221	8172	-11,4%	36,4%
10	FORD	7,292	8064	10,6%	87,6%
	Total	170,977	164,750	-3,6%	14,5%

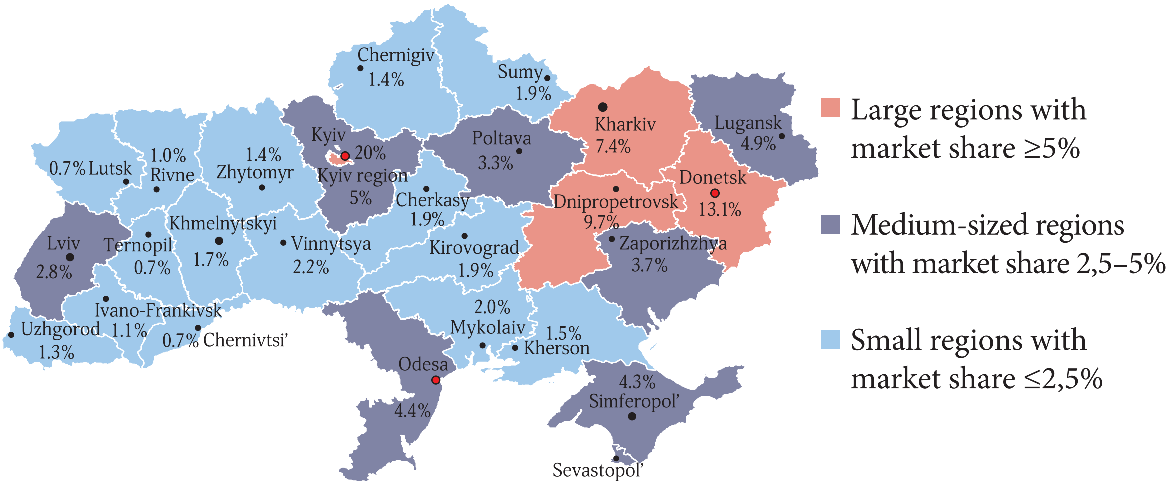
Source: *UkrAvtoprom*

In 2013 Ukraine's poor economy (showing negative GDP growth since 3Q 2012) depressed the local car market, resulting in a drop of car sales of 3,6% y/y in 9M 2013. The market leader in 2012, Hyundai, downgraded its sales forecast for the full year of 2013 to minus 10% due to the uncertain economic outlook and to the introduction of special customs duties for imported cars. Market players are expecting a 7%–8% decrease in sales in 2013.

During January–August 2013 Geely maintained its position as the fastest growing brand, jumping from #10 at the end of 2012 to #3 in September 2013. AIS, the general importer of Geely models, plans to increase the brand's market share from 5,2% in 2012 to 10% in 2013.

Regional statistics

Market share breakdown by region in terms of passenger car sales (number of sold cars in 1H 2013)



Market development in the short term

Since 2009 low cost brands have dominated the local car market. Car models costing under UAH 100,000 have been the best sellers in 17 out of 24 Ukrainian regions. The leading players in the low cost segment are Geely and the locally assembled ZAZ. The decline of VAZ's popularity played handsomely into the hands of Chinese car producers, helping them proliferate on the market. Due to their lower prices Chinese cars are less exposed to the impact of the special duties that were recently introduced. After the special duties took effect, for example, Geely's most popular model maintained a 10% price advantage over a similar car produced by the local ZAZ (UAH 57,900 vs. UAH 65,000). Other producers, like Bogdan and AIS, have already unveiled their plans to start SKD assembly of other Chinese brands, which will only strengthen Chinese brands on the Ukrainian car market.

Further development of the Ukrainian car market will depend on the country's economic environment. According to Peugeot Citroen Ukraine, the number of new cars sold will drop by 8% y/y in 2013 to 220,000 cars and by 2% y/y in 2014 to 215,000 cars. This will negatively impact the auto financing market, strengthening competition between local banks. Facing a flat market, local banks will have to develop new car financing packages in partnership with car dealers or OEMs.

Latest trends on the global car financing market

Currently, the major challenge for the car financing business in Western markets is changing consumer behavior, where car usage is being preferred to car ownership; this represents a clear trend, especially among customers aged 20–35. The younger generation in the West is more inclined to spend its money on new gadgets than on new cars. Americans aged 18–34, for example, bought 30% fewer new cars in 2012 than they did in 2007, while total U.S. sales declined by only 10%.

Experts agree that these changing trends pose a serious challenge to the automotive industry and that mobility solutions will be the next key strategy for the industry. Future mobility will be based on flexible use of cars, car sharing, and short term rental, with drivers paying only for the time they use a car or other means of transportation. According to KPMG the potential market for mobility services in developed countries is estimated to be 110 million customers by 2026.

In recent years the market for hybrid and electric vehicles reached the mature development level in Western Europe, North America, and Japan. Due to limited battery lifetimes and high battery prices OEM captives have started to provide separate packages, with the vehicle and the battery standing as two different products. An electric car will be financed or leased without its battery, and the battery will be leased under a separate contract. This differentiating approach is becoming more popular in developed markets for "green" cars.

3 CUSTOMS REGULATION

TRANSFER PRICING AND CUSTOMS VALUATION

Igor Chufarov, *Partner, Tax & Law, Transfer Pricing Leader, EY in Ukraine*
Igor Dankov, *Senior Manager, Tax & Law,*
Customs and International Trade Leader, EY in Ukraine;
Co-Chair of the Chamber Customs Committee

On July 4, 2013, Ukraine's Parliament passed the Transfer Pricing Law, which took effect on September 1, 2013. This law is relevant primarily to corporate income tax and VAT matters. However, the new transfer pricing law will also impact customs issues, and particularly customs valuation for cross-border sales involving related party transactions. New challenges could arise for importers now that the law has taken force.

Enforcement expected to increase

We expect both the tax and customs authorities to start applying the arm's-length principle based on their own set of rules more vigorously. The conflict between the two valuation approaches may trigger adverse tax implications for the importer. Recent EY's 2013 Global Transfer Pricing Survey revealed a lack of coordination between transfer pricing and customs valuation.

Tax and customs administrations pursue opposite interests in their controlling activities. The higher the profits, the higher the corporate income tax. Therefore, the tax authorities would like to see prices as low as possible in order to have the highest taxable profits. The customs authorities are responsible for collection of duty and VAT upon import of goods. They are thus interested in the highest possible values of goods in order to collect the most in customs duties.

Ukraine's tax and customs offices recently merged, but the two sides are unlikely to follow a common approach in the near future.

Controlled transactions

Under the law, transactions that are controlled for transfer pricing purposes, among others, would include:

- Trade in goods and services with a non-resident related entity where the aggregate value of transactions for the year equals or exceeds UAH50 million (approximately US$6,25 million);
- Transactions with non-residents incorporated in countries where the corporate income tax rate is lower by 5% or more than in Ukraine. According to the interpretation of the Ukrainian revenue authorities, these would be jurisdictions where the corporate income tax is 18,05% (15,2% from 2014) and below.

Accordingly, transfer pricing rules would apply to the goods imported within these transactions. For customs purposes, all goods would be valued in accordance with the valuation rules established by Ukraine's Customs Code, regardless of whether seller and buyer are related entities. Below we analyze valuation rules for transfer pricing and customs purposes.

Valuation of goods for transfer pricing and customs purposes

The law establishes the following transfer pricing methods; they are compatible with the OECD Transfer Pricing Guidelines:

- Comparable uncontrolled price (CUP);
- Cost plus;
- Resale minus;
- Transaction net margin;
- Profit split.

Customs valuation methods are based on the provisions of the Agreement on Implementation of Article VII of the GATT (the Customs Valuation Agreement) and include:

- Transaction value
- Transaction value of identical goods
- Transaction value of similar goods
- Deductive method
- Computed method
- Fall-back method

These methods have much in common. For instance, the CUP method broadly corresponds to the transaction value of identical or similar goods. Cost plus and resale minus are close to the computed and deductive methods respectively.

There are no equivalents for transaction net margin and profit split in customs valuation methodologies. Similarly, the equivalent of the fallback method cannot be found in transfer pricing methods.

More important is that there is no strict sequence for the use of transfer pricing methods. CUP is the preferable method unless it is impossible to apply it. Customs valuation methods are applied in a strict hierarchical order:

- The primary method for customs value is transaction value;
- If transaction value cannot be applied, other methods will apply in descending sequence;
- Application of deductive and computed methods can be reversed at the discretion of the importer.

Methods that are different by nature can thus be applied for customs and transfer pricing purposes, creating difficulties for taxpayers. It may happen in practice that there is a conflict between valuation of the goods under the TP rules and the value determined under the customs valuation methods.

The customs authorities may challenge the transaction value when they prove that the relationship between seller and buyer influenced the price (i.e., the price is not at arm's length). The declarant may contest and substantiate the opposite by demonstrating that the transaction value was close enough to the test values for identical or similar goods exported to Ukraine.

Customs value and transfer price may be different. The tax authorities may either accept customs value or disregard it for transfer pricing purposes during tax control. Actual practice, however, does not exist in Ukraine at the time of writing. Risks can be assessed only after transfer pricing audits actually take place and after business entities start filing transfer pricing reports. The revenue authorities (the Department of Tax and Customs Audit of the Ministry of Taxes and Duties) explained this approach at the meeting with the members of the Tax and Customs Committees of the American Chamber of Commerce that took place on September 18, 2013.

Reconciliation between the customs value and transfer price may be required as the customs value, in many cases, would include certain charges (e.g., royalties, transport, insurance, loading, unloading up to the border, etc.) that are payable separately.

Definition of related entities

For customs purposes related entities are defined in accordance with the Customs Valuation Agreement. Definition of related entities for tax purposes is available in the Tax Code.

Generally, these definitions have much in common. However, there are major differences. For instance:

Related entities for customs purposes **Persons shall be deemed to be related if:**	**Related entities for tax purposes** **Legal entities would be related where:**
any person directly or indirectly owns, controls, or holds 5% or more of the outstanding voting stock or shares of both of them	any person directly or indirectly owns the corporate rights of such legal entities and the size of corporate rights in each legal entity is 20% or more
one of them directly or indirectly controls the other. One person shall be deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter both of them are directly or indirectly controlled by a third person together they directly or indirectly control a third person	one of them directly or indirectly (through related entities) owns 20% or more of the corporate rights of the other legal entity

As can be seen, for customs purposes a relationship is recognized where the threshold for share ownership is 5% or more, whereas for tax purposes the threshold is 20%. Also, a relationship for customs purposes is based on the ability of one person to influence another legally or operationally. For tax purposes influence may be exercised through "other possibilities for impacting decisions taken by other persons."

Individuals will be related persons if they are members of the same family — this is generally a common provision. However, the Tax Code is more explicit in defining the family members in question (spouses, parents, children, brothers, sisters, etc.).

Under the Customs Valuation Agreement persons shall be deemed to be related if they are officers or directors of one another's businesses: they are thus employer and employee. The Tax Code focuses on relationships between legal entities whose executive directors are appointed by decision of one person; 50% of executive or supervisory boards are appointed by one person.

Overall, where entities are related for customs purposes, they would likely be related for tax purposes as well.

Special concerns for importers

Importers will want to particularly focus on these aspects of the new law:

Transfer pricing documentation

Companies should be ready to report their controlled transactions in 2014 (for September through December 2013). The law introduces a requirement that transfer pricing documentation be filed with the tax authorities at their request. That documentation is not on the list of mandatory documents to be submitted to customs during customs clearance of goods. However, we expect that these documents will be requested when the customs authorities verify the declared customs value, particularly in the event of a post-importation audit.

Taxpayers are well advised to prepare transfer pricing documentation taking into account customs valuation issues in preparation for this review by the customs authorities.

Transfer pricing audits

The tax authorities are allowed to carry out transfer pricing audits. The law explicitly prohibits verifying issues other than transfer pricing during such audits. While customs valuation would not be verified during a transfer pricing audit (and vice versa), taxpayers should expect that a transfer pricing audit could trigger a customs audit (and vice versa), particularly considering that the customs and tax offices have merged recently.

Price adjustments

The law allows taxpayers to adjust transfer prices (upward) provided that this does not decrease the assessed taxes. It appears that the taxpayer is not allowed to increase transfer prices if this reduces the already assessed taxes. At the same time, it is unlikely that a taxpayer would be able to adjust downward the customs value of imported goods if the tax authorities establish the "arm's-length price" at a lower level.

Although the law envisages a pro rata adjustment (i.e., by the seller and the buyer of goods simultaneously), the adjustment procedure for cross-border transactions is not clear.

The law does not envisage year-end true-ups.

Advance pricing agreements

Large taxpayers may seek an advance pricing agreement (APA) on transfer prices with the tax authorities in advance. Large taxpayers include entities whose aggregate income for the past four consecutive months exceeds UAH500 million (US$62,5 million) or whose total taxes paid for that period exceed UAH12 million (US$1,5 million).

It is unclear whether the customs authorities will accept declared customs value if it is in line with the advance pricing agreement. Unless the customs authorities explicitly confirm this, we recommend seeking an advance customs ruling in conjunction with an APA.

Special cases

For certain imported goods (including oil, gas, metal, and grain), the taxpayer may define the transfer price as the commodity exchange price/published price reduced by 5% (for sale transactions) or increased by 5% (for purchase transactions). It is not totally clear whether such prices would be accepted for customs purposes, and an advance customs ruling may be required.

Importance of interaction between transfer pricing and duties

EY's 2013 Global Transfer Pricing Survey shows a significant disconnect between the coordination of transfer pricing and customs valuation. The survey shows that a minority of taxpayers incorporate indirect tax considerations into their transfer pricing strategies. The survey indicates the following:

“Only 21% reported that they took customs issues fully into account, and only 27% said they took VAT issues fully into account when making transfer pricing decisions. Not surprisingly, customs and duties considerations were most important in those industries that face high customs duties or where tangible goods make up a significant portion of the value chain.

The automotive industry, which engages in high volumes of intercompany tangible goods trades that are often subject to duty, reported a high level of concern with indirect taxes. Forty-two percent of parent respondents said indirect taxes were a significant area of controversy, 84% took customs considerations into account in transfer pricing planning, and 75% took VAT considerations into account in transfer pricing planning.

Likewise, 83% of parent respondents in the consumer products industry reported that customs and duty concerns affected their transfer pricing planning, and 77% reported that VAT considerations affected their transfer pricing planning. Not surprisingly, only 40% of professional service companies and 34% of banking companies reported that their transfer pricing policies were affected by customs and duties considerations.”

The reason why many companies do not take customs issues into account while developing transfer pricing strategies is that the tax and customs authorities are each responsible for their own areas. This is not true for Ukraine. In Ukraine, as we mentioned above, the tax and customs authorities have merged. They have already started to interact in a comprehensive manner, and this interaction will only increase in the realm of transfer pricing matters.

Taxpayers should thus incorporate into their transfer pricing studies those elements that the customs authorities additionally need to determine acceptable customs valuation. Due preparation of a transfer pricing study with regard to customs valuation issues may mitigate risks and smooth the audit process.

Risk management tools

APAs could serve as a tool for helping to agree transfer pricing and customs valuation. As we have already mentioned, there is no certainty that customs will accept APAs. Logically, they should, but we need to wait and see what will happen in practice.

Another tool is obtaining advance customs rulings. In accordance with the Customs Code, customs may issue customs rulings at the request of business entities and individuals who move goods across the border. The customs office would issue a ruling at the requestor’s location free of charge, expressing the authorities’ view on the practical application of customs legislation.

Customs may issue rulings orally, in writing, and electronically within 30 days after receipt of a request. The ruling is addressed to a requestor and only the latter may use the ruling. An entity that has acted in accordance with the ruling issued in writing or electronically cannot be held responsible for a violation if, in the future, the authorities change or revoke the ruling.

The requestor may appeal the ruling to the higher customs authority (the Ministry of Taxes and Fees) or in court. If a court recognizes the ruling invalid, the entity may insist that a new ruling be issued with due regard to the court conclusion.

The main risk management tool, however, is to make sure that transfer pricing practices and documentation take into account indirect taxes, including customs implications.

Conclusions

Valuation of goods for transfer pricing and valuation for customs purposes have much in common, but there are also major differences (e.g., in qualifying the transactions as controlled, in defining related entities, in describing valuation methods, etc.).

In principle the price level agreed under the one discipline should be recognized under the other (that is, prices agreed under transfer pricing methodologies should be recognized for customs valuation and vice versa). There exists no certainty, however, that the authorities will immediately implement this approach in practice.

To mitigate risks, transfer pricing documentation should be created with due regard to customs and indirect tax issues. Otherwise, the transfer pricing documentation could trigger negative implications for customs and indirect tax purposes, including significant penalties.

Additional risk management tools would include concluding APAs with the authorities (in the case of large taxpayers) and obtaining advance customs rulings (in conjunction with the APAs).

British American Tobacco
Ukraine

GROWTH OF ILLICIT TOBACCO TRADE IN UKRAINE REPRESENTS AN UNINTENDED CONSEQUENCE OF TOBACCO INDUSTRY REGULATION

Tobacco companies have long accepted that smoking is risky and supported evidence-based regulation of the industry. Nowadays the legal tobacco business worldwide isn't about persuading people to smoke; it's rather about offering high quality products to adults who have already taken the decision to smoke and are aware of the risks.

The present time is seeing a fast and exponential increase in regulations within the tobacco industry across the entire world. Studies show that the only way to avoid smoking-related risks is not to smoke in the first place, and that the best way to reduce the risks is to quit. The World Health Organization (WHO) is driving the toughening of tobacco regulation in order to persuade smokers to quit. Despite increasingly strict tobacco control policies, however, many people continue to smoke, providing evidence that some regulation initiatives have little impact on tobacco consumption and "quit or die" approach could not work for everyone who smokes. To the contrary, certain changes in regulatory environment can have unintended consequences. Fostering illicit trade is the most important of these, and the most harmful.

Ukraine's regulatory environment includes most WHO requirements

In 2012 Ukraine's tobacco industry regulation environment underwent massive changes. These included an excise increase; introduction of large text and a pictorial health warning on packaging (covering 50% of the pack as opposed to 30%); a ban on advertising, sponsorship, and promotion of tobacco products; and a ban on smoking in HoReCa. As of now, Ukrainian tobacco control legislation encompasses major portions of the WHO regulatory agenda for combating the tobacco epidemic in the world.

Considerable changes in the regulatory environment in the 2nd half of 2012 – early 2013

2012 — 2013

Q3 — Q4 — Q1

Sept, 16
Law # 3778 entered into force (a ban on advertising & sales stimulation)

Oct, 04
Law # 1824 entered into force (health warnings increased to 50/50 with pictorials on back side)

Dec, 16
Law # 4844 entered into force (a ban on indoor smoking in HoReCa)

Jan, 04
Excise system re-shaped

Tobacco industry regulatory landscape in Ukraine in 2013

Health warning (HW)	HoReCa smoking ban	Level of tar & nicotine content in smoke	Trade regulations	Excise system
Mandatory 50% text health warning on front and 50% pictorial HW on the packaging's back for all tobacco products produced in or imported to Ukraine	Smoking of tobacco products, e-cigarettes, and hookahs is prohibited in HoReCa. Fines for placing ashtrays or smoking in HoReCa varies from UAH 1,000 to UAH 10,000	Maximum level of tar & nicotine content in smoke is 1.2 mg for nicotine and 12 mg for tar Tar and nicotine contents are estimated according to the methods determined by the International Organization for Standardization (ISO) Tar and nicotine contents must be indicated on the pack	Import, export, wholesale, and retail of tobacco products require licenses in Ukraine Ban on sales to youth (under 18) Ban on trade in educational, health care, and closed sports facilities Ban on trade in sports and child shops Ban on trade from vending machines Ban on van sales	Mixed excise system: ad valorem part – 12%; specific part – UAH 162.5, minimum collectable excise – UAH 217.6 (for filter cigarettes)

The illicit tobacco trade in Ukraine continues to grow

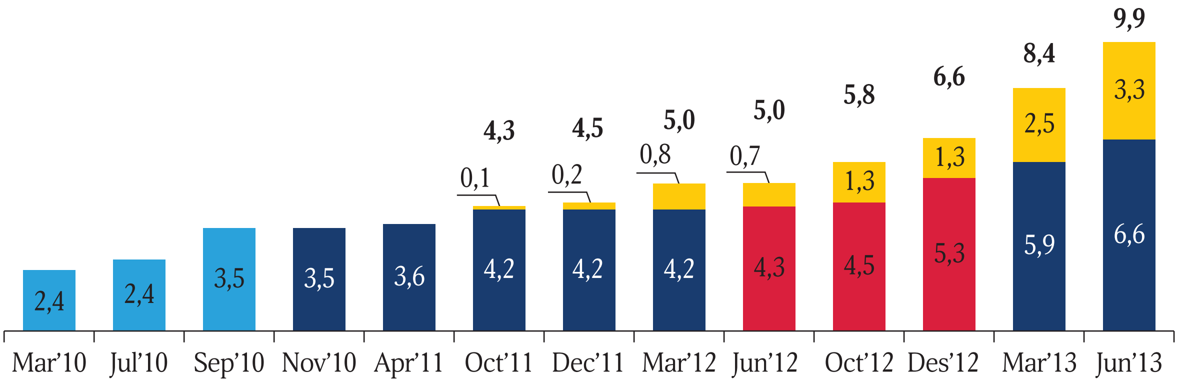
The radical change in the regulatory environment and the difficult economic situation in the country appear to have led to an unintended consequence – growth of the illicit trade of tobacco products in the country. Basic economic knowledge suggests that any restriction and/or price increase will make consumers look for cheaper easy-to-get alternatives. When it comes to tobacco, very often that alternative is readily available through an illegal, untaxed, and unregulated market.

Thus, in 2012 Ukraine experienced a significant increase in its illegal tobacco market share, mostly driven by growth in counterfeit volumes. According to research by Taylor Nelson Sofres Ukraine (TNS), during the last three years the share of illegal products – both counterfeit and contraband – has tripled. By the end of the first half of 2013 it accounted for almost 10% of total consumption.

According to TNS research, illegal import comes mostly from neighboring countries: Russia (54% of total illegally imported cigarettes), Belarus (19%), and Moldova (18%). The reason for this is the disparity between tobacco product prices in Ukraine and those in neighboring countries, as well as the relative ease with which it is possible to cross the Ukrainian border. Currently Ukraine has the highest excise duty rate in the CIS. In 2013, for instance, the minimum collectable excise in Ukraine for filter cigarettes was UAH 217.6 per 1,000 sticks, while in Russia it was about UAH 180. The main producers whose products are sold illegally on the Ukrainian market are Donskoy Tabak (Russia), Chisinau tobacco plant (Moldova), and the Grodno tobacco factory Neman (Belarus).

As Picture 2 shows, the share that counterfeit products hold increased dramatically in 2012 and early 2013. The taxes that legal tobacco producers pay (excise and VAT account for 75% of the UAH 7.5 price of a pack of cigarettes) make them unable to compete with illegal producers that pay no taxes and can sell their products at much lower prices. Such illegal products are in great demand among consumers with low purchasing power.

Growth of DNP (counterfeit and contraband) in Ukraine, TNS 2013



Illicit trade: drivers and facilitators

According to the recent ITIC report The Illicit Trade in Tobacco Products and How to Tackle It[1] there are two primary drivers of tobacco illicit trade in the world for both low and high income countries:

- Demand (consumers wish to save money);
- Supply (high profit potential for illegal producers).

At the same time there are several factors that can facilitate illicit trade and have a significant bearing on the incidence and scale of illicit trade: unbalanced tobacco taxation policy, protectionist policy measures, inadequate enforcement, exploitation of free zones, inadequate legislation, and public tolerance.

The authors of the publication mentioned above claim that tobacco has been subject to special taxes since the 17th century, as it really is a very good candidate for taxation revenues: demand is almost inelastic and the negative externalities are seen to justify taxation. Excise is usually the main tax in tobacco and it is often accounts for a majority of the final retail price. Besides providing governments with a secure source of revenue, tobacco taxes discourage tobacco consumption.

However, international experience – such as that of Ireland among the EU accession countries, plus Malaysia, Ireland, Turkey, and Singapore – shows that steep tax increases lead to sharp rises in illicit trade in tobacco products. This damages the long-term tax base and undermines public health objectives.

Apart from taxation, affordability can have the same effect on illicit trade. Low-income consumers are likely to turn to the illicit market. Given a regular source of illicit products it is extremely difficult to get consumers back to purchasing legal, taxed products. Some consumers are aware that they are purchasing smuggled and counterfeit goods, but they choose to do so in order to save money. The others perceive trade and use of illicit tobacco as victimless crimes, the implications of which are not obvious.

Global practices: Protocol to eliminate illicit trade under the WHO Framework Convention on Tobacco Control

The WHO Framework Convention on Tobacco Control (FCTC) was adopted by the World Health Assembly in May 2003 and entered into force on February 27, 2005. FCTC Article 15 contains seven clauses on combating illicit trade, which are currently legally binding for over 170 government parties. The Conference of the Parties (COP), which is the governing body of the FCTC, was driving adoption of a protocol to eliminate the illicit trade in tobacco products (ITP). The purpose of the ITP is to create more detailed binding obligations for parties towards curbing the illicit trade in tobacco products by building upon and complementing the existing legal obligations outlined in FCTC Article 15.

The ITP was adopted in November 2012 and is open for signature ratification and/or accession by the parties. It will enter into force once 40 parties have ratified it. As a multi-lateral treaty it will be binding on parties only once it is enabled into a national law.

[1] *The Illicit Trade in Tobacco Products and How to Tackle It, Second Edition, ITIC, 2013.*

Combating illicit trade in tobacco: political will, modern technology, and improved enforcement

Understanding all the local drivers and facilitators of IT, and taking into account international experience in this area, the tobacco industry has made several important steps towards combating illicit trade in Ukraine. They include achieving top level political ownership of the process, driving a balanced tax policy, improving law enforcement capacity, and informing the public about the implications of illicit trade.

Due to an ongoing dialogue with the Ministry of Revenue and Taxes of Ukraine, the current excise strategy is a rather balanced one, and excise hikes have been avoided in recent years; the government also shows understanding of the matter and cooperates on various anti-IT measures. According to Minister of Revenue and Taxes Oleksandr Klymenko, combating tobacco illicit trade is one of the major tasks the Ministry must tackle in cooperation with the industry. He has also expressed support for a transition from paper excise stamps to electronic ones based on Codentify™ technology, which could be an effective mechanism for addressing illegal cigarette trade in Ukraine.

Codentify™ is an electronic tax payment control system based on the latest digital technologies that can give the government a guarantee of control over tobacco production volumes and distribution in the country. It also provides for a simple mechanism for tracking cigarettes. Codentify™ uses advanced digital coding and labeling technology directly on the cigarette pack. This technology combines mechanisms for licensing, control of tobacco product production and sales, and verification. At the same time, the digital code printed on a pack of cigarettes gives each consumer the opportunity to quickly and easily check the legality of a purchased product using a free smartphone application.

Improving enforcement includes, among other things, consistent activities aimed at ending illegal trade of tobacco products in open markets and by street vendors, as open markets and street vendors sell up to 45% of all illegal products (both counterfeit and contraband) in Ukraine. Illegal trade on the open market is uncontrolled and unregulated; products are of poor quality and usually are sold to minors. Taking control over this illegal channel will be of mutual benefit to the tax authorities, legal producers, retailers, and consumers, who risk their health buying dangerous products.

Driving regulation to combat illicit trade of tobacco products

Regulatory proposals developed by the tobacco industry include:

- Mandatory registration of equipment for tobacco product manufacturing;
- Making sure that rights to import non-tobacco materials used in making tobacco products go exclusively to licensed manufactures of tobacco products;
- Enhance liability for production of counterfeits by criminalizing all related activities and raising penalties for counterfeit trade;
- Mandatory destruction of any equipment used in manufacturing fake tobacco products;
- Increase fines for illegal sale of tobacco products;
- Improve enforcement of tobacco control/anti-illicit trade measures;
- Implement electronic excise stamps based on Codentify™ technology;
- Implement transparent destruction procedures for counterfeit and contraband tobacco products.

UKRAINIAN BEER, KVASS AND CIDER MARKET OVERVIEW

Ukrainian beer market review

Basis on the results of eight months of 2013 experts forecasted that the beer market would fall by at least 7% for the year as a whole, for the largest contraction since 2009. The market, in fact, has declined by 10% in total since 2008.

A very disappointing summer especially hurt the year-end production statistics. For eight months of 2013 there was 4.5% market decline over the same period of 2012. Brewers reduced their production volumes from 21.75 million hectolitres to 20.7 million hectolitres.

Beer consumption per capita

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013 (Forecast*)
Beer consumption per capita, liters	45	51,5	61,1	61,6	57,3	60,7	50,1	59,6	56

Source: *Carlsberg Ukraine in-house data*
** Data analysis was based on eight months of 2013*

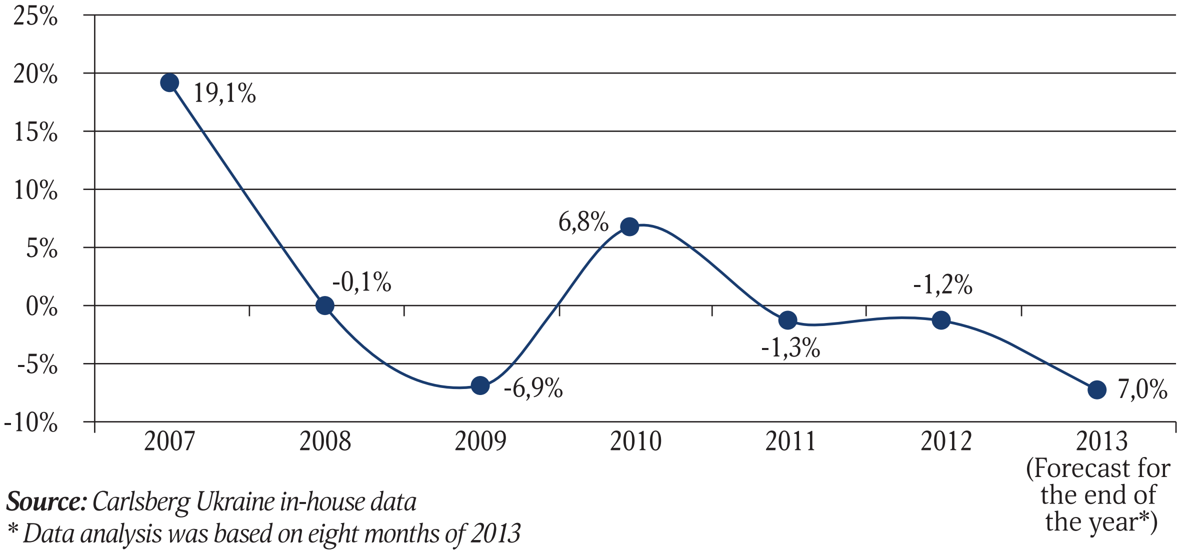
Beer import and export are also seeing negative trends. According to the Ukrpyvo association, export volumes in the first half of 2013 decreased by 2.2%, totalling 1.38 million hectolitres. Import volume decreased even more precipitously – the six-month for six months came to 14.2% (200 hectolitres).

Experts and market participants have identified several key reasons for this major decline. First, the bad Ukrainian economy in general worked against brewers. Average beer price on the market has risen 8.4% since the start of the year. The reason is the increase in raw material prices. Currently the consumer beer price in Ukraine is the same as the average European price, while the vodka prices here are among the lowest in Europe. The increase in beer prices during an economic recession along with consistently low prices for the leading alternative product could not but have a negative impact on beer market development.

The second reason was the particularly cold summer. Beer is a seasonal product, sales of which are often pegged to warm weather.

The beer market has not yet recovered from the crisis – 2013 market volume was 10% lower than 2008 market volume. After the significant decrease in 2009 (-6.8 %) as a result of the crisis, the beer market showed growth only once, in 2010 (+6.9 %), due to the extremely hot summer and the country's economic revival. Unfortunately, market volume fell for three straight years since.

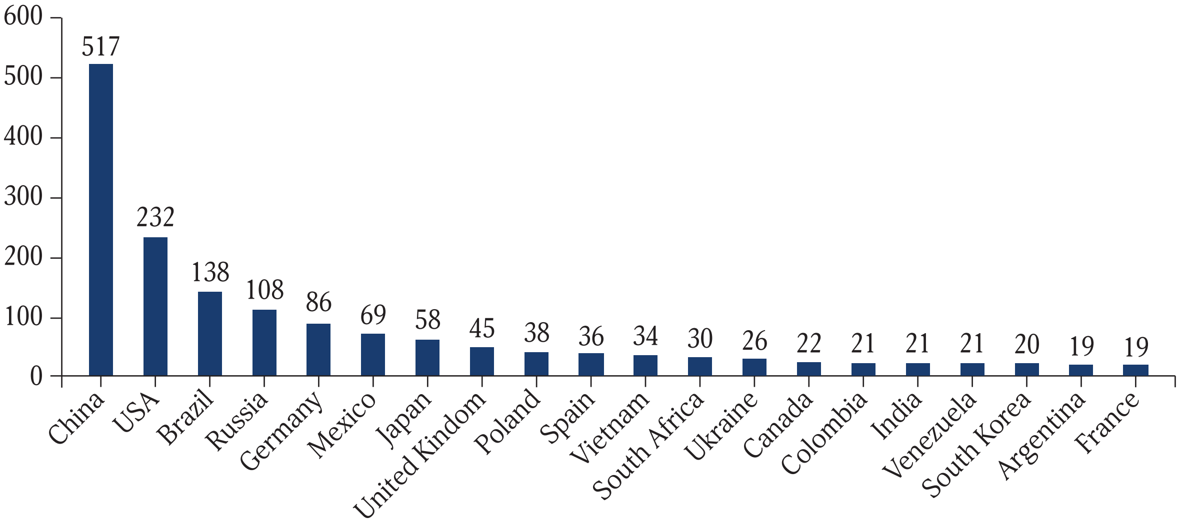
Beer market dynamics 2007–2013,



Source: *Carlsberg Ukraine in-house data*
** Data analysis was based on eight months of 2013*

Manufacturers have been trying to counter the negative economic trends and competing for consumers by launching innovative products, increasing supplies of bonus packs (e.g. 1.2 or 1.25 litres PET bottles), and offering price discounts.

Beer market volume in 2012, mHL



Negative economic trends affected the development of the price segments in 2013. The tendency towards decrease in the mid-price segment continued throughout the year: that segment lost four percentage points, decreasing 39%. With a view to economizing, some consumers have switched to cheaper brands in the economy class segment. This meant that volumes in the low price segment fell less than did the market as a whole and the segment remained at the previous year's level (36%).

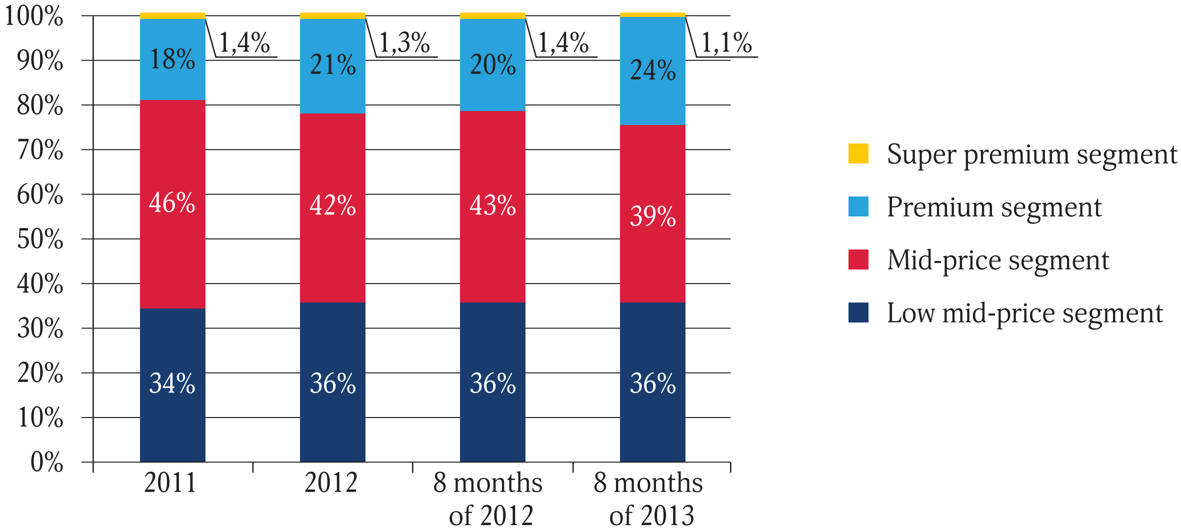
The premium segment showed a slight rate of decline, increasing its segment share by four percentage points, to 24%. It's in the premium segment that the most innovative products were concentrated in 2013.

Beer market dynamics by segment

Segment	**9 months of 2013 to 9 months of 2012**
Super premium segment	-20%
Premium segment	-1%
Mid-price segment	-11%
Low mid-price segment	-5%

Source: *Carlsberg Ukraine in-house data*

Beer market volume by segments, %



Source: *Carlsberg Ukraine in-house data*

There was a decline in sales of beer both in PET packaging and in glass bottles or cans in 2013. However, draft beer in HoReCa segment suffered the largest decrease, as this segment is the most sensitive to the weather effect.

Among all packing types, PET (plastic bottles) showed the slowest rate of decline, its market share increasing by three percentage points to 49%, whereas draft beer (in kegs) say the fastest rate of decline, its share decreasing to 11%. The shares of other packing types did not change since the last year, and were as follows: 34% – glass bottles, 6% – cans, 11% – kegs, 49% – PET (plastic bottle).

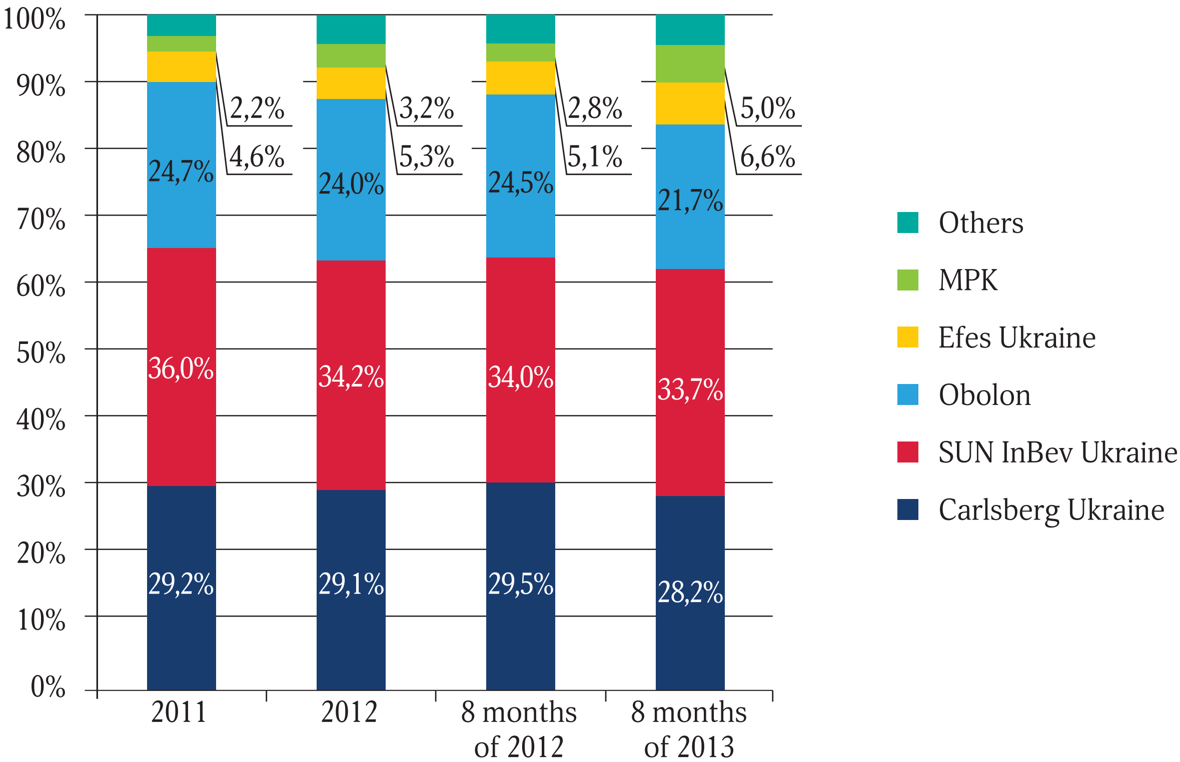
Beer market dynamics by packing type

Segment	9 months of 2013 to 9 months of 2012
Glass bottle	-10%
Can	-9%
Kegs	-14%
PET	-3%

Source: *Carlsberg Ukraine in-house data*

According to AC Nielsen, Carlsberg Ukraine's market share was 28.2% based on eight months of 2013. It was 29.1% in 2012.

