PRIVATE LAW

Potential for German investors: entering the Ukrainian market

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Following the break-up of the USSR, the Ukrainian economy went into a lingering depression. In the last few years, however, its potential has been recovering: Ukraine is now one of the most successful of the former Soviet republics in attracting foreign investment. The main issue for a foreign investor is thus not whether to invest, but how best to enter the Ukrainian market.

A large number of business ventures have proved that exposure in the Ukrainian market can be a profitable affair, gaining a firm foothold and succeeding. Germany's Knauf Group, for example, have announced plans to renovate the Knauf Gips Donbas factory in Soledar, Donetsk oblast, which they purchased in 2003, greatly increasing production capacity.[1] Moreover, a number of experts have declared Ukraine to be a country with enormous potential: it has an educated population, rich natural resources and is well placed geographically.[2] Ukraine's 48 million strong population is one of the biggest markets in Central and Eastern Europe, yet remains seriously under-explored by foreign investors. The active economic reforms of recent years directed at macroeconomic stabilization, privatization, and development of private property and liberalization of the Ukrainian market are public knowledge, and the increasing tempo of international cooperation is also

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[1] Knauf also unveiled a five-year investment plan envisaging pumping almost 31 million euros into the plant's modernization. Similarly, a subsidiary of Germany's Siemens AG agreed a 120 million euro contract in April this year to supply electrical equipment to a subcontractor for the Ukrainian state railway monopoly Ukrzaliznytsya, Siemen's largest order in Ukraine to date. Further, Dnipropetrovsk' Ukraine-Canada Construction (founded in 2003) and the Canadian architectural and construction consortium, Corecan, has started a USD 140 million residential real estate development project in a suburb of Dnipropetrovsk.

[2] E.g. Flemings/SARS Consortium, *Report "The Legal and Economic Environment for Foreign Direct Investments in Ukraine"*. On February 20, 2004, *Ukrainian news* reported the Ukrainian Finance Ministry as stating that "Financial analysts are predicting the phenomenal success of investments into Ukraine", with the ministry basing its statement on recent research reports on Ukraine by Britain's Euroinvest business magazine, Germany's Commerzbank and U.S.-based investment firm Morgan Stanley.

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suggested by agreements with international organizations such as International Monetary Fund, the World Bank, as well as by the fact that the international representative missions of the USA, Great Britain, Canada, Germany, and others are already at work in Ukraine.

There are a number of specific reasons to encourage foreign direct investments in Ukraine. Firstly, attracting foreign investment has been a priority for the Ukrainian government since independence and continues now in the government's efforts to promote Ukraine as a destination for foreign capital. During these years, Ukraine has suffered from a lack of domestic savings and investments and struggled to shift investment decision- making to the individual company level following so many years of Soviet investment centralization. Foreign investment would thus ensure accurate placement of capital whilst stimulating an inflow of technology know-how.

Ukraine's foreign investment needs are obvious in everything from agriculture to telecommunications. According to the Ukrainian government, the country is in need of around 40 billion US dollars for economic restructuring, according the EBRD annual convention in 1998. In 2002, Ukraine received only US$ 531 million in total foreign direct investment (FDI), and a mere US$ 5.6 billion since independence, a modest sum when compared to Poland which received $50 billion in FDI during the same period.[3]

Despite the positive changes of the last few years, there remain a number of vital economic problems to be solved; for instance, low living standards (the average salary is approximately USD 100 per month); technical and technological manufacturing is badly underdeveloped. Business is complicated by over-regulation, a heavy tax burden, inconsistent application of laws and a lack of respect for the sanctity of the law. Nevertheless, recent economic growth is slowly strengthening Ukrainian purchasing power. Assuming that economic growth and domestic investment continues, Ukrainian based companies are beginning to import higher-quality Western (and German) capital goods in order to modernize and expand their production capacity.

Almost all sectors in Ukraine can be considered good for investment. Agro business, food processing and packaging sectors have been among the most rapidly growing sectors of the economy. They remain the areas of potential growth in the future. The sector's potential depends upon transparent privatization and land-reform policies in agriculture, particularly the passage of The Land Code of 25 Oc-

[3] Ukraine Country Commercial Guide FY 2004: www.usatrade.gov.

tober 2001 (effective since 2002). The major provisions of the Land Code address the right of individuals to own, buy and sell land and also provides for foreign ownership of non-agricultural land and clarifies the rights of foreign investors.

The energy sector is another major area for potential investment. The successful privatization of some electricity distribution companies was the first step towards improving Ukraine's energy industry, increasing transparency and reducing corruption in the sector. This action was also the first truly large-scale privatization performed in Ukraine to international standards of transparency and fairness. Telecommunications and information technology, and the aviation industry are important growth sectors as well.

In order to do business in Ukraine, German investors need to have a general understanding of the Law on the framework of creation and functioning of special economic zones (SEZ) of October 13, 1992, followed by the series of specific laws for certain SEZ.[4] There are three types of special economic zones in Ukraine:

- Special (free) economic zones;
- Territories with the special investment regime;
- Territories of priority development.

The main purpose of the adoption of these zones is the creation of new jobs, the enhancement of foreign trade, attracting foreign investment, the active exchange of knowledge and technologies, the broadening of export base or import substitution, and so on. The territories of special investment regimes and of priority development do not have independent customs borders like free economic zones. Each zone is managed by an administration that approves and registers all investment projects to be carried out in the zone. Normally, free economic zones are created for a period of 10 to 30 years. The Cabinet of Ministers of Ukraine approved a standard contract for implementation of investment projects in free economic zones.

