

# Russia & CIS Express

Quarterly bulletin from PwC's Russia & CIS Business Centre  
Summer 2009

Special Feature – Ukraine

## In this issue

- Welcome
- Meeting Boris Krasnyansky, Managing Partner of PwC Ukraine
- Cast in iron?
- Will Ukraine capitalise on the opportunity to restructure the banking sector
- Tax and regulatory issues in the spotlight
- Managing the political agenda
- Ukraine dragged into deep downturn
- An interview with Jorge Zukoski, President of the American Chamber of Commerce
- Doing business in the UK
- Key facts and figures: Belarus
- News from the Russia & CIS Business Centre



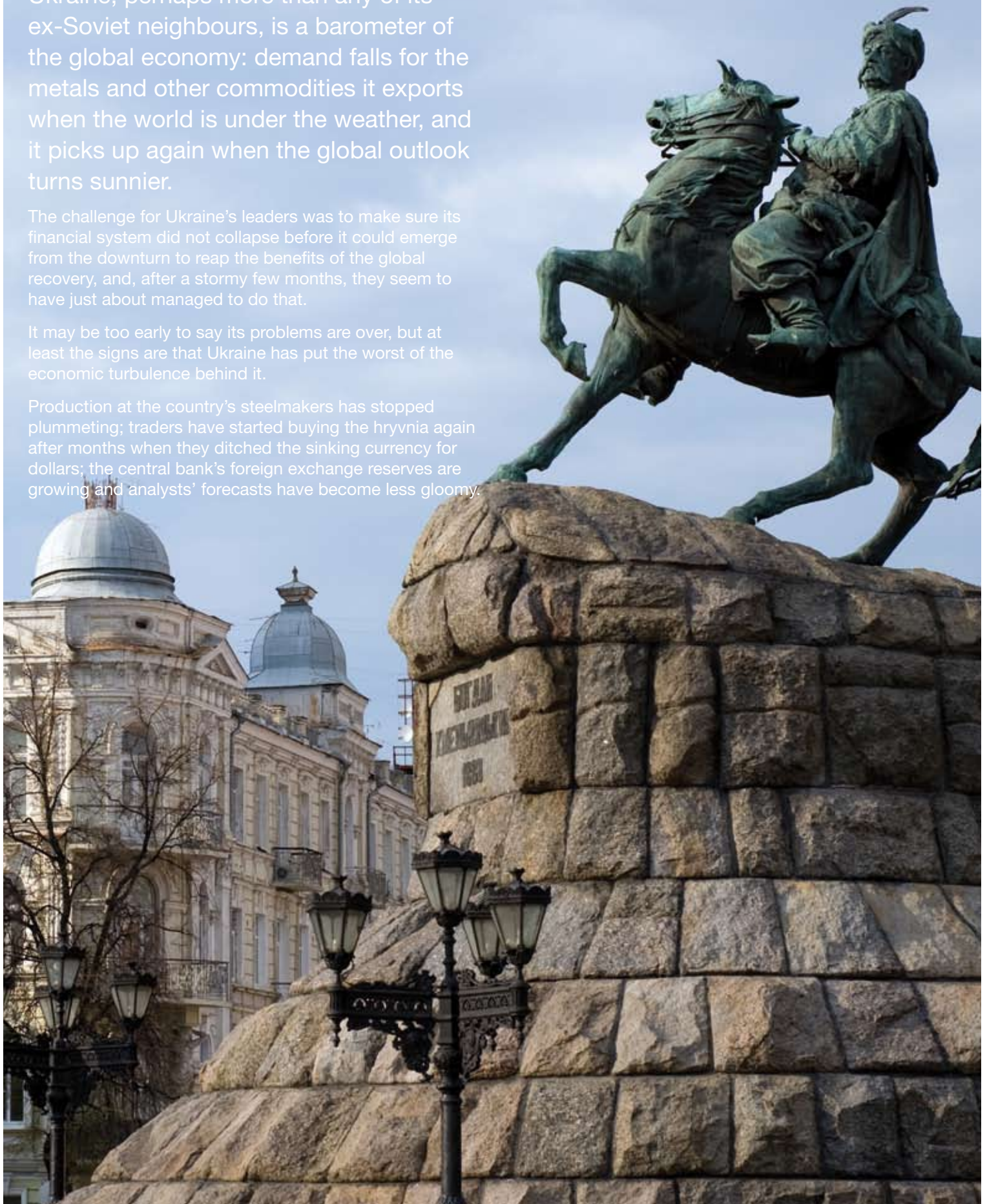
# Welcome

Ukraine, perhaps more than any of its ex-Soviet neighbours, is a barometer of the global economy: demand falls for the metals and other commodities it exports when the world is under the weather, and it picks up again when the global outlook turns sunnier.

The challenge for Ukraine's leaders was to make sure its financial system did not collapse before it could emerge from the downturn to reap the benefits of the global recovery, and, after a stormy few months, they seem to have just about managed to do that.

It may be too early to say its problems are over, but at least the signs are that Ukraine has put the worst of the economic turbulence behind it.

Production at the country's steelmakers has stopped plummeting; traders have started buying the hryvnia again after months when they ditched the sinking currency for dollars; the central bank's foreign exchange reserves are growing and analysts' forecasts have become less gloomy.



“With its export-driven economy, Ukraine was always going to suffer from the global downturn,” said Boris Krasnyansky, Managing Partner PricewaterhouseCoopers Ukraine. “The crucial factor is that the country appears to have weathered the storm.”

**“Ukraine needs to keep its financial system stable. If it can do that, then all the reasons that made it vulnerable to a global downturn will make it well-placed to profit when the world economy recovers,” he added.**

In the five years since Ukraine’s “Orange Revolution” swept in a new leadership committed to reform and integration with the West, political turbulence has dominated the outside world’s perception of this country of nearly 46 million people.

Infighting between President Viktor Yushchenko and Prime Minister Yulia Tymoshenko, former “Orange Revolution” allies, has hampered government, while bouts of wrangling with Russia over gas supplies has added to the instability.

What has attracted less attention is that away from the political fireworks, Ukraine’s economy has been growing steadily.

Gross domestic product grew by about 7 percent in 2007, and Ukraine was the third biggest destination for foreign direct investment – after Russia and Kazakhstan – in the 12-nation Commonwealth of Independent States.

That achievement is all the more significant because Ukraine has few of the oil and gas reserves that have driven foreign investment and economic growth in Russia and in Kazakhstan.

What Ukraine does have is heavy industry. The chemical and steel plants inherited from the Soviet Union have made it the region’s second biggest industrial power after Russia.

Ukraine is the world’s eighth largest steel producer and the metal accounts for 30 percent of its exports.

Before the slowdown, high demand from countries like China for steel to use in their booming construction industries brought orders rolling in.

But there are other factors besides its industrial might that make Ukraine a solid, long-term investment.

While integration with the West has been slower than promised in the heady days of the “Orange Revolution”, Kyiv joined the World Trade Organisation last year – ahead of Russia – and Ukraine has a partnership agreement with the European Union.