Market share distribution among major player

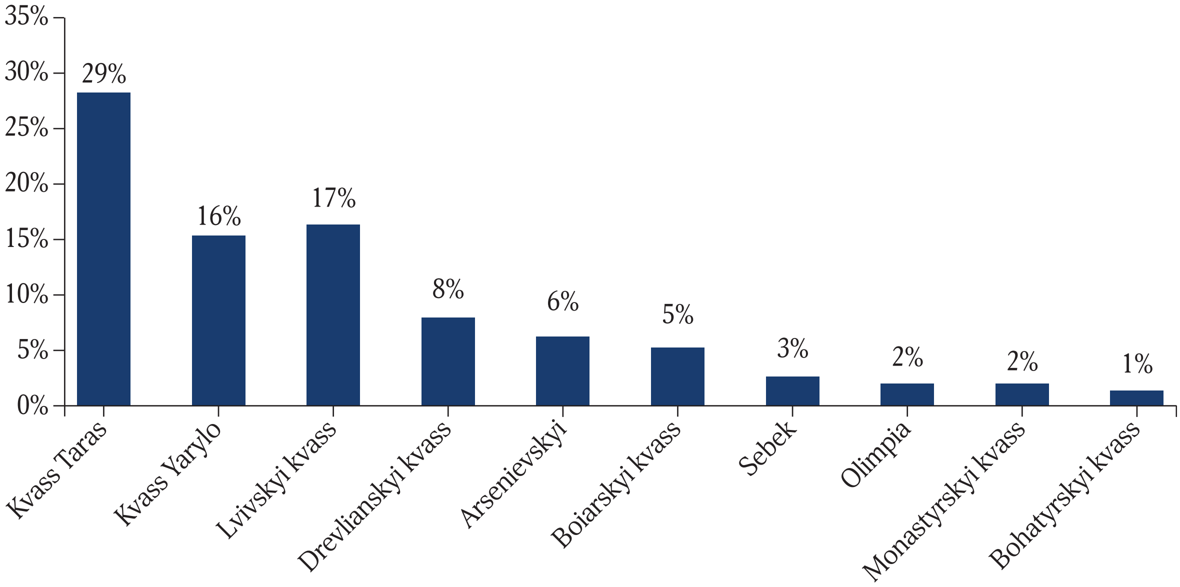


Source: *Carlsberg Ukraine in-house data*

Ukrainian kvass market review

- The development of the kvass market in Ukraine is similar to the development the beer market was seeing 10 years ago.
- Today Ukraine consumes about 2.6 liters of kvass per capita per year, whereas Russia consumes 3.2 liters and Belarus consumes 6.4 liters. The countries of the former Soviet Union consume 18 liters per capita per year, which is indicative of potential market growth in the future.
- The kvass market is becoming more structured, with the share of small regional players decreasing. Kvass Taras TM retains its leadership position in the competitive market.

Market share in volume terms, top 10 brands

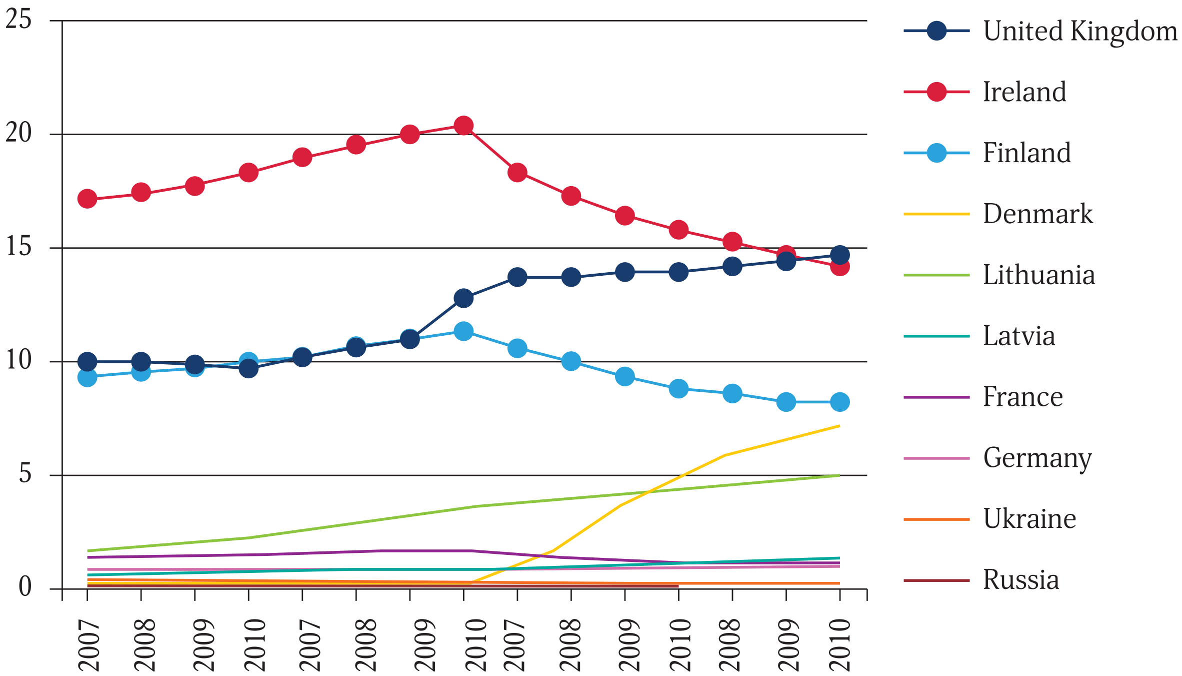


Source: *AC Nielsen as of August 2013.*

Ukrainian cider market review

- The 2013–2014 period will have been a developmental one for the cider market in Ukraine. It is currently still emerging, with Somersby natural fermentation cider, which entered the Ukrainian market in 2011, being one of the first in this segment.
- According to experts' estimates, the cider market will amount to 3–4% of the beer market in the next few years, i.e. about 1,0–1,2 million hectolitres. Experts currently estimate the cider market volume at 46 thousand hectolitres. That said, Somersby TM, which is produced by Carlsberg Ukraine, holds 70% of the market share.
- Today cider consumption in Ukraine and Russia is only 0.1 liters per capita per year. Consumption in Europe is much higher. Apple cider is most popular in the United Kingdom and Ireland.
- The cider market clearly has great potential for development

Cider consumption in Europe



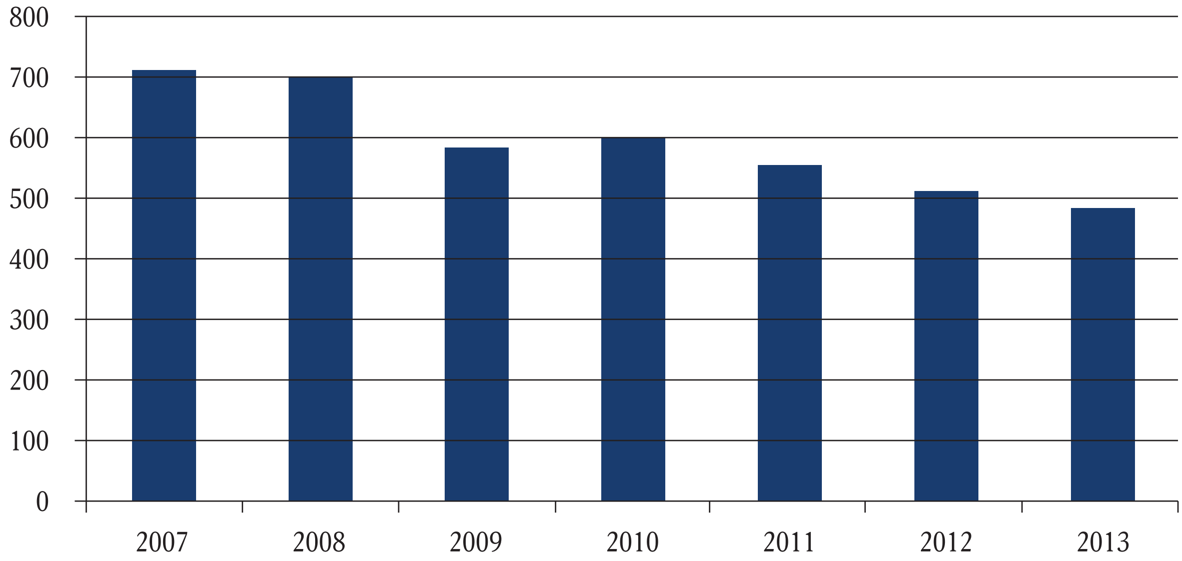
OVERVIEW OF THE UKRAINIAN SOFT DRINK MARKET

The Ukrainian soft drink market is characterized by many production facilities, distribution system consolidation, many players, intense competition, and a low level of soft drink consumption per capita in comparison to that of other countries. The dominant trend in the last three years has been the decline in all major product categories, excluding cola-flavored drinks.

Main soft drink market trends

Soft drink production reached its peak in 2007–2008, and since 2011 has decreased at a considerable pace year on year. In 2012 soft drink production volumes were 27% lower than they were in 2007.

Total soft drink production volume in Ukraine (million unit cases[1])



Source: *Coca-Cola System in Ukraine*

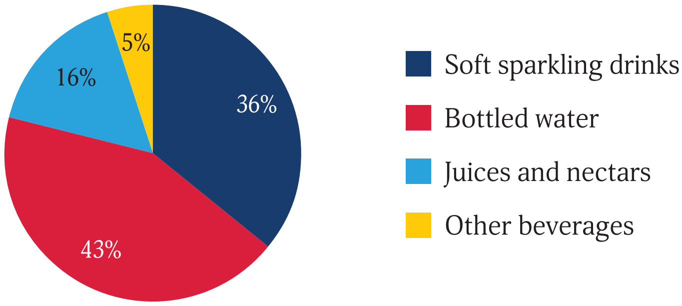
The main reason for the market's shrinking has been the 2008–2009 global economic recession, which made a strong impact in Ukraine. (The 18% decrease in GDP that Ukraine saw was what typical economies experience during civil wars or other major catastrophes.) Decreased household income and economic uncertainty prompted consumers to dramatically reduce their spending on non-essential goods, including soft drinks. Second, compared with other categories, carbonated beverages saw their price gap with other beverage categories, such as coffee, tea, and water, increase. The growth rate for soft drink prices thus exceeded the average CPI in 2011–2012 by 9 and 11 percentage points respectively. These price increases led to a decline in purchase frequency in this category. Third, Ukrainian consumers tend to consume fewer soft drinks than do consumers in neighboring countries and in the world at large. They tend towards more consumption of the so-called non-commercial beverages – tea, coffee, and homemade drinks. Consumption of commercial non-alcoholic beverages in Ukraine, for example, came to 270 ounce servings per person in 2012, which is 70% of Russia's consumption level (380 servings), 28% of Poland's (946 servings) and 40% of that of all other markets.

[1] *Unit case – the standard unit of product volume measurement used by the Coca-Cola System in Ukraine.*

Soft drink market structure

Four-fifths of the Ukrainian soft drink market is comprised of two beverage categories: bottled drinking water and soft sparkling drinks (SSD). The remaining fifth of the market consists of juices (including nectars) and so-called "other beverages," which include kvas, cold tea, and energy drinks. This market structure has been relatively stable in recent years, with the main development being the shrinking share of juices and nectars due to the increasing share of bottled water. Additional convenience and portability packages have greatly enhanced bottled water sales. The share of soft sparkling drinks is stable and hovers around 36%–37%.

Physical volume structure of the soft drink market in Ukraine (%)



Source: *Coca-Cola System in Ukraine*

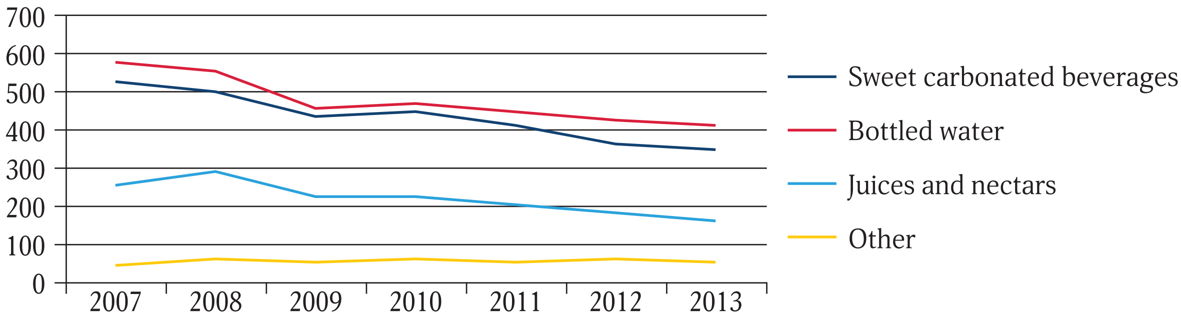
In 2012, juice and nectar production decreased by 31% compared to 2007. Juices are the most expensive products in the soft drink segment, which is why declining purchasing power and economic uncertainty affected them the most.

The bottled water market has also been impacted by the sluggish economic situation, decreasing by 4% in 2012 and by 25,8% since 2007.

Production of soft sparkling drinks decreased by 30,7% as compared to 2007 and by 10,7% in 2012. Two international players, Coca-Cola and Pepsi, defined this category, while several regional brands make up the rest of the market. The decline of regional brands was the primary cause of the major market decline that soft sparkling drinks underwent.

The leader of the SSD market, the Coca-Cola System in Ukraine, retained a 31,9% share in 2013. Its strongest brand, Coca-Cola, held a 20,8% market share.

Product category dynamics in Ukraine's soft drink market (million unit cases)



Source: *Coca-Cola System in Ukraine*

PepsiCo in Ukraine ranked second on the market in 2013 with a 15,4% share. The Pepsi-Cola brand itself held a 15% share. The reason for this is that other Pepsi SSD brands are not particularly well represented or promoted in Ukraine.

Cola drinks thus made up 37,9% of the SSD market in 2013, standing as the most popular category in Ukraine. Working against general market trends, cola production showed growth of 4,7 percentage points in 2013 over the previous year.

Market outlook

Slow recovery is expected in soft drink production in Ukraine in 2015. We anticipate that in 2014–2020 the market will increase by CAGR of 2% due to better general economic conditions and a recovery in consumer spending.

5 ENERGY

THE PECULIARITIES OF LEGAL REGULATION OF PRODUCTION SHARING AGREEMENTS

One of the few areas in Ukrainian economic life that's seen remarkable developments in terms of foreign investor activity is subsoil use, in particular production of hydrocarbons in Ukraine and on its sea shelf.

The year 2013 saw the signing of valuable agreements in this field. In January, in Davos, the State of Ukraine, Shell Exploration and Production Ukraine Investments (IV) BV, and Nadra Yuzivska LLC (governed by Nadra Ukrayny NJSC) signed a production sharing agreement (PSA) for recovery of hydrocarbons in the Yuzivska field (located in the Donetsk and Kharkiv regions). Later, in September, the joint operating agreement that compliments the PSA was signed during an official visit of Prime Minister of Ukraine Mykola Azarov to the Netherlands. And finally, on November 5, 2013, Ukraine and Chevron Ukraine B.V. signed a second PSA.

In general, Ukrainian legislation and established practice make possible three ways in which a foreign investor can conduct geological survey and mining operation activities in Ukraine.

In the first way, a foreign investor establishes an affiliate company in Ukraine. It obtains via tender a special permit for subsoil use and then performs the necessary work, either on its own or in concert with contractors.

In the second way, a foreign investor establishes a joint venture with a state-owned company. That company might already hold all the necessary permits for subsoil use. Even if it doesn't, joint ventures can enjoy a simplified permitting procedure, which is one of the advantages of public private partnerships.

In the third way, the investor concludes a production sharing agreement with the Ukrainian government. This form of public private partnership provides the most protection for the foreign investor. In addition, production sharing agreements benefit from a number of exceptions in the tax and customs laws, as well as in other areas.

Production sharing agreements are thus potentially very attractive for foreign investors, especially when significant amounts of money are being invested.

The Ukrainian government's participation in negotiations with potential investors in 2012–2013, including globally known oil and gas companies, apparently stimulated it to improve its subsoil use laws. Ukrainian law provides favorable conditions for import of goods that will be used in PSAs. For example, the government provides investors with approvals; quotas; special subsoil use permits; licenses for prospecting (exploration) and exploitation of mineral deposits; documents certifying the right to use land; and other permits and licenses related to subsoil use, performance of works, and construction of the structures stipulated by the PSA. (Part 3 of Article 4 of the Law of Ukraine "On Production Sharing Agreements" is the relevant document in this respect.)

We'll thus analyze here basic features of Ukraine's legal regulation of production sharing agreements.

Legislation that regulates production sharing agreements

The main legislative act that regulates the conclusion and execution of PSAs is, naturally enough, the Law of Ukraine "On Production Sharing Agreements" ("the Law").

The Code of Ukraine "On Mineral Resources," the Law of Ukraine "On Pipeline Transport," and certain other documents also touch on PSAs. Part of the Tax Code of Ukraine is devoted to regulating taxation in the context of a PSA.

Article 2 of the Law mandates that PSAs conform to it. It determines the basic legal requirements for PSAs and for legal relations that attend production sharing in the context of subsoil use. The rights and obligations of parties to PSAs are determined in accordance with the civil legislation of Ukraine, taking into account the peculiarities of the Law "On Production Sharing Agreements." Other Ukrainian legislation on PSAs shall, according to the Constitution of Ukraine, apply in compliance with the Law, which takes precedence over other legislative acts in this field.

Concept and subject of the agreement

According to Article 4 of the Law, one party, Ukraine, assigns the other party, the investor, to prospect for, explore, and extract mineral resources in the designated subsoil area(s) and to perform work related to the agreement for a specified period of time. The investor, meanwhile, undertakes to perform the assigned works at its own cost and risk. The investor is compensated for its costs and is remunerated by a portion of the profit from production.

By "profitable products" the law means a portion of the production, shared between the investor and the state. It is defined as the difference between production that's delivered to the measurement point and the portion of production that's transferred to the investors towards recovering expenses and, in certain cases, taking into account its indexation (cost-recovery production).

According to the Law, PSAs can be concluded for specific subsoil area(s) within which mineral deposits of national and local significance are located, including subsoil areas within the continental shelf and the exclusive (maritime) economic zone of Ukraine.

The Law makes possible changing the geographic coordinates of subsoil areas (mineral deposits) for which a PSA was concluded if the investor so wants.

Parties to the agreement

According to the Part 2 of Article 4 of the Law, a PSA can include several investors, provided that they incur joint liability for the agreement's obligations.

The parties to a PSA are the investor or investors and the state as represented by the Cabinet of Ministers of Ukraine (Article 5 of the Law).

Investors can be citizens of Ukraine, foreigners, stateless persons, legal entities of Ukraine or another state, associations of legal entities created in or outside Ukraine, or persons acting alone or jointly, if they have the appropriate financial, economic, and technical potential or relevant qualifications to use subsoil and have been identified as tender winners.

PSA relations between the state and the foreign investors are administered through the latter's representative office in Ukraine.

If two or more investors participate in a PSA, one is designated the agreement operator and represents their interests in relations with the state.

In some cases, a tender may require that the PSA be concluded between the tender's winner and a company indicated in the tender. The state owns 100 percent of the charter capital in that company, or that company establishes another company the participation interest of which is determined in the PSA (Article 7 of the Law).

According to the Law, the investor has the right to assign all or a part of its rights and obligations to any legal entity or physical person on condition that the entity or person has sufficient financial and technical resources and experience to perform the works the agreement stipulates (Article 26). The state shall not refuse consent to this without a substantial reason.

Assignment of rights and obligations of this sort shall be formalized by a written contract. If a Ukrainian investor assigns its rights and obligations to a foreigner or a foreign legal entity, the PSA can be amended upon the foreign investor's request.

Basic requirements for an agreement

Article 6 of the Law stipulates that a PSA shall be concluded with the winner of the tender, taking into account the tender's terms and the winner's bid.

Article 8 establishes mandatory requirements for the PSA.

In particular, the PSA must include: a list of the investor's activities; a mandatory work program with specified deadlines; amounts and types of financing, technological equipment, and other items (these amounts cannot be lower than those that the investor proposed in a competitive bid); and other essential terms.

Among other essential PSA terms are:

- a description of the subsoil area (mineral deposits) for which the agreement is being concluded, including geographic coordinates and depth restrictions;
- the conditions governing provision of the land plot for needs associated with subsoil use, and of the subsoil area;
- type(s) of subsoil use;
- list, scope, and deadlines for performance of the work stipulated by the agreement;
- procedure by which the parties can negotiate annual budgets and works programs;
- conditions governing mineral resource use;
- the procedure for determining the value of extracted mineral resources, including the currency in which the value will be expressed in the agreement with the foreign investor;
- the procedure for making payments for subsoil use;
- the point of measurement;
- conditions for calculating the amounts of cost-recovery products;
- composition of costs to be recovered with cost-recovery products;
- the procedure and conditions by which the state and the investor will share profit;
- the procedure for conserving or liquidating mining facilities;
- the term of the agreement, the date and place of signing, and the procedure governing its entry into force;
- the liability of the parties to the agreement and their means of securing it;
- the procedure for settling disputes.

In accordance with Part 5 of Article 8 of the Law, a PSA shall list the investor's obligations. These include favoring products, works, and services of Ukrainian origin and employing mainly Ukrainian citizens on Ukrainian territory to achieve the goals that the agreement stipulates.

This list, however, isn't complete. The Law of Ukraine "On Production Sharing Agreements" is a complicated one, and investors should understand its terms in their entirety when they draft PSAs. Failing to account for a part of the law could mean invalidation of the PSA.

The PSA shall contain the enclosures that the parties to the agreement make reference to in the text of the agreement.

The draft of the PSA shall be prepared in Ukrainian (Part 2, Article 10 of the Law).

A PSA, then, is a complex document, and drafting one requires a wide range of specialists and close attention to the peculiarities of Ukrainian law. Since it's the investor that drafts the PSA, moreover, it's the investor who will have to do the majority of the work.

M&A IN THE ENERGY INDUSTRY

Energy and energy source diversification have become a matter of survival for many states. The energy sector, meanwhile, is becoming more and more multifaceted from an M&A viewpoint and has its own peculiarities.

First and foremost, all around the world state companies and enterprises that belong to local authorities alike are playing especially active roles on the market. Second, it is precisely governments that are often selling energy industry objects around the globe, making it necessary to conform to the privatization laws of various countries. Third, the power industry is one of those economic branches that's most under the influence of the regulators of different countries. Fourth, the mergers and acquisitions market in the energy sector is characterized primarily by deals that are either large or very large, thus increasing the amount of time needed to prepare for them. Fifth, this market is a dynamic one, and trends on it are changing rapidly.

We've already defined that states themselves are key players on the global energy market, both directly and via state-owned companies and their affiliated structures. How does that fact influence the structure of a deal? Let's narrow the picture now to Ukraine. In addition to British law (and in rarer cases New York law), a transaction attorney working on a Ukrainian deal needs to know privatization law and environmental law. The reason for this is that virtually all energy sector assets once belonged to the Ukrainian government. In studying the history of a Ukrainian object's acquisition during due diligence, one has to assess the correctness of the privatization process. It's not unlikely that the object will be still "fresh," and before structuring the deal one will have to prepare the package of documents necessary for a privatization tender. In that event the scope of work grows fast, and the time frame of the deal can be substantially lengthened. In the Ukrainian context it's worth mentioning that privatization of objects of group G («Г»), to which the largest energy sector "giants" belong, can take up to a year and a half.

Some of the largest deals in Ukraine's energy sector have occurred during privatization of state-owned energy companies. In the last two years the State Property Fund of Ukraine has supplemented the state budget by UAH 5,3 billion by selling shares in nine energy sector companies.

So, for example, DTEK Holdings Ltd took part in a privatization tender to sell 50% of PS Dniprooblenergo stock, offering UAH 660,1 million for the government's stake. In 2012 DTEK Holdings Ltd won a tender for purchase of 40,061% of PJSC Donetskoblenergo stock and 25% of PJSC Dniproenergo stock. Russia's VS Energy group obtained a controlling interest in Kyivoblenergo and Rivneoblenergo stock from the American AES corporation for $113 million. Energoinvest Holding bought a controlling stake in Donbassenergo for UAH 719 million.

In Russia, Gazprom Energoholding was the winner in the public sale of almost 90% of United Energy Company of Moscow, one of biggest Russian energy companies, for $2,988,062,750.

In 2011 Gazprom entered Germany's retail energy market by acquiring German power and telecommunications provider Envacom Service GmbH.

Among other interesting deals concluded recently are the following:

- The Kazakhmys PLC group of companies sold the Kazakhmys Petroleum company. A deal valued at $100 million was concluded on August 24, 2011.
- China's Cnooc obtained the Canadian oil and gas company Nexen for $15,1 billion in 2013.
- On June 8, 2013 OAO Mechel closed a deal to sell 100% of stock in Toplofikaciya Ruse to the Bulgarian power company Toplofikaciya Pleven.

It is important to realize that the energy sector is one of those areas that are attracting attention from environmental watchdogs and various ecological agencies. There exist a multitude of ecological limitations and standards that must be taken into account during the implementation of a deal. At the same time, technical processes have to be in line with regulations. At the due diligence stage, as a rule, separate environmental and technical audits take place (with the involvement of specialized certified companies) in addition to legal and technical audits.

Pricing is an important point in the energy sector. Rates of various kinds are set not at the owner's sole discretion, but after different state commissions approve them. Taking that into consideration, a substantial amount of national legislation needs to be mastered.

For some power industries, this issue is most crucial. In particular, provision of a "green rate" is an absolutely necessary condition for solar energy projects. Without this rate, investing in such a project becomes pointless.

Among the other important documents, one should emphasize production sharing agreements and other agreements that may be of a public law nature. Inattention to detail might result in unforeseen expenses and lasting litigation.

As for implementing M&A deals within the jurisdiction of Ukraine, there are several points that should be kept in mind by attorneys who will be counseling on deals and performing due diligence of power companies. In the oil and gas sector, many assets are sold in the geological survey stage. In such a case the possibility of transitioning to commercial exploitation is absolutely crucial for the correct assessment of asset value and even for making a decision about a deal's feasibility. A peculiarity of licensing in Ukraine is that a license is almost always granted only for a geological survey; much less frequently is it granted for commercial exploitation. Licenses of the second kind are granted only in very rare cases. Only about 5% of licenses provide for both kinds of activity. Such assets are extremely valuable, and only the most affluent investors can implement these sorts of projects.

Another problem is land use. Extraction most often takes place on lands designated as farmland, therefore violating intended land use regulations. Ukrainian law permits geographical surveying on such land, but not commercial exploitation. The question of changing the land designation is at a standstill, so simple conversion of land is impossible. It's important to correctly assess risks and take into account that improper use of land can be terminated, leading to project shutdown and an end to operations.

It should be noted that Ukrainian state companies with development licenses have an established business custom: attracting investors and establishing with them joint ventures, in addition to concluding JV agreements. On the basis of such agreements, the state company usually provides the license, while investor invests money. This practice is illegal, as a license is inalienable from the legal entity to which it was granted. A qualified lawyer should thus additionally review the documents and assess the risks his client faces before the latter forms an alliance with a state company.

The mergers and acquisitions market in the energy sector is characterized primarily by large-scale and very large-scale deals – deals that necessitate a lot of preparation time. Such large-scale deals often have a distinctive specific structure. It might be necessary to attract financing from credit or financial institutions. Besides standard M&A knowledge, a deep knowledge of financial and banking law will be required.

In assessing the energy market as a whole, one must note that it's extremely dynamic and that the dominant trends change quite rapidly. In recent years the energy sector M&A market has been seen ups alternate with downs. There was a recession a few years ago, for example, while this year is seeing substantial growth. Investor interest in "clean" energy and renewable energy sources is growing. It's not materializing from scratch. Rather, it's being stirred up on the one hand by the expansion of different "green" rates and by state stimulation of alternate energy, and on the other hand by the limitations that traditional, environment-polluting energy imposes.

In this area we're seeing growth in solar energy demand, even as investors tire of biodiesel to a certain extent. Production of fuel from colza (rape) isn't as popular as it was just five years ago. On the one hand, colza technology substantially depletes soil fertility; on the other, the food shortages of recent years have made using agricultural lands for their initial purposes more profitable. In the meantime, development of renewable power generation technologies has created an alternative to biodiesel, lowering state subsidies and therefore substantially diminishing the profitability of biodiesel manufacturers.

Solar energy is the "fresh" and "fashionable" technology of the moment, enjoying more government attention. "Green" rates have become more profitable for investors, and there seems to be substantial potential in the field. Shale gas and LPG-related technologies are also attracting attention from investors. They lack the same fashionably "green" flavor, yet they represent real options in terms of diversification for countries that import energy, making them exceptionally topical. Yet shale gas poses an ecological question. In a tender in May of last year Ukraine chose Chevron and Shell as its partners in developing two shale gas deposits, yet local authorities in the country's west have opposed the project, citing environmental hazards.

Interest in bulk power and distribution systems (arguably the bread and butter of the traditional energy industry) isn't declining either. Active privatization in a number of countries is making these systems interesting assets, and numerous market players could start competing for them.

In general, the energy area is an exciting one. China and Japan, as well as German, Canadian, and U.S. infrastructural funds, will continue to be the primary shareholders in this market. Shale gas, renewable energy, and privatization of state energy companies will remain the primary market trends.

6 HEALTHCARE

2013–2014 Partnership for Ukraine to successfully compete in the global economy report

The healthcare market in Ukraine presents both opportunities and challenges for businesses interested in entering the Ukrainian market or increasing an existing investment. From a demographic perspective, the case for investing in the Ukrainian healthcare market is favorable. Statistics indicate that the quality and efficiency of healthcare must improve. This, however, should be balanced against the risks. Ukraine has a history of volatile legislative changes and there is limited collaboration between industry and the government. In addition, the market dynamics present unique challenges. Assuming fundamental changes in developing the healthcare sector, however, we can predict an improving investment climate.

Ukraine's population is rapidly decreasing, primarily due to very high mortality that is not offset by the birth rate or immigration. Every year the population declines by an average 700,000 persons. According to WHO forecasts, Ukraine will have 39 million inhabitants by 2030. Ukraine's birth rate is comparable to the EU's, but its mortality rate is twice as high.

Basic indices	**UA**	**EU**
Birth rate	11.0	11.0
Mortality rate (per 1000 inhabitants)	16.3	9.7
Growth rate (per 1000 inhabitants)	-3.5	+4.1
Life expectancy, years	68	78
Healthy life expectancy, years	59	67

Most mortality is the result of non-communicable diseases. Cardiovascular disease and malignant neoplasms take the lead among the reasons for mortality in Ukraine. These two factors account for about 80% of the total mortality rate.

Total death by cause	**Deaths**	**%**
Coronary heart disease	333 108	49.36%
Stroke	105 724	15.46%
HIV/AIDS	24 087	3.52%
Liver disease	23 723	3.46%
Other injuries	16 984	2.48%
Lung cancer	14 548	2.12%
Colorectal cancer	13 271	1.94%
Lung disease	12 851	1.88%
Tuberculosis	12 329	1.80%
Poisoning	11 306	1.65%

At the same time, the situation as concerns infectious diseases like HIV/AIDS and tuberculosis is alarming. Ukraine leads Europe in morbidity and mortality for these diseases. Environmental factors such as poisoning and injuries also play a role in mortality, especially in the middle-aged productive population.

Ukraine's healthcare system is not positioned to counteract these negative trends.

Despite Ukraine's significant number of primary care units and hospitals (the number of hospital beds per 1000 people is twice as high in Ukraine than in the EU on average), the resources are not distributed evenly. There is an excess of healthcare facilities in the cities and a dearth of them in rural areas. There is also a significant disposition of resources in favor of secondary (hospital) and tertiary (specialized) care at the expense of primary healthcare.

Physical resources	
Number of primary care units	8 200
Capacity of PC – Number of visits per shift	999 000
Number of visits per shift per 10 000 of population	219.8
Number of hospitals	2 500
Number of hospital beds	412 000
Number of hospital beds per 10 000 of population	90.6

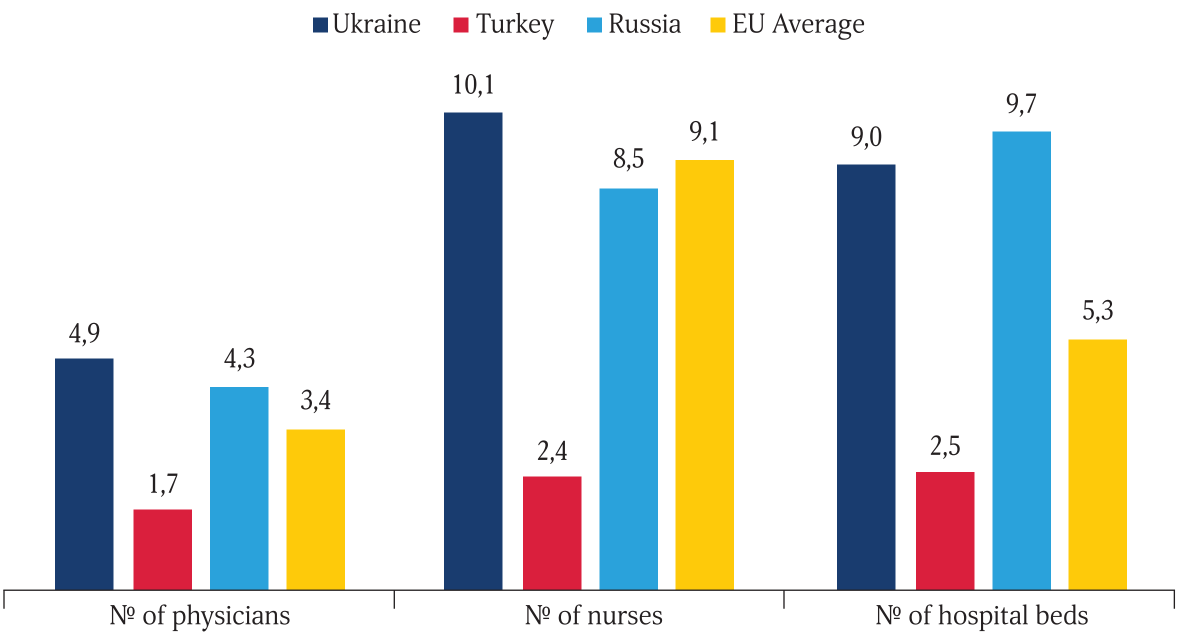
Ukraine's healthcare system is rather well-equipped in terms of its number of physicians and nurses. Per 1000 people it has more doctors and nurses than the EU.

Human resources	
Number of physicians	224 000
Number of physicians per 10 000 of population	49.3
Number of nurses	459 000
Number of nurses per 10 000 of population	101

Most of these healthcare professionals (HCPs) work in large cities, while rural areas suffer from a lack of qualified medical personnel.

The situation with medical personnel is aggravated by the fact that average monthly salaries in healthcare are below the country's average income level (UAH 2264 vs. UAH 3143). This compels young specialists to leave the healthcare system. It also explains why informal payments from patients to doctors for healthcare services are so common.

Healthcare resources



Ukraine thus formally has fairly strong quantitative indices for infrastructural and human resources allocated to healthcare. But again, these resources are concentrated in urban areas, while there remains a huge demand for them in rural areas.

Healthcare funding in Ukraine in 2012 came to about USD 10.5 billion (6% of GDP). About USD 6.5 billion (4% of GDP) of this funding is public and about USD 4 billion of it is private. When comparing Ukraine's healthcare system to that of other developed and emerging countries, a distinct picture of its systemic challenges and opportunities emerges. The most important statistic, the one that perhaps best captures the degree to which a country is investing in the health of its population, is per capita spending on healthcare at purchasing power parity (PPP). This statistic is important because it typically correlates with important healthcare outcomes such as life expectancy and the infant mortality rate. Recent statistics indicate that per capita healthcare expenditure at PPP in Ukraine is $495. In the United States it is $7,960, in Germany it is $4,219, and in France it is $3,969. To move to Eastern Europe, in Russia it is $1,043, in Bulgaria it is $995, in Romania it is $818, and in Belarus it is $782.

Perhaps even more indicative are the healthcare outcomes themselves, which unambiguously represent the degree to which the demand for healthcare is being fulfilled. Male life expectancy in Ukraine is 65 years of age, below the world average of 69 years of age and significantly below the life expectancy of wealthy countries like the United States (76 years of age) and Germany (78 years of age) and that of nearby developing countries Romania (70 years of age) and Bulgaria (71 years of age). In a certain sense, from a competitiveness perspective, the market in Ukraine offers significant growth opportunities, as per capita spending clearly must increase; healthcare spending per capita would have to almost double in order to reach the level of even the lowest-spending EU countries. But it becomes clear that, given high demand and low spending, the only way to improve expenditure statistics in Ukraine is to address priority and future sources of both public and private healthcare spending.

This year brought dozens of changes in the pharmaceutical sector's regulatory environment. Among them, implementation of an import licensing mechanism and of an updated market authorization procedure and the establishment of GMP confirmation requirements are those that concerned international pharmaceutical companies the most. Moreover, one can see an import substitution pattern in almost all the changes that regulators have either adopted or are considering at this stage.

An import license became obligatory for importing medicines to Ukraine as of March 1, 2013. The procedure for getting one has been quite formal and simple, establishing no new significant requirements. Yet a more complex and complicated procedure was created shortly after, and took effect on December 1, 2013.

In February 2013 local Ukrainian confirmation of GMP certificates for all foreign manufacturing sites became a precondition for importing medicines into the country. Manufacturers located in the PIC/S countries got a simplified procedure.

Updated regulation on market authorization took force in 2013, unifying various procedures and establishing some new requirements for applicants in Ukraine.

Changes in certain other areas demonstrate the clear import substitution dynamic that is at work here. Organizers of public tenders can now require local manufacturing facilities or service centers in Ukraine. This has made discrimination against foreign manufacturers even easier.

Market players will have no chance to let their hair down; more changes are expected in the nearest future.

In addition to import licensing, which is getting more and more complicated, the following areas are centers of attention:

- Pricing and reimbursement, which are among the most politically determined topics. Although nobody would oppose better public access to medicines, the proposed regulations clearly favor local producers.
- The lawmakers' proposal that GS1 marking become obligatory for medicines starting in 2015/2016.
- The initiative to adopt a compulsory licensing procedure, which remains a hot topic for R&D pharmaceutical companies, since the draft procedure may (if adopted) weaken intellectual property rights protection in Ukraine.
- Development of regulation in the area of orphan diseases, which is definitely a positive initiative.

More and more debates are taking place on the political level about the necessity of further restricting advertising and promotion of medicines, so changes in this area could soon occur as well.

Ukraine's investment attractiveness remains low for a number of factors. Many experts believe the following steps could dramatically improve the situation:

- Making public procurement procedures more transparent could bring more suppliers and investors to Ukraine. Allowing direct contracts with foreign suppliers on the regulatory level could clean out gray and corrupted economic areas.
- Finding additional sources of financing for the healthcare system, via either compulsory medical insurance or other relevant mechanisms, could work miracles. The legislation must change for this purpose, lawmakers say.
- Creating a good regulatory environment for PPP in healthcare is a top priority, say politicians; market players are of the same opinion.

With the needs of patients clear and an improvement in the investment climate tantamount, we can see the case for change. The healthcare industry is committed to doing its part to improve conditions, but this can only be accomplished with the support and commitment of all industry stakeholders. There may be tradeoffs to make in terms of the investment climate and other short-term goals in healthcare, and we realize that in some cases these may not always benefit all industry players. However, changes to the system should be considered in a transparent and collaborative manner, and there must be a vision of what the end goal will be for the healthcare industry. An investment in healthcare is a long-term outlay. Changes will not occur overnight. But when goals are met, the impact on society can be significant. Technology, innovation, and competition will be keys to successfully developing the industry structure. We also believe that, with an action plan focused on meeting both short and long term healthcare goals, and with a strategic approach to the industry's development, industry and government can work together to solve the many challenges that exist in getting the appropriate care to the patients that need it.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HEALTH CHECK: IS UKRAINE FIT FOR WORK?

Ukraine is witnessing an alarming trend: the health of its working-age population is deteriorating. Amidst other serious issues, the incidence and prevalence of non-communicable diseases (NCDs) are increasing every year across all age groups, according WHO Europe.[1] The challenges that NCDs pose have only recently reached the Ukrainian political agenda. In 2010 the Committee on Economic Reform urged the government to raise living standards by providing for healthcare sector investment in the Programme for Economic Reform 2010–2014. The State Programme for Activation of Economic Development has called for similar measures and, in 2011, the president approved the World Health Organization's framework "Health 2020: Ukrainian Dimension."[2] The latter is designed to implement strategic priorities in public healthcare, ranging from preventative measures for non-communicable diseases to the minimization of risk factors via an inter-sectorial approach, to investment in priority public health system areas such as primary healthcare and family medicine.[3] While these policies are important milestones for Ukraine, joint action is required at the governmental levels to secure investment for healthcare programmes that both improve the health status of the workforce and promote higher participation in the labor market. In addition to societal aging, the pension crisis, and a growing disease burden, which are challenging systems throughout Europe, Ukraine has yet other battles to win. Of particular concern is the problem of premature mortality. Life expectancy in Ukraine is only 68.2 years, which is years lower than the EU average. What's more, lifespans in Ukraine are constantly decreasing. Unless immediate action is taken, productivity, labor market participation, and public health in Ukraine are likely to decline still further, deepening the economic recession and making inclusive economic development even more difficult.

