Ukraine

Tuesday 18 September 2012

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Inside »

State in a struggle for identity and direction

Overview Kiev finds itself caught between the east and the west as elections loom, write *Neil Buckley* and *Roman Olearchyk*

Political rivalry: President Viktor Yanukovich has been criticised by the west for the jailing of Yulia Tymoshenko, below Corbis

As 60,000 fans filled Kiev's newly modernised Olympic Stadium in July for the Euro 2012 football championship final, it appeared in some ways to cement Ukraine's membership of the European "family" of nations.

The country's co-hosting of the tournament with Poland – the first time two former socialist bloc states have done so since the Berlin Wall fell – was widely deemed a success. It attracted hundreds of thousands of visitors, while the estimated $5bn Ukraine poured into infrastructure investments and other preparations will give the country a lasting boost.

"Everything we built for the championship will remain; new highways, airports, high-speed trains – all this will work for our economy," says Mykola Azarov, the prime minister.

But while impressed by their warm reception, visiting fans were not in Ukraine long enough to be aware of the retreat on democracy and human rights that has driven a wedge between Kiev, and the EU and the US.

Euro 2012 was marred by personal boycotts by some EU leaders in protest at what they saw as the politically motivated imprisonment last year of Yulia Tymoshenko, co-leader of Ukraine's Orange Revolution.

The former premier's conviction on charges of exceeding her powers, when she signed a gas deal with Russia in 2009, has become a symbol of what the west sees as a partial rollback of freedoms since Viktor Yanukovich beat her to become president in 2010. It has frozen the signing of a landmark EU-Ukraine political and free trade agreement – even though all negotiations are complete.

Signing that deal would have been the most decisive step towards European integration since Ukraine gained independence from the Soviet Union 20 years ago. Without it, the country remains locked in a two decades-old identity crisis over whether it wants to move towards Europe or re-establish closer ties with Russia.

Yet, confounding suspicions when he came to power that Mr Yanukovich would shift the country back into Russia's orbit, he and his government have had tetchy relations with Moscow. They have clashed over Ukraine's pressure to revise the gas deal signed by Ms Tymoshenko and reduce the high import price that is penalising the country's energy-guzzling heavy industry.

In return, Vladimir Putin, Russia's president, wants Ukraine to join a common economic space Russia is creating with Belarus and Kazakhstan, and to hand Russia control of the gas export pipeline across Ukraine to western Europe. For Mr Yanukovich, that appears to be a step too far.

All that has left Ukraine not just searching for its identity, but looking unusually friendless.

"The guy sitting in the presidential office has isolated Ukraine," says Arseniy Yatseniuk, co-leader of the Fatherland opposition bloc.

> The country suffered one of the deepest slumps on the planet, its economy shrinking by 15 per cent

The situation is far short of the hopes aroused by the 2004 Orange uprising of a democratic, west-orientated Ukraine. Some blame the EU for being slow to offer Ukraine the genuine prospect of membership.

Others blame the revolution's co-leaders, former president Viktor Yushchenko and Ms Tymoshenko. The two quickly fell out, and their feuding undermined progress on desperately needed reforms.

In the 2009 global recession, Ukraine suffered one of

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Ballot under scrutiny

Democracy There is intense international pressure for the parliamentary poll to be conducted fairly, writes *Roman Olearchyk*

Ukraine's October 28 parliamentary election is gearing up to be more than just the latest twist in a notoriously noisy and dramatic political saga.

President Viktor Yanukovich is under pressure to respect western values by holding a democratic vote. Failure could affect his domestic and international standing – and Ukraine's geopolitical trajectory.

In the run-up to the vote, Washington and Brussels have repeatedly warned Mr Yanukovich's administration that Ukraine's western integration aspirations hang in the balance.

With Yulia Tymoshenko, the ex-prime minister, and some of her allies jailed on what western leaders see as politically motivated charges, scrutiny of the poll will be intense.

Valeriy Chaly, a senior analyst at Kiev's Razumkov Centre think-tank, says: "There are already questions about the fairness of the vote – it's clearly not a normal situation when the top opposition leaders are in jail.

"At issue will not only be how people vote, but how the votes are counted, and the fairness of the pre-election process."

The west is pulling together large election monitoring missions.