The country’s location on the eastern edge of the European Union, and its deep sea ports on the Black Sea, help too. Costs for shipping steel, chemicals and grain to world markets are lower than for Ukraine’s competitors in Russia.

The growth of the steel industry in Ukraine owes much to strong global demand but also bears testament to the good conditions inside Ukraine for doing business.

Home-grown firms such as Metinvest and Industrial Union of Donbass (IUD) – the biggest and the second biggest Ukrainian steel producers respectively – have expanded to make major acquisitions abroad, while in 2005 the world’s biggest steelmaker, ArcelorMittal, bought the country’s biggest steel mill for US\$4.8 billion in a privatisation auction.

There is little doubt that political turmoil in Kyiv has hampered the economy: analysts say government decision-making is slow and reforms have been hesitant.

But some investors see a silver-lining even here. They say the government has been too divided to push through a proposed re-privatisation of former state enterprises which, if it had gone ahead, could have made the investment climate more uncertain.

And investors note that the rival factions in the government and presidential administration were able to bury their differences for long enough to negotiate a US\$16.4 billion loan programme with the International Monetary Fund. The loan has played a crucial part in restoring some stability to the financial system.

“Ukraine’s economy has shown considerable resilience,” said Elizabeth Henson, Tax Partner in PricewaterhouseCoopers LLP UK. “It has suffered a sharp fall in its currency, gas rows with its neighbour Russia, and government divisions, yet all the signs are that it has come out the other side intact.”

**“Ukraine’s more far-sighted industrialists and entrepreneurs are now getting their companies ready for the next phase in the global cycle: the recovery,” she added.**

An acquisition by the largest Ukrainian steelmaker Metinvest could be a sign of things to come. The firm concluded a deal in April to buy U.S. coal miner United Coal to help keep its smelters supplied with coking coal. In Ukraine, it seems, some firms are already looking beyond the storm clouds towards a brighter future.

by the editor of Russia & CIS Express

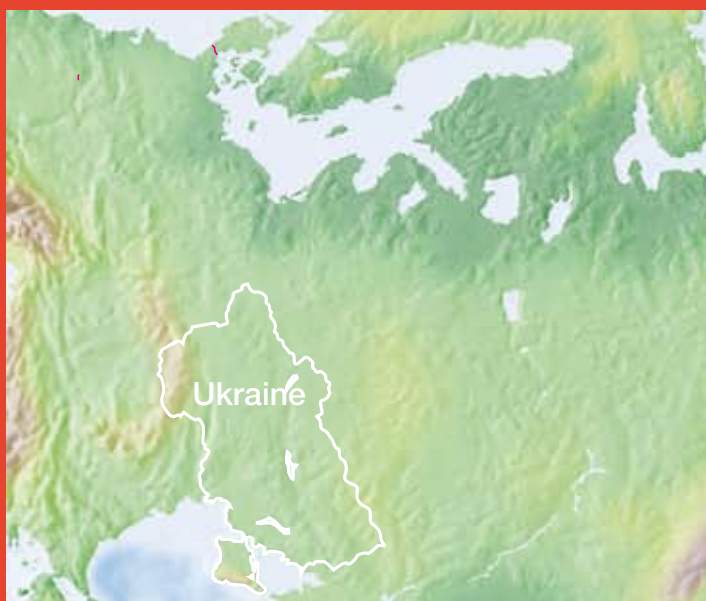


**Nick Page**  
PricewaterhouseCoopers LLP (UK)  
nick.r.page@uk.pwc.com

## Special Feature

# Ukraine

In 2004 the “Orange Revolution” in Ukraine captured the imagination of the global community with pictures of brave citizens fighting for democracy in the snowy streets of Kyiv. The economic and political challenges which Ukraine faces today are no less daunting in the short term.



Until 2008, Ukraine presented a story of enviable economic growth of around 7.9% of GDP per year. This was supported by a strong metals industry, positioning at the heart of Europe and a motivated work force. As our articles show however, the Ukraine economic picture is now entirely less optimistic with the national currency devalued by 50 to 60%, industrial production dropped by 31.8%, rising unemployment and an IMF financial rescue package of US\$16.4 bn.

This scenario is not currently being aided by the country’s feuding politicians and strained relations with Russia over natural gas supplies. However with a presidential election looming in 2010, there is hope that a more stable political system may result.

Despite all of this, Ukraine has proved itself to be a country of enormous resilience since independence in 1991. Once the global economic growth returns, there is a view that this country of 45m people, may once again attract the favourable attentions of foreign investors and may return stronger than ever. Watch this space!



Elizabeth Henson, Partner  
PricewaterhouseCoopers LLP (UK)  
elizabeth.c.henson@uk.pwc.com



# Meeting Boris Krasnyansky:

Managing Partner of PricewaterhouseCoopers Ukraine

## How long have you been with PwC Ukraine?

I joined PwC Ukraine back in 1993 with one of the predecessor firms as a manager and was admitted to the partnership in 1997. In 2001, I moved to Moscow to lead the management consulting practice for Russia and Ukraine. Then, I had a break from the firm for nearly three years where I was working at a financial services company as a client of the firm. When I was invited to head PwC Ukraine I jumped at the opportunity and moved back to Kyiv on 1 October, 2005 and have been in the role as Country Managing Partner since that point in time.

## What are the biggest business challenges facing PwC and your clients at the moment?

I like to start answering this question with a short background. Ukraine over the past five years has had one of the fastest growing economies in CEE as well as globally. The reason for this growth story is that Ukraine during the 1990s was growing more slowly than both its eastern neighbour, Russia, as it does not possess natural resources – the natural gas, the oil – to the same extent, and their western neighbours – Poland, Czech Republic, Hungary and the like – because Ukraine does not possess the same democratic background as those nations. In Ukraine's history, it has not been a separate state and did not have that culture of independence and decision making and the associated ramifications for the business environment that is possessed by our western neighbours. It took Ukraine until 2000 to accumulate business power and to grow its own businesses. And it is only since 2003 when the Ukrainian economy really began to grow quickly. But, since 2003 up until the crisis, Ukraine's growth has been phenomenal.

Now, when you grow fast, you also slow fast,

unfortunately. And that is what happened with Ukraine in comparison to neighbouring countries. The issues that our clients are seeing are clearly driven by the financial crisis, things such as the inability to attract financing from the banks, a large level of indebtedness within the industry groups of Ukraine, and in particular the steel industry, to foreign banks. Several significant Eurobonds previously issued are now coming due and with the slow down it is difficult to generate hard currency earnings. Along with this, Ukraine has also experienced a dramatic currency devaluation of 50 to 60%.

The second challenge is the political issues currently within Ukraine. At the moment there is a lack of consolidated political power, with the President, Prime Minister and the Rada, not necessarily acting as one "team" representing the best interests of the country on a continual basis, which, as a result, has precluded the country from taking quick decisive actions, which may prove beneficial and necessary during a time of financial crisis. However, I need to say that this lack of consolidated political power has also provided certain positives. For example, when a crisis erupts, it often leads to hasty decisions and provides a lack of certainty for the economic landscape with regards to the level of political interference. This has not been the case in Ukraine as the economic playing field has been pretty much left intact. At the same time, I must say, in terms of foreign investors, we have not seen strategic investors leaving Ukraine. The flight of capital has been that which came to Ukraine under speculative auspices. At the end of the day, Ukraine is still a country of in excess of 45 million people and is an attractive market going forward. We are actually seeing interest from private equity funds and certain industry strategic investors who are taking a long term perspective.