The impact of non-communicable diseases: a European perspective

Yet Ukraine is not an isolated case. EU member states have long borne the burden of non-communicable diseases. MSDs (musculoskeletal disorders) are the leading chronic condition among European workforces. Covering over 200 conditions that affect the muscles, joints, tendons, ligaments, peripheral nerves, and supporting blood vessels, MSDs cause pain and functional impairment.[4]

According to research conducted by the independent UK think tank The Work Foundation, which leads the Fit for Work Europe Coalition[5] — an initiative that's driving policy and behavior changes for workers with MSDs — 44 million workers in Europe are living with a work-caused MSD. Their physical and psychological disabilities can result in temporary, or permanent, work incapacity. They also place an additional burden on welfare systems, employers, taxpayers, and ultimately the economy (please see the infographic on page 5–6). The European Commission estimates that MSDs account for 50 percent of all absences from work lasting three days or longer and for 60 percent of permanent work capacity.[6] MSDs also cost Europe billions of euros. The direct and indirect costs of MSDs have been estimated at €240bn a year, which is up to 2% of GDP. "These are alarming figures by any standards and they're only likely to grow. Early diagnosis and intervention can help sufferers of MSDs to stay fit and stay at work longer, which will have a positive impact not only on them, but also on Europe's economy and on society in general," says Professor Stephen Bevan, Founding President of Fit for Work Europe and Director of the Centre for Workforce Effectiveness at The Work Foundation.

1 Ministry of Health of Ukraine: Draft Law of Ukraine «On Approval of the National Programme Health — 2020: Ukrainian Dimension," http://moz.gov.ua/ua/portal/Pro_20120316_1.html.

2 WHO Europe: Biennial collaborative agreement (BCA) 2012–2013. Implementation of the European health policy — Health 2020, http://www.euro.who.int/en/countries/ukraine/areas-of-work.

3 Who Europe: Health 2020, https://extranet.who.int/nutrition/gina/en/node/6089.

4 PUNNETT et al., 2004.

5 Fit for Work Europe is led by The Work Foundation and supported by Abbvie and GE Healthcare.

6 The European Commission, 2007.

The Fit for Work Europe Coalition has been advocating for early intervention in MSDs since 2007, when it released its first report on the impact of MSDs on the labor market in the UK. Ever since, research has been conducted in more than 30 countries in Europe through The Work Foundation, and various experts and key opinion leaders have joined the movement. The Coalition is led by four co-presidents – Professor Stephen Bevan, who is the Founding President of Fit for Work Europe and Director of the Centre for Workforce Effectiveness at The Work Foundation; Dr. Antonyia Parvanova, MEP; Dame Carol Black, expert adviser on health and work at the Department of Health in England; and Professor Paul Emery, Director of the Leeds Institute of Rheumatic and Musculoskeletal Medicine at the University of Leeds. Currently, Fit for Work Europe is working on driving change for workers with MSDs through evidence-based research commissioned independently in three major areas – policy, clinical, and health economics.

Yet Fit for Work Europe is not the only programme standing up for workers with chronic conditions such as MSDs. Similar alliances such as the Bone and Joint Decade and the European League Against Rheumatism (EULAR) have joined forces to position musculoskeletal conditions as a public health issue. For instance, the European League Against Rheumatism (EULAR) established in 2009 the European Parliament Interest Group on Rheumatic and Musculoskeletal Diseases.[1] Dr. Parvanova, who is a member of this interest group as well as co-president of the Fit for Work Europe Coalition, and a Bulgarian pediatrician and public health policy expert, warned in an interview with Parliament Magazine that "by 2030, around half of the population of several member states will have at least one work-limiting chronic health condition" and called for "joint budgeting between ministries and cross-governmental collaboration" to improve the health of workers and help them remain at work longer. Similar issues were debated by a panel of high-level experts at a summit in Brussels, organized in October 2013 by the Fit for Work Europe Coalition in partnership with the European Economic and Social Committee and with the official endorsement of the Lithuanian Presidency of the Council of the European Union. These experts included Dr. Roberto Bertollini of WHO Europe; Health Minister of the Republic of Lithuania V. P. Andriukaitis; and Gianni Pittella, Vice President of the European Parliament. They stressed that, in the context of an ageing population, Europe must deliver better healthcare to workforces in order to support employment and grow the economy.

Practical solutions to this challenge are emerging and are already being tested in some member states, such as Spain, Sweden, Latvia, and the UK, but they struggle to achieve political priority. For instance, a successful two-year trial of an early intervention clinic for people with MSDs that ran in Madrid proved that early diagnosis, proper treatment, and return to work practices significantly improved the health status and well-being of 3,300 MSD patients. The trial lowered the sickness absence rate by 39 percent and reduced job losses by 50%, recouping around €11 in costs for every euro invested in the programme. The results of the Spanish trial compliment findings presented by the Russian Higher School of Economics at the Health Technology Assessment Conference in Kazan, in September 2013. These revealed that the investment of one ruble in early intervention into rheumatoid arthritis and ankylosing spondylitis would bring seven rubles in return. Latvia has also made early intervention a national priority. This year the government adopted its National MSD Programme, which is going to be implemented in 2014–2020.

To show the advantages of early intervention, Professor Stephen Bevan of the Fit for Work Europe Coalition and The Work Foundation applied the principles of the Spanish trial to 12 European countries, where comparable data exist. "If these results were repeated across the whole of the EU, we estimate that up to one million more workers would be available to work each day. That would be a considerable boost to productivity and significantly reduce sick pay bills at a time when member states are under pressure to find ways to save, increase economic growth, and tackle unemployment and under-employment. Even if the reduction in the absence rate achieved were 25% rather than 39%, we estimate that in excess of 640,000 more workers would be available for work each day," said Professor Bevan.

Why is early intervention for MSDs a good idea for Ukraine?

Ukraine has much in common with EU countries, especially in the area of non-communicable diseases like MSDs. Data released by the Minister of Health suggest that up to 4 000,000 Ukrainians suffer from MSDs and incur the risk of cardio-vascular diseases that can lead to premature death. To complicate things still further, half of these patients are in the working age group (35 to 60 years old).

[1] *The EU Parliament Interest Group on Rheumatic and Musculoskeletal Diseases, http://www.eular.org/index.cfm?framePage=/eu_affairs_interest_group.cfm*

Ukraine's Ministry of Health has already developed a comprehensive programme for managing MSDs called "Care Programme for patients with Rheumatoid Arthritis for 2011–2015." This programme is one of the key performance indicators of the Draft Law of Ukraine "On Approval of the National Programme "Health — 2020: Ukrainian Dimension." However, the programme has been waiting for approval for several years now.[1]

Rheumatoid arthritis is an inflammatory form of MSD that's widely spread in Ukraine. The condition manifests itself when the immune system attacks the tissues lining the joints, inflaming and causing pain, heat, and swelling. According to the Ministry of Health programme, which is based on about 1% prevalence, there are 118,000 patients with rheumatoid arthritis (RA) in Ukraine. About 54,000 of these patients are workers under medical supervision. Furthermore, the State Report on Health Statistics in Ukraine reported in 2009 an incidence rate of 15.2 per 100,000 workers, which indicates that there are 4,226 new cases every year.

Around 20% to 30% of patients with RA become completely unable to work during their first two to three years of illness; about 50% become completely unable within 10 years; and an alarming 90% become so within 20 years. RA also contributes to the high mortality rate in Ukraine. Mortality rates among patients with RA are at least two times higher than among the general population, and they're getting worse every year.

Early intervention is crucial to RA patients, who can suffer irreversible joint damage the longer the disease is left untreated. Correct treatment is the major reason that many RA patients nowadays are not commonly seen in wheelchairs or suffering multiple joint damage in their hands or in other parts of their bodies. On top of that, as elsewhere in Europe, most costs associated with RA are due to temporary and permanent work disabilities. Hence, early assessment and diagnosis, as well as prevention strategies such as exercise, physiotherapy, life course planning, the right medicines, and faster and earlier returns to work are critical to movement, remaining pain free, and enjoying a longer, more active, and healthier lifestyle.

Ukrainian society seems willing to take active part in finding efficient solutions to MSD-related problems. Academics, health experts, economists, and charities are rallying against MSDs under the Fit for Work umbrella. Their mission is to convince the government to facilitate cross-ministerial collaboration and sharing of budgets, data, and outcomes between the health, labor, and social welfare authorities in order to secure early intervention programmes for working age patients with MSDs. Fit for Work has already started doing research on the prevalence and incidence of MSDs in the working age population in Ukraine. A report is due to be released in early spring 2014 alongside recommendations for the government, policy makers, clinicians, employers, and patients.

Greater participation in the labor market is key to driving economic prosperity in Ukraine and elsewhere in Europe.

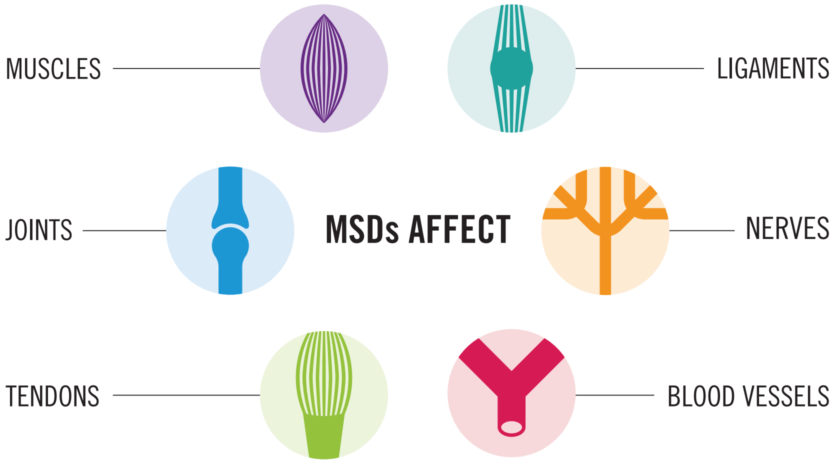
[1] *Conception of the treatment program for patients with rheumatoid arthritis for 2011–2015, http://rheumatology.org.ua/blog/news/1119/.*

MUSCULOSKELETAL DISORDERS

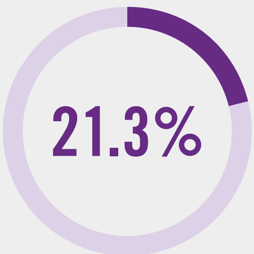
fit for work europe

WHAT ARE MSDs?

Musculoskeletal Disorders (MSDs) include over 200 conditions causing pain and functional impairment to people living with them. They include widely known conditions such as arthritis and back pain, injuries caused by trauma, such as fractures, and other conditions that are the result of genetic or developmental abnormalities, as well as bone and soft tissue cancer.



KEY FACTS ABOUT MSDs

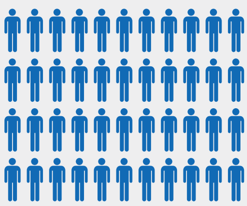


OF DISABILITIES WORLDWIDE ARE DUE TO MSDs

4TH GLOBALLY IN IMPACT ON THE HEALTH OF POPULATIONS [1]

2ND GREATEST CAUSE OF DISABILITY WORLDWIDE [2]

BIGGEST SINGLE CAUSE OF DISABILITY IS **BACK PAIN**



ACROSS THE EU **44M WORKERS HAVE MSDs** WHICH ARE CAUSED BY THEIR WORK

COST TO THE EU EACH YEAR IN LOST PRODUCTIVITY AND SICKNESS ABSENCE **(2% OF GDP)**

THESE CONDITIONS ACCOUNT FOR **HALF OF ALL ABSENCES** FROM WORK ...

... AND FOR **60%** OF PERMANENT WORK INCAPACITY [3]

1 Vos T, et al. Lancet 2012; 380:2163 – 2196
2 As measured by years lived with disability (YLDs)
3 Zheltoukhova, et al. The Work Foundation 2012

THE MADRID CLINIC

In Madrid a successful early intervention clinic for people with MSDs revealed that of the 13,000 patients assessed and offered early treatment after 5 days of sickness absence, temporary work absence fell by **39%** and permanent work disability fell by **50%**.[4]

If the findings from this study were rolled out across Spain, the equivalent of over **46,000** Spanish workers would be available for work each day rather than taking sick leave.

50%

REDUCTION IN PERMANENT WORK ABSENCE IN STUDY

39%

REDUCTION IN TEMPORARY WORK ABSENCE IN STUDY

26M

WORKING DAYS LOST TO MSDs EACH YEAR IN SPAIN

46,000

ADDITIONAL SPANISH WORKERS WOULD BE AVAILABLE FOR WORK EACH DAY IN SPAIN

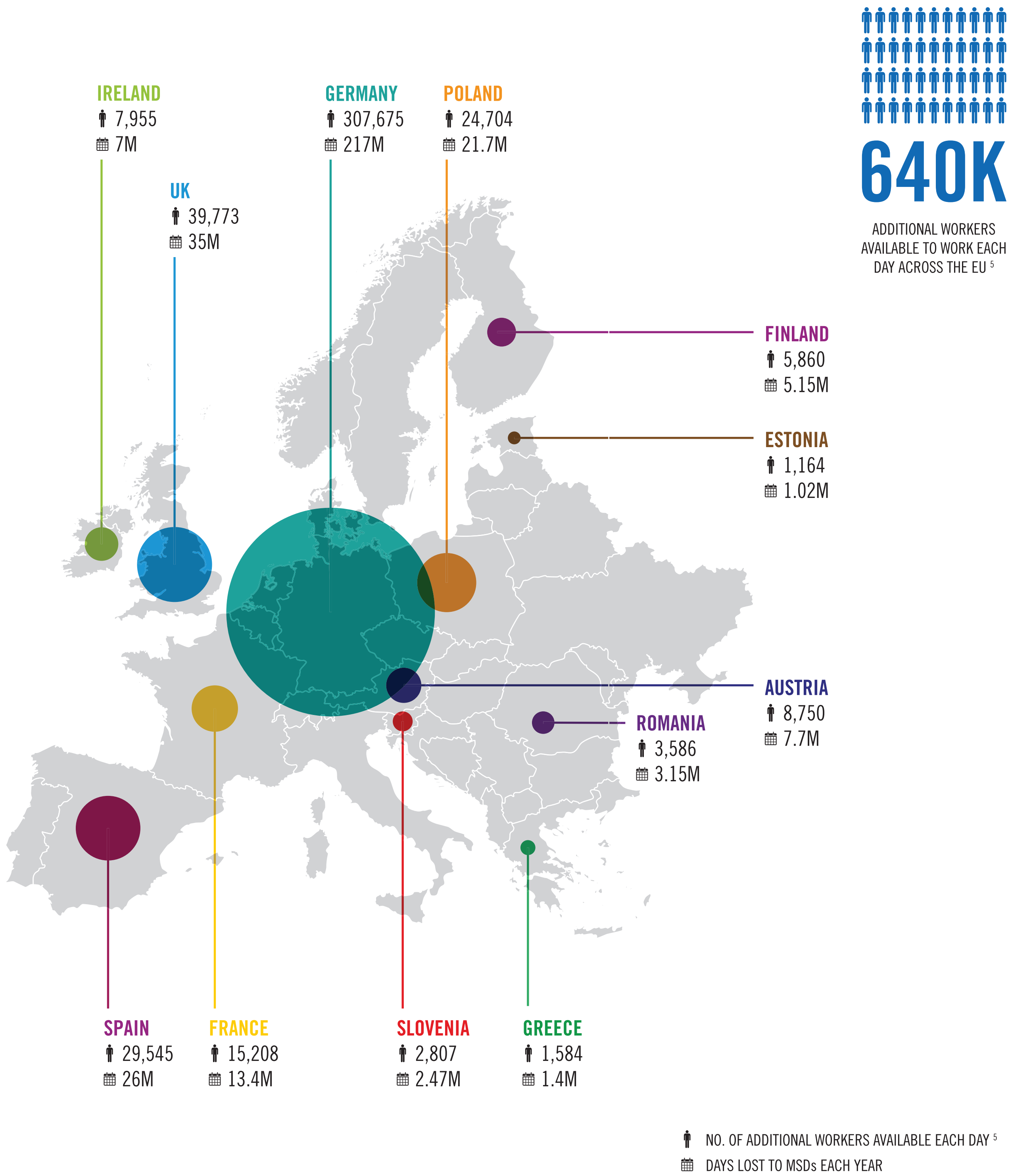
4 Abasolo, L et al, A Health System Program To Reduce Work Disability Related to Musculoskeletal Disorders, Annals of Internal Medicine, 143:404 – 414, 2005

IMPACT ON THE EU

The Fit for Work Coalition has developed estimates of the effect of repeating the results of the Madrid clinic across 12 EU Member States where comparable data exists. The following map from 12 Member States represent only 70% of the EU workforce.

Our estimates show that, if temporary work disability was reduced by **25%** the equivalent number of additional EU workers available for work each day would be **640,000**.[5]

The equivalent number of additional workers available to work each day if the Madrid results were replicated uniformly across the EU (ie a 39% reduction in temporary work disability) would be **1 million**.



5 These data assumes a lower success in reducing temporary work disability than the Madrid clinic – 25% rather than 39% – as the way patients are referred to early intervention services, such as the Madrid clinic, will vary considerably between countries. The data is therefore based in a more cautious scenario. Nonetheless, the number of lost working days avoided even in this scenario are still substantial, and show the potential impact that wider access to early intervention may have across the EU.

7 HOSPITALITY AND TOURISM

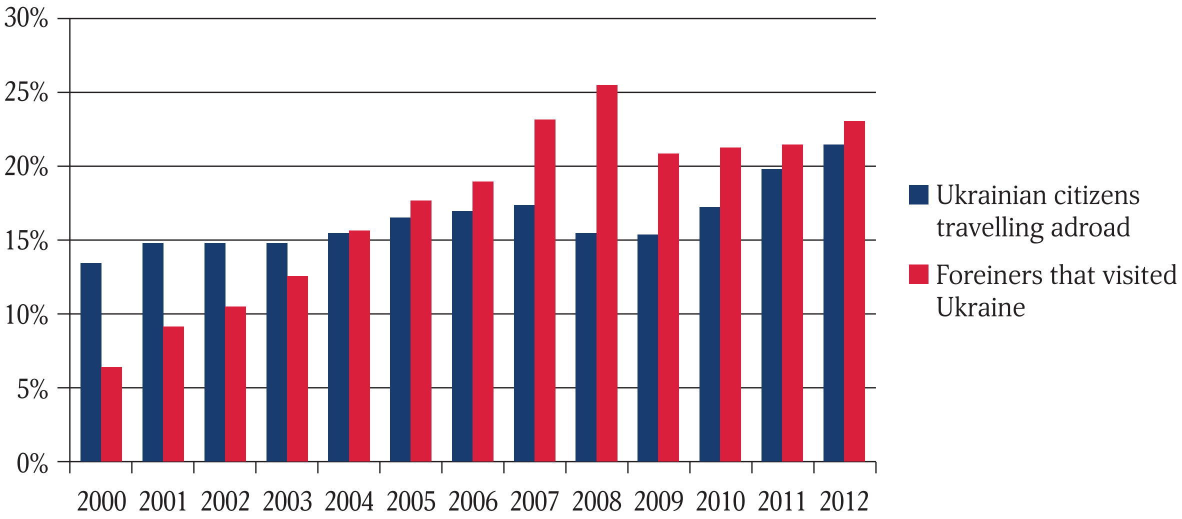
2013–2014 Partnership for Ukraine to successfully compete in the global economy report

In 2012 and the first half of 2013, hospitality and tourism returned to the positive trend established in 2003–2008. A stable increase in the number of tourists and in the volumes of services provided to them, as well as the emergence of new international brand hotels, indicated that a high-quality tourism product is taking shape, one that will satisfy consumers and be competitive on both the national and global markets.

The UEFA European Football Championship (EURO 2012) seriously accelerated development of tourism infrastructure and growth of the hospitality real estate market. In preparation for that event, starting in 2010 Kyiv and other regional centers renovated transport, sports, and tourism infrastructure. Despite that many hotel projects were not completed in time, 2012 saw the most active hospitality sector growth in the last decade. In 2012, 29 new hotels opened in Kyiv alone, resulting in a 30.5% increase of supply in the capital for the past four quarters.

Other key factors in creating supply for hospitality services in Ukraine included: the annual rise in foreign tourist inflow; the growth of business activity in Ukraine; and the high occupancy rate of the Ukrainian hotels (according to ArtBuild Hotel Group, occupancy in high-class hotels was 63–69%). According to the State Statistics Service of Ukraine, the number of foreign citizens visiting Ukraine increased in 2012 by 7.5% over 2011 (their number exceeded ~23M). That said, in 2011 the number of foreign tourists grew by only ~1% as compared to 2010 (~21.20M in 2010, ~21.42M in 2011).

Number of inbound and outbound tourists in Ukraine, million persons

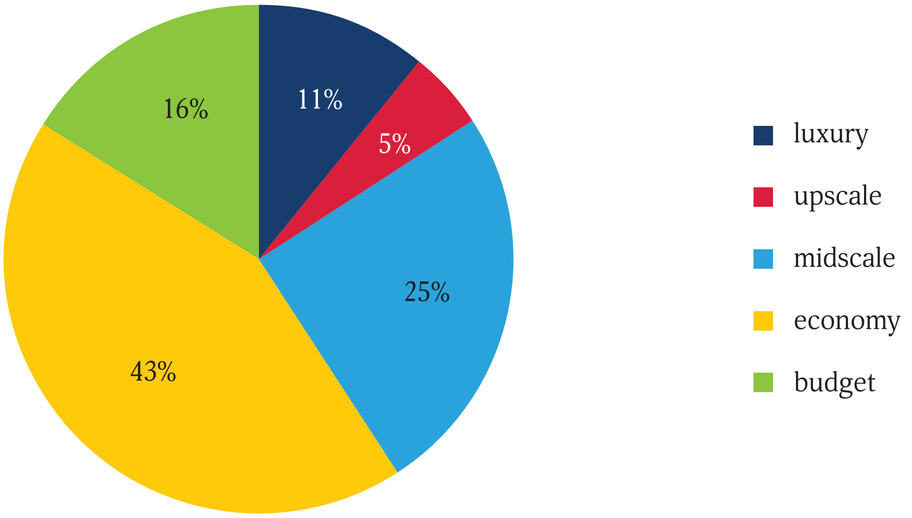


Source: *State Statistics Service of Ukraine*

The hospitality real estate market in Kyiv has evinced the most positive dynamics. According to ABHG, in early 2013, 107 hotels were registered in the capital, with a total of 10,628 rooms (not including departmental hotels, small hotels with less than 20 rooms, hotel-type hostels, resorts, or other accommodation types not in line with modern standards). Among these only eight belonged to international brands: there was one Hyatt Regency, InterContinental, and Fairmont Grand hotel each (category luxury); two Radisson Blu hotels (upscale), one each Holiday Inn and Ramada Encore (midscale); and one Ibis (economy). There is a trend towards a significant increase in the number of projects developed in cooperation with international hotel chains.

The largest share of the Kyiv hospitality market (43%) is occupied by the economy segment; upscale-luxury hotels occupy 16% of the market and the midscale category is represented by 25% of hotels.

Structure of Kyiv hospitality market, % of total number of rooms



***Source:** ArtBuild Hotel Group*

Furthermore, most of hotel room capacity in the budget, economy, and midscale categories is characterized by high wear indicators. The majority of these facilities are hotels built in the Soviet era that have seen partial renovation and upgrading. In Kyiv and in Ukraine at large there are no budget hotels operating under an international brand and there is just one modern high-quality hotel in the economy category that is managed by an international hotel operator – this is the Ibis hotel with its 212 rooms, which opened in 2011. However, it is hotels in the above segments that work in accordance with international standards that have the highest potential if the government truly intends to attract large numbers of foreign tourists looking for optimal price/quality ratios.

It is expected that the following hotels will open in Kyiv in the next three to four years: Swissotel, Hilton, Renaissance, Sheraton, and Best Western Plus. In addition, the Rezidor hotel chain, which is already operating in the region, will expand with the opening of a hotel under the Park Inn brand.

In spite of active development of the hospitality sector, the Kyiv hotel provision index is currently 3.7 per thousand citizens. That's a modest number compared to the indicators for similar European capitals (according to ABHG in 2012: Warsaw – 6.0; Berlin – 13.3; Vienna – 16.0; Stockholm – 18.4.).

Ukraine faces many issues hindering growth in hospitality and tourism, including an inefficient national hotel classification and regulatory framework and the lack of a comprehensive program for tourism industry development and funding. In 2012 and the beginning of 2013, the Chamber Hospitality and Tourism Committee reviewed issues related to the compulsory hotel categorization system and participated in discussions of the Draft Law "On Amending the Laws of Ukraine 'On Tourism' and 'On Insurance' Regarding Improvement of Their Provisions Taking into Account the Experience of Regulating Tourism Market Services of the Members of the European Union." The Draft Law aims at ensuring the rights and interests of Ukrainian citizens travelling abroad and foreign tourists in Ukraine; and at minimizing negative implications of unforeseen situations by improving state regulation of the tourism sphere. The Draft Law also seeks to foster development and rational use of tourism resources, apply European approaches to financial provision of tour operators and travel agents, and establish financial guarantees according to tourist medical insurance agreements.

Hospitality real estate market players have set the following short-term priority tasks and directions:

- Develop and implement a compulsory hotel categorization system.
- Develop a unified and comprehensive program for Ukrainian tourism industry development.
- Develop a unified statistics database (register) on the hospitality market in Ukraine.
- Stimulate development of budget-economy hotel categories by exempting them from income tax.
- Allocate a budget for forums and other events at the international level.
- Reduce the requirement by which 3–5-star hotels are exempted from taxation only when revenues from hotel room capacity make up not less than 50% of total income.
- Specify requirements and criteria for smaller hotels and for other accom-

modation facilities: recreation facilities and holiday hotels, resorts, apartment hotels, boarding houses, tourist camps, campsites, individual accommodation facilities, etc.

- Develop recommendations on amending the Classification of Business Activities.

The government has approved the resort and recreation area and tourism (in particular construction of recreation and tourism facilities) as the fifth top-priority sector, which shows its importance. Developing tourism in Ukraine means creating a favorable organizational, legal, and economic environment as well as developing and marketing domestic tourist services that can compete regionally and internationally. Reforming the legal and regulatory environment could create a business climate that is attractive for investment, encourage development, and enhance competitiveness.

8 HUMAN RESOURCES, LABOR & EMPLOYMENT

THE LABOR MARKET IN 2013

The year 2013 was a rather ambiguous one for the domestic labor market. Certain types of activity that attracted attention during 2012 failed to continue in a promising manner in 2013. Demand for most office jobs remained at the same level or even decreased. Last year's salary growth, meanwhile, failed to continue into 2013.

Nevertheless, the situation was not completely negative, as certain market conditions prospered. So let's start with the good news.

Demand for sales managers remained steady, since such employees are crucial for companies engaged in production or distribution or that provide services. Sales managers also play a crucial role in stimulating key company managers to boost profits. Indeed, the idea of boosting salary levels in order to boost the level of staff engagement has recently faded into the background. Salaries are currently going up only when results and efficiency improve.

IT specialists were also on firm ground, not least because they tend to be employed by the IT industry. They even saw their salaries rise by 10% to 20% on average over the course of the year. This had to do with several factors: a) development of the domestic IT market, in part due to the exit of several foreign companies; b) outflow of specialists to international companies. In 2013 the majority of IT-sphere employers changed their staffing arrangements, and many junior associates became specialists. Many entry-level employees, meanwhile, were hired as specialists. Relatedly, headhunters and HR specialists in the IT industry used social networks to find job candidates.

Another industry that saw hiring was the agricultural industry, which had a successful year. Ag firms have been searching for a wide range of employees: sales managers, IT professionals, economists, marketing managers, agricultural experts, and technical experts.

The agricultural industry is an excellent one for young professionals and recent technical university graduates to search for jobs in, offering salaries that are 15% to 20% higher than the average market salary.

Marketing managers, financial experts, and legal counsellors don't always have much in common, but this year they did: the market for their services was a relatively troubled one. Salaries remained stable and job openings were scarce, with each attracting a number of qualified candidates. Those who could contribute to business optimization had an easier time, such as marketing managers with strong analytical skills and financial managers with financial flow optimization experience. Such job seekers saw interesting job positions open up on the market every once in a while.

Legislation to protect the domestic auto industry significantly influenced the automotive job market. New duties and fees for automobile importers forced auto dealers to engage additional human resources in the first half of the year, when they were trying to make the most of the period "before the price boost." Once sales dropped, however, auto dealers started thinking more about optimizing staff quantities.

Since the banking sphere remains in a downturn, few banks opened new branches or offered new jobs. The majority of banks have been practicing optimization, and not all employees who were dismissed have been able to find new positions. To save money, a number of banks have taken to hiring recent graduates with low qualifications as cash operators, account managers, and the like.

The situation for blue-collar workers is gradually getting worse. In 2011–2012 approximately two million people, mostly workers in the trades, left the country in search of work abroad. Wages in towns and villages are low; they are far higher in the cities, where there are far more jobs, but the cost of living is vastly higher in the cities. This situation is causing competition for workers, especially since Ukraine's population is aging, and employers are resorting to things like giving workers transportation to work, making work conditions more comfortable, and the like.

Expectations for 2014

Given the challenging economic climate, there should be no general improvement in labor market conditions in 2014. The IT industry will remain profitable and IT specialists will remain in demand. As usual, professionals who can make a significant difference to companies will remain highly valued.

Most of the Ukrainian business community expected Ukraine to sign the association agreement with the EU in 2013. That would temporary complicate labor market conditions by leading to the shut-down (bankruptcy) of ineffective enterprises and by creating problems for entrepreneurs whose activity (such as distribution) is oriented towards Customs Union countries. Positive developments should thus be expected only in the mid- and long-term perspectives.

If salaries rise in any area, that will represent an exception to the rule. An employee who wants a higher salary should not expect his or salary to rise; rather, he or she should look for a higher-paid job.

EXPATS IN UKRAINE: LEGAL ASPECTS OF THEIR EMPLOYMENT AND RESIDENCY IN UKRAINE

Bogdana Choban, *Legal Services Practice Leader, EBS*

Issues surrounding foreigners' employment and residency in Ukraine are of high relevance for all expats who come to work in Ukraine for Ukrainian companies or for companies with foreign capital or investment or at the invitation of foreign companies duly registered and operating in Ukraine.

An "expatriate" is someone outside his or her own country, and the term applies to anyone who's a citizen of one country, but working under contract in another. Ukraine's legislation, however, has not yet defined the term "expat." Any citizen of another state or states is therefore considered to be a foreigner here.

Over the past few years, the legislative basis for the employment and residency of foreigners in Ukraine has undergone changes in terms of both procedures and required documents. Among the main regulations governing these issues today are the following: the Law of Ukraine "On the Legal Status of Foreigners and Stateless Individuals"; the Law of Ukraine "On Employment"; The procedure for the issuance, renewal, and revocation of permits for the employment of foreigners and stateless individuals, as approved by Cabinet of Ministers Resolution № 437, dated May 27, 2013; Cabinet of Ministers of Ukraine Resolution № 251 dated March 28, 2012 "On approving the design, manufacture, and issuance of a permanent residence permit and a temporary residence permit and a technical description of their forms and amendments to Cabinet of Ministers of Ukraine Resolution № 1983, dated December 26, 2002."

By changing the documentary requirements and the permitting procedures, the legislature has managed to make employment in Ukraine more complicated for foreigners. The main reason for these changes is that many qualified individuals are currently unemployed in Ukraine. However, businesses in Ukraine are in no hurry to give up hiring foreign personnel to conduct business operations; after all, international experience can be crucial to Ukraine.

It's specifically for this reason that Ukrainian employers are making considerable efforts to overcome the various obstacles and difficulties they face, even before they conclude employment contracts with foreigners. This is why they spend a lot of money and effort on obtaining employment permits for particular individuals categorized as foreigners or stateless persons. The barriers in question include inconsistencies between what the regulations demand and what is demanded by the actual situation as regards the preparation and collection of the necessary documents. In accordance with the Procedure for the issuance, renewal, and revocation of permits for the employment of foreigners and stateless persons, for example, an employer, in order to obtain permission to use foreign labor, must submit a list of documents to the territorial agency of the State Employment Service. This list includes documentation issued by a medical institution attesting to the fact that the person in question (the foreigner or stateless individual) does not suffer from chronic alcoholism, substance abuse, drug addiction, or infectious diseases of the sort listed by the Ministry of Health. Moreover, only a certificate issued by a healthcare establishment located in Ukraine and on the official Ministry list will be taken into consideration.

However, when the documents for a work permit are being prepared and submitted, the foreigner in question is as a rule still outside of Ukraine, and thus can't submit a medical certificate to his/her potential employer. The employer, in turn, can't request a certificate on the foreigner's behalf, given that it can be issued only to the individual himself or herself, after he or she undergoes the medical examination. Such disputes are particularly time-consuming.

Please note that an employer can conclude an employment contract with a foreigner only on the basis of that work permit.

It's a bit easier to employ a foreigner in a representative office of a foreign company duly registered in Ukraine. Here, however, other regulations come into play due to the fact that the potential employer must first obtain an official service card, valid for three years. This document will be the basis for the subsequent processing of the documents required for a long-term visa and a temporary residence permit. In effect, a service card is similar to an employment permit.

Under current law, foreigners and individuals without citizenship can enter Ukraine and travel abroad for employment purposes on the basis of a passport and documents certifying the right to temporary residence.

Nevertheless, a temporary residence permit must be registered so that the foreigner can not only enter and depart from Ukraine, but also legally reside in Ukraine for more than 90 days per 180-day period. After all, for a foreign national to work in Ukraine, he/she has to comply with all immigration regulations. A work permit signals a green light with respect to temporary residency regulations in Ukraine, because it is ultimately on the basis of that document that the foreign citizen can apply to a Ukrainian consulate in his or her country of residence for a type-D long-term visa to enter Ukraine and apply to the State Migration Service for a temporary residence permit.

If a foreigner is employed at a foreign representative office on the basis of a service card, the employer has to undergo an additional procedure to get an application from the Ministry of Economic Development and Trade of Ukraine. It's only once the foreigner has received the documents from his/her employer that he/she can apply to the Ukrainian consulate in his/her home country. There, the applicant must obtain a type-D visa, required for entering Ukraine and obtaining a temporary residence permit.

It would seem here that, after gathering all the necessary documents and completing the required procedures, the foreigner can safely live and work in Ukraine for the period stipulated. But unfortunately it turns out that there is yet another procedure, without which all of the steps described above are in vain. This procedure entails the foreigner's registration in his or her place of residence in Ukraine. Failure to register is deemed grounds for the authorities to revoke a temporary residence permit.

The obvious fact is that registering foreign citizens and stateless individuals to work in Ukraine takes a lot of effort and money, not only on the part of the employer, but also on the employee's. Both parties will be penalized if they fail to comply with any of these rules. That's why it's important for a company to receive professional support in employing foreigners. Such support will save companies not only money, but also a lot of time.

9 INFORMATION & COMMUNICATION TECHNOLOGIES

THE UKRAINIAN IT MARKET: THE FUTURE STARTS TODAY

The IT market represents one of the most dynamic segments of the Ukrainian economy and the global economy alike. Oleksiy Besarab, Cisco Technology Director in Ukraine, talks about trends and market changes in IT.

Setting course for the clouds, focusing on mobility

Which IT trends are the most vital for Ukraine today? First of all, there is the growing interest in cloud solutions. Different businesses are searching for working models that will allow them to take full advantage of modern technology without spending too much. Clients want to reduce capital costs by transferring them into operational costs, and cloud solutions help them do that. Other advantages of cloud solutions that make them successful are their controllability and flexibility.

Ukrainian companies are becoming more and more interested in mobility solutions that can provide their employees with access to corporate data from any location, primarily with the help of wireless technologies. One of the strongest mobility trends is known as BYOD – an acronym for "bring your own device."

The more people use smartphones and tablets, the more apparent the BYOD trend becomes. Personal devices are usually more advanced and functional than corporate devices, which is why employees want to use their devices in the workplace. IT managers are balancing security and support concerns with the very real potential to reap significant cost and productivity benefits from the BYOD trend.

Ukrainian business is accepting, and in some cases embracing, BYOD as a reality. A survey of 258 IT managers who attended the Mobility Without Borders forum in Kyiv in April 2013 provided good proof of this, with 42,6% of respondents saying that staff mobility is positive for their companies, with numerous employees working out of office with access to the corporate network. They named mobility, improved employee productivity, and greater job satisfaction as the key benefits that BYOD provides to both companies and employees.

The main force driving BYOD in Ukraine is top managers, who want to use their personal devices anywhere and are compelling IT departments to solve problems pertaining to secure connection to corporate networks.

Today business is relying more and more on information that's stored on various devices. That's why security is a top IT challenge. In addition, 2012–2013 saw data center virtualization became a wide-scale trend in Ukraine.

Video as a key element in business collaboration

As the workforce becomes more mobile and distributed, leaders are recognizing the benefits and growing impact of video as a key element in business collaboration. Video is becoming more pervasive in the business world, both globally and in Ukraine. Companies use video collaboration to improve communications, relationships, and productivity by helping people meet face-to-face over distances. Video also helps to reduce employee travel, real-estate costs, and environmental impact.

In Ukraine, for instance, Ukrtransgas and the National Bank have deployed large-scale videoconferencing networks. The National Bank's network connects the central office in Kyiv and 25 branches all over Ukraine. Another milestone project was implemented by UNIAN news agency, which, for the first time in the CIS, used videoconferencing to cover Ukraine's parliamentary elections. The MIM-Kyiv business school uses telepresence technologies for remote training.

It is quite likely that in five years immersive video communication will become a reality for today's Ukrainian schoolchildren, as TV became a reality for the older generation back in the day.

Changing the attitude of Ukrainian companies towards IT

Today Ukrainian customers have another approach to selecting IT solutions compared to what they had a couple of years ago. Previously IT departments had more autonomy to make decisions, manage their own budgets, and spend them according to their needs. Today, a customer expects that each corporate investment will increase specific business indicators in return. "How will this IT solution make us more successful as compared to our competitors? How will it improve both our staff performance and the quality of our customer service?" These are the questions that are being asked when it comes to IT. Choosing IT products has become a more conscious process at the senior management level: business decisions are being made by leaders who are focused on economic goals and looking at how IT can relate to business.

The criteria for evaluating IT solutions have changed as well. The fact is that today's Ukrainian IT market is quite diverse – there are hardly any single-option offers from single vendors. The role of the cost criterion has for that reason significantly increased in the past year alone. Customers are first paying attention not to the price, but rather to the total cost of ownership. Earlier they were more focused on the technical specifications and functionality of IT products.

Another trend is that a number of companies are building their business strategies in accordance with IT solutions. At issue is mainly interaction with clients and new service development. For example, banks might use social networks and mobile devices as new channels of communication with customers, and develop custom applications for them. In this area, the success of new service development depends on the "maturity" of a bank's IT service, which plays a key role here.

Finally, there's one more trend, this one having to do with Ukrainian customers. Companies with a more traditional attitude towards information technology (according to which IT is not considered a part of corporate strategy) tend to outsource their IT service functions. They have no need of an IT staff and a high service level is guaranteed.

IT for country development

Nearly 30 laws pertaining to IT have been adopted in Ukraine. The Law "On Basic Principles of Information Society Development in Ukraine" is one of the best in the world, covering as it does all areas, from economics to culture. But it's still a mere political declaration. Ukraine has taken only the first step on the path towards an information society, which implies that all government agencies will have websites. Unfortunately, the second step, which includes consulting and communicating with citizens via the Internet, has not yet started on the national scale.

However, there have been some examples of successful IT service implementation in the public sector. The State Tax Administration of Ukraine has established an exchange for electronic documents with digital signatures, and the State Customs Service is introducing electronic declaration. Moreover, local mayors are establishing administrative service centers, which represent an intermediate stage in evolutionary e-service development.

IT in education

There's a shortage in Ukraine of nearly 30,000 qualified IT professionals every year, and the number is growing. To reduce the deficit between supply and demand of professionals, IT education needs development and investment support.

A milestone event in Ukraine's IT education took place on September 27, 2013, in Kyiv, when the BIONIC Hill Innovation Park launched the BIONIC University project. This new educational institution is dedicated to training professionals for Ukraine's IT and other high-technology industries.

The nationwide "Open World" project is another important initiative in this area.