About 20 special economic zones and territories of priority development are currently operating in Ukraine. If foreign investors wish to create a new company in one of the above areas they usually need to invest a designated sum (from US$ 200 000 to US$ 1 million).

Corruption is a phenomenon that pervades some levels of society and government and some spheres of economic activity in Ukraine. Corruption stems from a lack of institutional traditions of transparent decision-making and societal understanding

[4] See www.welcometo.kiev.ua

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of the importance of corporate governance and transparency. Corruption ranges from misuse of government resources to non-transparent privatization and procurement procedures. In short, corruption impacts important decisions taken at the state level. But fundamental changes have taken place in the Government's attitude towards corruption. The President of Ukraine, Leonid Kuchma, has declared the fight against organized crime to be one of the top priorities of his administration. Moreover, there is a broad understanding of these problems within Ukrainian official circles and a general consensus among reformers on the need to ensure that foreign investors are greeted with a more favorable legal and regulatory climate. The hard work of transforming that consensus into law is one of the most important challenges facing the Ukrainian political system today. Ensuring that these laws are effectively executed represents a comparable challenge.

Foreign investment activity is regulated by the Law of Ukraine On the Regime of Foreign Investments adopted on 19 March 1996.[5] According to this law, foreign investment includes all kinds of assets invested by foreigners in the form of:

hard currency;
Ukrainian currency, in case of re-investment into the objects of primary investment,
- any movable and real estate;
- stocks (shares) and securities in hard currency;
- monetary claims in hard currency which are guaranteed by the first rate banks[6];
- rights of intellectual property, including copyright, useful models, industrial patterns, trade marks, know-how, *etc.*;
- rights to do business, including the rights to explore natural resources, *etc.*
- entering into various contractual agreements (including import-export contracts, cooperation agreements, or joint production agreements).

The current foreign investment law of 1996 envisages the registration of foreign investment with local authorities. Foreign investments include:

creating joint ventures;
acquiring stocks (shares) in existing enterprises;
creating 100%-owned foreign subsidiaries;
acquiring real estate (apartments, houses, land use rights);
acquiring property rights by purchasing securities and stocks (shares) of enterprises with such property rights.

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[5] See www.murs.com.ua/indexe.html

[6] The Law does not make clear what it understands by 'first rate banks'.

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Foreign investors are guaranteed under these rules the unhindered and immediate rights to repatriate their profits abroad, but only following the payment of a 15% withholding tax in addition to other mandatory payments in Ukraine, Such as profit tax, VAT, payroll taxes, *etc.* Any in-kind foreign contributions imported for a company's capital fund are exempt from customs duties. All import duties must be paid if an enterprise sells, transfers or otherwise alienates the contributed property for any reason, including the termination of activities. Foreign investors are also granted the general protection of Ukrainian intellectual property rights, and the right to decide whether to seek patent registrations in Ukraine or abroad.

According to the Resolution of the Cabinet of Ministers of Ukraine No.112 of 30 January 1997 On Approval of the Regulations on the Procedures for State Registration of Contracts on Joint Investment Activity with the Participation of Foreign Investors agreements (contracts) on production cooperation, joint production without setting up a new legal entity signed by Ukrainian companies with foreign investors in keeping with the Ukrainian legislation are also subject to state registration.

Opportunities for German investors in Ukraine are based upon international agreements between Germany and Ukraine, namely, On avoidance of double taxation of 03 July 1995, On assistance to realization and mutual defense of investments of 15 February 1993, On merchant shipping of 10 June 1993, and On International motor traffic of 10 June 1993, On Air traffic of 10 June 1993.

International Investment Bank JP Morgan named Ukraine the most investment attractive country in 2001 returning 57.1% of profit to foreign investors that year, the highest result for any country. Currently, foreign investment in Ukraine comes from 112 countries, with the main investors being from the US, Cyprus, the UK, Germany, and Russia. The biggest investors among EU countries are Great Britain (about USD 686 million), The Netherlands (about USD 464 million), Germany (about USD 441 million).[7]

There have, admittedly, been many assertions as to the difficulty of doing business in Ukraine. While this may be true for a newcomer, such difficulties should not be exaggerated. The main risks are the same as those everywhere: reliability of business partners. In order to obtain a due diligence report on a potential Ukrainian partner, a German company would be advised to contact a law firm or similar professional agent. Macroeconomic risk is a characteristic of all emerging markets. Other risks include the purchasing power of the population, which needs to in-

[7] The State Statistics Committee of Ukraine: www.ukrstat.gov.ua

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crease to develop production. Yet the current situation represents the most stable Ukraine has been since independence, from both a political and economic standpoint.

Probably no other country in the former Soviet Union has experienced such a large gap between economic performance and potential as Ukraine. Endowed with good natural resources, superb agricultural land, a well-educated population, ethnic peace, and a strategic location in Europe, Ukraine was positioned to be one of the most successful of the former Soviet states in attracting foreign investment. Ukraine's business environment is complex and challenging, but it presents unprecedented opportunities to investors who can align the needs of the Ukrainian market with their own needs, combine local expertise with the best international practices, and use a practical, hands-on approach in developing the market. The country does offer long-term investment potential for those who understand the region and follow a careful risk-tolerant program of development.