## Meeting Boris Krasnyansky:

### What are your greatest achievements in the current job?

As previously mentioned, I came back to PwC Ukraine in October 2005. Since that point in time through summer 2008, our last full year of results, the firm has grown from 130 employees to more than 400, while in terms of revenue, the practice has more than tripled. That two and a half year period of time was very fascinating in that the major issue was trying to find the highly qualified personnel expected of PwC to serve the needs of our rapidly expanding client base. Being able to manage this level of growth and still provide exceptional service to our growing client list is something of which I am very proud. Another achievement of which I am quite proud is that I have been elected by the business community to the Board of Directors of the American Chamber of Commerce and since last January, my fellow board members bestowed an even greater honour upon me by voting me Chairman of the Board of Directors. Additionally, I have been appointed a member of the Foreign Investors Council under the Prime Minister of Ukraine which meets to discuss certain government initiatives and the potential impact on Ukraine's economic climate. To be recognized and honoured by my business peers and the government of Ukraine, my home country, and have the opportunity to give back to these communities, is something that is very special to me.

### As to the future, what are you tackling next?

There are two dimensions to this question. From a business perspective, crises come and crises... eventually... go. And, this is the best time for any organization to take a step back, assess their strategy, their competition and concentrate on how to improve their business to better provide value to their customers and improve future results. This is something we are doing as a firm and something we are assisting our clients in doing across the country. I believe a key objective for us, both PwC and our clients, is to come out of the crisis in a stronger position than we were when we entered it, which will allow us all to bring additional added value to our clients. From a personal perspective, Ukraine is my country. I am committed to PricewaterhouseCoopers Ukraine. I really enjoy the feel of the partnership and working with our clients and employees. Going forward, I am very much looking forward to continuing my efforts to make a difference, within the firm and for our clients, as well as for my home country, Ukraine.

Boris Krasnyansky is Managing Partner of  
PricewaterhouseCoopers Ukraine  
[boris.krasnyansky@ua.pwc.com](mailto:boris.krasnyansky@ua.pwc.com)



Ukraine ranks eighth in the global steel producing countries, with crude steel production of 43 million tons in 2008. Steel also accounts for some 60% of Ukraine's export revenues, so as demand was paralysed by the global liquidity crisis, the fall in steel intensive sectors like construction and the auto industries and concerns over future global economic growth, the fortunes of Ukraine have also suffered. How Ukraine's steel producers will cope in the new economic realities will depend on how these entities were managed during the boom times and how quickly the global economy recovers, but also the decisions their managers will make now and in the coming months.

The Ukrainian steel sector is dominated by a handful of oligarch's, who control the iron ore reserves and vast smelters and metal rolling plants built when Ukraine was one of the industrial powerhouses of the Soviet Union. The sector is typically characterized by aging facilities, labour intensive and energy intensive open hearth furnace production processes and therefore in need for significant overhaul and upgrade, but also significant over capacity. Therefore the need for capital investment must be balanced by the need for rationalization, something more easily done in a centrally planned economy than between competing oligarchs.

Metinvest is the country's largest steelmaker, controlled by System Capital Management, followed by ArcelorMittal, the world's largest steel producer who bought the massive Kryvorizhstal plant at a privatisation auction four years ago then Industrial Union of Donbass ("IUD"). Behind these giants is another tier of operators: Zaporizhstal controlled by the Midland Group; Interpipe, a group specialising in the production of pipes; and the Ilyich Iron Works, a company run by the former Soviet-era management of the plant.

These producers while sharing the same geography are fiercely competitive and reluctant to cooperate, which unfortunately may not be in the best interest for Ukraine. While the industry has undergone some degree of consolidation, for example System Capital Management



merged their steel assets with those of the Smart Group, it is not enough to weed out the weak performers. These producers also have different levels of vertical integration and therefore different strategies for capturing the value chain. Self sufficiency and access of iron ore and coal reserves is proving to be a key success factor in this environment. Ukrainian steel exports (80-85% of production) are heavily skewed towards the lower value semi-finished goods including billets and slabs. Again, these producers have looked to expansion into the higher value/margin products via downstream integration via acquisition in Europe. The main customers for Ukrainian steel has been the Asian markets, Europe and the CIS, however as Chinese exports have increased, Ukrainian exports have been redirected to the Middle East and Africa but only the most agile companies have managed to capitalise in these new markets.

Within this context, Ukrainian steel producers have followed different strategies to diversify their risk including:

- Vertical integration to secure raw materials and achieve self sufficiency, (Metinvest acquired Ukrainian iron ore facilities, and recently completed the acquisition of coal reserves in the United States, IUD signed long-term supply contracts for iron ore from Brazil);
- Downstream integration to capture better margins in finish speciality goods, which has lead to acquisitions into foreign markets (Metinvest acquired rolling mills in Italy and England, IUD acquired mills in Poland and Hungary)
- Investments into upgrading existing facilities, and finally
- Profit repatriation by the oligarchs to finance their other investment needs

The growth in the Ukrainian economy since the Orange Revolution was fuelled by the foreign acquisitions in the banking sector which then fuelled consumer and mortgage leading, which further fuelled the real estate and construction sectors. The high oil prices have also resulted

in increased demand for pipes. And while steel prices and production remained high, Ukraine saw unprecedented economic growth which encouraged even further investment.

However, the global economic slowdown, coupled with the banking crisis, the fall in oil prices and the stagnation of the real estate and construction sectors, left Ukraine in crisis. The back bone that had supported Ukraine's economic growth collapsed overnight and the impact was as quick as it was dramatic. In the forth quarter of 2008, the local currency suffered a 57% devaluation. The National Bank of Ukraine issued legislation to effectively prevent new lending and limit capital flight. Construction and mortgage lending ceased and the IMF stepped in with a US\$16.4 billion facility to support the economy.

As demand for global steel declined, Ukrainian production fell some 40%, many plants operated at half their capacity and some have ceased production. Prices for steel fell to a third of their peak levels in the middle in 2008 and the US dollar/Euro denominated debt taken on to fund their acquisitions and capital investments has left a heavy burden on some producers. Banks who were previously eager to lend to the sector at any cost when gross margins were over 60% are no longer willing to extend or rollover their facilities. As is common in developing nations, many long-term strategic investments are funded by short-term debt and the banks unwillingness to continue supporting these loans has left the sector in turmoil.

However, the crisis has had some benefits:

- Ukraine, already a relatively low cost producer because iron ore, coke and coal can all be sourced locally, has found the currency devaluation has further reduced its costs in dollar terms and thereby increased its international competitiveness;
- As many of the steel plants are located near ports of the Black Sea, exporting is cheaper than compared with their Russian or land locked competitors;

# Cast in iron?



The crisis has created significant excess capacity in the shipping sector and export markets previously inaccessible due to prohibitive transportation costs are now accessible;

- There are added reasons to look at cost reduction including headcount reduction and more energy efficient processes; and
- Further consolidation is likely in the market as the weaker producers are forced to either shut down or sell.