It aims to create a single educational and informational online space for pupils, teachers, and parents all around Ukraine. By the end of 2013 2,000 schools are to receive modern digital equipment. By the end of 2015 every school in Ukraine will have it.

Cisco is contributing to solving the shortage problem by expanding its Networking Academy Program, which teaches students how to design, build, troubleshoot, and secure computer networks. The company now has nearly 200 Networking Academies operating at universities, colleges, and secondary schools in all of Ukraine's regions. In the 2012/2013 academic year almost 9,000 students developed their IT skills through this program in Ukraine.

What to expect tomorrow?

IT innovation is advancing rapidly. We are entering an age in which the Internet will change the lives of everyone on the planet for the better. The forthcoming "Internet of Everything" era will create new capabilities, richer experiences, and unprecedented economic opportunity for businesses, individuals, and countries. Today, the task for IT companies is to help professionals make the right decisions. This will help to unlock the full potential of the Internet in business innovation, government transparency, and quality of life all over the world.

CLOUD COMPUTING TRENDS IN UKRAINE

Dmitry Turchyn, *Server & Tools Business Group Lead Microsoft Ukraine*

So what really is cloud computing? Why is it so broadly promoted and even more broadly contested by skeptics? Is it really a game-changer or is it just another bubble, especially for Ukraine? Let's analyze the situation.

Industry trends

First, the cloud is no longer the trend. It was the number one topic in technology a couple of years ago, but now things have changed: according to Gartner, the top trend in technology now is Big Data, followed by mobility, with the cloud taking third place. This actually leads to an interesting point, however: while firms are now looking into how to make money with Big Data and boosting efficiency with a mobile workforce, neither of these trends would be possible without the cloud. A typical technologically savvy organization looks like this: it leverages insight into internal and external data and acts almost in real-time to capture opportunity (Big Data), thus empowering employees to collaborate and work from any location and on any mobile device.

But where is all this data stored and processed? And how much should a company invest in building modern applications and in deploying those new services? How to manage unpredictable volumes of data and processing? How can an organization manage the cloud-connecting devices that employees bring to work? Cloud technologies make all of this possible, through their core characteristics: elasticity, self-service, resource agility, and cost per use.

But is the cloud really that important? Let's see. This planet is home to more than 1,1 billion mobile users, more than a billion Facebook users, and 2,5 billion Internet users, and the amount of information on the planet is increasing by 10 times every five years. In the last two years alone more data has been created than was created throughout the entire previous history of mankind. Dealing with all of this can look like a challenge, and it is. It's a challenge, moreover, that will create two types of companies: those that do make use of growing data to increase sales and those who do not.

The cloud technology market will double by 2016, revolutionizing, in concert with mobility, the technological landscape, just as mobility reshaped the PC market. According to IDC, the number of server shipments declined in 2013, and the picture is similar worldwide. This means more companies are leveraging cloud services or optimizing their existing infrastructure. At the same time, using virtualization to run different workloads on the same hardware is becoming mainstream and establishing a basis for cloud infrastructure deployment.

Cloud services for SMBs and enterprises in Ukraine

It's hard to overestimate the impact that cloud technologies are currently having on business, on government, and on our personal lives, and that impact is bound only to grow exponentially. These services have come to change what we expect from companies in industries such as banking, travel, and retail in terms of data accessibility, ease of use, and security. They are also changing how and when we access those same services: from a smart phone, a PC, a tablet, work, an airport, a café, or home.

One item rarely talked about when we talk about the cloud is how those services are consumed. This is critical to driving penetration into the broader population: as PCs, tablets, smartphones, e-readers, and Internet-connected appliances become cheaper and Internet access more available, consumer demand will explode. In Ukraine alone, smartphone sales have grown by 56% year over year, while tablet sales have grown to 127,000 units per month: and tablets are a market that didn't even exist three years ago!

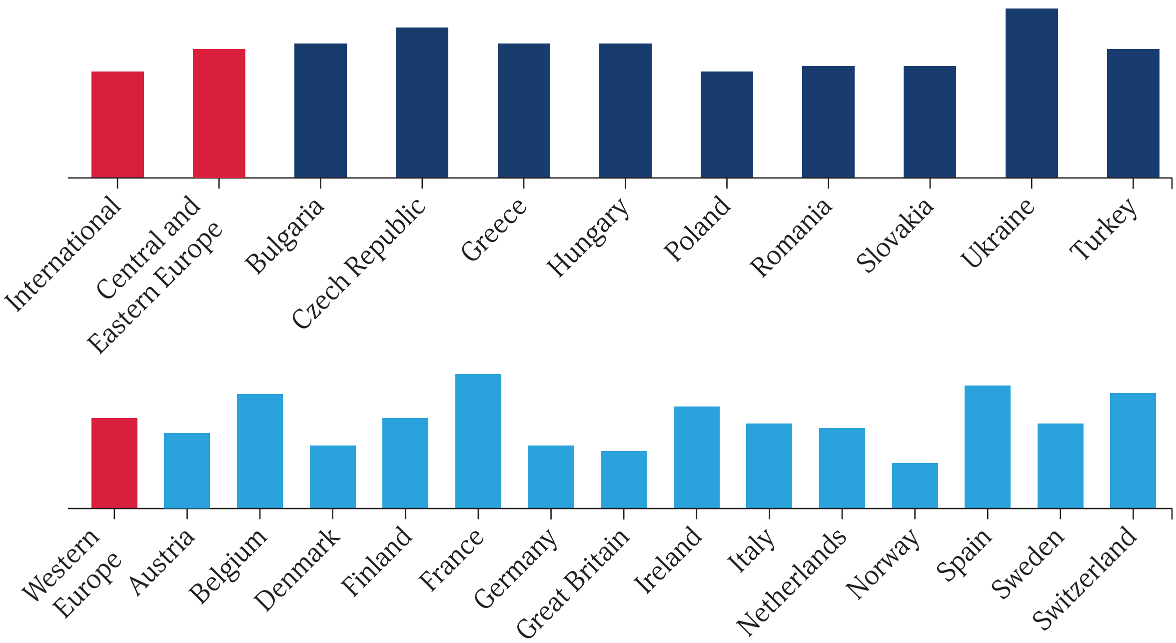
In Ukraine we're seeing the beginnings of a trend according to which large companies outsource their IT functions (although Ukraine is seeing it later than the rest of the world). This, coupled with the fact that Ukraine has a significant base of IT developers (it's number two in this respect in Central and Eastern Europe), signals the potential for a significant growth in cloud adoption in coming years. We see this trend as more likely to happen for new projects (according to market research, up to 70% of customers call "speed of launching projects" a major driver of cloud adoption) as companies upgrade their aging infrastructures.

Based on a recent survey of SMBs across Europe, Ukraine is ahead of the pack in overcoming fear of relying on the cloud to run email, data storage and backup, document exchange, instant messaging, voice over IP (telephony), and productivity suites. Eighty-five percent of Ukrainian SMBs are already using some form of these technologies via the cloud.

And those using the cloud are more likely than non-users to be planning a number of expansion activities over the next three to six months, such as launching a new product, hiring employees, and investing more in technology. But probably the ultimate validation of the cloud's impact on business is the fact that 66% of SMB cloud users in Ukraine agree that cloud computing is going to become more important for the success of their organizations.

As for large enterprises, the cloud represents a massive opportunity to free up capital from traditional IT investments in infrastructure and funnel it to projects more directly aligned with organizational objectives. Over the last couple of years we have seen, both internationally and in Ukraine, collaboration, video conferencing, and office productivity tools shift to cloud services; and more recently companies have been contemplating moving their accounting and ERP (Enterprise Resource Planning) systems to the cloud as well. These systems provide an integrated real-time view of core business processes such as production, sales, order processing, and inventory management, but they do so at a high cost for maintenance, support, and customization. Thanks to the growth and resilience of cloud services these costs can be significantly reduced or even eliminated altogether, which was impossible to imagine a couple of years ago.

Percent of current cloud users, %



Local datacenter or global cloud service?

Should I choose a local or a global cloud provider? What should an organization take into consideration in making such a decision? The cloud services market is very diverse, and while Ukrainian customers are thinking about whether to "go cloud" or not, the variety of offerings keeps growing.

Local datacenters are seeing bigger revenue opportunities from higher-level cloud services and have started building cloud provider layers on top of their current simple co-location and datacenter space rent models. Consistent with this trend, 2013 saw the launch of Parkovyi, the largest datacenter in Ukraine. It provides full IaaS (Infrastructure as a Service) functionality, which allows customers to deploy real SaaS (Software-as-a-Service) services. On the other hand, global cloud providers keep growing their presences in Ukraine at an even faster pace. As an example, Microsoft not only leverages its local sales force and support to sell Windows Azure and Office 365 services, it also allows local invoicing from Ukrainian partners, which allowed three-digit growth in Windows Azure sales in 2012; similar booming growth was expected for 2013.

In comparing local and global cloud service offerings, there are certain important factors to consider that can make one more favorable than another. For heavily regulated industries, deployment via local service providers can be an excellent option when issues like privacy and national security are critical. On the other hand, global cloud services can offer economies of scale, geographically distributed locations, and better access to global markets. For example, in Windows Azure a single copy of a piece of data is replicated by default not only within the datacenter, but also to remote Microsoft Datacenters in other countries, making data loss a very unlikely event. Also, while local datacenters in Ukraine are moving towards a full IaaS model, global cloud providers can offer a much broader set of services, including not only IaaS and SaaS but also PaaS (Platform-as-a-Service) models, which are critical for technology startups.

For governmental internal IT and citizen services, the potential of the cloud is hard to overestimate: it not only cuts costs and guarantees technologies that are always up to date, but also allows for decreasing administrative burden on organizations and citizens. As a result, building modern government cloud-based services can positively impact citizen satisfaction and ease of doing business. All this can improve the business climate and economic performance. And while global cloud service use is limited for the government (due to regulations), local cloud providers are a great platform on which to make this vision a reality.

Conclusion

Ukraine, where the big businesses trends of the moment — Big Data and mobility — depend on cloud technologies, is set for a bright cloud future in upcoming years. While local data center capacity is growing, local players have to re-imagine their service offerings, adopting higher-level services with increased added value and higher margins. The government needs to provide a clear legal framework that facilitates business both internally and externally as these services become globally accessible. The emerging scenarios — data analytics in cloud, and ERP, CRM, and accounting system deployment in cloud — have accelerated by the end of 2013. New SMBs and start-ups are in many cases cloud-borne from the start, as speed of deployment and resource elasticity are vital during a business's launch phase.

Finally, we encourage potential cloud adopters (both businesses and consumers) not to make decisions on whether to adopt or not to adopt, but rather to think what further benefits the available services could bring beyond cost savings. They should also think over what providers can facilitate their transitions to the cloud, leveraging their existing investments while safeguarding their privacy and data.

In any case, your competitors have most probably already incorporated cloud technologies as part of their business strategies.

UKRAINE IS EASTERN EUROPE'S BEST DESTINATION FOR IT OUTSOURCING

Over the past 20 years, Ukraine's information and communications technology (ICT) sector has grown and gained strength. Exports of ICT services have grown an average of 25% annually over the last 10 years, even when major world players contracted as a result of the global financial crisis. The quality of Ukraine's math and science education and its tertiary enrolment ratio, the highest in the region, form the main basis for the sector's growth.

Ukraine is also attractive from the point of view of telco tariffs. The World Economic Forum ranks Ukraine as number two for mobile cellular tariffs and number six for fixed broadband Internet tariffs. Multinational companies are finding that their branches in Ukraine are growing much faster than their branches in other countries.

Last year the Fortune 500 cited four IT companies from among the Ukrainian TOP-25 as among the world's best 100 outsourcers.

This brief review examines current trends in Ukraine's IT services and software development industry and forecasts its further development.

ICT Service Export

ICT service exports include computer and communications services (telecommunications and postal and courier services), and information services (computer data and news-related service transactions).

In 2012–2013, ICT service exports in Ukraine continued their growth, as indicated in Table 1 (stated below). The figures show that both old and new index calculation methods resulted in the same growth trend. The new method was first used in 2012; the World Bank started recalculating corresponding values since 2005. The absolute value of total exports calculated using the new method increased almost threefold as compared to the old one (from $1.275 billion to $3.812 billion). Other services that make a significant contribution to the total value were added to the index, so it's difficult to separate the necessary part because it's overshadowed by data for other services.

Table 1. ICT service export (BoP, current $ millions)

Year	2005	2006	2007	2008	2009	2010	2011	2012
Old method	247	380	504	597	777	947	1,275	–
Growth old method	59.4%	53.8%	32.6%	18.5%	30.2%	21.9%	34.6%	–
New method	789	1,091	1,661	2,344	2,143	3,175	3,812	4,272
Growth new method		38.3%	52.2%	41.1%	-8.6%	48.2%	20.1%	12.1%

Source: *The World Bank*

We explored other, more specialized studies, to understand how the Ukrainian software development industry is working now. The TOP-25 Ukrainian IT companies rating, provided by the online resource DOU, is one of them.

Table 2. TOP-25 by Ukrainian unit size as of September 1, 2013

Company	Country	Staff	Vacancies
Luxoft	Russia	3,082	421
EPAM Systems	USA	3,000	180
SoftServe	Ukraine	2,708	286
GlobalLogic	USA	2,365	120

Company	Country	Staff	Vacancies
Ciklum	Denmark	2,023	195
Samsung R&D Ukraine	Korea	1,100	54
Infopulse Ukraine	Norway	1,038	100
ELEKS	Ukraine	849	42
Nix Solutions	Ukraine	750	20
NetCracker	USA	724	50
ISD	Ukraine	710	20
Miratech	Ukraine	650	40
Lohika	USA	640	50
Parus Corporation	Russia	550	6
DataArt	USA	469	62
Terrasoft	Ukraine	455	44
Sigma Ukraine	Sweden	400	40
Software MacKiev	USA	400	22
SysIQ	USA	373	50
AM-SOFT	Ukraine	356	17
CS Ltd.	Ukraine	320	12
Softline	Ukraine	297	3
Intecracy Group	Ukraine	290	9
Cogniance	USA	259	7
Magento	Ukraine	250	3

***Source:** DOU*

If we compare the data in Table 2 with the corresponding data from September 1, 2012, a year earlier, we see that the number of employees at TOP-25 IT companies increased from 20,408 to 24,058, i.e. by 18% on average. In 2012 average monthly wages in the IT industry were an estimated $1,700; meanwhile, they grew over the last year by 3% to 8%, according to DOU. We can thus estimate the annual turnover of the largest IT units. Assuming that payroll comprises roughly 70% of an IT company's expenses, and assuming a 15% average profit margin in the industry and that headcounts on September 1 are more or less the average annual headcounts, annual revenue equals the average monthly wage* headcount* 12 months / 0.7 / 0.85.; i.e. the gross operating revenue of all TOP-25 Ukrainian companies is about $866 million (which is 23.7% more than it was the previous year and which amounts to 20.3% of total ICT exports from Ukraine). Using the old ICT service export calculation methodology, the revenue of all TOP-25 Ukrainian companies amounted to 55% of total ICT export. While average IT company staff growth is near 18%, we estimate average annual ICT industry revenue growth to be 23.7%.

The lion's share of the revenue mentioned above was until recently associated with ICT exports. And, as analysts have estimated that the revenue of the TOP-25 companies accounts for about half of exporters' share of ICT industry revenue, the industry's annual export volume is estimated at $1.732 billion.

Ukraine's domestic IT market

According to the IDC, the IT market in Ukraine in 2012 generated $3 104.1 million. Despite the problems in the Ukrainian economy that year, the market continued to grow (by 1.3% compared with the previous year). PC sales accounted for a large part of the market (57.0%), taking into account that those sales fell by 3.1% in 2012. The main subjects of this article, however, are IT services and software development, the segments that influence internal market growth. The IT services segment increased in 2012 by 15%, from $245 million to $281.7 million, while the software segment grew by 10.5% (from $245.4 million to $271.1 million). According to the IDC, $ 271.1 million includes sales of licensed software, whether developed abroad or domestically. Since this study deals with the domestic market only, we need some additional research.

Analysts at PMP performed an integrated assessment of the Ukrainian domestic market's IT services and software development segments. They give a consolidated figure of EUR330 million for those segments, which at a euro/dollar rate of around 1.3 comes to $430 million. The domestic software market comes to $ 148.3 million. According to the IDC, the domestic software market is playing a significant role in driving the total software market growth of 10%.

Back to home

Until recently, the foreign and domestic ICT markets were separated. Companies working in the domestic market weren't interested in exporting and the largest IT companies weren't particularly interested in the domestic market. The situation started to change over the past year, however. IDC analysts who studied Ukrainian IT-related tenders noted that despite the problems with the economy and in public finances, the government procurement volume is rapidly growing. Ukrainian tenders in 2012 totaled 3.3 billion UAH in worth; of this sum, 16.2% went for software development and 12% went for IT services. IDC lists the largest customers:

- Ukrtransgaz PAT Naftogaz of Ukraine — 458 million UAH
- PAT State Savings Bank of Ukraine — 174 million UAH
- National Bank of Ukraine — 162 million UAH
- Ukrainian State Enterprise Mail Service Ukrpochta — 146 million UAH
- DP Naek Energoatom — 104 million UAH
- State Customs Service of Ukraine — 94 million UAH
- State Statistics Service of Ukraine — 85 million UAH
- Pension Fund of Ukraine — 69 million UAH
- Ministry of Justice of Ukraine — 66 million UAH

The first five organizations listed accounted for 31% of all IT purchases in 2012, according to the IDC.

Ukrainian IT companies with an international reputation and experience in major projects worldwide have become more and more interested in the domestic market for two reasons: first, they're interested in growing; second, their international experience is now in demand on the domestic market. While in 2009, for example, Miratech reported less than 10% of its revenues as originating with domestic customers, in 2013 it reported around 50% of its revenues as coming from the domestic market.

The key to success

A necessary condition for the sustainable growth of the Ukrainian IT industry is labor market capacity. Let's consider Ukraine's labor market and business environment and compare them with those in its nearest neighbor countries.

Table 3. Human capital background for ICT industry growth

	Quality of math & science education		Tertiary enrolment ratio		Population (millions)	Tertiary enrolment (millions)
	Rank	Value	Rank	Value		
Ukraine	24	4,78	8	82%	45,59	37.384
Hungary	32	4,6	31	60%	9,944	5.966
Russia	50	4,31	12	76%	143,5	109.060
Romania	51	4,3	34	59%	21,33	12.585
Bulgaria	52	4,28	39	57%	7,305	4.164
Poland	60	4,13	17	72%	38,54	27.749
Moldova	65	4,06	58	39%	3,56	1.388
Kazakhstan	66	4,05	50	43%	16,8	7.224
Czech Republic	73	3,96	26	65%	10,51	6.832

***Source:** "The Human Capital Report," by the World Economic Forum, October, 2013*

The most important indicator for the ICT industry's successful development is the number of qualified staff. Country population and the tertiary enrolment ratio are the main factors in the availability of qualified staffers. As Table 3 shows, despite Ukraine's second-place position in the region for number of people enrolled in university education, it's a top IT destination due to the quality of its math and science education indicator. In this category Ukraine is far ahead of its closest neighbors in Eastern Europe and the former USSR, with a global rank of 24 out of 122.

This represents a strong result, especially in combination with Ukraine's 67th place showing in business and university R&D collaboration. For pay related to productivity and ease of finding skilled employees Ukraine is in 22nd and 57th places, respectively.

The Global Talent Index 2012 report, published by Heidrick & Struggles, shows similar results. In that report Ukraine ranked 12 worldwide based on quality of compulsory education and 17 in the Overall Talent Index.

In looking at the numbers of vacancies at the Ukrainian units of IT companies (Table 2) it becomes clear that the high index values we mentioned above form a basis on which Ukrainian units can hope to grow fast in the near future.

Turning to "The Global Information Technology Report 2013," we see that Ukraine is attractive from the point of view of IT tariffs: It's ranked number 2 globally for mobile cellular tariffs and 6 out of 144 for fixed broadband Internet tariffs. These excellent results speak persuasively for themselves.

Elsewhere this report lists Ukraine's adult literacy rate at 99.7%, putting Ukraine in fifth place out of 144. A full 32.1% of the workforce, furthermore, is employed in knowledge-intensive jobs (putting Ukraine in 38th place).

Let's take a look, too, at the World Bank's "Doing Business 2014" report. In the ease of doing business category, Ukraine is ranked 112 out of 189. Yet in the previous year Ukraine was ranked 137. For this reason the World Bank put Ukraine first among the 10 economies that improved the most across three or more areas since 2012/13.

According to the International Telecommunication Union's 2013 Report, "Measuring the Information Society," Ukraine's ICT Development Index is 4.64 (68th out of 157). Ukraine's ICT Development Index increased by 0.26 points, from 4.38 (69th place) to 4.64 (68th place), over the past year.

Among those advantages that Ukraine has and that competiveness reports often do not note is a convenient location (in Europe's heart, a two-hour flight from most European capitals) and a visa-free regime for the US, the EU, the CIS, Japan, Australia, and some other countries. These are simple advantages but significant ones, since other major ex-Soviet counties require visas from EU and US citizens. In addition, the Ukrainian mentality is pretty close to the European one.

All of these factors are crucial for ICT exports.

Practice as proof of the theory

To confirm the quality indicators for Ukrainian IT engineers that we mentioned above, we can take a look at multinational IT companies in the Ukrainian TOP-25 (Table 2).

Table 4. Growth of Software 500 IT companies with a presence in Ukraine

Rank	Year	Company	Revenue ($Million)	Revenue Growth	Employees WW	Employees Ukraine	Ukr Staff Growth	Out of Ukr Staff Growth
140	2013	EPAM Systems	433.780	29.67%	10,300	2,850	36.7%	23.7%
178	2013	Luxoft	301.070	19.44%	5,754	2,612	22.7%	2.1%
403	2012	DataArt	25.000	31.60%	720	276	32.7%	–
432	2013	Miratech	13.720	36.57%	600	600	18.1%	–

Source: *Software 500*

Table 4 clearly shows that multinational companies with presences in Ukraine prefer to grow mostly on the basis of their Ukrainian units. This proves that the Ukrainian labor market can find enough qualified experts on acceptable terms for employers.

Last year, three companies with large units in Ukraine (EPAM System, Intetics, Luxoft) and one Ukrainian company (Miratech) earned mention in the Fortune 500 among the world's best 100 outsourcers.

Source: *www.globalservicesmedia.com*

Nine of 25 companies mentioned among the Ukrainian TOP-25 IT companies (Table 2) were also in last year's "2013 Global Services 100" list of the world's best IT services providers: Ciklum, DataArt, EPAM Systems, GlobalLogic, Intetics, Lohika, Luxoft, Miratech, and SoftServe.

It's not only large IT companies in Ukraine that generated high demand all over the world – their IT staffers taken separately (freelancers) are also highly prized. According to oDesk, one of the largest international freelancer's exchanges, in the second quarter of 2013 alone, Ukrainian specialists earned about $8 million, for fourth place after India, the US, and the Philippines. The top three most popular projects are web programming, mobile applications, and desktop applications.

How to keep the growth going

1. Tax privileges and support from the government

The World Economic Forum's "Global Information Technology Report 2013" put Ukraine at 130 out of 144 for "Importance of ICT to the government's vision" and 122 out of 144 for "Government success in ICT promotion."

The IT industry support law that the Verkhovna Rada approved on January 22, 2012 marked the beginning of a range of positive developments in this area. As of November 2013, more than 150 Ukrainian IT companies had paid income taxes at a reduced rate of 5% instead of at the previous 25%.

Today, plenty of other evidence proves that the government's attitude towards the IT industry has changed drastically. In his opening speech at the meeting of the Cabinet of Ministers of Ukraine on October 30, 2013, Ukraine's Prime Minister Mykola Azarov said, "The Ukrainian IT industry already holds a certain leadership position in the world, and it has even greater potential. The consolidated European market can easily absorb this success. It's time to raise the issue of additional incentives that will create a new Ukrainian digital industry." At the end of his speech, the Prime Minister instructed the Ministry of Economics and Gosinformnauki to work with IT market participants to submit to the government a draft plan for Ukraine's strategic integration into the EU digital technology market.

In addition, the Ukrainian government decided to create a council that will assist the State Agency on Science, Innovations, and Informatization in implementing state policy in the IT sphere. The council's members include presidents of leading Ukrainian technical universities, members of Parliament, government agency representatives, well-known Ukrainian scientists, and IT company managers.

2. IT education

Obviously, no bounded system can grow indefinitely. Even without sufficient effective demand on the market the revenue growth of Ukrainian IT companies is limited by the number of qualified IT professionals available.

IT Ukraine, the association for Ukrainian IT professionals, surveyed IT education in this country in 2013. Supported by IT companies, IT Ukraine kept track of IT specialists graduating from 15 leading Ukrainian universities between 2000 and 2012. Though the total number of IT specialists graduating varies from year to year, the number of employed specialists tends to grow. This is a result of the increasing quality of IT education in Ukraine. But even if IT education in Ukraine is on solid ground, it can still get better.

Source: IT Ukraine Association

At least three things are necessary for increasing the supply of qualified IT workers:

- Increasing the range of IT services
- Improving the quality of IT education
- Creating new channels for effective training for IT specialists

Today, work is ongoing on all three fronts. The state order for training IT professionals has increased by 15%. Competition among candidates for the IT faculties of the leading Ukrainian universities significantly increased this year.

To improve IT education, the Ministry of Education and Science in 2013 established a working group to harmonize IT education with the requirements of modern IT companies.

3. Infrastructure

Currently, Ukraine is actively developing the Bionic Hills infrastructure project, which will be a distant analog of Silicon Valley. Smaller IT conglomerates, however, require new business centers in addition to huge infrastructural projects. There are two reasons why such centers are being built. First, there's the effectiveness with which IT conglomerates work (as proven by the experience of numerous countries). The second is that IT companies tend to be major tenants in commercial real estate in Ukraine. According to the consulting firm Colliers International, in 2012 the IT sector rented 35% of new offices, 14% more than it did in 2011. In the first half of 2013 IT companies formalized the three largest transactions in the real estate market. Analysts note that the active development of the IT industry in Ukraine is allowing participants to change their office premises.

Executive summary

After a 12-month study of ICT in different countries, Gartner included Ukraine in its list of the Top 30 Countries for Offshore Services in 2010 and named it one of the three most cost-attractive countries in the EMEA region. Today Ukraine continues strengthening its position in the IT outsourcing industry. Limited client IT budgets are prompting companies to move towards outsourcing service providers that deliver high-level service at low prices. Companies thinking of investing in technology or just outsourcing IT services will find a range of high-quality service providers in Ukraine.

АХА СТРАХУВАННЯ
змінюємо / стандарти

10 INSURANCE MARKET

UKRAINIAN INSURANCE MARKET REVIEW: CURRENT SITUATION, MAIN TRENDS, AND FORECASTS

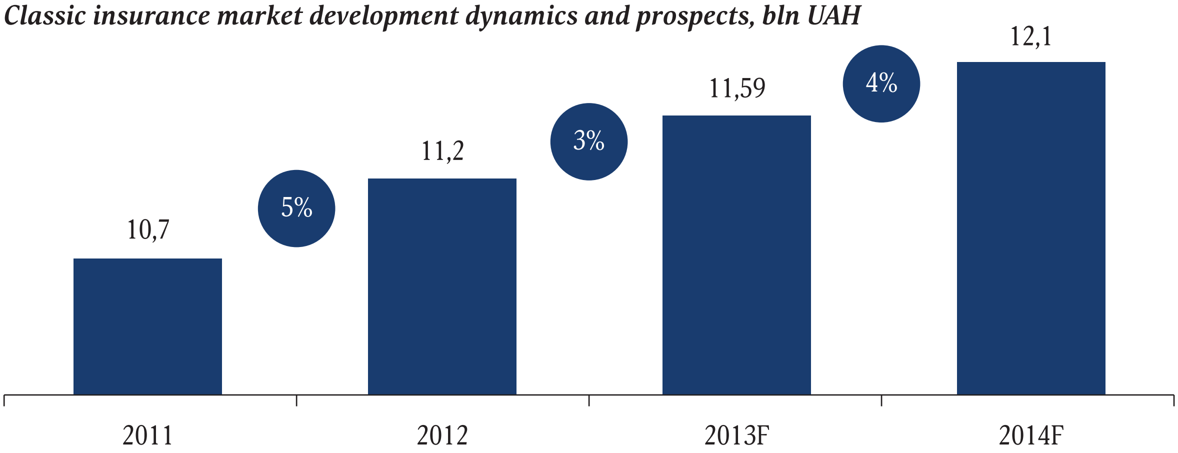
Andrey Peretyazhko, *First Vice President of AXA Insurance, President of the Ukrainian Insurance Federation*

Forecasts for the end of 2013 and 2014 years are based on the data cited in the article. Official insurance market results for 2013 will be available no earlier than the beginning of 2014.

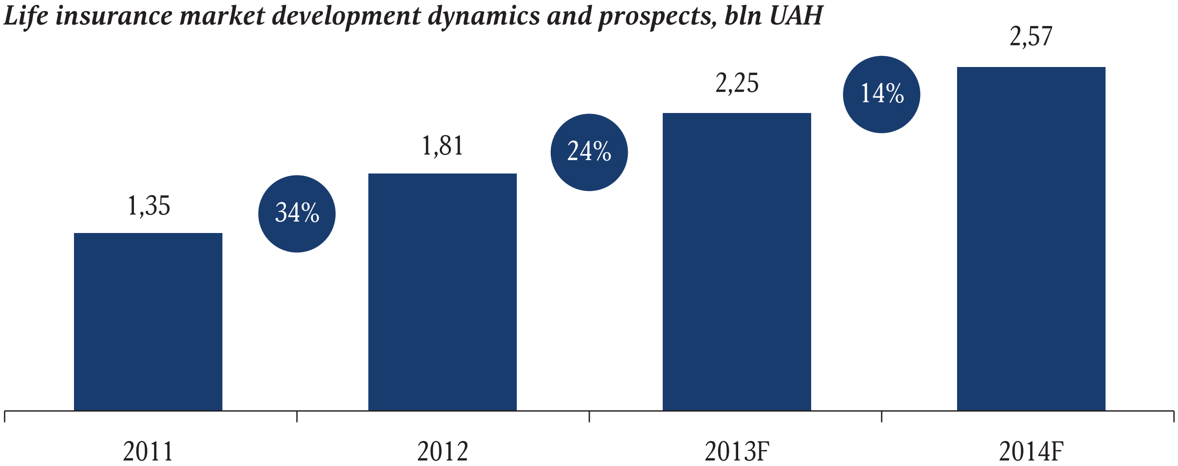
The situation in 2013

In 2013 classic insurance market growth rates decelerated, and will be in the range of 2%–3% in the risk segment and 10%–13% in the life insurance segment. If in 2012 the classic market grew by 5%, in 2013 forecasted growth in the non-life market came to about 3%. Growth rates on the life insurance market have been notably higher: 34% in 2012 and 13% in 2013. That comes to about UAH 2 billion in growth.

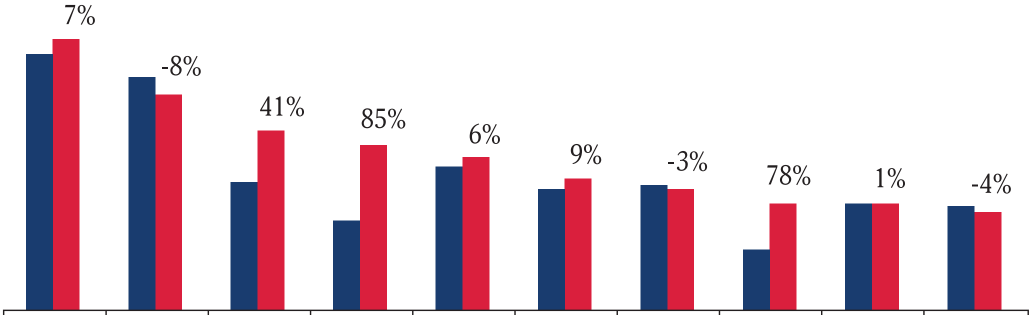
Classic insurance market development dynamics and prospects, bln UAH



Life insurance market development dynamics and prospects, bln UAH



TOP-10 Players on the P&C individual insurance market 2011–2012 (based on insurance premiums, UAH K)



	AXA	Oranta	Alfa Insurance	Arsenal	Providna	UNIQA	TAS	Naftagazstrakh	USG	UPSK
12m 2011	537 167	492 239	268 788	189 310	303 339	255 959	262 718	127 844	224 701	218 285
12m 2012	574 343	454 165	379 906	350 221	320 971	279 226	255 819	228 038	226 391	210 341
(+/-, %)	7%	-8%	41%	85%	6%	9%	-3%	78%	1%	-4%

Source: *"Insurance Top" magazine for 12 months 2012*

There are several main factors influencing the market. The first one is the acceleration of the CASCO decline rate. CASCO market growth in 2013 was improbable, and it will see decline of from 3% to 5%. The main reason for the decline was the introduction of a CASCO mortgage insurance credit portfolio, which formed before the crisis. The year 2013 was the last in which such contracts will be present in insurers' portfolios. Compensators that had to increase their premiums via new car sales and auto lending are even today demonstrating negative dynamics compared with a year ago. At best new business volume will stay at the 2012 level; at worst it will decline.

The next factor on the non-life market is MTPL, which represents the second-largest product. After the limit increase and the change of payment procedures in the life and health sphere, it made sense to expect higher prices for those types of insurance. Politically, however, the government is unready for an MTPL rate increase. Despite that this type of insurance has become unprofitable, we shouldn't count on a rate increase in 2013.

The property insurance market is seeing a similar situation. The mortgage market is stagnant: there are few new investors, and few new objects to insure. The only thing compensating for this situation is insurance that accompanies consumer lending. There is growth in the personal insurance segment (life insurance, accident insurance) and in the development of those property insurance contracts that accompany consumer lending or that are found on the retail market. Household appliance insurance is becoming more and more popular, providing additional growth in this segment.

Health insurance is also seeing constant growth, given the absence of any serious reform in the healthcare sphere. As before, the corporate sector is the main customer, and we're seeing a standard increase of 10–15% every year. All the other types of insurance, which make up on average 20% of the market, will most likely see no significant growth and will fail to influence growth rates for 2013.

Main trends

The last few years have seen several trends. The first is price and commission damping on the MTPL market. The regulator is still finding it impossible to put matters in order in this area. The number of insolvent companies and the amount of unpaid compensation or compensation paid only after long delays, and in unfair sums, is growing from month to month. This seriously damages the image of the whole insurance market, as it's the most common sort of insurance that is in question here, involving more than 8 million Ukrainians.

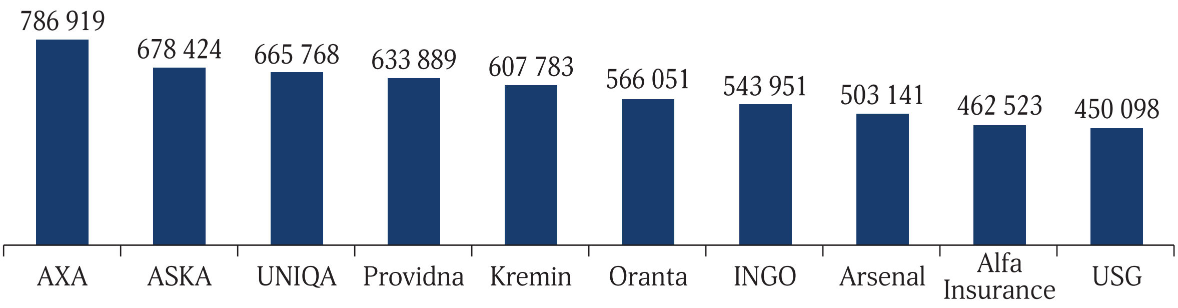
The second trend is the further decrease in property insurance rates, especially in the corporate sector, where a fierce price struggle is going on. Some players are trying to increase their shares of the CASCO market by resorting to price competition. If we observe the price policies of the main players/market leaders, however, we see no big changes: prices adequately reflect the efficiency of this type of insurance and the companies are trying to make at least a minimal profit in this largest non-life insurance market sector.

Although health insurance has been seeing some growth, there's still not enough profit. The main players realize that their portfolios often include clients that demonstrate high loss ratios. Despite their doing so, however, most of these clients are able each year to change their insurers and conclude agreements on favorable terms, thus directly damaging other insurers. It is probable that 2013 was a crucial year in this respect, one in which the main players decide (as they did with CASCO in 2009) that finally this type of insurance provides but a minimal profit; they'll then start cleaning out their portfolios and abandoning such clients in the interests of profitability. The market demands changes of this sort, and sooner or later will see them.

As for life insurance, a main problem is the single social dues fee that's calculated on personal types of insurance. It strongly damages the corporate sector, first and foremost in the area of long term life insurance for company employees. This problem came up more than two years ago. By average estimates, the market lost a minimum of UAH 400 million in payments in the last three years. The market has been deprived of UAH 800 million in growth in recent years. Lobbying for improvement in this area is currently a main concern for life insurers.

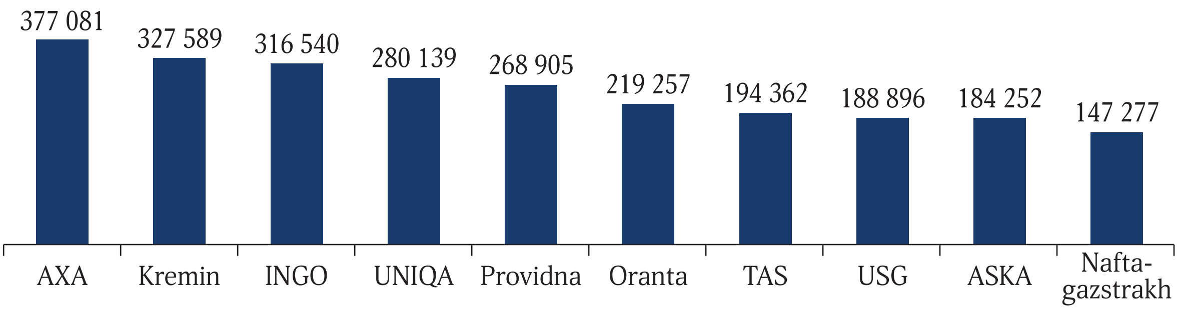
As regards new players, big foreign players cannot be expected to enter the market. Yet many companies that can neither solve their capital problems nor attract additional investment are transforming one way or another. New owners are appearing and companies are leaving the market or trying to merge with other insurance companies. In 2013 several insurers were forecasted to appear on the market that would rapidly gain momentum based on two factors: the first is lobbying; the second is that these companies form parts of fast-growing financial and industrial groups.

TOP-10 Players on the P&C insurance market (based on insurance premiums, UAH K)



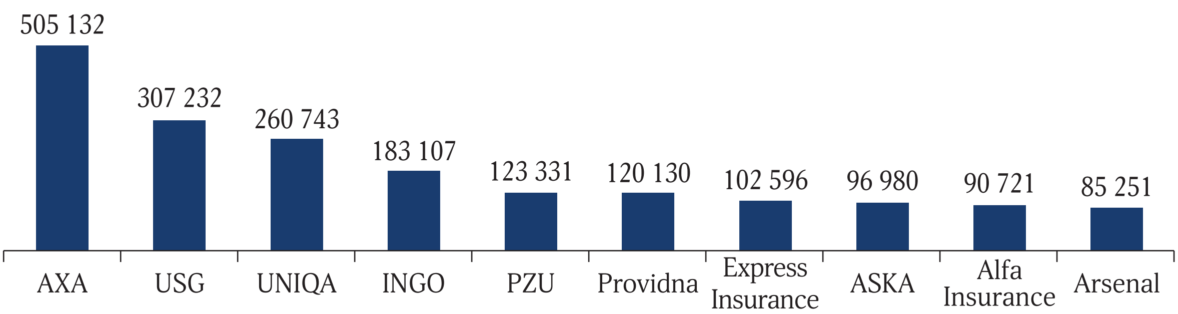
Source: *"Insurance Top" magazine for 12 months 2012*

TOP-10 Players on the P&C insurance market (based on insurance payments, UAH K)



Source: *"Insurance Top" magazine for 12 months 2012*

TOP-10 Players on the CASCO insurance market (based on insurance premiums, UAH K)



Source: *"Insurance Top" magazine for 12 months 2012*

GRISCHENKO & PARTNERS
LAW AND PATENT OFFICES

11 INTELLECTUAL PROPERTY RIGHTS

IS THE CUSTOMS REGISTER OF INTELLECTUAL PROPERTY OBJECTS A REMEDY FOR PROTECTING IP OWNER RIGHTS OR A PROFIT-GENERATING INSTRUMENT FOR PATENT TROLLS?

To accede to the Common Economic Space, Ukraine must meet a number of obligations to harmonize its legislation with international law. Specifically at issue are laws protecting intellectual property and controlling trafficking in counterfeit and pirated goods in Ukraine.[1] Administrative levers play a significant role in preventing trafficking of that sort, including those of the Customs Office of Ukraine, which is charged with protecting intellectual property rights at the customs border.