The various steel producers have had differing success with dealing with the current economic situation. Ilyich Iron Works and IUD which are dependent on buying US dollar denominated iron ore are not fairing as well as producers that have their own domestically produced iron ore. IUD is further hampered by the significant debt drawn to acquire its European assets. Many such acquisitions occurred at the peak of the market and prices paid may not be supportable in the current environment. ArcelorMittal's acquisition in the privatisation auction included various conditions such as maintaining production and head count numbers thereby limiting its ability to reduce staff levels. But, the major question is have the oligarchs retained their war chest from the super profits generated in 2007 and 2008 periods to continue supporting these plants? It is clear the western banks have their own domestic issues to deal with before they deal with foreign concerns.

So, how will the Ukrainian steel sector look after this economic crisis?

- The over capacity issue is a major concern. This can be addressed by further consolidation before certain inefficient plants are closed down. For example, IUD are rumoured to be in discussions with Evraz, the Russian steel group regarding a possible merger, Metinvest have already ceased production at one of their three steel mills
- Improvement in labour productivity. The steel producers will need to streamline head count and increase productivity. Most producers have operated 3 day production weeks and it is likely this trend will continue in the short-term, however ultimately a more sustainable solution will need to be found
- Improved production processes using modern technologies and reducing the open hearth production process. Institutions likes the EBRD and World Bank have incentive programs to encourage investment into modern, energy efficient technologies
- Mergers with other international steel companies. The issues facing Ukraine steel producers are not isolated to Ukraine. There are potential benefits from

an international merger including securing access to markets, securing raw materials supplies, sharing technologies and work practices

Ultimately, Ukraine needs the global economy to improve to support its steel exports, accordingly Ukraine's recovery will lag behind that of the rest of the world. In the short-term, Ukrainian steel producers face some tough decisions and some even tougher negotiations with their bankers.

There will be winners and losers following this economic slowdown. Most will emerge from this tough period battle-scared but more cautious, hard headed and pragmatic – all attributes that will make them better able to compete than when the downturn began. No one is talking about a bright future right now. But it is manageable. The crisis is not forever. From this crisis, we think the Ukrainian metallurgical industry will emerge with fewer, more streamlined, integrated producers that are better prepared for the future.

**Nilesh Lad, Partner, Metals Group  
PricewaterhouseCoopers Ukraine**

Nilesh Lad is an assurance and advisory partner currently based in Kyiv. Nilesh joined PwC in Birmingham in 1989 and worked in the Miami and Moscow offices before transferring to Kyiv in 2005 to lead the Transaction Services group. Nilesh has extensive experience of working in the CIS and assisting foreign companies with their investments in the region and assisting local companies access the international capital markets.

nilesh.lad@ua.pwc.com

and

**Oleg Shudra, Director,  
PricewaterhouseCoopers Ukraine**

Oleg Shudra joined PricewaterhouseCoopers in 1998 and is an assurance services director based in Kyiv. Oleg has broad experience in providing audit, accounting and taxation related services to both national and multinational clients with an emphasis on Ukraine's metals production industry.

oleg.shudra@ua.pwc.com

# Will Ukraine capitalise on the opportunity to restructure the banking sector?

The initial response of the Ukrainian authorities to the on-going financial crisis was promising. With the help of the IMF and World Bank, the Ukrainian authorities were quick to conduct diagnostics of the biggest banks and place into administration those banks which could not withstand the events of the fourth quarter of 2008.

In addition the central bank was active in providing the necessary liquidity to commercial banks, having to date provided approximately US\$13 billion in loans to commercial banks. This amount of liquidity support should be measured against the total customer deposit base of the banking sector as a whole, which as at 1 April 2009 totalled approximately US\$44 billion, representing a decrease of over 20 percent since the start of the year.

There are currently 185 banks licensed in Ukraine. This number has been relatively stable over the last 10 years. In contrasting the Ukrainian banking sector with that of other countries in central and eastern Europe, this statistic alone differentiates Ukraine from its neighbours. Despite the aggressive entry of many foreign banks into the market over the last five years, with nine of the top twenty banks (representing 70% of total banking sector assets) being majority owned by foreign banks, the smaller Ukrainian banks have shown remarkable resilience. For many years Ukrainian banking sector analysts have predicted consolidation and the recent events gave extra weight to the logic behind this expectation. However predictions of wholesale closures of smaller banks which lack the support of strong shareholders are yet to materialise.

The current approach to bank recapitalisation demonstrates the authorities determination to maintain the sector in its current form. There are twelve banks currently under administration of the central bank, three of which are in advanced stages of nationalisation. The largest of the twelve banks in administration is the tenth biggest bank by total assets, with a share of 3% of total banking system assets. One of the three banks to be recapitalised is ranked 39 by total assets, with only 0.5% of total banking system assets.

The primary objective of recapitalisation is to protect depositors by providing the banks with the liquidity to meet their obligations to depositors. To date the government has announced that it will take stakes of between 84-99% in three banks after investing on average US\$420 million in

each. The amounts to be invested appear to be high given that the retail (individual) deposit base of each bank range from US\$290 million to US\$616 million. The government has stated that it will sell these stakes to investors once the sector has returned to stability, presumably in 3-5 years. The approach taken by the authorities to bank recapitalisation raises a number of questions:

- After recapitalisation and exiting from administration, will these banks remain viable businesses? The Ukrainian banking sector has seen a period of intense competition, with a large number of banks fighting for market share. Would customers return to banks whose brand may be seen as permanently damaged?
- Even if the banks are able to retain or attract a customer base, would investors be prepared to pay such amounts to enable the government to recover its investment? Given the acquisition activity in the banking sector between 2005-2008, one may conclude that anyone who wanted to be present in the Ukrainian market is already present. Second and third tier banks which were sold in the boom period fetched less than US\$400 million, even when multiples were at levels far higher than we would expect to see in the coming years.

Regardless of the outcome for individual banks subject to recapitalisation, the overriding question is whether as a result of the authorities quick action, the sector will emerge stronger from the crisis. Certainly the presence of foreign banks has provided some much needed stability and with the authorities on-going commitment to work with the international agencies, confidence is returning to the sector.



**Jock Nunan**  
Partner, Financial Sector Leader  
PricewaterhouseCoopers Ukraine  
jock.nunan@ua.pwc.com

# Doing Business in Ukraine: Tax and regulatory issues in the spotlight

According to the 2009 World Bank Report, Ukraine continues to be rated at the bottom of the ladder for doing business, with particular problems/concerns around compliance and dealing with the authorities.

Laws are unclear and subject to reinterpretation. In this article we provide some recent examples - with a conclusion that the need for professional consultancy, even in times of economic crisis, is critical.

## **Residency permits for foreigners and their spouses.**

The authorities have recently amended the regulations (and opinion) in respect of the need for foreigners to obtain residency permits and visas to live and work in Ukraine. Individuals that do not require visas for entering the country for short term stay (citizens of the United States and EU countries for example) are only permitted to remain in Ukraine for up to 90 days in any 180-day period. If they exceed this time limit they may be fined when leaving Ukraine and could be turned back at the border when they next attempt to enter the country without a visa. The authorities have explained that if an individual is working in Ukraine then he/she should obtain a temporary residency permit – an administrative headache that requires an individual to hold a work permit, hands on assistance from the landlord, a HIV and TB test, and numerous visits to notaries and public officials. Starting from 14 May 2009, there is also a requirement to present a notarised translated copy of university certificates and other qualifications legalised at the Ukrainian consulate in the country of issue, when applying for the work permit.

Spouses also need to obtain visas; even though according to the law such a visa (business or private) merely allows an individual to remain in the country for a period of up to 90 days in a 180-day period.

Individuals working for representative offices face an even greater hurdle compared to those employed by the Ukrainian entities, as they are subject to the same rules but are not able to obtain a work permit (a critical requirement for obtaining a residency permit). Catch 22!

Negotiations with the authorities are ongoing and as of today there have been no major hold ups at the Ukrainian border.

## **Foreign exchange losses**

Since August 2008 the Hryvna has devalued by more than 50% against the US Dollar. The authorities are determined to minimize the ability to obtain a tax deduction for the resulting foreign exchange losses. If the foreign exchange losses relate to a loan denominated in foreign currency, then the losses are clearly tax deductible, but if the losses relate to hard currency trade payables, then the tax office will try to deny a tax deduction. Careful planning should alleviate this problem.

## **Utilisation of tax losses**

In early May 2009 the Cabinet of Ministers passed a resolution that restricted the utilisation of 2008 and earlier year tax losses during 2009. Many taxpayers were made aware of this and were reluctant to utilise the losses in the 2009 first quarter return (due 12 May 2009). After substantial lobbying, the Government decided not to publish the resolution and is therefore not effective (ie prior year losses can be utilised during 2009 and later years). However, the situation could change at any time and taxpayers that have unutilised tax losses should be prepared for this potential change. Proper planning for utilisation of tax losses could override the issue.

## **Conclusion – seek professional advice – constantly**

Doing business in Ukraine is challenging but the potential is unlimited. Rules and regulations change on a daily basis – sometimes for the better. Investors should seek out professional advice throughout the investment period. There are a number of tax incentives and strategies that could minimize tax liabilities and maximize returns.



**Ron Barden, Partner,**  
PricewaterhouseCoopers Ukraine  
ron.j.barden@ua.pwc.com

# Managing the political agenda

Among former Soviet states, Ukraine has been among the hardest hit by the effects of the global financial crisis. At a time when a stable political system is important for measures to help the economy, Ukrainian leaders have struggled to work together.

While there is the potential for improved stability in the long term, feuding among politicians is going to make government-led recovery efforts more difficult to develop and execute in the short and medium terms.

The political battles that are raging in Kyiv – the biggest being between erstwhile political allies President Viktor Yushchenko and Prime Minister Yulia Tymoshenko – are hardly new for any observer of Ukrainian politics since the 2004 “Orange Revolution”. In the past, this fighting delayed economic reforms, but was not critical to Ukraine’s economic prospects. The public, while increasingly irritated by the political maneuvering, tolerated it when strong demand for Ukrainian steel, chemical and agricultural exports helped produce annual GDP growth of more than 7%.

But the downturn in the economy has made the political problems more relevant to markets, investors, and the public at-large. The economy, which was already slowing down in the months prior to the onset of the global downturn, has suffered as demand for key exports dropped, while the global drop in liquidity has harmed the banking sector. Unemployment has risen to 3% by government measure, and as much as 6%, according to independent estimates, with white collar jobs in Kyiv being hit along with blue collar jobs in eastern and southern Ukraine.

National leaders have been working to fight the worst effects of the economic slump. But they have also been fighting over parliamentary coalitions, election dates, and constitutional reform. Political competition has made it exceedingly difficult for officials to remain focused on economic recovery efforts. The lack of a stable majority in parliament, for one, has limited Tymoshenko’s ability to get important legislation passed.

Public accountability has been important in bringing leaders together on a limited number of problems, however. Yushchenko and Tymoshenko have managed to cooperate on critical issues – such as securing a US\$16.4 billion loan from the IMF in November 2008 – where failure to produce results could lead to significant negative political repercussions. Comprehensive assistance to ailing sectors of the economy, or the restart of the privatization program needed to generate budget revenue, are proceeding more slowly.

The incentive to cooperate in the short and medium term will lessen with the onset of the campaign for the presidency, expected to start in late 2009 or early 2010. Yushchenko and Tymoshenko are expected to be joined by former prime minister Viktor Yanukovich and former speaker of parliament Arseniy Yatsenyuk in the race. Policymaking likely will be haphazard, with compromises driven by necessity and urgency. Many economic reforms considered important for long-term economic growth and increased foreign investment will likely remain sidelined until the political situation stabilizes.

In spite of these problems, a relatively quick turnaround in the Ukrainian economy could leave the country in a stronger position than it was prior to the crisis. Recovery will be dependent on a rebound in demand for exports, though there are high hopes for the agricultural sector in 2009 to pick up some of the slack. International financial institutions continue to support the government, and will be instrumental in recapitalization and reform of the banking sector. IMF loan obligations will leave the central bank with a more liberalized exchange rate policy, and potentially greater independence from the government. While politicians are divided on Ukraine’s integration with NATO, none of the aforementioned presidential candidates opposes closer EU ties. And while political instability is likely to stretch well into 2010, Ukraine could see a more stable political system emerge out of the realignment that will come with presidential elections. Political leaders could build on these changes to move ahead with reforms that help the economy over the long term, and encourage foreign investment. The course politicians set in the coming months will be an important determinant for how changes in the economy and investment environment unfold.



Alex Brideau, Analyst in Eurasia Group’s Europe & Eurasia practice.

Eurasia is a geo-political risk consultancy covering a broad range of emerging and frontier markets; it works closely with PwC on advising clients on monitoring and mitigating political risk.

[brideau@eurasiagroup.net](mailto:brideau@eurasiagroup.net)

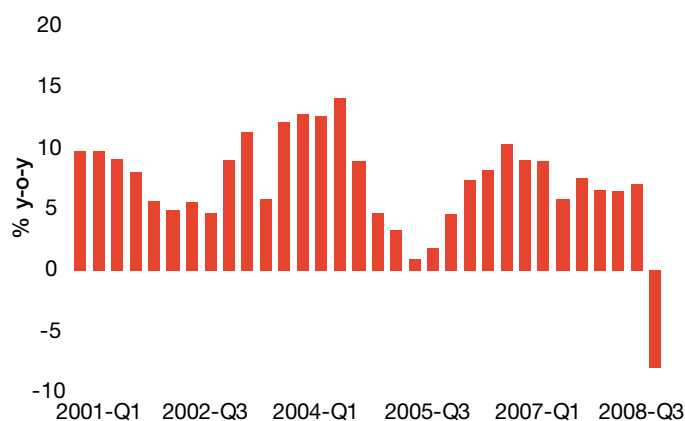
# Ukraine dragged into sharp down turn

Prior to the global economic downturn, the Ukrainian economy had been growing strongly, with 7.9% GDP growth in 2007. Signs were actually starting to point towards the economy overheating as domestic demand surged.