The advantages of the new Customs Code of Ukraine, which took effect in June 2012, include that it better protects intellectual property rights when goods cross the country's customs border. In particular, it prescribes a special procedure for customs control and clearance of goods containing intellectual property objects[2] and an appropriate procedure for how customs agencies should interact with each other. Ukraine's current customs laws provide for quite an efficient way to protect intellectual property rights holders against imports or exports of counterfeit goods: adding intellectual property objects to the Customs Register of Intellectual Property Rights (hereinafter the Customs Register), which is maintained by the Customs Department of the Ministry of Revenue and Duties.

The Customs Register's task is to enable a rights owner that believes that movement of goods across Ukraine's customs border may infringe on its rights to appeal to prevent that movement. Based on Customs Register data the customs agencies then decide to suspend customs clearance of the goods for up to 10 business days. The rights holder has 10 business days after receiving the customs clearance suspension notice to inform the customs agency in writing about any judicial recourse it is taking to protect its rights; or to file a written request for an extension of the suspension (for not more than 10 additional business days). If there is no evidence of a violation, the suspended goods are cleared on common terms.

Some economic entities have recently seen certain persons unfairly take the opportunity to add intellectual property objects, such as industrial design patents, to the Customs Register. The goal is to suspend the customs clearance of original goods and require their importers/exporters to make payments (so-called "royalties") so that the goods can be freely imported or exported. An electronic version of the Customs Register indicates that there recently joined it industrial items, such as "bottle cork," "bearing," and "tablet computer," protection of which is sought by Ukrainians who have obtained patents for them.

These manifestly unfair practices are possible because the intellectual property laws are imperfect. Although the Law of Ukraine "On the Protection of Rights to Industrial Designs" determines novelty as the key criterion for the patentability of an industrial design, the relevant regulation – the Rules for Examination of an Industrial Design Application – as

[1] *This issue is receiving special international attention. See, for example, http://www.kyivpost.com/content/business/us-ambassador-protection-of-intellectual-property-rights-should-be-a-priority-for-ukraine-330899.html.*

[2] *In accordance with the Customs Code, intellectual property objects include objects of copyright and associated rights, inventions, utility models, industrial designs, trademarks, geographical indications, and plant varieties.*

approved by Ministry of Education and Science Order № 198 dated March 18, 2002, provides for only a formal expert examination of an application, with no verification of an industrial design's conformity with the novelty criterion.

The laws are widely exploited by unscrupulous rights holders, so-called "patent trolls," who can be both individuals and legal entities. These "trolls" patent industrial designs — sets of essential features that became generally available before the application date — and then file patent appeals and claims in order to enrich themselves at the expense of the original product owners or exporters/importers.

What should exporters/importers, dealers, and retailers do in response to patent trolls? Analysis of the law indicates that a valid patent for an industrial design may only be invalidated at law, via a claim filed by the entity whose rights are being infringed. As executive authorities, the customs agencies are legally required to protect a patent holder's exclusive rights. They're required to help the rights holder protect its rights, even if that holder acquired them unfairly, and thus to suspend customs clearance of the goods in question as per that right holder's request. There currently appears to be no way to protect against patent troll blackmail other than to bring a legal action to terminate a troll's patent. To prevent such problems in the future, a manufacturer (or importer/exporter) of a certain good should also register the industrial design for it and add it to the Customs Register. This will definitely indemnify a manufacturer (importer/exporter) from the claims of patent trolls.

Solving the same problem at the state level will mean changing the intellectual property laws, specifically the Law of Ukraine "On the Protection of Industrial Designs" and the relevant regulations. To this end, it's necessary to require that, before it issues an industrial design patent, the State Intellectual Property Office not only examine the application, but also determine whether the object meets the novelty condition.

In addition, the Verkhovna Rada should empower the Chamber of Appeals of the State Intellectual Property Office to consider administrative appeals filed by concerned third parties (such as importers, manufacturers, and sellers of goods) and to terminate patents that do not meet patentability criteria (such as the novelty criterion). The possibility of terminating patents administratively would substantially lighten the load on the court system and shorten the appeals process, thus improving the situation.

The patent troll problem requires work on the part of the legal community. At stake is the development of international commerce and foreign economic relations and the quality of Ukraine's investment climate.

THE ROAD TO RECOVERY

Insights from an international study of business “birth” and “death” rates in 35 countries around the globe, including Ukraine by RSM International

Preview

Starting with a marked global economic decline from December 2007 onwards, the Great Recession, as it has come to be known, has affected the entire world economy. However, there are stark differences in the degree to which each individual country has been, and continues to be, affected.

Business creation is one of the most telling indicators of economic vitality. In this paper we have looked at new business creation and destruction – or births and deaths – in 35 key global markets. The results make for fascinating reading. The challenges faced by the advanced industrial economies are significant and, more than five years since the financial crisis began, have not been fully overcome. Many developed nations are caught between the dilemma of debt reduction and the need to raise taxes to facilitate that process. Both debt reduction and tax rises, however, can impede entrepreneurship. Reduced public spending has sent many firms that supply the public sector out of business, while tax rises have eaten into the ability of businesses to invest and create jobs.

Entrepreneurs in wealthy economies are facing other challenges, not least banks with the burden of bad debts that are still reluctant to fund what they perceive to be ‘risky’ startups. In fact, access to capital may be the single biggest constraint on new business creation in advanced economies. The dilemma faced by governments – how to repair public finances and reach a sustainable fiscal position without suffocating entrepreneurship – has vexed economists. Western banks, bruised from the credit crisis and struggling with bad debts, are being asked to bolster capital buffers, but enhanced capital requirements inevitably reduce their capacity to lend to the real economy. This is not an easy conundrum for governments to solve, but it is clear that the banking crisis has had a long-lasting impact on the ability of many economies to finance business creation and sustain those enterprises over the longer term.[1]

Creative destruction

The process of creative destruction permits the redeployment of productive resources (labour, capital, technology) tied down in uncompetitive businesses to new market players better able to make efficient use of those assets.

In his classic 1942 book Capitalism, Socialism and Democracy, the Austrian economist Joseph Schumpeter[2] described the interplay of business births and deaths as the central feature of capitalism:

“The opening up of new markets, foreign or domestic, and the organisational development from the craft shop and factory...illustrate the same process of industrial mutation–if I may use that biological term–that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism.”

In Schumpeter’s view, the “gales of creative destruction” characteristic of modern capitalism enable the generation of new economic value. As weak companies exit the scene, dynamic start-ups enter the market with superior products and services. The process of creative de-

[1] Jean Stephens, CEO, RSM International.

[2] Joseph Alois Schumpeter (8 February 1883 – 8 January 1950) was an Austrian American economist and political scientist. He is widely regarded as one of the most influential economists of the 20th century, cited by The Economist magazine (Aug 2012) as “the champion of innovation and entrepreneurship whose writing showed an understanding of the benefits and dangers of business that proved to be far ahead of its time.”

struction permits the redeployment of productive resources (labour, capital, technology) tied down in uncompetitive businesses to new market players better able to make efficient use of those assets.

Against this backdrop, RSM has conducted a comparative study of business births and deaths. Drawing on data collected by RSM member firms and a wide variety of international statistical sources, this paper examines global, regional, and national trends in the entry and exit of companies. It reviews the extent to which economies are creating and sustaining new businesses, identifying what some governments are doing to encourage entrepreneurship, and comparing the impact of the global financial crisis on business creation across diverse global economies.[1]

Drivers of business births & deaths

The laws, regulations, and governance structures of national economies strongly influence rates of business births and deaths. The World Bank's widely cited Ease of Doing Business Index tracks the institutional factors affecting company formation and closure:

Starting a Business: Time, cost, procedures, and minimum paid-in capital needed to start and operate a business

Getting Credit: Ability of start-up companies to obtain working capital; availability of credit agencies to evaluate the creditworthiness of entrepreneurial firms; legal rights of lenders and borrowers

Protecting Investors: Reporting requirements of start-up companies seeking investment capital; transparency of financial documentation; shareholder rights; protection of minority investors

Enforcing Contracts: Time, cost, and procedural complexity of commercial lawsuits; availability of dispute resolution mechanisms; speed and efficiency of judicial processes

Resolving Insolvency: Bankruptcy laws; liquidation procedures; asset recovery arrangements; company wind-up practices

One would anticipate high business "churn" (the sum of enterprise births and deaths) in countries that perform well in the above-cited metrics: Australia, Canada, Hong Kong, New Zealand, Singapore, the United States, the United Kingdom, et al. In these countries, the procedures for starting, registering, and funding new businesses are comparatively fast, efficient, and low cost. Similarly, the legal/regulatory arrangements governing the closure of companies (particularly the disposition of liquidated assets) are predictable and transparent in those countries. By contrast, one would expect relatively low rates of business births and deaths in developing countries where the rules and regulations governing company formation and closure are costly, opaque, and time-consuming. This includes countries in Sub-Saharan Africa beset by authoritarianism and political conflict (e.g. the DRC, Zimbabwe), unstable countries in the Middle East (e.g. Iran, Iraq, Syria), and former Soviet republics where market-friendly reforms have not taken hold (e.g. Tajikistan, Uzbekistan).

However, RSM's research indicates that the relationship between institutional structure and business churn is highly complex. A case in point is the BRICS group of large emerging markets. Those countries rank low in the World Bank's Ease of Doing Business Index: China #91, Russia #112, Brazil #131, India #132. But RSM's analysis demonstrates that the BRIC countries have outperformed the advanced industrialized economies in business creation since the 2007 financial crisis, collectively posting a rate of net company formation nearly eight times that of the G7 countries.

Research now shows that despite the low rating of Ukraine in terms of ease of doing business according to the World Bank, Ukraine is not far behind BRICS and well ahead of many developed countries in terms of business births and deaths.

Global trends in business demography

RSM's comparative data set highlights recent global trends in business demography. By tracking enterprise births and deaths during the period preceding and following the Great Recession, this data provides important insights on how companies worldwide responded to the deepest economic downturn since the 1930s.

Next figure reports changes in the active company registries of select countries between 2007 and 2011. These registries reflect the net effects of company entries and exits, and thus serve as an indicator of business formation in the selected countries. The findings are illuminating:

- The G7 countries (Canada, France, Germany, Italy, Japan, the U.K., the U.S.) experienced a net addition of just 846,000 companies in 2007–11 for a compound annual growth rate of 0,8 %. Within that group, France posted the strongest growth of net enterprise formation (CAGR 4,5 %).

[1] *David Bartlett, Economic Advisor to RSM.*

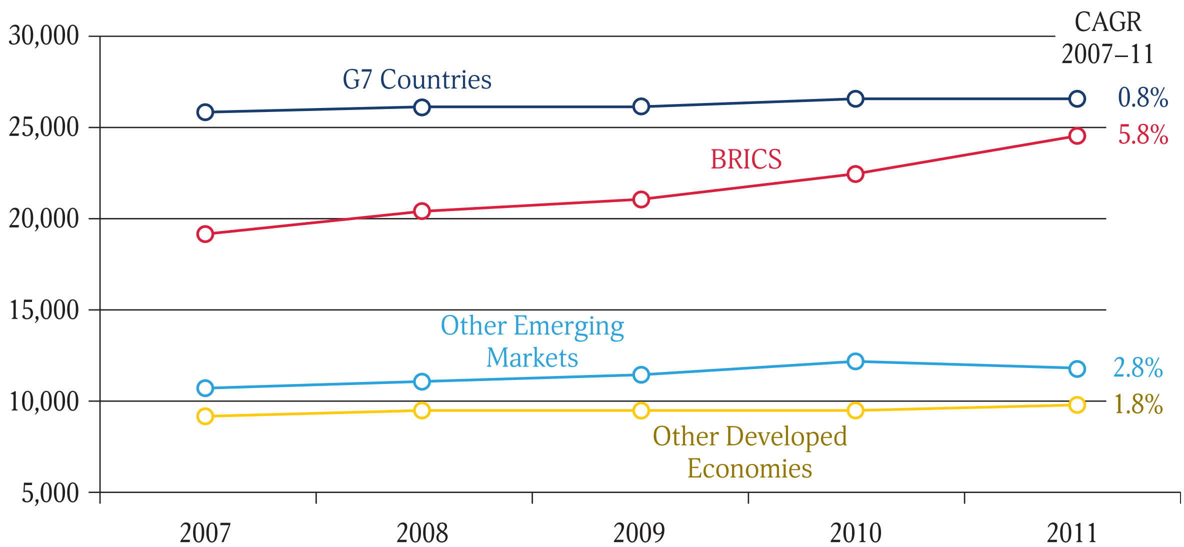
- During the same period, the BRICS (Brazil, Russia, India, China, South Africa) generated a net addition of 4.8 million companies for a CAGR of 5,8 %. China led that group with an increase of 2,9 million companies (CAGR 6,8 %). South Africa (which formally entered BRICS in 2012 but whose active registry numbers are reported for the whole period) is the laggard of the group, incurring a net loss of 138,000 enterprises.
- Other emerging markets reported strong rates of net business formation: Hong Kong 9,9 %, Mexico 6,6 %, and Ukraine 5,2 %, with Hong Kong leading the table of 35 countries (Appendix).

Change in number of active enterprises (in 000's), 2007–11

The results of RSM's active company register analysis mirror the broader trajectory of the world economy since 2007, with the robust emerging markets exhibiting higher rates of net business formation than the slow-growing developed economies of Europe, Developed Asia, and North America.

Since 2007, the BRIC countries have outperformed the advanced industrialized economies in business creation, posting a rate of net company formation nearly eight times that of the G7.

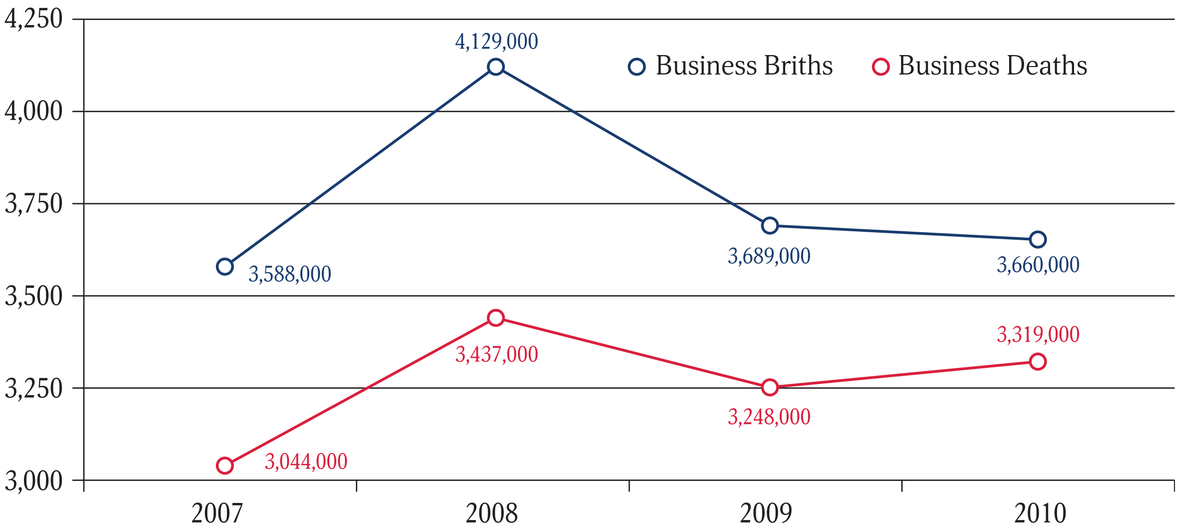
Business Formation in the World Economy
Active Company Register, Selected Countries, 2007–11 (Thousands of Companies)



Source: *RSM International Research*

The figure below reports total business births and deaths in a select group of countries in 2007–10. The data indicates a sharp increase in business churn in 2007–08, when enterprise deaths increased by 17,9 % and births by 20,1 %. The rate of business births in this sample declined in 2009–10, converging toward pre-recession levels. The trajectory of business deaths stabilized during that period, albeit at a higher rate than the pre-recession period. Preliminary data for 2011–12 suggest a continuation of this general pattern, as enterprise births have eclipsed deaths to produce a net positive business formation.

Total Business Births and Deaths
Selected Countries*, 2007–10 (Thousands)



* Brazil, Czech Republic, Germany, Greece, Hong Kong, India, Italy, Japan, Netherlands, Poland, Russia, Sweden, United Kingdom, United States, Turkey

Source: *RSM International Research*

Changes in the number of active companies in Ukraine from 2007 to 2011 (see Appendix 1) confirm the above pattern. The level of business births overtakes business death level throughout all period of study. Ukraine reports the sharpest increase in business charm by 7,6% in 2007–2008. In the following years there is a clear tendency to decline in new business formation with the least net positive result for the years 2010–2011 and a decrease in business charm to 3,6%.

Next figure reports compound annual growth rates of new company formation in a select group of countries between 2007 and 2011. The findings are illuminating:

New Company Formation
Business Births, CAGR 2007–11

France	65,4%	Austria	49,0%
Japan	58,6%	Germany	49,0%
Poland	55,3%	Bulgaria	47,4%
Brazil	54,0%	Russia	47,2%
Hong Kong	53,9%	Portugal	46,7%
Czech Republic	53,4%	United States	46,2%
Albania	53,1%	United Kindom	46,1%
Singapore	51,6%	Norway	43,4%
India	51,5%	Greece	42,0%
Taiwan	51,3%	Croatia	41,4%
Tunisia	50,8%	**Ukraine**	42,2%
Netherlands	50,2%	Ireland	41,0%
Belgium	49,2%	New Zealand	38,8%
Sweden	49,2%	Tukey	30,3%

Among the G7 group of developed countries, France posted the largest increase in the total number of active enterprises over the last five years – an increase of 562,000, representing a 19,1 % increase, or 4,5 % expressed as a compound annual growth rate. This result is surprising in view of the fact that other G7 countries (Australia, Canada, Germany, the U.S.), have registered stronger GDP growth rates than France.

To bolster the country's flagging economic competitiveness the French government has taken important steps to spur new business creation. In 2009, the government launched a programme for small businesses called "Auto Entrepreneur" that prompted a surge in startups.

Auto Entrepreneurs are micro businesses with turnovers under €80,000 for industrial enterprises and under €32,000 for services. The scheme simplifies and reduces the tax liabilities of small businesses, enabling Auto Entrepreneurs to avoid many of the heavy social charges levied on employers in France.

The success of the Auto Entrepreneur scheme measured by new business growth inspired the French government to introduce a two year limit and lower income thresholds in order to harmonize the tax treatment of small companies. While critics argue that the Auto Entrepreneur programme has merely created a tax haven for the self-employed, the scheme is widely credited for stimulating new business growth and invigorating French entrepreneurs.

Ukraine is also experienced in taking steps to reduce the tax burden on small business. The simplified system of taxation, accounting and reporting of small businesses was introduced in Ukraine in 1998, and since 01 January 2012, lawmakers have introduced new rules for its implementation and a number of other positive changes.

These include a double reduction in single tax rate as a percentage of revenue, increase of the maximum allowable annual revenue and others. Although it can be assumed that in making these changes the government hoped to increase state budget revenues.

Despite a number of limitations to the use of the simplified tax system, additional single tax rates in some cases, and the range of fines provided for, in our view, these changes have led to an increased number of small businesses and positively influenced the development of small and medium businesses in Ukraine, especially in field of services, trade etc.

Conclusions of the RSM study

Amid a global financial crisis and recession of historic proportions, entrepreneurs around the world have launched new companies in a wide range of industries. A number of these start-up companies did not survive the post-recession period, as continuing limits on growth capital and a weak global recovery forced the closure of newly-formed enterprises. But the surviving start-ups provide a foundation for economic growth in coming years: the new enterprises that managed to withstand the recent economic and financial headwinds are the ones possessing the competitive assets (skilled managers, strong technology, superior products and services) requisite for sustained growth.

This survey of enterprise births and deaths offers valuable insights into the international business environment of the post-recession era:

- Despite a challenging economic environment, new business formation continues to grow in a number of advanced industrialized countries, including statist economies like France and Japan commonly seen as inhospitable to entrepreneurs. The French model has been heavily influenced by initiatives such as the Auto Entrepreneur programme.
- RSM's research into business births/deaths reveals a significant performance gap between developed and emerging markets, with the BRICS countries outpacing the G7 economies in net business formation after 2007. That result echoes broader trends in the world economy, as emerging markets display increasing dynamism amid slow growth in the advanced industrialized countries.
- RSM's research shows important differences within the emerging market group. For example, South Africa lags behind the other BRIC countries and Ukraine in net business formation despite its more sophisticated legal/institutional structure.

Results of the RSM study in Ukraine

Statistical results obtained by RSM APIK on the number of active enterprises showed that in the period from 2007 to 2011 their number in Ukraine increased by 523,000 companies, representing a

5,2% compound annual growth rate. The same aggregate growth rate is shown by the Netherlands, one of the leading advanced economies, which outperformed a number of other countries with developed economies and institutional structures, and Brazil, which ranks second after the U.S. in overall business formation.

Ukraine's positive results are also associated with changes in the institutional structure of the country in terms of the World Bank's Ease of Doing Business Index. According to this study, in 2013, 2011, and 2012 Ukraine implemented significant reforms in three main regulatory areas: starting a business, registering property, and taxation. These changes will allow Ukraine to enter the top 10 most heavily reformed world economies. These changes will allow Ukraine to enter the top 10 most heavily reformed world economies. According to the rankings, Ukraine improved its position by 18 points in the "Tax" index (moving from #183 to # 165) and thus was able to finally overtake the countries with the highest tax burden in the 2013 ranking.

According to investors, Ukraine's tax system moved from being characterized by four major barriers to being characterized by four less disturbing ones, thus improving the investment climate. Entrepreneurs believe that in quarters 3–4 of 2012 several problems were resolved: filing documents became less time-consuming, personal contact with tax authorities stopped being required, and online filing became available.

The positive trends in business formation that Brazil and France have seen reaffirm that governments can do more to encourage entrepreneurship and help businesses thrive.

The situation in Ukraine requires close cooperation between banks, businesses, and the government. The government's role in this process is primarily to improve the legal framework. It is possible to boost business activity by simplifying the mechanisms for lending to small businesses. For now, banks abstain from lending to domestic businesses due to the lack of protection of their interests, to the fact that there are no real mechanisms for non-performing loans, to lack of transparency, and to the low profitability that small businesses post.

To improve the investment climate and promote entrepreneurship Ukraine should continue to develop constitutional guarantees for protection of investors and investments and ensure their maximum transparency.

According to the Law "On Stimulation of Investment in Priority Sectors of the Economy for the Purpose of Creating Jobs," investors are offered certain incentives; however, the procedures for obtaining them require revision in many cases. According to analysis, 70% of appeals considered by the National Securities and Stock Market Commission in 2012 came from minority shareholders on violation of their rights and about 11% were associated with changes in legislation.

The progress our country has made and the results of RSM International's research encourage optimism, but if we are to see Ukraine among the developed countries, those with high rates of investment attractiveness and a favorable business environment, considerable effort is still required from the government and the business community.

Methodology, sources & appendix

This paper is based on business demography data collected by RSM International member firms in 35 countries. The database draws on information from national statistical offices on active company registers and new business births and company deaths between 2007 and 2011.

Yearly changes in the company registers permit calculation of net business formation in the sampled countries. Yearly increments of new company births and deaths enable a comparative analysis of business churn trends within and between the developed economy and emerging market groups. The data collected has also been cross-referenced against other publically available research and analysis including the Eurostat Business Demography Indicators and the OECD Structural and Demographic Business Statistics.

RSM acknowledges that differences in national statistical reporting methods hinder the use of fully standardized statistics for country-country comparisons. Against that qualification, RSM has a high level of confidence in the findings and conclusions of this study.[1]

[1] *For full article, please see our site www.rsmapik.com.ua*

Total number of active enterprises (in 000s), 2007–11

	2007	2008	2009	2010	2011	Compound annual growth rate
G7	25,968	26,293	26,344	26,543	26,814	0,8%
BRICS	19,361	20,386	21,266	22,644	24,219	5,8%
Hong Kong	655	711	772	864	956	9,9%
Cyprus	184	208	221	237	254	8,4%
Albania	80,1	94.5	95	103	109	8,0%
China	9,600	9,715	10,427	11,365	12,531	6,9%
Switzerland	499	514	526	537	648	6,8%
Mexico	1,093	1,157	1,213	1,316	1,411	6,6%
Russia	3,635	4,232	4,470	4,556	4,555	5,8%
Brazil	4,420	4,607	4,847	5,129	5,414	5,2%
Netherlands	956	1,021	1,089	1,124	1,170	5,2%
Ukraine	2,337	2,516	2,685	2,759	2,860	5,2%
Singapore	329	358	367	382	397	4,8%
India	750	789	803	847	902	4,7%
France	2,949	3,022	3,107	3,318	3,511	4,5%
New Zealand	474	506	521	533	564	4,4%
Tunisia	520	542	568	597	602	3,7%
Malta	57	59	61	63	65	3,3%
Croatia	119	132	132	142	129	1,9%
Belgium	714	731	746	753	768	1,8%
Norway	400	410	415	419	425	1,5%
Turkey	2,567	2,594	2,614	2,652	2,715	1,4%
Greece	949	968	975	982	995	1,2%
Poland	3,347	3,410	3,386	3,537	3,490	1,1%
Australia	2,074	2,071	2,051	2,125	2,132	0,7%
UK	2,280	2,326	2,342	2,351	2,343	0,7%
Canada	2,342	2,325	2,379	2,428	2,405	0,7%
Germany	3,140	3,186	3,135	3,165	3,215	0,6%
Ireland	181	184	185	186	185	0,6%
Austria	403	406	401	406	409	0,4%
US***	8,681	8,789	8,709	8,696	8,776	0,3%
Italy	3,982	4,042	4,054	3,998	3,985	0,0%
Taiwan	600	578	579	586	597	-0,1%
Japan	2,594	2,603	2,617	2,587	2,579	-0,1%
Sweden	1,076	1,045	1,026	1,008	1,044	-0,8%
Portugal	616	631	612	590	596	-0,8%
South Africa	956	1,042	719	747	818	-3,8%

13 LEGAL SYSTEM

LEGAL SYSTEM OVERVIEW

Court System

The Ukrainian court system consists of courts of general jurisdiction and the Constitutional Court of Ukraine. The courts of general jurisdiction are organized according to the principles of territoriality and specialization and include the following: local courts; appellate courts; the High Specialized Courts; and the Supreme Court of Ukraine, as Diagram 1 below shows.

The Ukrainian Court System

	Supreme Court of Ukraine		
	Review of decisions of the High Specialized Courts in limited cases identified according to the procedural rules		
Cassation Instance	High specialized court for civil and criminal cases	High commercial court	High administrative court
	Cassation review of commercial, administrative, civil, and criminal cases.		
Second Instance	Appellate courts	Appellate commercial courts	Appellate administrative courts
	Consideration of cases at appeal		
First Instance	Local general courts	Local commercial administrative courts courts	Local administrative courts
	Initial consideration of cases		

In addition, the Supreme Court of Ukraine issues decisions pertaining to the impeachment of the President of Ukraine.

Since Ukraine is a civil law country, the exercise of judicial power is based on the application of statutes. Due to recent procedural changes, however, Ukrainian courts can refer to and consider decisions of the Supreme Court of Ukraine in deciding a dispute.

Commercial litigation in Ukraine

As a general rule, a commercial court will review any business-related dispute between business entities (including individual entrepreneurs). Commercial cases involving individuals will be adjudicated in local general courts.

There are no limitations (including monetary limits) on the jurisdiction of the commercial courts, other than specialization and territorial factors.

Ukrainian courts' jurisdiction over disputes involving a "foreign element" is established in accordance with the Law of Ukraine "On International Private Law." This law lists those disputes with a foreign element that Ukrainian courts are to review. The list includes cases in which (1) parties previously agreed on Ukrainian court jurisdiction; or (2) the damage that is the subject of the dispute took place on the territory of Ukraine; or (3) the act or event that is the cause of the dispute took place on the territory of Ukraine. This law also lists disputes falling within the exclusive jurisdiction of Ukrainian courts. Such disputes include disputes (1) on real estate located in Ukraine; (2) over intellectual property rights that require registration on the territory of Ukraine; (3) bankruptcy disputes, provided that the debtor has been incorporated under the laws of Ukraine; or (4) cases relating to issuance or annulment of securities originating in Ukraine.

There remains, however, a certain inconsistency in how Ukrainian courts apply these provisions.

Commercial arbitration

There are currently two well-established arbitration institutions in Ukraine: the International Commercial Arbitration Court of the Chamber of Commerce and Industry of Ukraine and the Maritime Arbitration Commission of the Chamber of Commerce and Industry of Ukraine.

A business-related dispute between a foreign legal entity or individual entrepreneur and a Ukrainian legal entity or individual entrepreneur may, by agreement of the parties, be referred to international commercial arbitration and settled by either an ad hoc arbitration tribunal or an arbitration institute, either within or outside Ukraine. A business-related dispute involving only Ukrainian parties with no foreign investments may, depending on the subject matter of a particular dispute, be referred to domestic arbitration (treteisky sud) on the territory of Ukraine only and is not subject to international commercial arbitration. At the same time, disputes between Ukrainian legal entities with foreign investment or between participants in them, as well as disputes between such entities and other Ukrainian entities, may be referred to international commercial arbitration.

Companies

The basic rules governing the establishment, maintenance and liquidation of business legal entities, as well as governing mergers and acquisitions in Ukraine, are provided in the Civil Code of Ukraine and the Commercial Code of Ukraine, both adopted on January 16, 2003 and effective since January 1, 2004. Apart from the Civil Code and the Commercial Code, the Law of Ukraine "On Companies" (the Company Law), dated September 19, 1991, and the Law of Ukraine "On Joint Stock Companies" (the JSC Law), dated September 17, 2008, govern various issues related to mergers and acquisitions, as well as to establishing, maintaining, and liquidating companies in Ukraine.

Under the Civil Code, legal entities that carry out entrepreneurial activities in order to earn profit must be established as companies. The following types of companies may be established in Ukraine: general partnership, limited partnership, added liability company, limited liability company, and joint stock company.

Of these, the most common vehicles for conducting business activities in Ukraine are joint stock companies (JSCs) and limited liability companies (LLCs), both of which embody the concept of limited liability for investors.

Joint Stock Companies

JSCs are very similar in form and operation to US corporations, German AGs, and French sociétés anonymes (SAs). A JSC is a company whose charter capital is divided into shares of equal par value. Shareholders of a JSC are liable for the latter's obligations only to the extent of their equity contributions to its charter capital.

A JSC may exist as either a public or a private company (the rough equivalents of the open and closed JSCs that existed under the former legislation). A JSC may be established either by a single founder or by a group of founders. The number of shareholders in a private JSC may not be more than 100. A JSC may not be owned by a shareholder if it is a wholly-owned subsidiary itself. One and the same legal entity or individual cannot wholly own all of the shareholders in a JSC.

A minimum capitalization of 1,250 times the minimum monthly salary as of the date of the JSC's formation is required in order to establish it. The minimum monthly salary is established by the state budget law for each year. In December 2013 it was UAH 1,218 (approximately $152.4), meaning that the minimum capitalization amount was UAH 1,522,500 (approximately $190,479).

The first issuance of shares upon the establishment of either a public or a private JSC must be made exclusively by means of a private placement of shares among its founders.

A public JSC may issue additional shares by means of public and private placements of shares. Furthermore, a public JSC is obliged to ensure that its shares are admitted for trading on at least one Ukrainian stock exchange, while it is not mandatory to undergo the listing procedure.

A private JSC may issue additional shares only by means of a private placement of shares. If a private JSC's shareholders' meeting decides to carry out a public placement of its shares, then that JSC's charter must be amended; in particular, the JSC must be changed from a private one to a public one. Changing a JSC from private to public and vice versa is not considered to represent the JSC's transformation.

An issuance of shares by either a private or a public JSC must be registered with the Ukrainian National Commission on Securities and the Stock Market (the Securities Commission) by means of the registration of the share issue, prospectus, and report on the results of the placement of the shares. Upon registration the Securities Commission issues a certificate on the registration of the share issue. In the event that a JSC fails to register any issue of its shares with the Securities Commission, any and all of the share purchase agreements it entered into with respect to the share issue, as well as with respect to any subsequent share issues, will be deemed ineffective.

Limited Liability Companies

Legally, an LLC is similar to a German GmbH and a French société à responsibilité limitée (SARL). Investors in an LLC, i.e., its interest-holders or participants, are liable for its commitments only to the extent of their contributions to its charter capital. Their participatory (that is, ownership) interests in the LLC are expressed in the form of relevant percentages of the LLC's charter capital. Participatory interests in an LLC do not qualify as "securities" for the purposes of the applicable Ukrainian legislation and therefore are not subject to registration with the Securities Commission.

Similar to a JSC, an LLC may be established either by a single founder or by a group of founders. The maximum number of founders/participants of an LLC may not exceed 100 legal entities or individuals. An LLC may not be a wholly-owned subsidiary if its sole participant is a wholly-owned subsidiary itself. An individual or a legal entity is not allowed to be the sole participant in more than one LLC in Ukraine.

There are no legal restrictions on how the participatory interests of an LLC may be distributed. This issue remains entirely within the discretion of the founders of the LLC. Currently there is no minimum capitalization requirement for an LLC.

Representative Offices/Branches

Ukrainian legislation provides that representative offices are deemed to be structural divisions of an enterprise, albeit located in localities different from the locality of the headquarters of the enterprise. "Branches" of foreign enterprises do not technically exist in Ukraine, but representative offices are their closest equivalent. Representative offices do not enjoy the status of separate legal entities.

A foreign legal entity may establish a representative office in Ukraine in order to carry out marketing, promotional, and other auxiliary functions on behalf of the foreign legal entity. It is less clear whether a foreign legal entity may also conduct trade or business through a representative office, although "commercial" representative offices (in effect, the equivalents of "branches" of foreign enterprises in most other countries) are quite common in Ukraine. Recent practice has been to permit a representative office to carry out a wide range of commercial activities (including signing contracts and conducting import, export, and other transactions). Normally, such practices result in the creation of a permanent establishment in Ukraine for tax purposes; the commercial representative office's activities thus become taxable in Ukraine (whereas, generally speaking, the activities of a representative office are non-taxable). In some cases it is required either as a matter of law or as a matter of practice to establish a legal entity rather than a representative office (to conduct telecommunications activities or activities subject to licensing, for example).

Antitrust & competition

General

Antitrust and competition matters are governed by the Law of Ukraine "On the Protection of Economic Competition," which became effective on March 2, 2002 (the "Competition Law"). In 2005 the Competition Law was amended by the addition of a new requirement regarding transactions subject to the prior approval of the Antimonopoly Committee of Ukraine (the "AMC").

Transactions and Actions Subject to Prior AMC Approval

Merger control regulation

Pursuant to the Competition Law, the following transactions may be subject to prior AMC approval: (i) mergers or consolidations of legal entities; (ii) the acquisition of direct or indirect control over a legal entity; (iii) the establishment of a joint venture by two or more legal entities/persons, provided that such establishment does not result in the coordination of competitive conduct among the business entities that established the business entity or between the business entities and the newly established business entity; and (iv) the direct or indirect acquisition of, the obtaining of the ownership of, or the assumption of management of, the shares (participatory interests) of a business entity, if such acquisition results in the obtaining or the exceeding of 25% or 50% of the voting rights of the target business entity, in all cases provided that the below financial and/or market share thresholds for the financial year preceding the year of the transaction are exceeded.

Financial thresholds:

- the aggregate worldwide asset or sales for all parties to the transaction, including related entities, exceeds EUR 12 million or its equivalent in another currency; and
- the aggregate worldwide asset or sales for each of at least two parties to the transaction, including related entities, exceeds EUR 1 million or its equivalent in another currency; and
- the asset or sales in Ukraine of at least one party to the transaction, including related entities, exceeds EUR 1 million or its equivalent in another currency.

The asset/sales value is calculated as of the last day of the last financial year prior to the transaction. The asset/sales value of a party to the transaction shall include the aggregate asset/sales value of all entities/persons related to the party to the transaction by control.

Market Share Threshold:

The market share of any party or the combined market share of all parties to the transaction including entities related by control on any product market exceeds 35 percent, and the transaction takes place on this or an adjacent product market.

In calculating these thresholds all business entities in any way controlling or controlled by the entity are taken into account, not only the actual merging, consolidating, establishing, or acquiring business entity.

Concerted actions

According to the Competition Law any actions/arrangements/behavior of business entities that could limit, eliminate, or distort economic competition on any product market in Ukraine are prohibited unless the AMC individually permits them or they fall under a limited number of exemptions provided by the Competition Law. Any proposed concerted actions should thus be assessed separately on a case by case basis, since the AMC is quite active in this area and thoroughly investigates various product markets (particularly distribution arrangements, vertical arrangements, and collusive behavior).

Capital markets

The debt and equity securities markets in Ukraine are regulated by several laws (the Laws of Ukraine “On Securities and the Stock Market,” “On the State Regulation of the Securities Market in Ukraine,” “On the National Depositary System and Specifics of the Electronic Circulation of Securities in Ukraine,” “On the Depository System in Ukraine,” and others) and by regulations and resolutions issued by the Securities Commission.

Types and Forms of Securities

Ukrainian legislation recognizes the following categories of securities: equity securities such as shares of capital stock and investment certificates; debt securities such as state bonds of Ukraine, municipal bonds, corporate bonds, treasury bills, deposit certificates, promissory notes, and bills of exchange; mortgage-backed securities such as mortgage-backed bonds, mortgage-backed certificates, mortgage receipts (zastavni), certificates of funds of operations with real estate (certyficaty fondiv operatsiy s neruhomistyu); privatization securities; derivative securities; and commodity-related securities (documents acknowledging the receipt of goods for shipment, such as bills of lading).

Depending on the type of security, Ukrainian issuers may issue them in registered (nominative) form, bearer form, or order form, as well as in documentary (certificated) form and non-documentary (book-entry or electronic) form.

The transfer of ownership rights to registered securities in documentary form is effected by means of assignment. Ownership rights to bearer securities issued in documentary form are transferred as of the moment of the physical transfer (delivery) of the securities to the new owner. Ownership rights to securities in documentary form, whether bearer or registered, are confirmed by the certificates of these securities.

The transfer of ownership rights to both bearer and registered securities in documentary form, if such securities have been immobilized (that is, converted into a non-documentary form), as well as to registered securities originally issued in non-documentary form, is effected from the moment they’re credited to the new owner’s securities account, which is maintained by a securities custodian. Ownership rights to such securities are evidenced by an extract from the securities account, issued by the custodian.

Securities Commission

The Securities Commission is the state agency authorized to determine and implement a uniform state policy in the area of the development and operation of the securities market in Ukraine and to carry out state regulation and monitoring of the issuance and circulation of securities and derivatives on Ukrainian territory. The Securities Commission has been granted broad powers with respect to the formation of the overall legislative framework for the operation and development of Ukraine's securities market. It also has registration, licensing, compliance monitoring, and enforcement powers.

Depository System

On 12 October 2013 the Law of Ukraine "On the Depository System of Ukraine" (the "Depositary System Law") came into effect. It establishes a central securities depository (CSD) in Ukraine on the basis of one of the current securities depositaries: the National Securities Depositary of Ukraine. The Clearing Center was, in addition, established on the basis of the All-Ukrainian Securities Depositary. The Clearing Center is a bank responsible for cash settlements of securities transactions entered into both on stock exchanges and outside stock exchanges, when these transactions envisage the "delivery versus payment" settlement system. In addition, the Clearing Center procures payment of returns on securities. The Depositary System Law has clarified the model by which intermediated securities are held by drawing a distinction between securities and "rights in securities."

Securities Traders

Securities traders are licensed by the Securities Commission to perform any or all of the following activities with securities: brokering activities, dealer activities, and underwriting and securities management activities. Save for certain exceptions, transactions with securities must be carried out with the participation of securities traders.

Stock Exchanges

Securities are traded in Ukraine on stock exchanges and via the over-the-counter electronic market trading system, the PFTS. In 2006 the PFTS established a subsidiary, the PFTS Stock Exchange, which was licensed by the Securities Commission as a stock exchange in 2007. In addition to the PFTS Stock Exchange, there are nine more stock exchanges that are active in the market to different extents. At the current time the secondary market for securities in Ukraine is highly volatile and its liquidity is inconsistent.

State Securities

The Ministry of Finance of Ukraine, acting upon the authorization of the Cabinet of Ministers of Ukraine, may issue bonds to finance domestic or external state debt.

Foreign entities and individuals are permitted to invest in domestic state bonds through Ukrainian custodians that are clients of the NBU as the depository of state securities. Since 2000, Ukraine has carried out a number of issuances of foreign state bonds (known as Eurobonds, denominated in euros and in US dollars) on the international capital markets. These bonds are currently being actively traded in the international capital markets.