Net exports had become an overall burden on the economy with imports rising by 19.7% in 2007 compared to only 3.1% growth for exports. Additionally, while based largely on supply-side pressures, inflation hit a decade high in May 2008 of 31.1%, driven by skyrocketing food and fuel prices.

However in 2008, Ukraine was severely hit by the global financial crisis with GDP decelerating to an annual growth rate of 2.1%. Specifically in Q4 2008, GDP contracted by 8% y-o-y, following a rise of 6.4% y-o-y in Q3 2008 (see Chart 1 below). This was the worst result since the economy began its transition to democracy in the early 1990s.

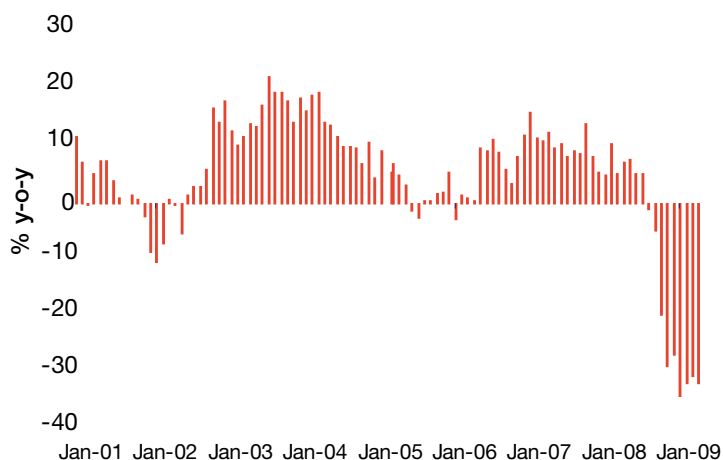
**Chart 1: GDP plummeting**



Source: State Statistics Committee of Ukraine

The global economic downturn caused a sharp contraction in industrial output as external demand dried up. In April 2009, industrial production dropped by 31.8% y-o-y following similar falls since the turn of 2009 (see Chart 2 below). Contractions in output have notably been felt within the steel industry, which accounts for around 5% of GDP and 40% of Ukraine's exports. Facing a major slump in demand alongside a collapse in global steel prices, Ukraine's steel industry has slashed production by more than half. Not surprisingly, this has resulted in mass lay-offs in the industry.

**Chart 2: Industrial production slashed**



Source: State Statistics Committee of Ukraine



As the global financial crisis gathered speed, the Ukrainian hryvnia came under pressure in 2008 as capital outflows accelerated. Following interventions by the Ukrainian central bank and an IMF sponsored financial rescue package of US \$16.4 billion, the currency stabilised in early 2009 (see Chart 3 below). Such stabilisation was short-lived though as the IMF put on hold its rescue package in mid-February in response to a failure by Ukraine's authorities to comply with its lending terms. However, following April's IMF staff review, the loan facility is now being renewed.

**Chart 3: Exchange rate against the US dollar**



Source: Reuters Investor

The Ukrainian political situation remains fairly volatile and is undermined by a lack of clear and stable political alliances between the major parties. Such instability has led to Standard and Poor's cutting its rating for Ukraine by 2 levels to CCC+, seven levels below investment grade and the lowest in Europe.

Ukraine's relations with Russia impose lingering risks. Ukraine has had an ongoing dispute with Russia over the supply of natural gas through Ukrainian pipes to the rest of Europe. The dispute escalated at the end of 2008 and saw Ukraine's gas supply being cut by Gazprom (Russia's state-owned gas company) on 1 January 2009. In April, the dispute was eventually resolved, but tensions between the two nations remain. On 3 June Russia's Prime Minister Vladimir Putin, warned that natural gas pumped via Ukraine to Europe could be cut off by early July if Ukraine fails to pay for its gas contracts, and urged the EU to intervene.

The global economic slowdown and international investors' retreat from emerging markets have led to a major deterioration in the economic outlook for Ukraine. Continued falls in fixed investment and industrial production are expected alongside future contractions in Ukrainian consumption. Consequently, we are forecasting GDP to contract by 10% in 2009 before recovering to positive growth on average in 2010 of 0.5% as external demand starts to improve.

Compiled by Yael Selfin, Head of Macro Consulting, PricewaterhouseCoopers LLP (UK)

yael.selfin@uk.pwc.com

# An American in Kyiv:

## An interview with Jorge Zukoski, President of the American Chamber of Commerce



### How did you end up in Ukraine?

Actually, I met my American wife on a plane heading to Ukraine at the end of 1996 as we were both slated to do some business development work for a small to medium size enterprise development project that was funded by the U.S. Agency for International Development (USAID) and implemented by Development Alternatives International. We were to manage and develop business centres throughout Ukraine that were designed to provide small to medium sized Ukrainian entrepreneurs with business skill development helping them to be successful. After two years with the abovementioned project I was recruited to join the American Chamber of Commerce. My wife, Courtney, has been involved as a contractor on various donor funded projects over the years and is currently working for Microsoft as their Partners in Learning and Community Affairs Manager.

### What is the aim of the American Chamber of Commerce?

Our tagline is “uniting leading companies from 50 nations across the globe”. We represent the large strategic institutional investors and service providers around them. We are not solely focused on American companies. We represent the large multinationals from many nations as well as a vast majority of the foreign direct investment coming into Ukraine. The American Chamber of Commerce has four primary pillars of activities, or goals, which we strive to undertake professionally:

1.) To advocate and lobby on behalf of our members, to protect their interests in Ukraine and to build a better

business environment that allows domestic and foreign investors to prosper and develop in this challenging market

- 2.) To provide our members with an information platform, both via print and electronic platforms. We do this because in a market like Ukraine publically available sources of reliable information are very difficult to come by. As such, we have found that our members are interested in getting as much information as possible that assists them in making rational business decisions in this complicated environment. Additionally, we connect our members electronically, through a number of Chamber communication tools as well as our website, which also contains a vast amount of useful information ( [www.chamber.ua](http://www.chamber.ua) )
- 3.) To provide the over 10,000 employees of our member companies with a proactive segmented networking platform. In this environment, because it is so difficult to obtain reliable information, we find that our members are interested in networking for two reasons, the first of which is to talk to other people in various industry sectors that might be dealing with similar difficulties or challenges and to understand how they have overcome those obstacles to be successful. Sharing this kind of information is very important. Secondly, our members tend to prefer to source goods and services from other members as there is a certain level of business ethics and code of conduct that are inherent in the types of members we represent as the Chamber
- 4.) The fourth pillar is that we are very assertive in promoting Ukraine as an investment location. We

spend a lot of time, both I personally, as well as the organisation as a whole, promoting Ukraine, highlighting the immense opportunities in this under-invested country which is on the border of the “new, larger Europe”. But, also, at the same time clearly expressing the challenges in building a successful business in Ukraine, which can easily be overcome via understanding the market, building the relationships that are necessary and engaging the service providers that are critical to ensure our member companies are successful.

### What are common misconceptions that you have heard from potential investors?

It is interesting because there are quite a few common misconceptions we hear from potential investors. One is Ukraine is somewhere within Russia, or part of Russia, which I find interesting. The second misconception is Ukraine is so underdeveloped in terms of infrastructure and some other basic necessities necessary for business, that it makes an initial due diligence trip useless. As such, there are some investors that have unfortunately not been to Ukraine to understand all that the country has to offer. There is not enough information about Ukraine that is easily accessible and has therefore promulgated these misconceptions as well as a number of other inaccuracies including the nature and impact of the ongoing political instability and financial crisis. It gets back to a lack of reliable information creating a rather incomplete picture of the realities of the business environment in Ukraine. So often, we find ourselves filling in the blanks in these pictures left by the media to provide the complete picture of the opportunities and challenges that are present here in Ukraine.

### What do you see as the biggest opportunities for the companies not already present in this country of 46 million people?

At the end of the day, we have more than 46 million people living in a country on the border of the new larger Europe, representing an amazing consumer market as well as a human capital resource and a potential export platform into and out of the new larger Europe as well as Russia. Ukraine also has a free trade agreement looming with Europe that is very realistic and something that will come to fruition in the future. The country is also rich in certain natural resources and has an amazing potential in the sphere of agriculture. There are many industry sectors which are currently under-invested. The wonderful thing about Ukraine is that you do not need to re-invent the wheel or your business processes to gain a competitive position in the marketplace. Due to the under-investment dynamics and the countries competitive advantages, a number of opportunities exist for companies that are willing to jump in and expand their global operations. One of the things we see, and it is very apparent, especially

among the large multinational companies that we represent, is that there is a realization that when global growth resumes, there will be a very few countries driving the growth. Obviously, you have the BRIC countries (Brazil, Russia, India, and China), but, certain outliers also exist which are not necessarily top of mind for companies, one of which is Ukraine. So when you look at the Chamber's members, many of them are large multinational companies that have a long-term perspective on this market. They look at the market strategically over the coming decades understanding that the current financial crisis is merely a blip on the radar screen and are investing more, increasing their footprint, grabbing market share and are positioning themselves so that when the growth resumes they will be in a better position than they were heading into the crisis.

### What are some of the initiatives of the American Chamber of Commerce?

One of the main programs recently launched by the Chamber is what we call our “Partnership for Successfully Competing in the Global Economy.” We actually began this program in advance of the financial crisis, but as a result of the downturn it is even timelier. This initiative is geared towards developing a partnership between the Ukrainian Government, the private sector, the NGO community, as well as the expert community and the diplomat and donor communities to develop and implement a comprehensive legislative and regulatory reform agenda that allows Ukraine to successfully mitigate the current financial crisis as well as position itself favourably for when the growth returns. We understand that Ukraine as a nation is competing for a limited amount of both domestic and foreign investment. Historically, Ukraine has not been successful in competing for that investment. As we all understand, and as one of the former US Secretaries of Commerce once told me, “capital is a coward” and we all understand that at the end of the day, money is going to flow to markets where investors are comfortable that there is rule of law, contract sanctity, streamlined transparent bureaucracy and so on; all things that make a country able to successfully attract limited global financial investment resources. Our philosophy has been to take advantage of the downturn to push forward a reform agenda, with other organizations seeking reform, such as the International Monetary Fund and World Bank, which will allow Ukraine to compete successfully in the future. This initiative has been the current focus of the American Chamber of Commerce in Ukraine.

### Will the impending elections have any impact on these initiatives?

The short answer is both yes and no. Some initiatives will move more quickly because there will be political will to get them done before the elections, while other initiatives will not move until after the elections and a new coalition

# An American in Kyiv



is put together. Our job at the Chamber is to understand what is doable now, expend our time and resources on those initiatives and put the other objectives on the back-burner until we see an applicable window of opportunity. As a Chamber we have been doing this for the past 17 years and I, personally, have been involved with this for the past 12 years, so we therefore have a pretty long term view of the market and understand acutely when the windows of opportunity are open and grab them when we can.

## What groups of companies or industries do you see now joining the American Chamber of Commerce?

We see two different spheres of members joining. One sphere of companies joining the Chamber are entities that already had operations in Ukraine in advance of the financial crisis and now realize that there is an increased need for the value added benefits that the American Chamber of Commerce offers. Over the last 6 to 8 years, most companies in Ukraine have been managing growth and when managing growth they might not be looking to reform the business environment or help Ukraine become a more rational place to do business. But, with the financial crisis, all of these factors become more relevant. The second sphere is a group of aggressive pioneers whose organizations have access to capital. In Ukraine, a lot of the services that are necessary for establishing a business – office space, asset prices, and so on – have been dramatically reduced. For these organizations, they see the opportunities in markets like Ukraine and realize now is a good time to enter the market and take advantage of this window of opportunity.

## What are your impressions of living and working in Ukraine?

My wife and I have found Ukraine to be an absolutely fascinating place that is filled with amazing people and potential. At the end of the day, the Ukraine of 1996, when we first arrived, is vastly different than the Ukraine of 2009. When my wife and I first arrived in Ukraine, the infrastructure is not what we see today. In regards to quality of life on a personal level, the restaurants, the hotels, the shopping facilities, the concept of having grocery stores, GSM phones, and satellite service providers – all the things that make life a little more comfortable are all here now, which was not necessarily the case when we first arrived. So on a personal note and a quality of life note, we have seen dramatic changes. Regarding the business environment, we have also

seen the country grow and develop rapidly. The bottom line is that the business environment in which we are operating today is dramatically different and has almost no similarities to what it looked like when Ukraine became independent from the Soviet Union. We still have a very long road to go, but the accomplishments of the political elite in pushing forward a reform agenda breaking from the Soviet legacy to a democratic market economy has been amazing to witness. And, for our organization to be a very small part of this change, this is something of which I am very proud. We are also very pleased to see the Ukrainians embracing and pushing for a more European country. Personally, we have found that Ukrainians have been open and accepting of the international community with relationships based on trust and respect. There has always been a desire of the people to engage and learn international best practices in an effort to help their society become more of what they, the Ukrainian people, would like it to be, which we believe is to become more of a part of Europe.



Jorge Zukoski – President, The American Chamber of Commerce in Ukraine

president@chamber.ua

The American Chamber of Commerce in Ukraine (“Chamber”) is among the most active and effective non-government, non-profit business organizations operating in Ukraine. One of the Chamber’s principal activities is to represent the foreign investment community as well as to facilitate the entrance of potential new investors into the Ukrainian market. The Chamber advocates on behalf of its Members who are from more than 50 nations across the globe not only to the Ukrainian government, but also to all other governments, which are economic partners of Ukraine, on matters of trade, commerce, and economic reform. The Member organizations of the Chamber represent the largest strategic and institutional investors, as well as the service providers around them, operating in Ukraine who have committed a majority of the foreign direct investment into this market.