CORPORATE GOVERNANCE AS A KEY TO BUSINESS EFFICIENCY

The need for effective corporate governance

Ukraine today is seeing the establishment of corporate governance as an effective legal instrument for developing and protecting the business community. Economic growth and investment here depend on management in the corporate sector and on how parties to corporate relations conduct themselves.

The term "corporate management" is often used to denote corporate governance, but it shouldn't be. "Corporate management" is a narrow term that denotes one form of corporate governance, in particular that exercised by corporations' executive bodies. Corporate governance, on the other hand, encompasses the work of all of a company's governing bodies (the shareholders, the board of directors, and the general director or collegial executive body). The goal of this governance is to make the company function well externally (in its relationships with shareholders and its cooperation with the state authorities and other parties interested in the company's legitimacy, including creditors and customers).

Among the elements of effective corporate governance are the following:

1) informational transparency, which implies the timely exchange of information between shareholders and governing bodies, as well as public disclosure in accordance with Ukrainian law;
2) cooperation among the governing bodies in order to improve the company's investment activity;
3) clear definition of the number of corporate body members in the company's charter and in its internal regulations, as well as a clearly defined quorum; division of powers among governing bodies; and compliance with the law during decision-making procedures;
4) observance of the rights and legitimate interests of all shareholders regardless of how many shares they own.

Effective corporate governance is a key to making a company attractive to potential investors.

Corporate governance under Ukrainian law

The establishment, operation, and liquidation of a company in Ukraine are regulated by the Civil Code of Ukraine № 435-IV dated January 16, 2003 (as amended), the Commercial Code of Ukraine № 436-IV dated January 16, 2003 (as amended), the Law of Ukraine "On Business Associations" № 1576-XII dated September 19, 1991 (as amended), the Law of Ukraine "On Joint Stock Companies" № 514-VI dated September 17, 2008 (as amended), and the Law of Ukraine "On Securities and the Stock Market" № 3480-IV dated February 23, 2006 (as amended). Corporate governance is also subject to regulation by a number of legislative acts of the National Securities and Stock Market Commission (the "National Commission"), and particularly by the Principles of Corporate Governance, approved by Decision of the National Commission № 571 dated December 11, 2003, which are of an advisory nature.

The most common corporate forms in Ukraine are the limited liability company (LLC) and the joint stock company (JSC). According to information from the State Statistics Service of Ukraine (http://www.ukrstat.gov.ua/), as of September 1, 2013 there were registered 25,108 joint stock companies in the Unified State Registry of Legal Entities and Individual Entrepreneurs, and 505,099 limited liability companies.

Limited liability companies are more popular than joint stock companies because of their simplified foundation and registration procedures, their more flexible corporate governance forms, and their fewer regulatory requirements and limitations. A joint stock company, on the other hand, is attractive because of its public nature.

Limited liability companies and joint stock companies have similar corporate governance bodies, subject to certain differences established by law. These include the general meeting of participants (shareholders) and the executive and controlling bodies.

A general meeting of shareholders can resolve on any matter related to the activities of a joint stock company provided that the matters have been brought before the meeting in accordance with Ukrainian law.

A joint stock meeting's general meeting of shareholders must take place at least once a year, while a limited liability company's must take place at least twice a year unless its charter specifies otherwise. The LLC's meeting takes place more often because the procedure for holding it is simpler. If a JSC's general meeting isn't convoked within two years, the National Commission is entitled to file a lawsuit to terminate the company.[1] Furthermore, Ukrainian legal requirements for convening and holding general shareholders' meetings do not apply to joint stock companies with a sole shareholder. A sole shareholder in a JSC has the legal capacity to approve all decisions unilaterally.

According to the "one share – one vote" principle each shareholder has one vote at the general meeting, except for in the case of a cumulative voting procedure. In an LLC each participant has a number of votes pro rated to its participation interest in the company.

The general meeting of either a JSC or an LLC is the highest governing body of the company and may resolve on any company matter. The general meeting of a joint stock company resolves on most matters by a simple majority vote of those shareholders who registered at the general meeting and own voting shares. Matters put to a vote might include the company's primary activities, approval of its internal regulations, and distribution of the company's profits and losses. Under Ukrainian law, however, some matters require a qualified majority of over three-fourths of shareholder votes. These matters include amending the company's charter, increasing (or decreasing) authorized capital, and changing the company's type. With regard to limited liability companies, general meeting resolutions are adopted by a simple majority of votes, except for in cases when a qualified majority is required.

Supervisory board and audit committee members at JSCs are elected by cumulative voting procedure. According to this procedure, the aggregate number of the shareholder's votes is multiplied by the number of seats in the corporate body that is being elected; each shareholder can either give its votes to one candidate or divide them among several. The law does not provide for a cumulative voting procedure at limited liability companies.

Under current Ukrainian law, there is no requirement that a supervisory board be established as the governing body at an LLC. A supervisory board, which protects the rights of shareholders and controls the activities of the executive body, is, however, required for a joint stock company if there are more than ten shareholders-owners of common shares. The powers of a joint stock company with nine or fewer shareholders are exercised by the general meeting of shareholders.

At both a limited liability company and a joint stock company an executive body manages day-to-day operations. The executive body can be either collegial (such as a board of directors or management board) or a sole body (a director or general director). The chairman of a collegial executive body is not an independent governing body. Thus, if a company is to obtain rights and obligations (including to enter into an agreement within the powers established for a collegial body by the company's charter), the chairman of the management board must bring the matter before the meeting of the board or other corporate body in accordance with its competence. The relevant opinion in this area has been expressed by the Supreme Court of Ukraine in its Resolution № 13 "On the Practice of the Handling of Corporate Disputes by Courts" dated October 24, 2008 (the "Resolution № 13").

The current legislation of Ukraine does not allow a person to hold more than one office on corporate governing bodies. A member of the supervisory board of a joint stock company may not be a member of the executive body or audit committee. In addition, the company's officers and their affiliates are not allowed to represent the interests of other shareholders at the general meeting of shareholders.

Shareholders' agreement

In Ukraine the shareholders' agreement mechanism remains undeveloped at the legislative level. As a general rule, shareholders may enter into a shareholders' agreement; however, its provisions must be consistent with the statutory rules and procedures established by Ukrainian law. Moreover, Ukrainian court practice restricts the right of shareholders to choose the governing law for shareholders' agreements. The High Commercial Court of Ukraine, in its Recommendations "On the Practice of Application of Legislation in Court Proceedings Associated with Corporate Relationship" № 04-5/14 dated

[1] *Paragraph 31–1 of Article 8 of the Law of Ukraine "On State Regulation of the Securities Market in Ukraine" №448/96-BP dated October 30, 1996 (as amended).*

December 28, 2007 ("Recommendations № 04/5-14"), stated that shareholders' agreements governing relations among shareholders (foreign legal entities or individuals) or relations between shareholders and a company with regard to the company's activities shall be considered null and void if the agreements are governed by foreign law. Moreover, relations between the founders (participants) of the company with regard to its establishment, to the appointment and competence of its governing bodies, and to the convening and approval of decisions at the general meeting shall be governed by Ukrainian law. The provisions of the Ukrainian law are mandatory, and failure to comply with them represents a violation of public policy. In addition, a shareholders' agreement with regard to a company registered in Ukraine shall not be subject to enforcement if it is regulated by foreign law.

Peculiarities of court practice in corporate and other disputes

In corporate governance disputes the main issue is to define the type of dispute: whether it is of a corporate nature or related to other court disputes (to labor disputes, for example). The relevant elements of a dispute, such as its subject, its territorial jurisdiction, and the parties to it, depend on defining what type of dispute it is. The law does not give a shareholder the right to file a lawsuit in order to protect a company's interests, except for in cases when that shareholder is authorized by the company or by the company charter to take such actions. Moreover, when settling a corporate dispute, particular attention shall be paid to the violation of substantive rights or legitimate interests that are subject to protection. Particularly, there is no possibility of satisfying claims aimed at protecting rights that could be violated in the future; or claims with regard to which it remains unknown whether a right will be violated (paragraph 11 of Resolution № 13).

Corporate disputes include those that occur between a company and its participant (shareholder) with regard to the company's establishment, operation, governance, and termination. The most common corporate disputes include the following:

1) Challenge to the resolutions of the general meeting of shareholders (participants) by a shareholder (a participant). At joint stock companies a resolution can be challenged within the three months after its adoption. The most frequent grounds for a challenge are the following:
   - adoption of a resolution without a quorum for holding the meeting or adopting such a resolution;
   - violation of the requirements of law and/or of charter documents in convening or holding the meeting;
   - adoption of a resolution on issues that aren't on the meeting's agenda.
2) Invalidation of the company's foundation (charter) documents, in particular due to their inconsistency with the law and/or the powers of the governing corporate body that adopted them; and to violations of the plaintiff's rights and legitimate interests as a result of the documents' adoption.
3) Disputes with regard to violation of preemptive rights for the acquisition of a participation interest (or a part of it) in an LLC's authorized capital. In such disputes, the sale of a participation interest (or a part of it) in a way that violates the pre-emptive rights of other participants shall not invalidate the transaction. As the Supreme Court of Ukraine noted in its Resolution № 13, in such a case any company participant can file a lawsuit in order to transfer the purchaser's rights and obligations to the participant itself. These relations will also include the transfer of a participation interest (or a part of it) into ownership under an agreement of exchange.
4) Disputes over a participant's withdrawal from a limited liability company. According to Resolution № 13, the participant's withdrawal from a company occurs on the date on which the withdrawal application is delivered to the company's official. In the meantime, according to Recommendations № 04-5/14, a participant is deemed to have withdrawn from the company after the general meeting has made a decision to that effect on the grounds of his withdrawal application. In the absence of such a decision, the withdrawal occurs after the date of expiration of the notification term for the withdrawal as established by law or the company's charter. These differences can result in a number of additional disputes with regard to the participant's withdrawal, so the provisions are subject to regulation by Ukrainian law.

In the event of disputes between companies on the one hand and members of executive bodies or supervisory boards on the other, the following should be taken into consideration. The disputes have occurred as the result of challenges to decisions on dismissal (removal, suspension, revocation) by members who have entered into employment agreements with the companies in question. These disputes are thus subject to civil proceedings as labor disputes. They are therefore not of a corporate nature and cannot be settled under the rules of subject and territorial jurisdiction that exist for corporate disputes.

Legislative prospects in the corporate relationship field

The year 2013 saw the development of a number of legal drafts meant to improve corporate governance principles and mechanisms.

There was, for example, the draft Law “On Amendments to Some Legislative Acts of Ukraine Regarding Improvement of Joint Stock Companies’ Activities” (registered as № 2037 on January 17, 2013), which was adopted in its first reading by the Verkhovna Rada on June 18, 2013. The draft Law obliges a joint stock company with more than 100 shareholders/owners of common shares to employ a corporate secretary, as well as establishes the competencies of that secretary. It also improves the mechanisms for convening and holding general shareholders’ meetings (particularly by making possible absentee voting (poll voting)). In addition, the draft Law introduces new rules for JSC incorporation and transformation.

There was also the draft Law “On Amendments to Some Legislative Acts of Ukraine on Protection of Investors’ Rights” (registered as № 2013a on May 15, 2013), adopted in the first reading on September 17, 2013. According to this draft Law a derivative lawsuit mechanism is expected to be created for companies. This mechanism will allow participants in companies to file lawsuits in those companies’ names in order to bring company officers to responsibility for losses that their unlawful acts or omissions cause. It should be noted that according to the draft Law developed for the second reading, the participants (shareholders) owning ten and more percent shares in the company’s authorized capital have the discussed right.

Another legislative act meant to develop corporate governance principles is the draft Law “On Amendments to Some Legislative Acts of Ukraine on Improving Corporate Governance at Joint Stock Companies” (registered under № 3441 on October 17, 2013). Its main purpose is to create at JSCs “squeeze out” procedures of the sort that are quite common in international practice. The “squeeze out” mechanism, or compulsory buy-out of shares, is a mechanism according to which a shareholder who acquires at least 95 percent of a company’s shares can compel the minority shareholders to sell out to him.

There was also the draft Law of Ukraine “On Limited Liability Companies and Additional Liability Companies” (registered as № 2011 on January 14, 2013). It means to improve the law governing companies, including the law as regards incorporation, operation, and termination of limited liability companies and additional liability companies. At the same time, it establishes the rights and obligations of participants in such companies. The Verkhovna Rada will also consider, as an alternative, the draft Law “On Limited and Additional Liability Companies” (registered as № 2011-1 on January 25, 2013).

Despite the steps the government took in the last year to improve corporate governance, more needs to be done. The minimum necessary number of governing bodies (including the supervisory board and the collegial executive body) should be established at the legislative level. The institution of independent supervisory board members should be implemented; such members should not be allowed to hold any company offices for at least three years preceding their election and they should have no title to company shares. Also demanding attention are shareholders’ agreements, through which shareholders can establish company management, corporate dispute settlement, company financing, share alienation, and other procedures.

14 LOGISTICS AND TRANSPORTATION

LIBERALIZING THE AIR TRANSPORTATION MARKET IN UKRAINE

There are currently two ways of doing business in the air transportation field. The first is to liberalize the market, which is what states with powerful airline companies do, including the USA and the EU countries. The second is to protect the native market, which is what Ukraine does.

Given globalization, a state's adherence to a traditional protection policy means weakening its national airlines' market positions. At the same time, liberalizing could mean that foreign airlines will expand on the Ukrainian internal market, causing trouble for native companies. A fierce dispute is taking place in Ukraine between those who want government control in air transport and those who don't.

The Chicago Convention provides a flexible platform on the basis of which to move towards liberalization, taking into account various goals, market conditions, and long-term needs. In some cases, however, a deliberate approach is justified: careful decision-making can lead to better results.

If Ukraine is to liberalize, certain issues have to be taken into account in terms of their possible consequences for the national market.

First, there's the principle of fair competition. Competition, of course, functions as an objective market control mechanism. For a developing country, competition is a dynamic process, one that expresses itself in better technology and air transportation (including expansion of low-cost airlines), the opening of new markets, and new ways of organizing how business is done (by means of commercial agreements between airline companies or airline alliances, for example).

Today, unfortunately, Ukraine seems to be practicing an inherently unfair brand of competition, characterized by the following:

a) dumping – that is, prescribing rates for transportation on a level insufficient to cover expenses;

b) adding excessive capacity or flight frequency;

c) misuse of airlines; route or market dominance.

Second, there's the question of aviation security. During liberalization, control mechanism changes can blur lines of responsibility.

Third, there's air carrier assignment. Who owns an airline and controls its activity is a key question in the context of liberalizing air travel. Easier access to the market gives airlines better access to capital markets and lets them expand their coverage through mergers and acquisitions, which strengthens the industry, boosts efficiency, and promotes fair business practices. At the same time, lifting restrictions stimulates competition.

In Ukraine national tenure and effective control criteria stipulate that a new airline in the country must have 49% foreign capital. It's generally thought that this ensures the principle of reciprocity and ensures that each party to an international agreement grants equal right to the other.

At the same time, liberalization gives airlines more flexible market access criteria, based either on "interest reciprocity" with third countries or on the "chief place of business and effective normative state control" principle. This is more suitable for national markets that are distinguished by an additional capital deficit and that thus require the involvement of foreign airline companies or capital to increase traffic.

Based on the experience of developed countries, implementing this approach in Ukraine will necessitate four stages:

Perform control of flight and aviation security via acceptance and adherence agreements within the limits of ICAO.	Stage 4
Stipulate normative control via state assignment of the carrier.	Stage 3
Terminate restrictions related to dominant national tenure.	Stage 2
Define differences between commercial control performed by owners and normative control performed by an authorized body; traditionally these are combined to create an effective control system.	Stage 1

Liberalization requires modernizing monitoring conditions during the assignment of air carriers, thus allowing air carriers to adjust to changing environments. Approaches may differ, however, and include widening the scope for signing agreements outside the context of state ownership and control in the near future, reducing by stages the national ownership percentage, changing the fixed time relative to types of air transportation (including charter and freight transportation), and providing for review of each specific case.

Fourth, there is the issue of Open Skies agreements, currently the most crucial civil aviation issue facing the country. An Open Skies policy is based on the principal of free trade and competition, mandating the complete absence of administrative measures (relating, for example, to periodicity, routes, number of carriers, and so on) in airline agreements between specific states. This will give foreign air carriers access to the Ukrainian market. Only strong companies will survive if Open Skies takes force.

The conflicts between different countries' laws and the varying approaches that different countries take is developing into a real barrier for companies in this sphere.

The main benefits of Open Skies agreements are as follows: air transportation will be in the best interests of consumers and represent an integral element of regional infrastructure; the presence of foreign airlines will stimulate economic growth, padding the budget with profits from tourism and from increased business and foreign investment, even as it creates more jobs; there will be more competition, thus improving services and lowering prices for consumers.

Fifth, there's market access. Since the government controls commercial rights to provide transport services (with the goal of providing for a balance of advantages), Ukraine's aviation authority can liberalize access to the market in a step-wise, ordered fashion, controlling unrestricted access and preventing unfair competition by the dominant carriers.

Generally speaking, market access is about more than just commercial rights. It also entails the need to liberalize in the areas of capacity, price formation, charter transportation and services (services related to the mutual use of codes, for example, land services, and automated booking system services).

One aspect of liberalization that requires additional analysis is the lease mechanism for aircraft, including the mechanism for leasing them abroad. This mechanism would give carriers significant advantages, allowing for the extension and diversification of services. At the same time, situations in which a lessee operates an aircraft with the lessor's crew ("wet leasing") may lead to losses for the lessee, especially in situations when the lessor's salary payments and other payments are lower than the lessee's or when the labor and social laws of the lessor's country (in case of wet leasing abroad) provide for less security and grant fewer rights to workers than the laws of the lessee's country.

Although leasing gives airline companies advantages and a certain flexibility, there exist the risk of dilution of flight and aviation security and the risk that companies could use commercial rights that haven't been approved.

Sixth, there's the issue of public support and promotion. In a liberalized market, airlines might receive budget subsidies towards stabilizing the air transportation market, in the best interests of serving customers.

Seventh, there are consumer interests. Air transportation is a public service that demands regulation in the best interests of customers.

The European Union has made great strides in consumer protection. In 2005, for example, the industry standards "Airline Companies' Obligations in Passenger Service" and "Voluntary Obligations of Airports in Passenger Service" took force, and considerable attention has been paid to enforcing them. The United States has strict requirements that airlines report on service quality so that information about flight delays and cancellation can be collected.

Eighth, there's the question of risk assessment. National policy to liberalize the air transportation market necessitates assessing risks that could prevent meeting targets. These risks are as follows:

A. Competitive risks on the national level; these are connected with the possibility that an airline, particularly one involved in cargo transportation, could change extremely low prices, thus fostering unfair competition;

B. Operational risks connected with imperfections in approved procedures and in technical and regulatory support;

C. Geopolitical risks, which can reduce business on certain markets;

D. Technology-related and ecological risks; these can degrade security, mandate additional costs, and reduce demand for air transportation.

Air travel liberalization arose at the end of 1970s. In autumn of 1978 US President Jimmy Carter signed two documents that had significant repercussions for civil aviation: first, the Airline Deregulation Act transformed the internal US air transportation system; second, the International Air Transportation Negotiations Statement of the US Policy for the Conduct of Negotiations created new possibilities for airline companies that offered international flights.

In 1985 the US Department of Transportation approved free purchase and slot sales, giving airlines the right to use airports within a certain period of time.

The first attempt to liberalize the skies in Europe happened in the mid-1980s. In 1984 the United Kingdom and the Netherlands signed the first Open Skies Agreement. In 1985 similar agreements were signed between most European countries.

The late 1980s saw most southeast Asian countries liberalize their domestic and international air markets as well. Now, apparently, it's the turn of our young democracy to liberalize.

Although liberalization became widespread in the 1980s and 1990s, the majority of airlines continue to rely on bilateral intergovernmental air transport treaties. Air traffic between EU member states and the rest of the world (except the USA, Canada and Singapore) is governed by conventional agreements that limit competition. Moreover, chances are very low that most countries of the world will sign Open Skies agreements in the next 10 or 20 years. There are also certain gaps in the agreements that have already been signed. First, modern intergovernmental treaties eliminate the Seventh and Eighth "Freedoms of the Skies." Second, most countries worldwide continue to limit non-resident shareholding in national airlines. Even in the US an overseas investor cannot hold more than 25% of shares in an airline. There are other restrictions on free competition as well.

Despite such barriers, air transportation continues to liberalize. As the global economy comprehends more and more countries, the aviation industry is suffering considerable losses due to barriers and restrictions posed by outdated legislation.

But advocates for liberalization need to continue to marshal their arguments. First, governmental regulation does not promote diversified airline products and high administrative barriers prevent new players from joining the market. Second, carriers who become more dependent on the government show less initiative and autonomy. Third, increased competition will promote innovation, lower fares, optimize costs, and create more value for customers.

Based on our analysis of foreign expertise in implementing national air transportation policy, and taking into account the pros and cons of protectionism on the one hand and liberalization on the other, we conclude that Ukraine requires a balanced approach based on dedication to protectionist practices (should they prove cost effective) and a general adherence to liberal ideas based on the Chicago Convention.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THE UKRAINIAN AUTOMOTIVE MARKET: PROBLEMS AND OUTLOOKS

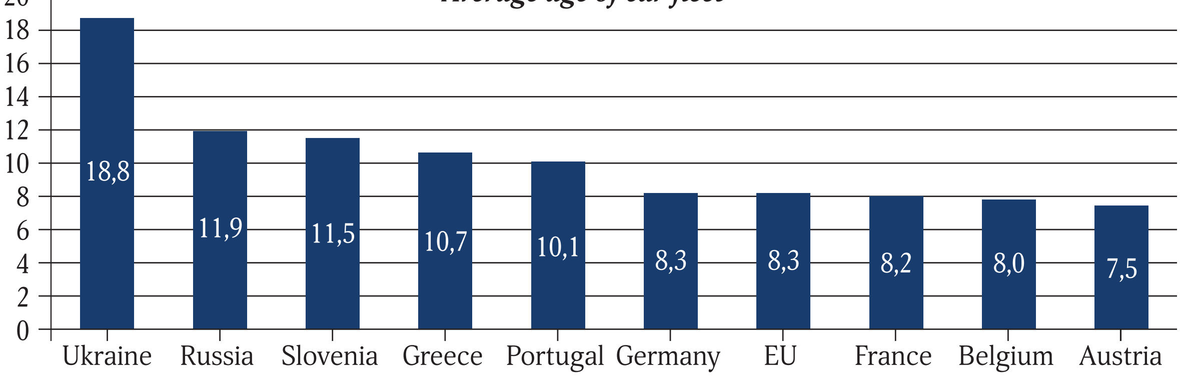
The year 2013 was marked by legislative changes that impacted the Ukrainian automotive market. First, in April, additional duties were introduced for cars imported into Ukraine: for petrol cars with engine capacity of 1 to 1.5 liters the 10% duty was boosted by 6.46%; for petrol cars with engine capacity of 1.5 to 2.2 liters it was boosted by 12.95%. Meanwhile, September 1 saw a recycling fee instituted, to be paid when an import car enters the country. Its size is estimated based on coefficients of a base rate of UAH 5,500, depending on engine capacity.

These changes proved to have an adverse effect on the market. Annual results indicate that the automotive market continued to decline (-10% since 2012). As predicted, Ukrainian consumers are disinclined to choose domestic cars on the basis of price alone. The quality and performance of Ukrainian cars fail to meet consumers' needs, which is why protectionism is insufficient for supporting the development of the domestic automotive industry. Rather, a comprehensive strategy is required. Such a strategy has, in fact, been developed and implemented in Russia. As a result, most of the major players on the global automotive market have established production capacities in Russia and invested billions of dollars into the sector.

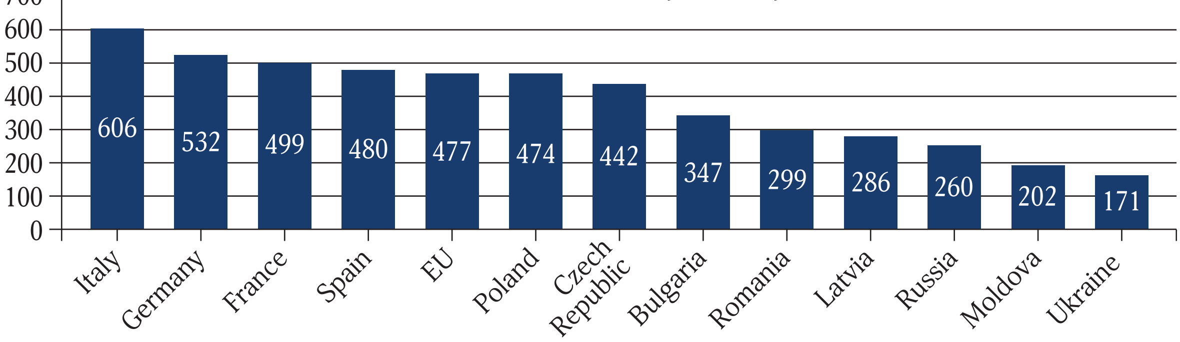
The Ukrainian automotive market is also of much interest for investors, considering that in terms of its potential (according to sales data for the period up to 2008) it is only three times smaller than the Russian market and is one of the seven largest markets in Europe. The potential is based on such factors as, among others, car fleet age (the average fleet age in Ukraine is 18.8 years) and fleet saturation per thousand residents (there are 171 cars per thousand people in Ukraine). According to these indicators the Ukrainian automotive market is Europe's most undeveloped, and is even inferior to those of many CIS states.

Given the huge potential, the future development of the Ukrainian automotive market relies on a number of factors.

Average age of car fleet



Market saturantion with cars per 1000 persons



Economy

Unfortunately, there are no economic premises for automotive market growth. GDP growth in 2013 will at best be zero, considering that industrial production has demonstrated a downward trend for over a year, that domestic consumption is gradually falling, and that the trade deficit and reduction of NBU reserves raise the risk of national currency depreciation.

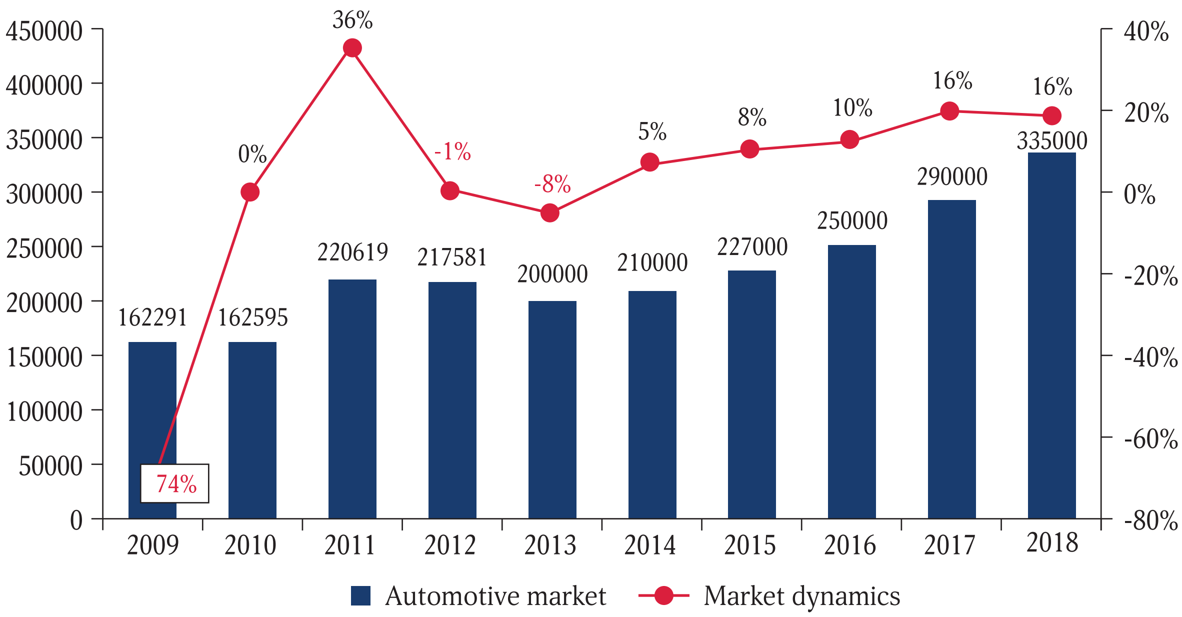
Legislation

Introduction in 2013 of new barriers for importers created a new problem for market growth. The future of the special duty and the recycling fee are currently under discussion. If the law remains unchanged in 2014, and the special duty and recycling fee remain on the books, the market will at best be at the 2013 level. If the tax and fee are cancelled (or greatly reduced), the market has a chance to grow by 10% next year.

Loans

Lending is one of the most significant of the factors that could change the automotive market's short-term dynamics. Currently, car sales on credit account for an average of 17% of the market. In the pre-crisis period they accounted for 50% of total sales. In the post-crisis period (2009) this share fell to 10%. The 2010–2011 period saw significant recovery of consumer lending, resulting in car market growth. In 2012 and 2013, however, the positive loan dynamics significantly slowed down due to a significant rise in interest rates. Today, lending relies on the ability of certain importers to partially bear the costs of bank credit resources.

We can conclude, then, that the growth potential of the Ukrainian automotive market is quite high, but that external factors (primarily economic and legal ones) are preventing its fulfillment. Therefore, the likely scenario for the market is gradual growth.



15 REAL ESTATE DEVELOPMENT

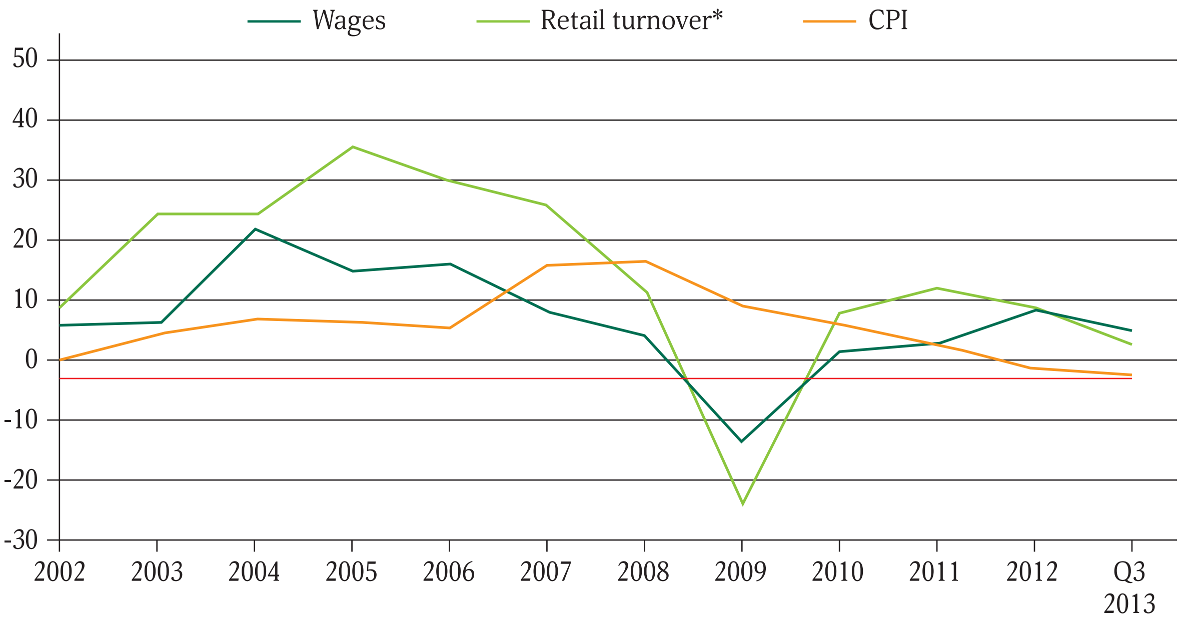
OFFICE, RETAIL AND WAREHOUSE MARKETS OVERVIEW 2013

Retail market

Fundamentals

Of all sectors of the domestic economy, the retail sector has been less susceptible to economic instability. It posted two-digit turnover growth in the last three years, which is a reflection of sustained increase in real wages coupled with low inflation. During January – September 2013, organized retail turnover in Kyiv grew at a still respectable 6.4% y-o-y, though the pace of turnover growth decelerated due to the slowdown in growth of real wages (+8.8% y-o-y – Kyiv).

Kyiv wages, retail turnover and consumer price index (% change, y-o-y)



*– *Includes organized retail sales only*

Source: *Kyiv Statistics Office*

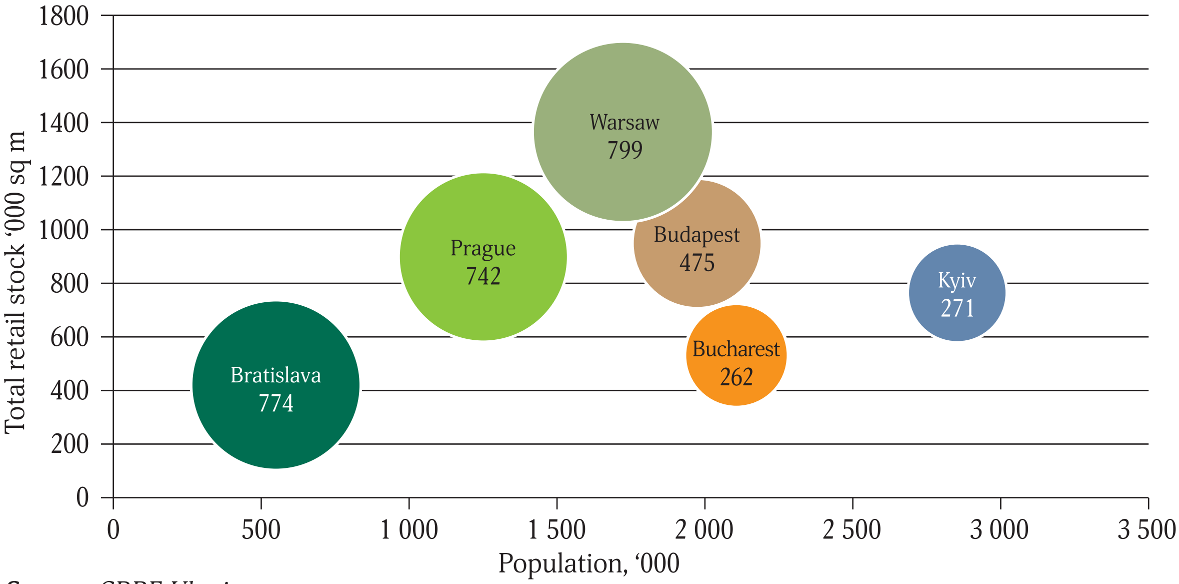
Demand

Of all sectors of the domestic economy, the retail sector has been less susceptible to economic instability. It posted two-digit turnover growth in the last three years, which is a reflection of sustained increase in real wages coupled with low inflation. During January – September 2013, organized retail turnover in Kyiv grew at a still respectable 6.4% y-o-y, though the pace of turnover growth decelerated due to the slowdown in growth of real wages (+8.8% y-o-y – Kyiv).

Supply

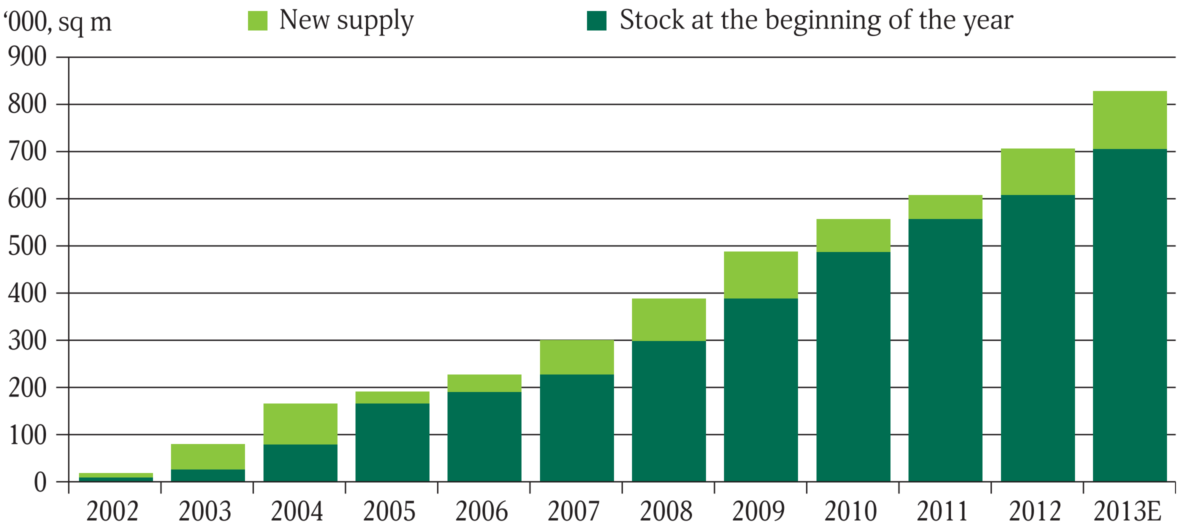
As of December 2013, with the delivery of four professional shopping centers – Gulliver (45,200 sq m GLA), Silver Breeze (16,000 sq m GLA) with its mixed-use schemes, Phase I of Marmelad SC (5,500 sq m GLA), and the first Manufactura outlet center (18,200 sq m GLA) – total retail stock[1] increased by 12% y-o-y to amount to 771,100 sq m. Moreover, one more shopping center, Art Mall (37,000 sq m GLA), is to be commissioned by year-end. The completion of Phase II of Marmelad SC (33,200 sq m GLA) and of Atmosphera SC (30,000 sq m GLA) has been postponed to H1 2014. Quality retail space market saturation rose from 244 sq m to 271 sq m per 1,000 people, and there remains growth potential for retail development in the city.

Retail premises per 1,000 inhabitants in selected cee capitals, sq m



Source: *CBRE Ukraine*

Kyiv shopping center stock



E – estimation
Source: *CBRE Ukraine*

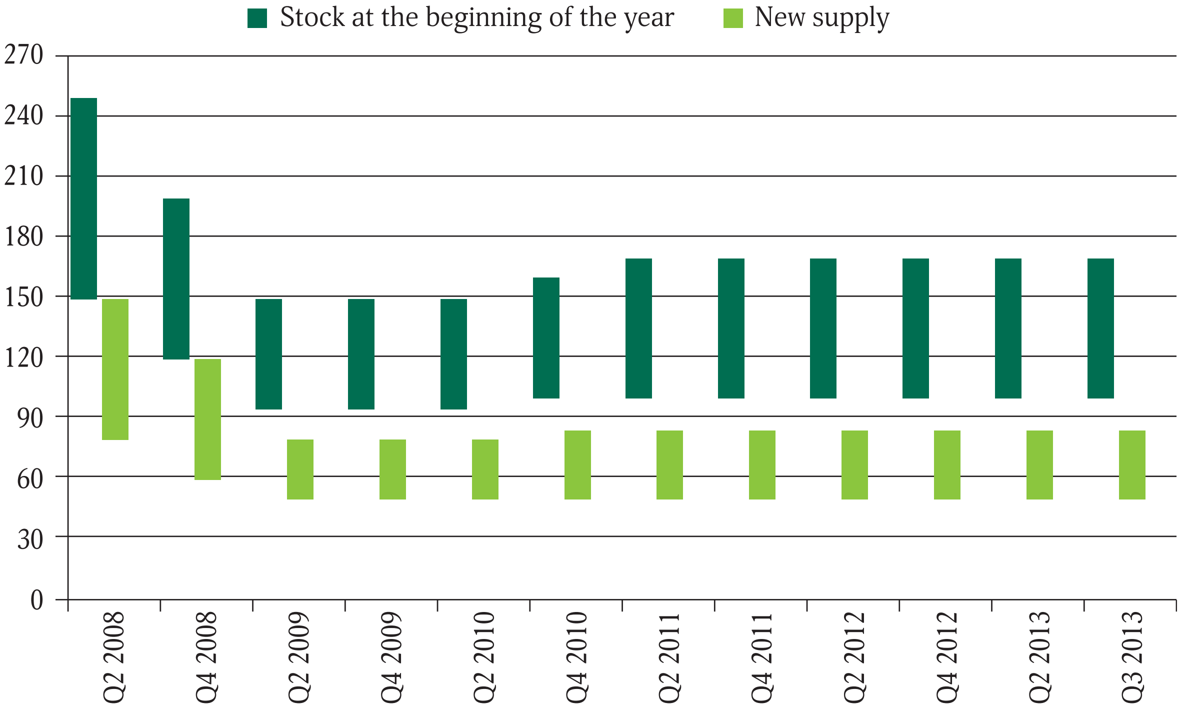
Shopping center development activity continues to expand. Construction of two large-scale schemes, the Blockbuster Mall (90,000 sq m GLA) and the Lavina shopping center (100,000 sq m GLA), as well as the reconstruction of TSUM (Kyiv's central department store), commenced during January–November 2013. Currently, approximately 465,000 sq m of modern retail space is scheduled for delivery over the course of 2013–2015. Relatively stable development activity looks likely to follow thereafter. There remains, however, a high probability of delivery delays due to constrained financing amid the economic slowdown, which is more than likely to restrict development progress in the short run.

[1] [A shopping center] is a retail property that is planned, built, and managed as a single entity, comprising units and "communal" areas and with a minimum gross leasable area (GLA) of 5,000 sq m; 50% of the tenant mix should consist of chain retailers.

Vacancy and rents

As of Q3 2013, demand was strongly focused on prime space, availability of which was typically limited, with vacancy ranging between 0% and 2%, while secondary vacancy increased moderately on the back of large volumes of new supply. Prime rents in professional shopping centers stood in the range of $100-$170/sq m/month (triple net) for a typical gallery unit of 100–200 sq m. Rental rates in other shopping centers varied between $55 and 85/sq m/month for gallery tenants.

Base rents in Kyiv (USD/sq m/month)



Source: *CBRE Ukraine*

Outlook

Given its vigorous ability to withstand economic shocks, retail is expected to remain the most prosperous segment among commercial real estate market segments in Ukraine. Should consumer sentiment remain strong in forthcoming months, occupier demand for retail premises is expected to stay healthy, particularly in good quality retail schemes and competitive locations. At the same time, retailers are taking a cautious approach to expansion nationwide in the near term, in view of recent signs of the weakening of consumer sentiment as a result of slowing real wage growth. Given the timely delivery of the entire announced volume of retail space, new supply will reach ca. 122,000 sq m by the end of 2013, which is 30% up compared to last year's numbers. As a result of large-scale addition of new shopping centers, competition in the sector will increase moderately, which may put upward pressure on average vacancy in secondary shopping centers around the city by the end of 2013. Vacancy in the prime shopping centers, however, is expected to stay close to zero, as retailers are heavily focused on prime properties. With a significant volume of new supply delivered in 2013, the prospects for broad-based rental growth are slim. Fuelled by still-robust retailer demand, rents for quality space are forecasted to stay roughly stable by year-end.

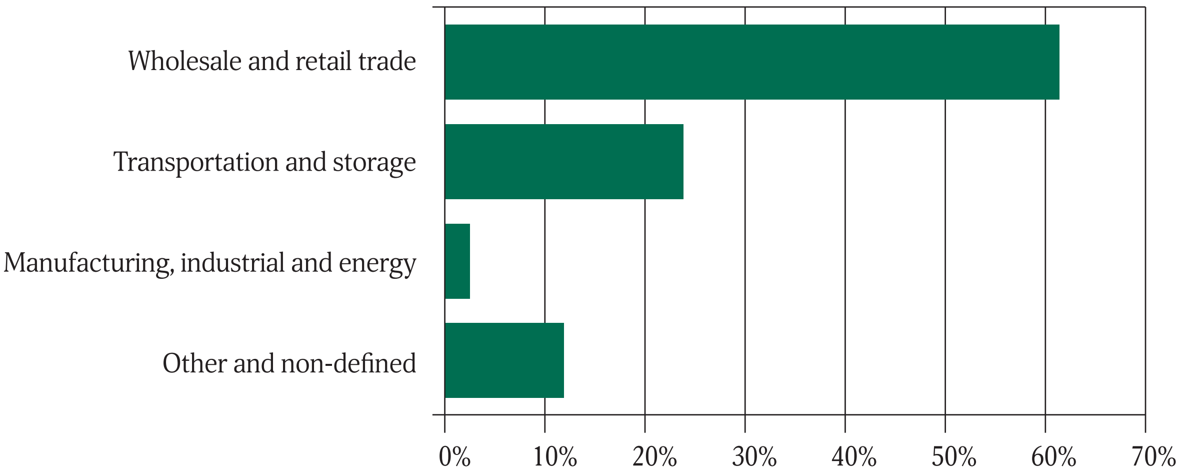
Warehouse market

Demand

A significant slowdown of the economy in 2012 and weak macroeconomic indicators at the beginning of 2013 resulted in relatively moderate levels of transactional activity in the warehouse market over the first nine months of 2013. After two years of stable transaction volumes, take-up comprised approximately 142,000 sq m in Q1-Q3 2013, for a 12% decrease y-o-y.

As of the end of Q3 2013, there were no significant changes in the take-up structure in terms of industry distribution. In view of still-growing retail turnover, the wholesale and retail trade sector dominates, with a 61% share in take-up, despite having lost 16 pp y-o-y. The transport and storage sector maintained second position in the structure and even increased the previous year's result by 10 pp, reaching 24% in the total volume of gross absorption. Following the trend of previous years, trade companies predominantly relocated to new warehouse space.

Take-up structure by industry in Q1-Q3 2013*

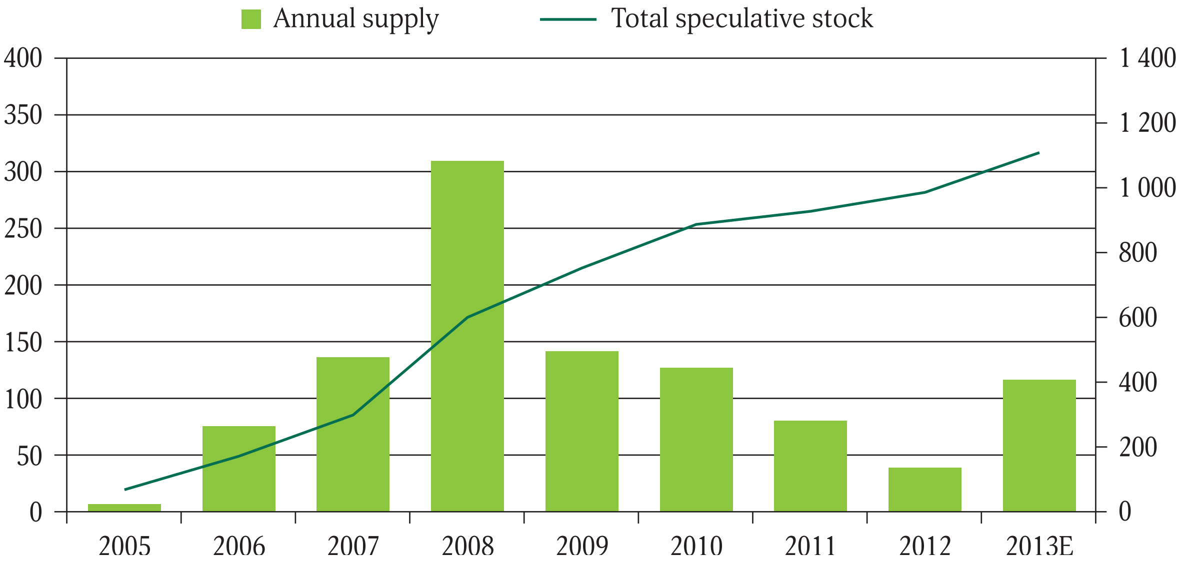


** base – volume of transactions, sq m*
***Source:** CBRE Ukraine*

Supply

By the end of November 2013, competitive stock reached approx. 1.21 mln sq m, growing by 8% since the beginning of the year. The warehouse market saw 131,200 sq m of new supply. The Fozzy build-to-suit distribution center accounted for 90,000 sq m of this and space previously used for owner occupation accounted for 6,000 sq m. An important fact is that there are no speculative schemes under construction in excess of 10,000 sq m, which signifies that developers are unwilling to take the risks associated with large speculative projects or that sizeable ground-up construction remains economically unviable.

Kyiv annual development completions and total speculative stock ('000 sq m)

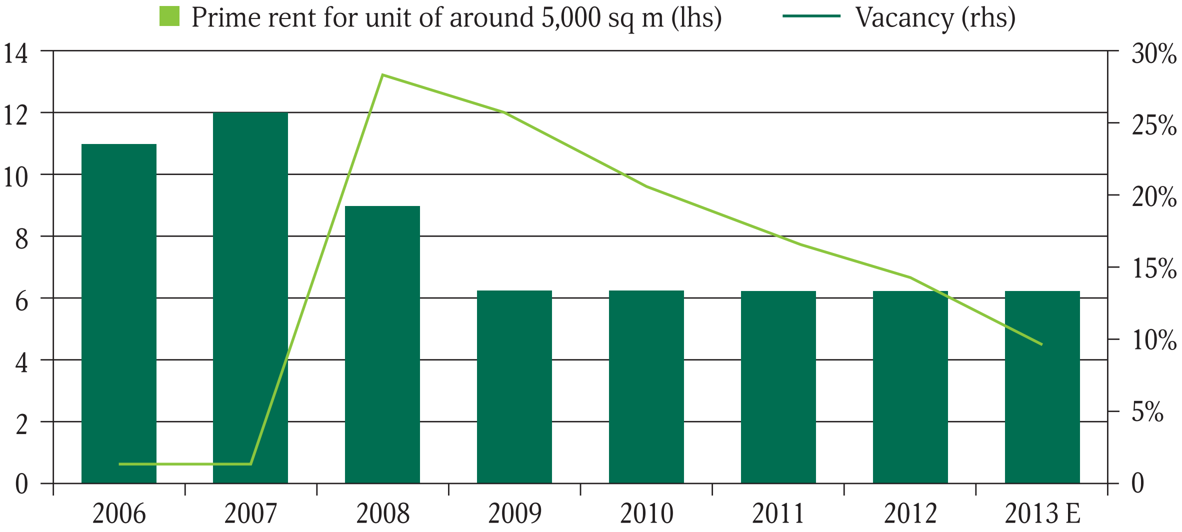


E – estimation
***Source:** CBRE Ukraine*

Rents and vacancy

Overall, the warehouse market situation was stable during Q1-Q3 2013. Moderate demand with an absence of new supply caused the average vacancy rate to decrease from 12.9% to 11.1% (-1.7 pp from Q4 2012). Rental rates remained generally flat and ranged from $5.5/sq m/month to $6.5/ sq m/month (triple net).

Average prime rental rate (USD/sq m/month) and vacancy rate



E – estimation

Source: *CBRE Ukraine*

Outlook

New supply in 2013 could total 138,000 sq m, which is about twice the amount recorded in 2012. With no new speculative starts expected before the end of the year, the market will likely experience a particularly low level of development completion in the near future. Project size is unlikely to exceed 10,000 sq m, with medium- and large-scale schemes emerging only under build-to-suit arrangements.

As of the end of November 2013, the most likely scenario is for the vacancy rate to stabilize in the 10.0%–11.0% range by the end of the year. The key factor giving grounds for caution is the fact that retail turnover, one of the main sources driving warehouse demand, is beginning to slow down. Under these conditions, it is highly unlikely that the base prime rent will show any signs of growth in 2013. On a positive note, however, online retailing is expected to grow, which may result in some demand for warehouse premises, as evidenced by first transactions appearing on the market in 2012–2013.

Kyiv offices

Demand

In contrast to the previous year, 2013 got off to a good start as far as the office occupier market is concerned. Take-up (leasing and sale transactions) has rebounded strongly, exceeding the results of the whole of 2012 in just the first few months of the year. However, demand was mostly driven by relocations and consolidations rather than by net expansions, which indicates that market conditions continue to be challenging. CBRE estimates that take-up equaled around 100,000 sq m in the first nine months of 2013, which is 25% more than the figure for 2012.

As for occupiers' preferences, most transactions exceeding 1,000 sq m in size were signed in new buildings delivered during the last three years, offering reasonable combinations of price and quality. In by-the-industry analysis, IT & High Tech and Telecommunications continued to dominate the market, including an owner-occupier acquisition of 7,500 sq m in a Class B Premium Center located outside of the CBD. That transaction became the largest of the year so far.

Key office lease transactions in Q1–Q3 2013

Occupier	Industry	Property	Submarket	GLA*, sq m
Ciklum	IT & High Tech	Gulliver	Olimpijskyi	7,000
DTEK	Manufacturing, Industrial & Energy	101 Tower	South-West	5,400
Ukrrechflot	Transport and Logistics	Rialto	North	2,400

EPAM Systems	IT & High Tech	Eurasia	Olimpijskyi	2,300
Parimatch	IT & High Tech	OB at 14a Bazhana St.	NC-SE	2,100
Glaxo SmithKline	Healthcare and Pharmaceuticals	Silver Breeze	NC-SE	2,000
German Embassy	Public Sector	101 Tower	South-West	1,800
Boehringer Ingelheim	Healthcare and Pharmaceuticals	101 Tower	South-West	1,400
Reckitt Benckiser	FMCG	SP Hall	North	1,160
Yves Rocher	Wholesale & Retail Trade	OB at 33 Sagaidachnogo St.	Podil	1,000

**- gross leasable area*

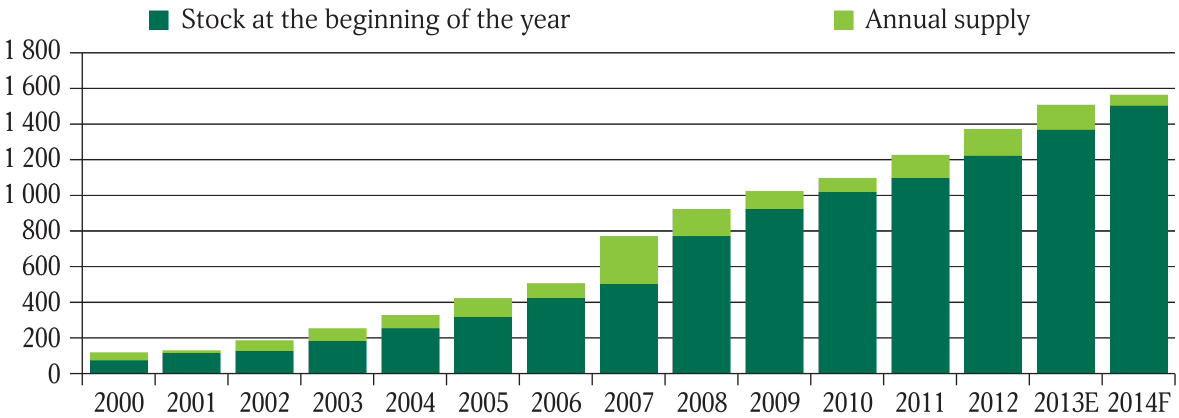
Submarkets are defined according to the new central business district (CBD) delineation introduced by CBRE in September 2011: Prime, Pechersk, Podil, Olimpijskyi, Shevchenkivskyi – CBD; South, South West, West, North – CBD fringe; NC-SW – non-central location, south west (right bank), NC-NW – non-central location, north west (right bank), NC-NE – non-central location, north east (left bank), NC-SE – non-central location, south east (left bank).

***Source:** CBRE Ukraine*

Supply

Due to several large completions, the office market is witnessing steady growth of new quality supply for the third consecutive year. As of December 2013, six new office schemes totaling approx. 130,000 sq m had been delivered to the market since the beginning of the year, boosting total competitive stock to around 1.50 mln sq m. As before, most of the new office space is concentrated on the West (Right) Bank, while the East (Left) Bank continues to experience low levels of new professional completions. In fact, only one scheme was delivered in 2013 in that part of the city: 28,500 sq m of Class A quality office premises in the Silver Breeze mixed-use scheme.

Kyiv annual development completions and total competitive Stock ('000 sq m)



E- estimation
F – forecast
***Source:** CBRE Ukraine*

Vacancy and rents

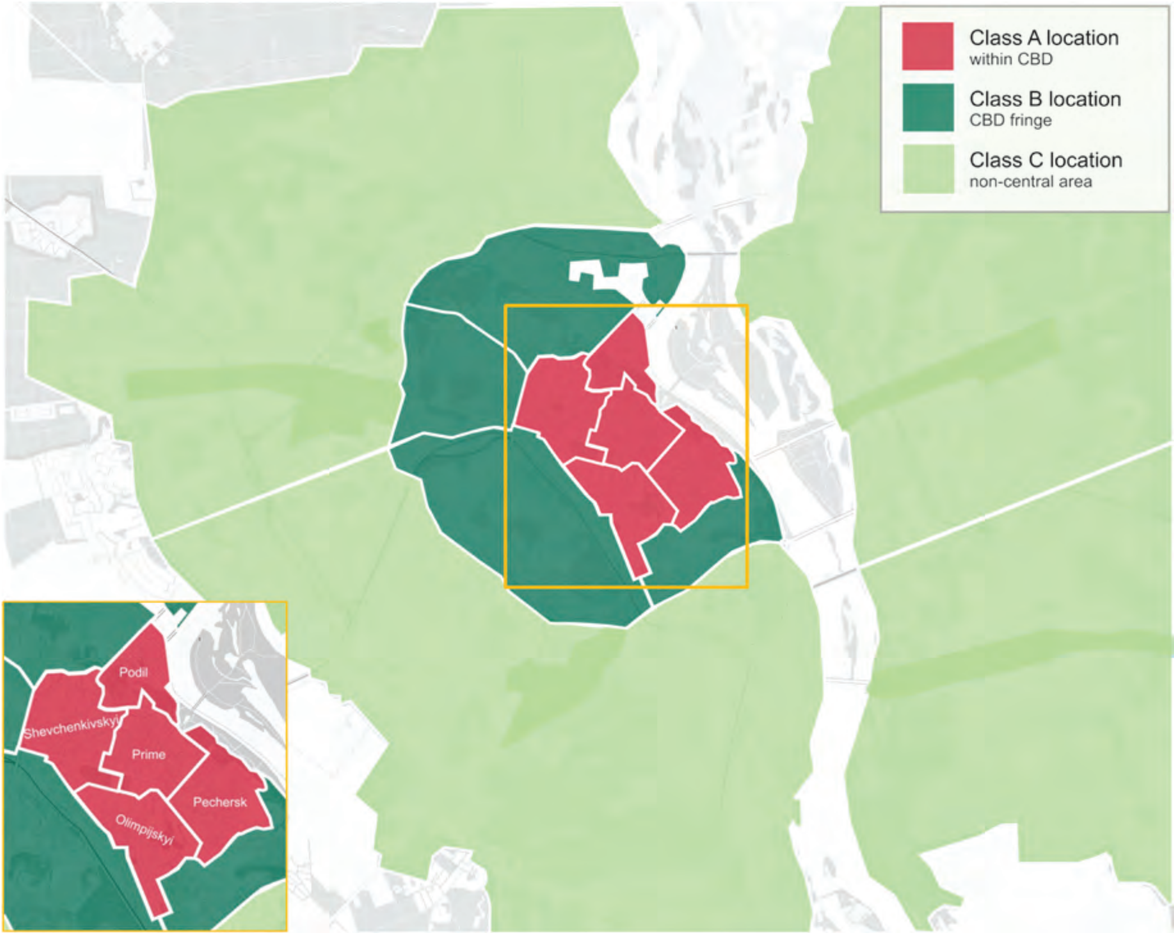
Overall vacancy dynamics remained negative in the first nine months of 2013, as the market continued to experience growth in volume of unoccupied premises. Transactional activity, driven mostly by relocations and consolidations (vs. expansions), coupled with an increase in the new supply of modern office stock, pushed the vacancy rate up to 27.5% (+2.6 pp vs. Q3 2012). Additional development completions combined with low rates for occupational growth and market entry appear to be placing more upward pressure on the vacancy level for the remainder of 2013.

The office market did not witness significant changes in rents during Q1-Q3 2013. Indicative prime rent remained flat at $33 per sq m/month (triple net). Asking rental rates continue to vary from $25 to $40 per sq m/month for Class A space and from $12 to $29 per sq m/month for Class B properties in CBD, depending on location and building occupancy. However, given the growing market competitiveness, the gap between nominal and effective rents is continuing to widen. As of the end of Q3, the average difference amounts to approximately 30%.

Kyiv office base rental range and vacancy, by location as of Q3 2013

Class A location	Quality A	Quality B	Vacancy
Prime	$35–40	$24–29	3.3%
Pechersk	$35–40	$24–29	38.2%
Podil	$28–32	$23–25	10.8%
Shevchenkivskyi	–	$22–26	24.5%
Olimpijskyi	$25–33	$18–25	21.6%
Class B location	Quality A	Quality B	Vacancy
CBD fringe	$23–30	$12–20	18.4%
Class C location	Quality A	Quality B	Vacancy
Non-central area	$21–24	$12–15	25.6%

Source: *CBRE Ukraine*



Outlook

The subdued economic environment and high vacancy rates highlight that no notable improvements should be expected on the Kyiv office market in the near future, other than further increase of modern office stock, thanks to the delivery of new speculative schemes. Large amounts of available space will continue to fuel competition among business centers, which is bound to exert further pressure on rental rates. However, the outlook for 2014 is more positive, in line with the widely expected return to a general economic recovery. The anticipated improvements in economic conditions in 2014 should strengthen business confidence in Ukraine which, in turn, is likely to translate into occupier expansion plans and then into growth in demand for office space. However, taking into consideration the fact that business growth generally follows sustainable signs of economic recovery, significant positive dynamics on the office market may not be apparent until 2015.

16 TAXATION

CRIMINAL LIABILITY AFTER A TAX AUDIT AND THE NEW CRIMINAL PROCEDURAL CODE OF UKRAINE

Oleksiy Spivak, *adviser of KM Partners law firm, attorney-at-law*

A year after the new Criminal Procedural Code of Ukraine took force on November 20, 2012 the issue of criminal proceedings for white collar crimes remains acute. Particularly at issue is the risk of becoming criminally liable for tax evasion in Ukraine.

Introduction

The new Criminal Procedural Code has considerably changed things. Pre-trial investigation has seen especial changes: the stage in which a case is initiated and charges are brought has been cancelled, while a stage in which the suspect is notified that he or she is under suspicion has been added.

According to the previous Criminal Procedural Code, which dated to 1960, the initiation stage served as a barrier between pre-investigation procedures (which lasted 10 days) and the pre-trial investigation. In addition, the initiation of a criminal case could be appealed. This represented an effective instrument for protecting against investigations and against pressure on companies. According to Ministry of Internal Affairs statistics, up to November 20, 2012 the police had received 3,163,810 applications and crime reports, 79.1 % of which did not lead to criminal proceedings.

With the taking force of the new Criminal Procedural Code, the initiation stage was transformed into a stage during which data is registered in the Unified Register of Pre-trial Investigations. Now, after receiving an application or notification about a crime, the investigator or prosecutor is obliged to register data about it in the Unified Register within 24 hours, and to initiate an investigation. Refusal to accept or register an application or notification is not permitted. Nobody is notified about this registration or about the initiation of the proceedings, since the Unified Register has a limited range of users. This means that if there is no public investigation or, for instance, search or seizure of property, a taxpayer might find out about the criminal proceedings against it only when it receives a notification of suspicion.

One of the new Criminal Procedural Code's biggest drawbacks, then, is that it's impossible to contest the logging of data in the Unified Register and the initiation of an investigation. The new Code also conceals another danger: that criminal proceedings can "hang" in the Unified Register during the entirety of the term in which it's possible to bring a party to criminal responsibility (that term is 10 years according to part 3 of Article 212 of the Criminal Code of Ukraine). An investigator's or prosecutor's investigation, then, faces no temporal limits (except for those prescribed by the statutes of limitation for particular crimes).

If, in accordance with Part 1 of Article 219 of the Criminal Procedure Code, the pre-trial investigation period lasts two months from the date of the notification of suspicion, then the question remains: why do 84.1% of criminal proceedings (233 of them) end up with no result?

In practice any dispute with the tax authorities can result in criminal proceedings against a taxpayer's officials. There have even been instances of tax evasion proceedings that were initiated in the absence of a tax audit. A tax administration official might have come to his or her own conclusions about a company's having violated the law; he or she might even have gotten the supposedly incriminating information off the Internet. Criminal proceedings can thus be used as a way to pressure taxpayers.

Notification of suspicion represents the next stage in the process. The investigator has the right to notify the person under suspicion, presenting "sufficient evidence" of the person's "committing a criminal violation." At the moment of notification the person is considered "under suspicion" and enjoys the rights and guarantees envisaged by the new Criminal Procedural Code. Before the notification the person almost completely lacks procedural rights or avenues of defense. When the pertinent data is logged in the Unified Register, then, the person in question obtains witness status and possesses only minimal rights to self-defense, whereas the investigator and the prosecutor can investigate fully. Then, after the person is notified of suspicion, the investigator has two months to conduct the investigation. After this period (which a prosecutor can extend) the investigator either has to close the case or to bring it to court with a bill of indictment.

The scheme for pretrial investigation according to new Criminal Procedural Code looks like this:

Notification of the crime or if crime was detected personally by the investigator or the prosecutor

↓

Registering the data in the URPTI and the start of investigation

(From this moment the investigator has the right to:
Conductseizure, search, interrogations, audits and undercover investigations;
Carry calls and actuators;
Appoint expertise)

↓

Notifying the person of suspicion

From this moment the person receives the status of the suspected, Preventive measures (holding in detention or pledge) may be applied to the person, as well as seizure of property, the person may be suspended from its duties

↓

Drawing up the indictment

After this the person receives the status of the accused, the pretrial investigation is finished and the case is brought tj the court

Criminal liability for tax evasion

Tax evasion is the most common charge after big tax audits. Article 212 of the Criminal Code establishes the following types of criminal liability for intended tax evasion, when the actions in question have resulted in non-receipt of funds into the state budget or state trust funds:

- Part 1 of Article 212 of the Criminal Code envisages criminal liability for intended tax evasion if the actions in question have resulted in actual non-receipt of funds to the budget or to state trust funds in considerable amounts (a "considerable amount" means taxes, charges, or other obligatory payments exceeding the legislatively-prescribed tax-free minimum income a thousand or more times). This quantitative indicator changes annually; in 2013 it was UAH 573,500 (approximately $72,000).
- Part 2 of Article 212 of the Criminal Code envisages criminal liability for the same actions as described above when they are carried out in concert by a group of people or if they result in actual non-receipt of funds to the budget or to state trust funds in large amounts (a "large amount" means taxes, charges, or other obligatory payments exceeding the legislatively-prescribed tax-free minimum income three thousand or more times). This quantitative indicator also changes annually; in 2013 it was UAH 1,720,500 ($215,000).

- Part 3 of Article 212 of the Criminal Code envisages liability for the actions envisaged by the Article's part 1 and 2 when carried out by a person who has previously been sentenced for tax evasion or if they have resulted in actual non-receipt of funds to the budget or to the state trust funds in especially large amounts (an "especially large amount" means taxes, charges, or other obligatory payments exceeding the legislatively-prescribed tax-free minimum income five thousand or more times). This quantitative indicator changes annually; in 2013 it was UAH 2,867,500 ($358,000).

Taking into consideration the poverty line for an employable person and the social tax benefit, responsibility under Article 212 for 2013 is as follows:

UAH	2010	2011	2012	2013
Social tax benefit	434,5	470,5	536,5	573,5
Qualification under part 1 of Article 212 of the CCU (1000 * the social tax benefit)	434 500	470 500	536 500	573 500
Qualification under part 2 of Article 212 of the CCU (3000 * the social tax benefit)	1 303 500	1 411 500	1 609 500	1 720 500
Qualification under part 3 of Article 212 of the CCU (5000 * the social tax benefit)	2 172 500	2 352 500	2 682 500	2 867 500

Article 212 mandates the following penalties for tax evasion:

- A violation according to Part 1 of Article 212 brings a fine of UAH 17,000 to UAH 34,000 ($1,125 to $4,250) or prohibition from occupying certain posts or engaging in certain activities for two to three years;
- A violation according to Part 2 of Article 212 brings a fine of UAH 34,000 to UAH 51,000 ($4,250 to $6,250) and prohibition from occupying certain posts or engaging in certain activities for up to three years; and
- A violation according to Part 3 of Article 212 brings a fine of UAH 255,000 to UAH 425,000 ($31,800 to $53,125), prohibition from occupying certain posts or engaging in certain activities for up to three years, and forfeiture of property.

The sanctions currently envisaged by Article 212 are as follows:

Part of the Article	Primary punishment	Obligatory additionalpunishment
Part 1 of Article 212 of the Criminal Code of Ukraine	Fine of from UAH 17 000 to 34 000 UAH or deprivation of right to occupy some posts or to engage in certain activities for a term of from 2 to 3 years;	–
Part 2 of Article 212 of the Criminal Code of Ukraine	Fine of from UAH 34 000 to 51 000	Deprivation of the right to occupy certain posts or to engage in certain activities for up to 3 years;
Part 3 of Article 212 of the Criminal Code of Ukraine	Fine of from UAH 255 000 to 425 000	Deprivation of the right to occupy certain posts or to engage in certain activities for up to 3 years and forfeiture of property.

According to part 2 of Article 53 of the Criminal Code the fine for a violation under part 3 of Article 212 cannot be lower than the cost of the property damage that occurred as a result of the crime or than the income that the crime generated. In practice the property damage cost is the value of the tax liabilities that the tax authorities accrue. In calculating property damage caused by tax evasion, only unpaid taxes (as defined by the tax authorities) are taken into consideration, and not penalties or fines.

It should also be noted that if a person who has been sentenced under part 3 of Article 212 fails to pay the mandated fine, a court can jail him or her in line with part 5 of Article 53 of the Criminal Code and Articles 537 and 539 of the new Criminal Procedural Code.

The unpaid part of the fine will be proportionally substituted by a prison term according to the following formula: one day of imprisonment for every eight tax-free minimum incomes. In other words, an unpaid fine of UAH 136 ($17) will bring one day of imprisonment. In general, fines established by part 3 of the Criminal Code's Article 212 can be substituted by a prison term of 5 to 10 years.

Relief from criminal liability

There exists a statute of limitations with regard to bringing people to criminal responsibility for tax evasion. After a certain period, that is, one is relieved of criminal responsibility.

For tax evasion foreseen by part 1 and part 2 of Article 212 of the Criminal Code (that is, evasion of considerable and large tax amounts, respectively), which is considered a minor crime, the time limit is two years. That is, criminal liability for tax evasion vanishes in cases when two years pass between the date of the criminal conviction and the date on which the sentence takes legal force.

For felony tax evasion (as per part 3 of Article 212 of the Criminal Code) the time limit for imposing criminal liability is 10 years.

Relief from criminal liability due to the expiration of the statute of limitations does not apply automatically. The Criminal Procedural Code states that a court must rule whether there are grounds for removing criminal liability and stopping a criminal proceeding.

An offender may be exempt from criminal liability under part 4 of Article 212 of the Criminal Code if he or she pays the necessary taxes and fees (that is, compulsory payments) and repays the losses to the state that his or her delayed tax payment has caused (via imposition of financial penalties and fines) before he or she is brought to criminal liability (that is, before notification of suspicion is served). Still, granting relief from criminal liability is exclusively the province of a court. To restate: paying off taxes and financial sanctions does not automatically relieve a party of criminal liability.

There is one more way to safeguard against criminal prosecution. Paragraph 56.22 of Article 56 of the Tax Code states that when an administrative appeal of a controlling body's decision is filed with a higher controlling body and/or with a court, the notification of suspicion cannot be based on the decision under appeal until the administrative appeal proceedings have been finished or the court has issued its final decision.

Thus, if an accusation of tax evasion under Article 212 is based on a tax audit, the alleged offender will not be notified of suspicion until the administrative appeal of the tax authority's post-audit decision is finished and/or the Higher Administrative Court of Ukraine (and in some cases the Supreme Court of Ukraine) issues a decision against the taxpayer.

Please note that paragraph 56.22 of Article 56 of the Tax Code cannot apply if the notification of suspicion is not only based on the controlling body's decision, but is also confirmed by additional evidence. Such evidence might for instance be protocols from the interrogation of a witness or conclusions from an expert.

Conclusion

Given how often criminal proceedings are used to pressure taxpayers, protective measures are of great importance.

The administrative appeal procedure or court appeal of tax authority decisions will probably be the most effective ways to protect taxpayers' officials from criminal liability. As we discussed above, notification of suspected tax evasion cannot occur until a final court decision has been issued.

At the same time, being proactive in defense of taxpayers is always advisable. Taxpayers should exercise their right to appeal the resolutions and actions of investigators and prosecutors to the higher authorities or in court, either during pre-trial proceedings or later on.

HANDLING TAX DISPUTES IN UKRAINE

***Tetyana Matsyuk,** associate with Vasil Kisil & Partners Law Firm*

According to statistics[1] published by the Superior Administrative Court of Ukraine, disputes between taxpayers and the state tax authorities accounted for 34% of all disputes including state bodies that the local administrative courts considered in the first half of 2013. Disputes with the tax authorities are thus among the most common administrative proceedings today.

Tax disputes: subject matter and grounds

A tax dispute is a disagreement between a taxpayer and a tax or customs authority regarding the tax relations that exist between them (mutual rights and obligations). Such disputes arise from different interpretations of the tax legislation. The most common tax disputes concern invalidation of tax notifications-decisions, questions of the legality or illegality of the inspection orders that the Ministry of Revenue and Duties issues, and recognition of other orders as either legal or illegal (such orders might have to do with cancellation of VAT registration, the single tax, and so on).

The Tax Code of Ukraine defines a tax notification-decision as a written notice from a supervisory authority regarding a taxpayer's obligation to pay a sum of money as determined by a supervisory authority or to make appropriate changes in its tax reporting.

A taxpayer tends to receive a tax notification-decision after a tax audit. They can have to do with the fact that the taxpayer underestimated its tax liability, with the amount that the taxpayer owes, or with the negative value of the object of taxation.

Tax audit results are issued as acts or certificates. Should an audit discover violations, an act is issued; if there were no violations, a certificate is issued. The Tax Code of Ukraine gives a taxpayer the right to disagree with a tax audit act in the period before it's used as a basis for the issuance of a tax notification-decision.

A taxpayer that disagrees with a tax audit's conclusions or with the data set forth in the act is entitled to file its objections with the supervisory authority within five working days of receiving the act. The supervisory authority considers these objections within five working days of receiving them.

The supervisory authority issues the tax notification-decision within 10 working days following the day on which the taxpayer receives the tax audit act. If the taxpayer files objections to the act, the tax authority issues the tax notification-decision within three working days following the day on which it reviews the objections, sending a written response to the taxpayer.

Before a taxpayer goes to a higher-level tax authority or a court to appeal a notification-decision resulting from a tax audit, therefore, it has the right to file objections to the audit act directly with the authority that performed the audit.

Once the authority that performed the audit reviews the objections, it issues a tax notification-decision. Tax notifications-decisions can also be appealed via administrative and/or judicial procedure.

Appealing tax notification-decisions via administrative procedure

Appealing a tax notification-decision via administrative procedure means filing a complaint with a higher-level supervisory authority and asking that the original decision be renewed.

The complaint should be lodged in writing within 10 calendar days after the receipt of the tax notification-decision or other decision that's in dispute.

If the supervisory authority decides to fully or partially reject the taxpayer's (primary) complaint, the taxpayer has the right to file the secondary complaint with a higher supervisory authority within 10 calendar days following the date on which the taxpayer receives the rejection.

[1] *http://www.vasu.gov.ua/ua/generalization_court_practice.html?_m=publications&_t=rec&id=3063&fp=11.*

Primary complaints against tax notification-decisions issued by the local state tax inspection are filed with the supervisory authorities in the Autonomous Republic of Crimea, in the cities of Kyiv and Sevastopol, and in the country's regions and inter-territorial bodies.

Secondary complaints against tax notification-decisions issued by supervisory authorities in the Autonomous Republic of Crimea, in the cities of Kyiv and Sevastopol, in the country's regions and inter-territorial bodies, and customs authorities are filed with the Ministry of Revenue and Duties of Ukraine.

For example, a primary complaint against a tax notification-decision issued by the State Tax Inspection in the Pechersky district of Kyiv will be filed with the Chief Directorate of the Ministry of Revenue and Duties, in Kyiv. If the taxpayer disagrees with the Directorate's decision, it can then lodge a complaint with the Ministry of Revenue and Duties of Ukraine.

When a disputed tax notification-decision is issued by the Interregional Directorate of the Ministry of Revenue and Duties' – Central Office for servicing major taxpayers or by the specialized state tax inspections that service major taxpayers in the cities, the administrative procedure consists of only step: the taxpayer requests a review from the Ministry of Revenue and Duties.

The authority that considers the taxpayer's appeal adopts a reasoned decision and sends it to the taxpayer within 20 calendar days following the date of its receipt. Delivery is by registered mail or by simply handing it to the taxpayer against written acknowledgement. The authority has the right to extend the term for reviewing the complaint, but for no longer than 60 days, subject to the prior notification of the taxpayer.

If the decision isn't sent to the taxpayer within the 20-day period or within the extended term, the complaint is considered fully satisfied in favor of the taxpayer. That's also the case if the decision to extend the consideration period isn't sent to the taxpayer by the time the 20-day period expires.

The administrative procedure is considered to represent pre-trial settlement of a dispute. A supervisory authority decision that was earlier appealed cannot be brought for administrative appeal.

Administrative procedure usually takes anywhere from one to three months, depending on the number of complaints that have been submitted and the efficiency of the supervisory agencies in question. This sort of pre-trial dispute resolution procedure is rarely successful, but it does represent an opportunity to prepare for further appeals in court, as the taxpayer gets more time to collect evidence and prepare its legal position.

Judicial appeal of tax notifications-decisions

The taxpayer has the right to appeal a tax notification-decision in court either without appealing it under the administrative procedure or after exploring that avenue.

Deadlines for filing a tax notifications-decision appeal in administrative court

In both cases it's important to pay attention to the timeframe during which a taxpayer has the right to sue:

- If the taxpayer has previously filed an appeal against a tax notification-decision with higher-level supervisory authorities (as described above), then he has the right to file a lawsuit to invalidate the tax notification-decision within a month:
  - after the administrative procedure has been exhausted;
  - starting on the day when the Ministry of Revenue and Duties issues its decision about the complaint;
  - starting on the day following the last day of the period provided for the submission of a complaint if the complaint was not submitted within the specified period (paragraph 19 of Article 56 of the Tax Code of Ukraine);
- If the taxpayer did not use the administrative procedure it has the right to appeal a tax notifications-decision for 1095 days after receiving the decision (paragraph 18 of Article 56, Article 102 of the Tax Code of Ukraine).

Nevertheless, one must take into account that tax notifications-decisions must be challenged in Administrative Court within 10 days of their being received – or within 10 days of receipt of the decision resulting from the top-level tax authority review of the payer's complaint – if collection of the tax debt is to be avoided.

Court fees for appealing tax notifications-decisions in administrative court

The Superior Administrative Court of Ukraine's letter № 165/11/13-12 of 18.01.2012 states that claims to invalidate tax notification-decisions represent property claims. When asking an administrative court to invalidate a tax notification-decision, then, the petitioner must pay a court fee of 2% of the value of the property claim, but no less than 1.5% of the minimum wage and not more than four times the minimum wage as established by law as of January 1 of the calendar year. That said, recent changes to the law that governs court fee payments state that the fee due for filing an administrative property claim is 10% of the court fee rates. The balance of the court fee is charged to the claimant or defendant in proportion to the granted or rejected part of the claim.

Tax disputes in administrative courts

Appealing tax notifications-decisions or other tax authority decisions in court requires filing a claim for invalidation or revocation of the contested decision with the local administrative court.

If the claim meets all the requirements, the judge rules to open the proceedings. Local administrative courts should decide on tax disputes and other administrative matters within a reasonable time frame, but in no longer than a month from the date on which the proceedings begin. The litigation process has a number of stages: the representatives of the taxpayer and the tax authority present their cases; the court reviews the evidence; the court deliberates; the court issues a decision on the case.

Appealing a judgment, the appeal/cassation procedure, and Supreme Court of Ukraine review of judicial awards

Parties to a tax dispute have the right to appeal a local administrative court decision in the administrative court of appeals if the first-instance court has issued a decision that violates substantive or procedural law or that has incorrectly or incompletely established the facts of the case.

The appeal is filed with the administrative court of appeals through the local administrative court within 10 days from the date the decision is announced or within 10 days from the day the appellant receives the act if the full text of the decision was issued after the hearing. The maximum term for considering an appeal is 46 days from the date of the decision to open the appeal proceedings.

An administrative court of appeals decision may be appealed in the Superior Administrative Court of Ukraine. The cassation court verifies whether or not the courts of first instance and the appellate court properly applied substantive and procedural law and whether the legal assessment of the facts in the case was correct. It cannot examine evidence or determine or accept as proven circumstances that have not been established in the judgment; nor can it decide on the validity of evidence.

An appeal has to be filed within 20 days after the court of appeal judgement takes force or 20 days from the date on which the full version of the act is drawn up, if the full text of the decision was drafted after the hearing. A cassation appeal should be considered within a month after the appellate court receives the administrative case.

The Supreme Court of Ukraine can in exceptional circumstances reverse tax dispute decisions. The petition for review of a judgment may be filed only on the following grounds:

- A court of cassation instance has applied the same substantive law in different ways, resulting in different judicial awards for similar legal relationships;
- An international judicial institution whose jurisdiction is recognized by Ukraine establishes that a court case has resulted in a violation of Ukraine's international obligations.

Because of the considerable workloads that burden administrative courts, tax disputes in local administrative courts, courts of appeal and courts of cassation instance may collectively take more than a year.