# Doing Business in the UK

## UK economy – update

The recession in the UK economy deepened in Q1 2009, which reflected the widening effects of the credit crunch and associated effects on the real economy. UK GDP fell by an estimated 2.4% in Q1 2009. The year-on-year rate of contraction accelerated to 4.9% in Q1, having been only 0.5% as recently as Q3 2008. Domestic demand contracted by an estimated 5.7% in the year to Q1 2009. Business investment fell sharply, employment was down and consumer spending declined. Net

exports continued to provide a boost to the overall economy as import growth has slowed by even more than export growth due in part to the weak pound during the first quarter. There were tentative signs of stabilisation in Q2 2009, but the economy is still likely to have contracted in that quarter.

Risks to UK economic growth are more balanced than they were a few months ago given recent tentative signs of stabilisation, but downside risks nonetheless remain significant.

At the same time, there are also some upside risks associated in particular with the potential impact of the large global and UK fiscal and monetary easing in recent months, the full effects of which will not be felt until later in 2009.

## Doing Business and Investing in the UK Guide A Guide by PricewaterhouseCoopers LLP (UK)

An essential guide by PricewaterhouseCoopers for overseas owned companies and individuals who are looking to do business and invest in the UK.

This guide has been written for investors planning to enter the UK market. It provides insight into the key aspects of undertaking business and investing in the UK, from establishing an entity to dealing with employees, giving answers to the many questions facing the community of overseas investors and is a great starting point for anyone looking to conduct business in the UK.

It has been designed so that you can directly go to any section that is of interest to you, or gives you the choice to download the complete document.

The UK is one of the most open markets and diversified economies in the world, and continues to be an ideal choice for setting up a European base, serving as an effective gateway to the rest of the world. We continue to welcome inward investment and fresh talent into the UK and hope this guide will provide you with the insight needed to make an informed choice.



To access the guide, please visit:  
[www.pwc.co.uk/investuk](http://www.pwc.co.uk/investuk)

# Key facts and figures: Belarus



Geography	The Republic of Belarus occupies a territory of 207,000 sq. km. It borders on Lithuania and Latvia in the North, Ukraine in the South, the Russian Federation in the East, and Poland in the West.
Capital	Minsk (1,830,000 residents as of 01.02.2008)
Population	The population of Belarus is 9.67 million people (as of 01.01.2009)
Language	Belarussian and Russian
Currency	Belarussian ruble, BYR (since 26 July 1993) FX Rate: £1 = 4,665.4 BYR (as of 30.06.2009)
Foreign trade	In 2008 Belarus' foreign trade in goods increased over 2007 to US \$72.4 billion. Belarus foreign trade turnover in services has come up to US \$6.36 billion in 2008 The major trade partners are the Russian Federation (48.4% of share in the trade), Netherlands (8.3%), Ukraine (6.9%) and Germany (4.5%) Major export articles include: metals, wood, chemical and agricultural products
Leading industry sectors	The leading industry sector is manufacturing, which comprises 28.1% of GDP. Trade and catering comprise 10.6% of GDP, transport and communications 8%, construction 9.4%, agriculture 8.4%
Inbound Foreign Direct Investment (FDI)	US \$1,772 million in 2007
Tax rates	Corporate income tax: 24.0% VAT: 18.0% Personal income tax: 12.0%
PricewaterhouseCoopers presence	PwC oversees business in Belarus from its office in Lithuanian.

Source: [www.president.gov.by](http://www.president.gov.by) , [www.belembassy.org](http://www.belembassy.org) , [www.export.by](http://www.export.by) , [www.mfa.gov.by](http://www.mfa.gov.by) , [www.gtk.gov.by](http://www.gtk.gov.by) , UNCTAD

For further information about doing business in Belarus, please contact Alina Listopad at the Russia & CIS Business Centre.

This section features a different CIS country each time.

Next edition: Armenia



# News from the Russia & CIS Business Centre

The Russia and CIS Business Centre has again been active in the last quarter and the following is a brief summary of selected activities.

## Welcoming Alina Listopad

Alina has joined the Russian & CIS Business Centre as a manager and in that role she will be overseeing day-to-day activities of the Centre. Alina has been with PricewaterhouseCoopers for almost ten years, most recently she worked in Risk Assurance Services. Alina brings with her considerable enthusiasm and she is looking forward to building on the success of the Russia & CIS Business Centre.

For her contact details, please see the bottom of the page.

## Kazakh-style dinner

PwC invited non-executives directors of Kazakh companies to join partners from the PwC UK and Kazakh firms for a dinner in the Travellers Club. The dinner, hosted by Sir John Stuttard, took place on 18 June. It was an informal evening of topical discussion and provided a networking opportunity.

Encouraged by the success of this dinner, we will be organising in the future other events for non-executive directors of Russian & CIS companies. If you would like to take part, please contact Alina Listopad.

## PricewaterhouseCoopers at the KAZAKHSTAN GROWTH FORUM

PwC was proud to sponsor Kazakhstan Growth Forum again this year. It took place 17-19 June in London. PwC was represented both by the UK and Kazakhstan firms. From the UK side, PwC speakers included Sir John Stuttard, Vice Chairman of the advisory board who chaired a session on the opening day. Alper Akdeniz, Managing Partner and Peter Wilkin, Assurance Leader, represented PwC Kazakhstan. We were encouraged by the number of visitors to the PwC stand at the event and it should not be a surprise that the most popular publication there was the Spring edition of the Russia & CIS Express – which, as the regular reader will remember, was dedicated to Kazakhstan.

## PwC sponsored Russia & CIS Mining Symposium

This event, held at PricewaterhouseCoopers LLP's Embankment Place office on 18 and 19 June, focused on mining sector challenges and investment opportunities in Russia, Central Asia and Ukraine. Speakers included PwC Assurance partner Jason Burkitt. The conference was attended by executives from over 80 companies and provided networking opportunities.

For more information please email [russia@uk.pwc.com](mailto:russia@uk.pwc.com) or contact:



**Alex Bertolotti**  
Russia & CIS Business Centre  
Leader  
PricewaterhouseCoopers LLP (UK)  
020 7213 1253  
[alex.bertolotti@uk.pwc.com](mailto:alex.bertolotti@uk.pwc.com)



**Alina Listopad**  
Russia & CIS Business Centre  
Manager  
PricewaterhouseCoopers LLP (UK)  
020 7804 9398  
[alina.listopad@uk.pwc.com](mailto:alina.listopad@uk.pwc.com)

# PwC Russia & CIS Business Centre

The Russia & CIS Business Centre is part of PwC UK's Emerging Markets programme; other territories/regions with dedicated Business Centres are Central & Eastern Europe, China and India.

The objective of the Business Centre is to be a central contact point and information source for UK clients wishing to explore business opportunities in Russia and the CIS, and for companies and individuals from the region wishing to conduct business in the UK. The Business Centre is actively involved in business networks in London and around the UK focused on Kazakhstan, Russia and Ukraine.

For more information, please email [russia@uk.pwc.com](mailto:russia@uk.pwc.com)



[pwc.co.uk/emergingmarkets](http://pwc.co.uk/emergingmarkets)

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Design hb04743