Claims filed by income and revenue agencies (shortened proceedings)

Proceedings in cases of claims filed by income and revenue agencies are of a special, shortened type, according to which the court doesn't resolve a public legal dispute, but rather exercises control over revenue and fee agency decisions and actions that can affect taxpayer rights and interests.

The parties to such a proceeding are the following: the applicant, the income or fee agency that registered the claim, and the taxpayer with respect to which the claim was made. This type of process is used in four cases:

- To suspend outgoing transactions from a taxpayer's accounts;
- To confirm the validity of the administrative arrest of a taxpayer's assets;
- To recover tax debt;
- So that the head of an enterprise can take an inventory of fixed and material assets that were or are under customs control or that the enterprise uses; and of goods that have been placed under a customs procedure.

* * *

According to data from the Ministry of Revenue and Duties website, the first half of 2013 saw more than 104,000 cases involving its agencies pending in courts; these cases involved a total of UAH 167.1 billion. The Ministry won 31,500 tax cases in 2013, totalling UAH 23.1 billion, while taxpayers won almost 6,000 cases, totalling UAH 16.3 billion.

These statistics, of course, are relative, since many tax disputes resolved in favor of the tax authorities involve litigation to cancel the VAT payers registration and the like; that is, they are in most cases pure formalities and are indisputably resolved in the authorities' favor.

It's also worth noting that the total number of disputes resolved in favor of the tax authorities exceeds the number of disputes resolved in favor of taxpayers by more than five times (31,500 cases as opposed to 6,000 cases). Yet the amount of disputed monetary obligations in cases the tax authorities won exceeds the amount in cases taxpayers won by less than twofold (UAH 23.1 billion as opposed to UAH 16.3 billion). This suggests that appealing tax notifications-decisions and decisions in Ukrainian administrative courts is likely to result in positive outcomes for taxpayers.

THE NEW TRANSFER PRICING LAW: UKRAINE AIMS AT IMPROVED TAX TRANSPARENCY

Konstantin Kaprushin *and* ***Oleksandra Tovkun,*** *KPMG Ukraine*

One of Ukraine's main challenges on its way toward European integration is harmonizing its economic and tax legislation with the European acquis communautaire. The goal is to ensure fair competition and good corporate governance and tax transparency in the Ukrainian economic area.

An issue that has raised a lot of discussion lately is the Law "On Amendments to the Tax Code of Ukraine Regarding Transfer Pricing," which took force on September 1, 2013. Even though the international business presence in Ukraine has been increasing in recent decades, the transfer pricing rules have been vague and rarely applied by the tax authorities. Moreover, the very concept of transfer pricing is new to the Ukrainian legislative field. It was introduced for the first time in the new Transfer Pricing Law. The Ukrainian tax authorities, however, have adopted a proactive approach, learning from world transfer pricing experience and developing a legislative base to ensure that the new law is fully and correctly applied.

The absence of a proper transfer pricing system within a multinational company can result in an outflow of taxable income from specific countries (so-called base erosion). Given the substantial budget deficit in 2013,[1] this is an especially sensitive issue in Ukraine. According to the Ministry of Revenue and Duties, in 2012 more than $20,5 billion in commodities was exported from Ukraine through related parties, giving rise to concerns of whether profit shifting had taken place. To counter possible harmful practices, the tax authorities have established two major ways to monitor transactions performed by Ukrainian taxpayers with related parties. First, before May 1, 2014, taxpayers are obliged to report the controlled transactions they performed in 2013 to the tax authorities. Second, based on the filed reports, tax authorities may request transfer pricing documentation with regard to specific transactions. Regular taxpayers will have 30 days (60 days for large taxpayers) to prepare and submit such documentation. It should include thorough information on the transaction and the parties performing it, functional analysis (a detailed analysis of functions performed, risks incurred, and assets employed by each party to the transaction), and proof that the price charged or profitability level reached in the controlled transaction is at arm's length. The latter can be obtained either through a benchmark study (usually conducted with the use of specialized databases) or by calculating a range of comparable uncontrolled prices. Failure to file a report on controlled transactions or to produce transfer pricing documentation may result in large fines and will likely trigger a tax audit.

One of the specifics of the Ukrainian transfer pricing law is that it stipulates control not only over transactions performed with related parties, but also over those performed with independent parties that are tax residents of the so-called low tax or offshore jurisdictions (or that effectively pay their taxes in such jurisdictions). A jurisdiction is considered to be low-tax if its corporate income tax rate is five percentage points or more lower than in Ukraine. Such an approach imposes comprehensive control over all operations where base erosion and profit shifting (BEPS) could potentially occur.

BEPS has recently been a matter of growing importance for the European and global community. Numerous multinational companies, such as Google, Starbucks, and Facebook, have been publicly criticized by the state officials of different countries for using tax optimization schemes and thus underpaying large amounts of taxes in the countries where resources were actually consumed and value created. Most of these schemes are formally legal, exploiting existing double-tax treaties and using tax preferences offered by low-tax and offshore jurisdictions, widely resulting

[1] 34,7 billion UAH in Jan-Aug 2013.

in the so-called "double non-taxation" of profits. OECD has issued several documents addressing this problem.[2] One way to counter BEPS is to improve tax legislation and to ensure dialogue between tax administrations across Europe and the world. Ukraine is an integral part of this process. The enactment of the Transfer Pricing Law can be viewed as a step forward in Ukraine's economic and political collaboration with the global community. Another achievement is the cooperation with the U.S. Internal Revenue Service on the Foreign Account Tax Compliance Act (FATCA) that is about to commence. FATCA aims to establish an information exchange among tax and financial institutions regarding the accounts of U.S. tax residents, and should contribute to increasing tax and financial transparency in their global operations.

Finally, Ukraine has recently joined the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, accepting the G20 Standards in this field. All of the above is evidence that Ukraine has made a move toward improved tax governance and better economic legislation in order to fit into the European and global legal field.

[2] *Addressing Base Erosion and Profit Shifting; OECD Action Plan on Base Erosion and Profit Shifting.*

CREATING TAX EFFICIENT ISLAMIC FINANCE SOLUTIONS IN UKRAINE

Introduction

A growing number of businesses in Ukraine are becoming interested in using sharia-compliant financial instruments.

No Ukrainian banks yet offer Islamic finance products to the public. Given the growing interest in them, however, we can expect them to appear in Ukraine in the not too remote future.

The growing interest in Islamic finance in Ukraine is constrained by the absence of special legislative rules, particularly in the tax field, which would stimulate the use of Islamic financial instruments. At the same time, due to Ukraine's tax system neutrality and to the system's up-to-date character, there are no provisions that prohibit Islamic finance projects. Having said that, though, proper tax and legal analysis and structuring will often be required.

REPO

The REPO mechanism is widely used in Islamic financing (in ijarah wa iqtina schemes, for example). REPO operations always involve a double sale of assets between two contractors. The purpose of REPO operations is for one party to meet its borrowing needs.

The REPO mechanism

The borrower in a REPO operation is the original seller of the securities that are used as loan collateral. The second transaction in a REPO agreement involves the lender's resale of the same securities back to the borrower at a higher price. The difference in price represents the interest for a lender.

Under an ijarah wa iqtina contract, the borrower is also the original seller of the underlying assets (immovable property, for example). The lender in turn rents out that immovable property (an office building, perhaps) to the borrower and receives from the latter rental payments. At the end of the lease agreement the lender sells the office building back to the borrower. The resale price is usually greater, as it comprises accrued rental payments.

Taxation of REPO operations in Ukraine

Current Ukrainian legislation does not contain rules that would prohibit REPO operations. Such operations, however, require careful planning.

VAT:

The Ukrainian Tax Code provides a tax exemption for granting cash loans and for rendering securities and REPO operation services. This is a major factor for Islamic financing involving the double sale of underlying assets, given that, according to the general rule, resale incurs double VAT taxation in Ukraine.

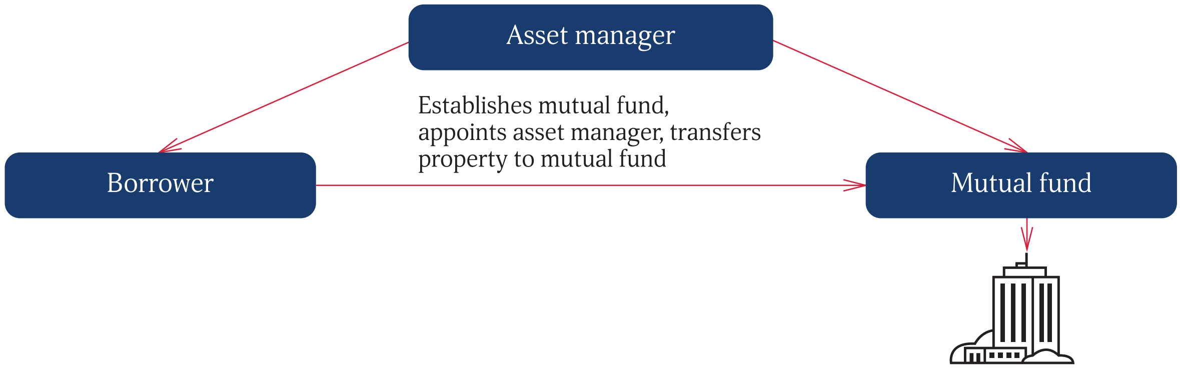
Profit tax:

The profit that a REPO operation generates is classified for tax purposes as genuine profit. It's possible to use REPO transactions to repurchase shares in Ukrainian companies and to re-purchase shares in mutual funds.

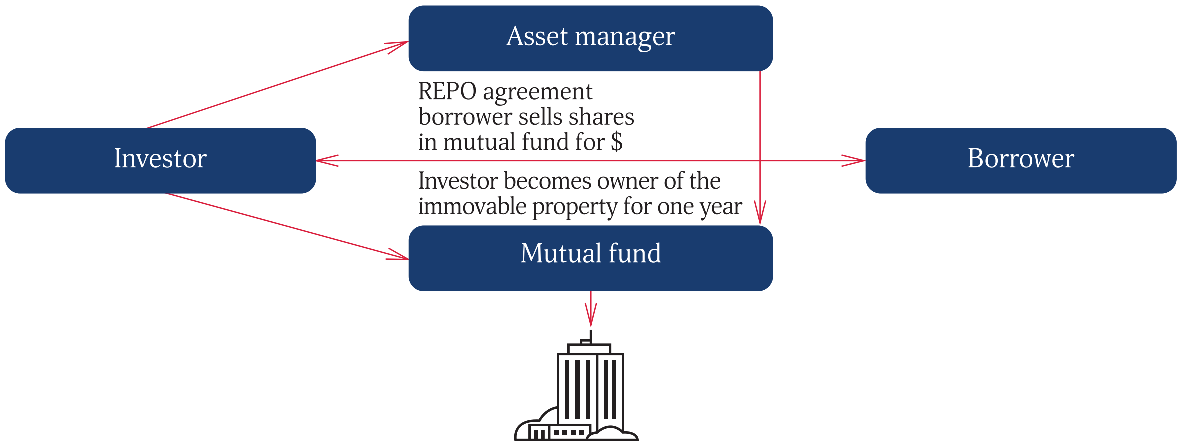
Mutual funds

According to the current legislation a mutual fund does not have a legal personality and is not a taxpayer as such. Mutual funds are separate property portfolios managed by professional asset managers. Many experts consider mutual funds a suitable instrument for Islamic financing. Investment shares in mutual funds represent by themselves the right to the property that constitutes the mutual fund.

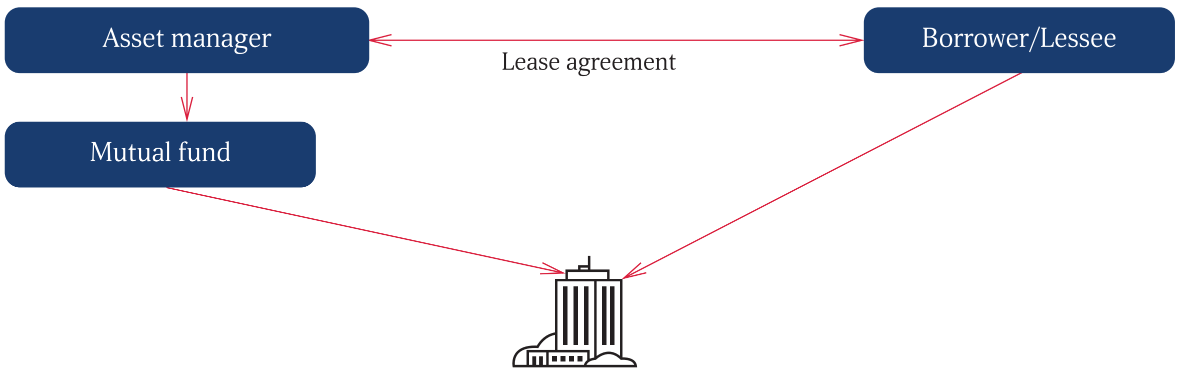
Establishing a mutual fund



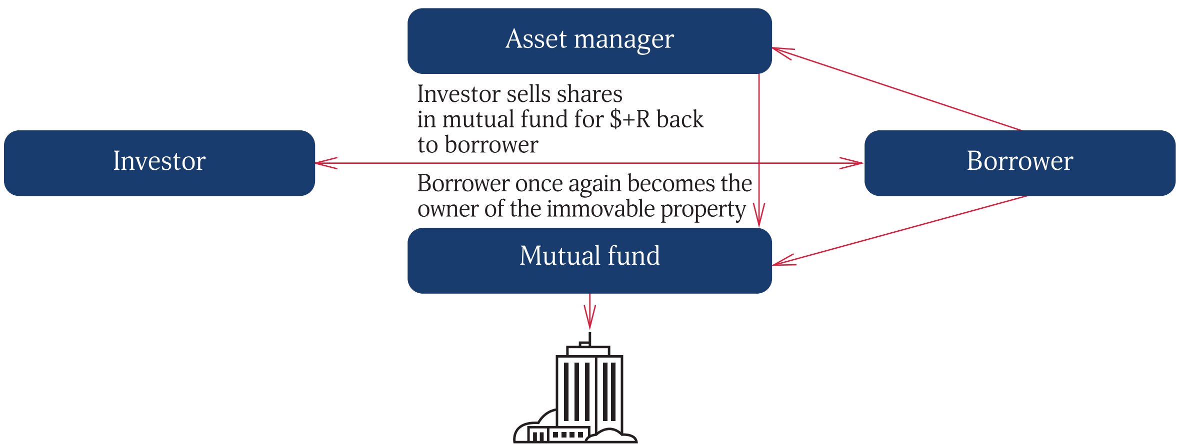
REPO agreement



Lease agreement



Resale operation (second transaction in REPO agreement)



Commentaries

"R" represents rental payments the borrower made to the asset manager at the end of the lease agreement. "R" may be considered as a deductible expense for the borrower.

Expenses

The borrower reduces the tax base by "R" at the end of the REPO agreement.

Income

The following categories of investors are to pay 19% profit tax on "R" income (or 15% in the case of a non-resident without double tax treaty protection) after the sale of the underlying assets back to the borrower:

- Ukrainian investors;
- Foreign investors with permanent establishments in Ukraine;
- Foreign investors without permanent establishments in Ukraine — residents of states that do not have double tax treaties with Ukraine.

The situation changes where a double tax treaty (DTT) applies. Ukrainian international treaties take priority over domestic Ukrainian legislation.

DTTs to which Ukraine is a party often lack REPO-related provisions. Consequently, other tax rules envisaged by international tax treaties will apply. Further taxation depends on how the tax authorities define profits derived from the alienation of shares in mutual funds:

- As interest income;
- Or as income from the sale of property;
- Or as capital gains unrelated to property (e.g. shares).

The least desirable variant is obviously number two, where there is a 19% profit tax rate.

The tax rate for interest income depends on the DTT in question. For example, the Ukraine/UK DTT provides for a 0% tax rate.

Capital gains unrelated to property are taxable by the state of the investor. Many states, however, would treat shares in a mutual fund as shares income on which qualifies for a participation exemption.

As for VAT, loans and alienations of shares in mutual funds are tax-exempt.

In the end, investors can obtain a 0% tax rate on their income derived from the resale of shares in Ukrainian mutual funds, and thus benefit from a tax-efficient Islamic finance instrument. Tax risks could arise, however, if the Ukrainian tax authorities define the result as related to the sale of the property.

Issuing sukuk in Ukraine

As mentioned above, the Ukrainian tax and legal system contains no specific legislation on issuing sukuk. At the same time, the tax and legal framework in the field of securitization as developed over the last 10 to 15 years, is neutral, investor-friendly, and efficient. It is also possible to use non-Ukrainian special purpose vehicles to organize issuance of securities. These securities may subsequently be traded or listed either on foreign stock exchanges or on the Ukrainian stock exchange.

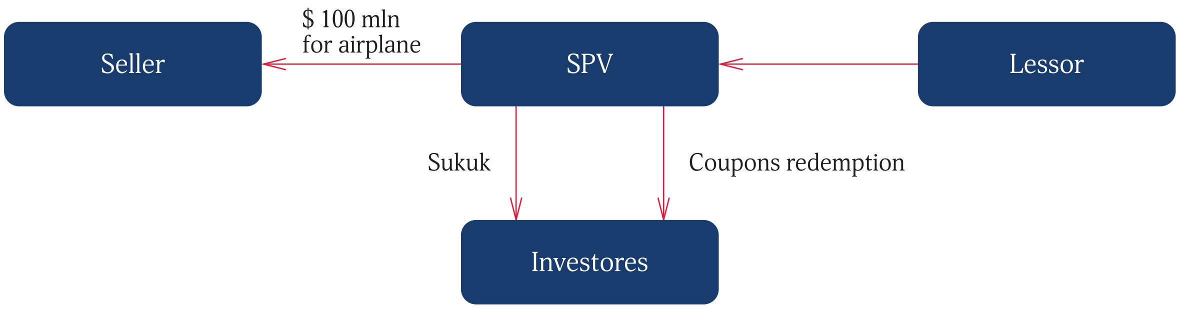
Issuance of sukuk by Ukrainian companies is therefore possible either in Ukraine or abroad. Considering that interest in Islamic finance is growing in Ukraine, the issuance of the first Ukrainian sukuk might take place in the not too remote future.

Aviation leasing

In some areas, such as aviation leasing, a typical transaction structure resembles the typical structure of sukuk. An aviation lease transaction could thus be structured as sukuk without significant complications.

Despite this, it is sometimes said that Ukrainian law poses serious obstacles to issuing sukuk. We believe these statements are not entirely correct. It will thus be useful to demonstrate the tax consequences that issuing sukuk will trigger, for instance in the securitization of aircraft leasing.

The analysis involves a typical sukuk structure, as follows:



Under domestic tax law, lease and interest payments to non-residents are subject to withholding tax of 15%, while lease and interest payments to Ukrainian corporate residents are not taxed by way of withholding. Income is taxed in the hands of Ukrainian residents by way of self-assessment at the same rate.

For the purposes of this analysis it must be noted that while genuine interest is regarded as inconsistent with the principles of Islamic financing, for tax purposes certain payments within Islamic financing structures may qualify as interest for the purposes of applying tax treaties. Hereinafter, when we discuss "interest" in the context of sukuk structures we understand sharia-compliant payments or their components, qualifying as interest for double tax treaty purposes only.

Under certain Ukrainian double tax treaties the 15% withholding tax on interest and lease payments is reduced or eliminated. Such a tax treaty benefit is granted upon provision of a tax residence certificate by a non-resident recipient of the income. Collecting such tax residence certificates for a significant number of investors might make the process difficult. If there is a significant number of foreign investors, therefore, it may be useful to issue sukuk through an SPV abroad.

Depending on where investors are located, the SPV may be established either in Ukraine or abroad. As internal Ukrainian leasing operations do not result in sophisticated tax consequences and do not involve an international element, we will consider a structure more appropriate for international investors, one with the SPV located outside of Ukraine.

In light of the Ukrainian withholding tax implications, decisions related to the location of an SPV should also be made with regard to the relevant tax treaty. Preferably, such a tax treaty should provide for zero withholding tax on lease payments and interest deriving from Ukrainian sources. The SPV's jurisdiction should also allow tax free payment of outbound interest and lease payments from the SPV to investors.

A limited number of countries are popular in Ukraine for the purpose of establishing SPVs in financial structures. At present the United Kingdom and Cyprus are among the most frequently used, as these countries provide for a stable and predictable tax and legal framework, investor-protective legislation and international tax, an appropriate infrastructure, and a tax-friendly environment. The Ukrainian tax treaties with these countries provide for zero or reduced withholding tax on interest. It is worth noting that the tax treaty with the Netherlands does not impose withholding tax on lease payments to foreign investors, and that the Netherlands do not impose withholding tax on interest or lease payments under domestic law.

If an SPV is established in a foreign jurisdiction, this SPV (the lessor) would lease out aircraft to a Ukrainian aviation enterprise (the lessee). Hence the major Ukrainian tax consequences to consider would be as follows.

Tax consequences of issuing sukuk

A. Withholding tax in Ukraine

Under the general rule, the withholding tax rate on interest and lease payments in Ukraine is 15%.

Under the Ukraine-Netherlands double tax treaty lease payments to tax residents of the Netherlands are exempt from withholding tax.

The only requirement is that the Ukrainian lessor be provided with a tax residence certificate. This certificate may be obtained from the relevant competent fiscal authorities.

Another important requirement to comply with is that the tax residence certificate be apostilled or that the full procedure for its legalization be completed.

Failure to provide such a tax residence certificate may result in 15% withholding tax on the entire amount of the payment. In such a case the non-resident SPV entitled to tax treaty benefits would have to request a refund of the withheld tax from the Ukrainian tax authorities. This may turn into a lengthy and complicated procedure; it is thus better to provide the Ukrainian lessor with a tax residence certificate prior to the payment of income.

B. Value added tax in Ukraine

The general VAT rate in Ukraine is 20%. Ukraine generally follows the principles of the EU VAT directive. As in most cases the businesses operating aircrafts will be VAT payers, VAT will be neutral (that is, VAT paid should be off-setable against VAT received) and should not result in an additional tax burden.

In fact, even if this service is subject to Ukrainian VAT, because the service provider is not located in Ukraine the VAT would be paid and offset against its own VAT liabilities by the Ukrainian lessor. This would effectively eliminate an additional tax burden on lease payments.

Conclusion

The current Ukrainian tax environment is an adequate one in which to structure Islamic finance transactions, in particular in respect of securitization for aircraft leasing with the involvement of foreign investors.

Appropriate tax structuring may require the establishment of an SPV outside of Ukraine, which is not uncommon in conventional securitized leasing transactions. The use of the Netherlands, the UK, or Cyprus for the establishment of such an SPV should facilitate tax efficiency and simplicity of investment for foreign investors.

On the basis of our vast experience in structuring and implementing conventional aviation leasing transactions, we believe that implementation of such a transaction in a sharia-compliant way through the issuance of sukuk will create no adverse consequences and can be successfully implemented within Ukraine's current tax and legal framework.

17 GLOBAL TRENDS THROUGH A UKRAINIAN PRISM

What's going on in the world today? What are consumers thinking? Recent years have seen constant monitoring of global trends, towards answering these questions.

In summing up the results of 2013, UMG International chose three popular world trends and then viewed them through the eyes of Ukrainian consumers. These trends are as follows:

- "The mobile cocoon" – this refers to the new world of possibilities for consumers that Internet and mobile devices are creating
- "The share economy" and "marketplaces" – mutually beneficial exchange, sharing, and buying of goods and services, directly between consumers
- Brands that demand social responsibility from the consumer

These trends are interesting because they're based on dynamic developments in technology and communications, and because they change consumer behavior. They way they're manifesting themselves in Ukraine highlights the differences between the behavior of Ukrainian consumers and the behavior of other consumers around the world.

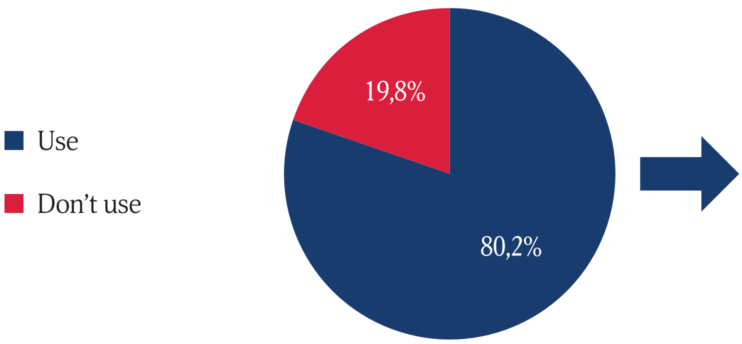
The mobile cocoon has developed as the result of the combination of several tendencies in the digital world:

- The increase in the number of smartphone owners
- The expansion of the Internet audience due to the prevalence of mobile devices
- Changing consumer behavior due to the extensive use of applications

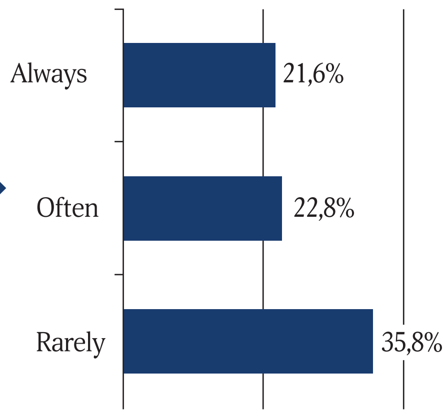
It's clear that smartphones are here to stay in our daily lives. People don't leave home without them, and keep them on hand wherever they are. The smartphone market is growing by at least 50% per year.

A survey of regular Internet users in Ukraine between 18 and 65 years of age showed that 80% of users use their smartphones to search for information anywhere, any time.

Using a smartphone to search for information



The frequency of use of a smartphone for information



** Data from a study conducted by UMG International in October 2013*

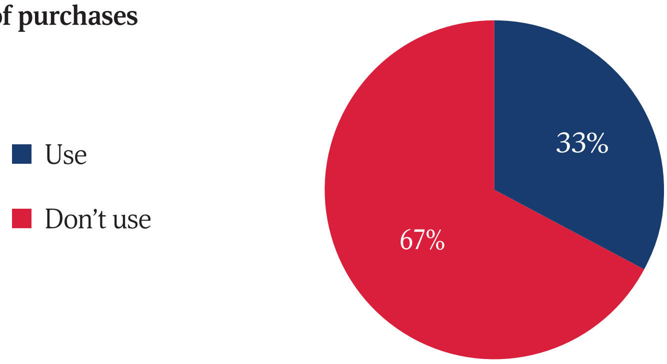
Sample: 162 respondents, 18–65, regular users of the Internet

The global consumer is becoming simultaneously more sophisticated and more dependent. A smartphone serves as a mobile office, a handheld search engine, an adviser on a range of issues, and a source of entertainment.

Smartphones are even becoming integral for shopping in stores: a potential buyer can immediately access information about a product and compare price offers. In addition, 93.8% of regular Ukrainian Internet users buy goods that they previously discussed on social networks, received advice about, or previously tried.

A smartphone perfectly supports its owner's desire to go "public" with his or her purchases. In addition, a user can map out his or her location, share with others what he or she is doing and with whom, and make public his or her particular impressions of any given moment. Half of the world's smartphone owners engage in this sort of activity. Only a third of Ukraine's smartphone owners in Ukraine publicly discuss their activities, however.

Geo-tagging and sharing pictures of purchases

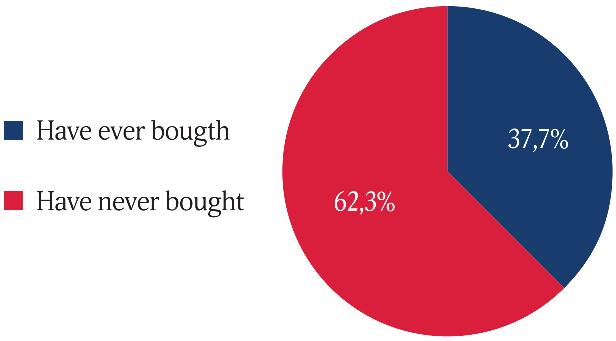


** Data from a study conducted by UMG International in October 2013*

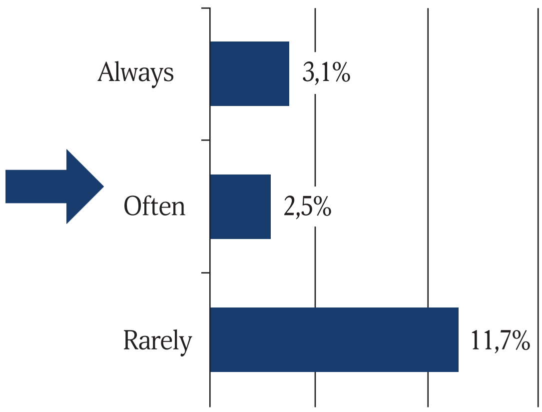
Sample: 162 respondents, 18–65, regular users of the Internet

Applications are also affecting smartphone owner behavior. The global consumer has already passed through a boom of downloading free applications, selecting the most interesting and beginning to pay for advanced features (more than half of smartphone users worldwide pay for applications). Ukraine started seeing a boom in free applications only recently. But paid applications are not far behind. Thirty-eight percent of regular Ukrainian Internet users have already purchased applications at some point.

Buying apps for a smartphone



Frequency of purchase of paid smartphone applications



** Data from a study conducted by UMG International in October 2013*

Sample: 162 respondents, 18–65, regular users of the Internet

The next trend slowly but surely gaining popularity across the world is the share economy. The principle behind the share economy is simple: people share various things or services, so that one party saves money, and the other generates some passive income.

The idea of the share economy isn't new, but it's currently becoming much more widespread. Western consumers are changing their attitude towards their property. Property is no longer an end in itself; meanwhile, people are becoming more inventive in terms of how they make money.

The past four years have seen more than 100 companies spring up offering people the opportunity to earn income from renting out their physical assets, including houses, cars, parking lots, and even tools.

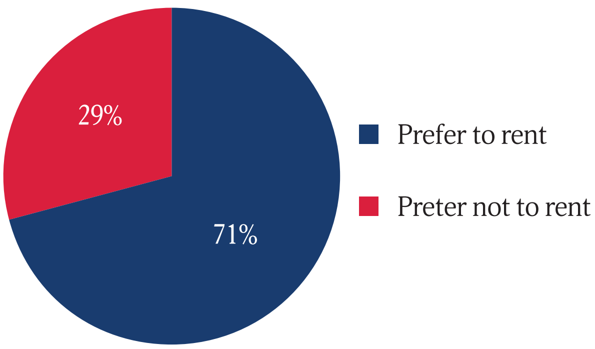
Producers can benefit from this trend as well. A company's marketing, for example, might be based on two aspects:

- It might rent out its products, expecting that in the long term the consumer may want to buy a product he or she has already tried out

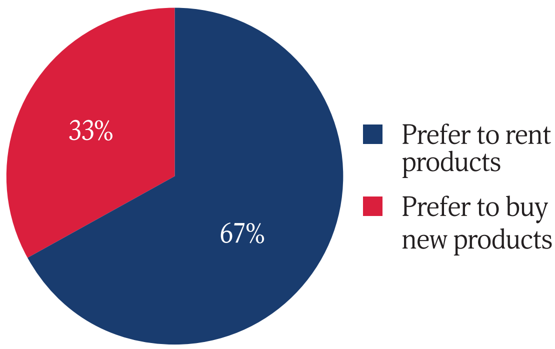
- It can promote its product as an asset, one that will generate additional income for an owner who rents it out

The share economy is currently taking root in Ukraine. Seventy-one percent of regular Ukrainian Internet users prefer to rent housing and transportation from local people when they travel. And 67% prefer to rent or borrow products instead of buying them new.

Direct rental of houses and transport among the local population when traveling



Direct rental of products for one-time consumption



** Data from study conducted by UMG International in October 2013*

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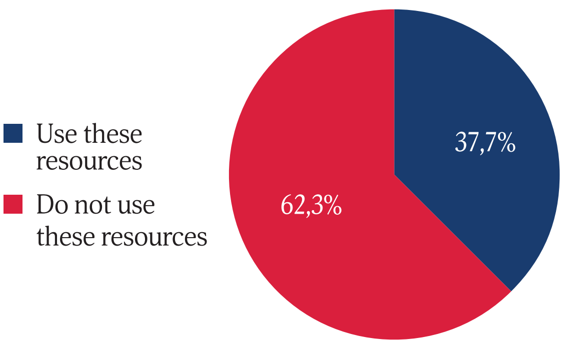
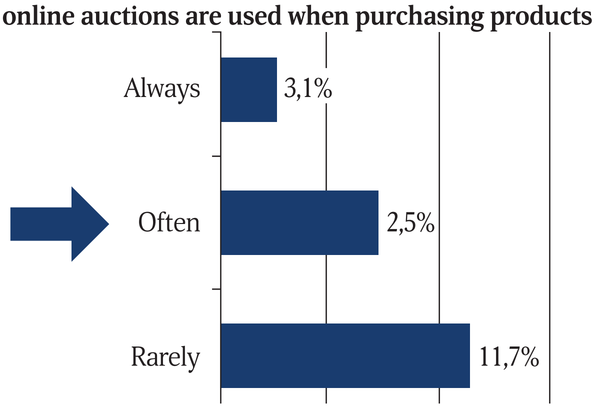
Purchasing products at online info boards and online auctions



Frequency with which online info boards and online auctions are used when purchasing products



** Data from study conducted by UMG International in October 2013*

Sample: 162 respondents, 18–65, regular users of the Internet

The popularity of these resources is based on confidence that they offer less expensive goods and services than do commercial structures.

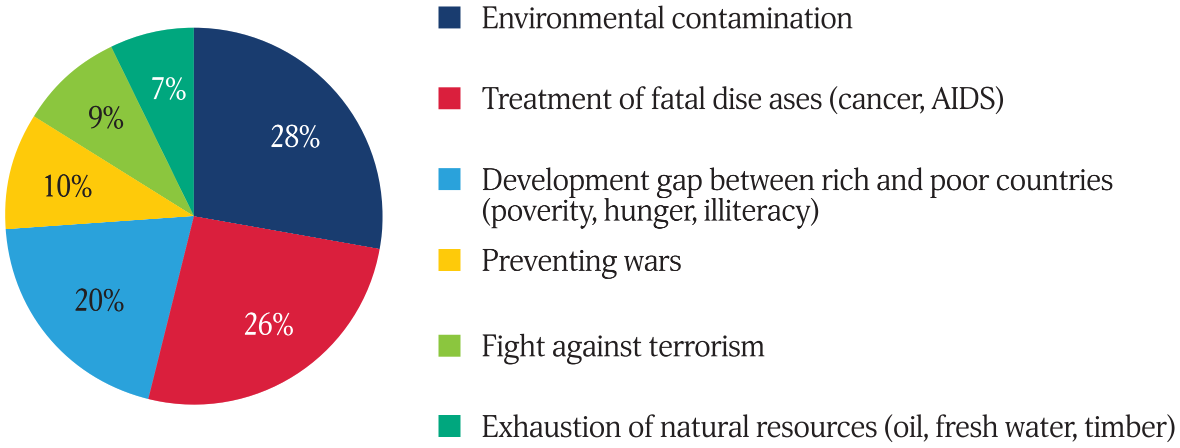
An important issue for the international community is social responsibility, with brands actually playing a teaching role in this area.

Corporate social responsibility long ago became the norm in the West. The next step will be brands that have already demonstrated their social focus, and that educate consumers and cultivate responsibility among them.

The principle is simple: the brand clearly explains why the consumer needs to pay more for it than for other brands, and how the difference will be spent. Brands are starting to work with independent structures that are professionally engaged in solving global problems.

Ukrainian consumers are concerned about the same global challenges as global consumers are. They're just as concerned about pollution (28%) and deadly diseases (26%). Some 20% of Ukrainian consumers are worried by the development gap between rich and poor countries.

Global world problems that concern Ukrainians



** Data from study conducted by UMG International in October 2013*

Sample: 162 respondents, 18–65, regular users of the Internet

Twenty-five percent of regular Ukrainian Internet users feel that the best way to alleviate global problems is to purchase goods from socially responsible brands; 20% see the solution to be donating unnecessary or second hand items.

Methods of consumer participation in solving global problems

** Data from a study conducted by UMG International in October 2013*

Sample: 162 respondents, 1 – 5, regular users of the Internet

Finally, the "depth" and speed of the global trend penetration rate in Ukraine should be noted.

The mobile cocoon based on digital and mobile technology has taken between a year and a half and two years to penetrate Ukraine and achieve popularity. The main brake here is that Ukrainian consumers lack the means and the will not only to use the cocoon, but to pay for it.

Share economy penetration in Ukraine depends on how willing Ukrainians are to participate in it. Penetration here is held back by the underdevelopment of platforms for exchange.

Western experience shows that the share economy in Ukraine will face the following problems in the next three to five years:

- The weak legal framework for barter relationships on the Internet
- Low level of consumer trust in society (confidence that they won't be cheated, robbed, etc.)
- Societal prejudice against using second-hand products

Brands that demand social responsibility from consumers have not yet taken off in Ukraine. It's too early to talk about social responsibility here, since the income level in the country prevents consumers from thinking along such lines. Only the question of strengthening corporate social responsibility is relevant for Ukraine so far.

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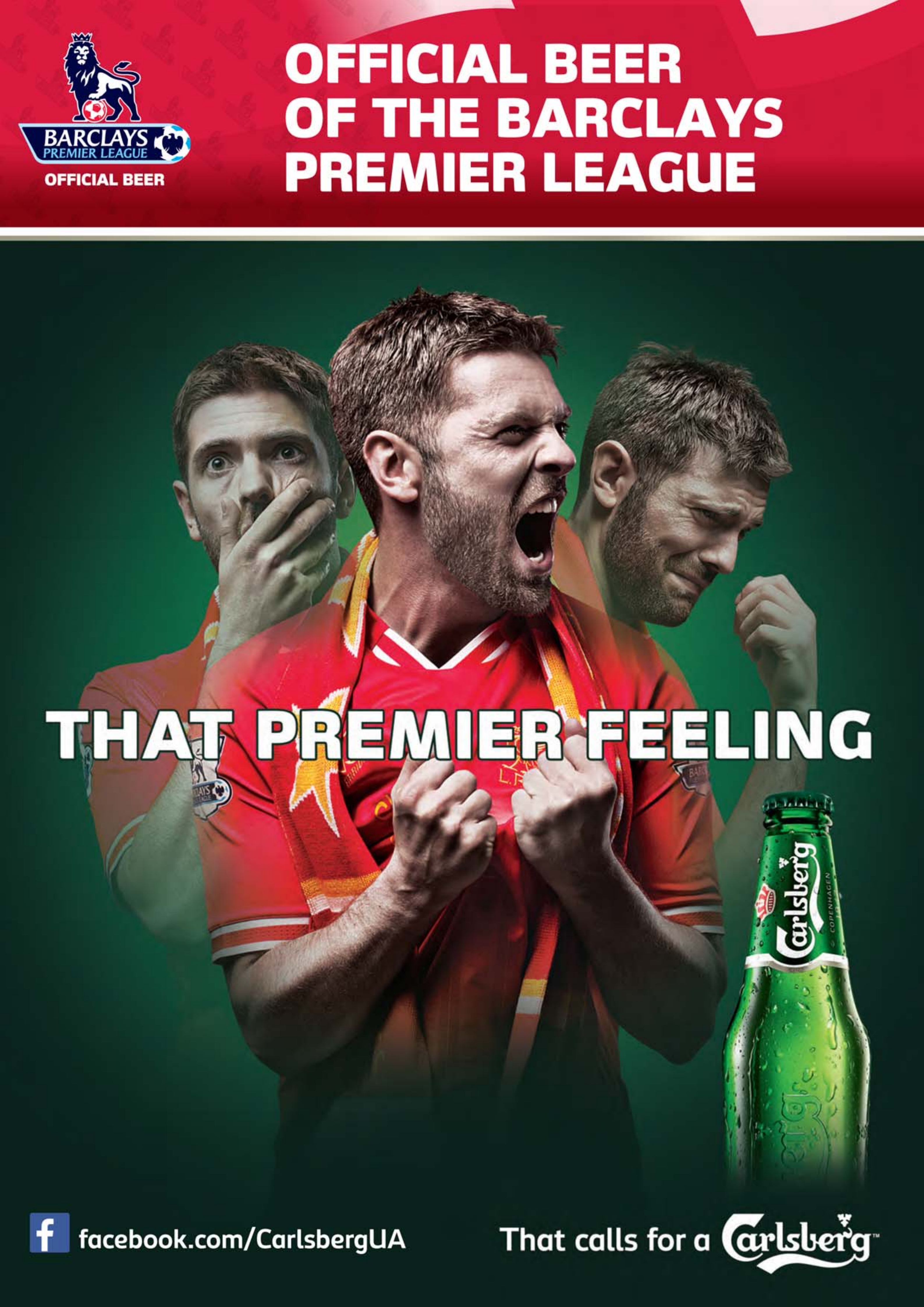
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