Ms Tymoshenko's camp claims Mr Yanukovich has purposely sidelined his main rivals through politically motivated prosecutions, and this alone is enough to judge the contest unfair.

Should the vote be judged undemocratic, Mr Yanukovich's administration could find itself alienated from the west. This, in turn, could make him more vulnerable to pressure from Russia, still keen to reassert itself over Ukraine.

"Ukraine is now nowhere," says Arseniy Yatseniuk, former parliament speaker and the co-leader of Tymoshenko's Batkivshchyna [Fatherland] opposition bloc. "[It's] definitely not with the EU and western world, nor is there clear dialogue with Russia, with whom relations are often a one-way street – with them pressing to a point where you have to agree," he adds.

Split into two main parties, Tymoshenko's Fatherland and heavyweight boxing champion Vitali Klitschko's Udar [Punch], the opposition pledge to unite after the election and reverse what they describe as Mr Yanukovich's U-turn on democracy, to combat cronyism and kleptocracy and put Ukraine back on the Euro-integration path.

"If we get a majority in parliament, we can restore the balance of power . . . restore parliament, which is currently a [rubber-stamping] subsidiary of the president," Mr Yatseniuk says.

Mr Yanukovich has pledged to hold fair elections, but opposition groups point out that it was his allegedly rigged victory in 2004 that prompted the Orange Revolution.

Opora, an election watchdog, says the pre-election atmosphere has been marked by intimidation, voter manipulation and muzzling of the media.

TVi, the only television channel that dares to investigate government corruption, is being pulled off the air by many regional cable TV operators. Its management has faced investigations by prosecutors.

The opposition claim that the authorities are unwilling to risk losing power through a fair vote and are calling upon the west to introduce travel bans on Mr Yanukovich's inner circle.

Ms Tymoshenko, who has been in prison for more than a year, addressed EU leaders in a letter this month, saying: "Make a statement right now that these elections are illegitimate. After the elections are over it will be too late. The dictatorship in Ukraine has practically been built."

Polls show citizens largely disapprove of Mr Yanukovich's handling of domestic politics and the economy. Attempting to bolster support, his ruling parliamentary majority has been prepared to wade into a particularly divisive issue.

> 'If we get a majority . . . we can restore the balance of power'
>
> **Arseniy Yatseniuk**
> **Fatherland co-leader**

In an attempt to woo voters in the country's mainly Russian-speaking east and south, it passed a law this summer upgrading the status of Russian language.

The controversial move triggered protests. Ukrainian-speakers in western regions fear boosting Russian language usage will undermine Ukrainian, and deepen the political and cultural divide between the country's east and west.

Though opinion polls suggest the appetite for protest among Ukrainians is high, trust in the opposition is weak. If protests against vote fraud materialise, they could be smaller than during the Orange Revolution – not enough to play a game-changing role.

"These elections will not, in themselves, be a breakthrough, but could prevent a deeper slide into authoritarianism," says Mr Chaly. "It's more of a warm-up for bigger battles, including the [2015] presidential election."

The road ahead is long, Mr Yatseniuk concedes.

"The opposition is 2 per cent ahead in the polls, but there is a huge number of swing voters seeking new faces, about 20 per cent. I don't think they will back the government, but they could back other political forces [backed by] the government – so-called spoiler parties," he says.

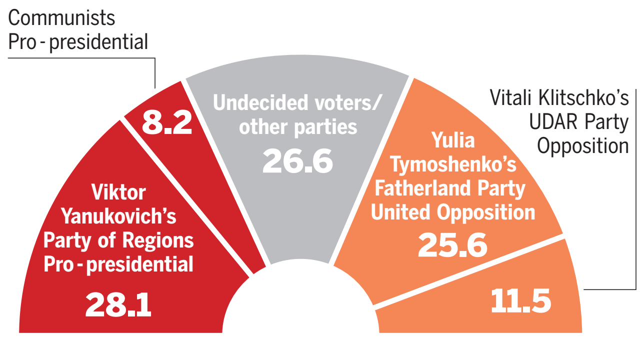
"The simple answer is to topple Yanukovich. The realistic answer is to restore the balance of power, democracy, and restore credibility. You can't steer the country without people's trust," Mr Yatseniuk adds.

But an opposition victory in the parliamentary poll could also create problems. It could intensify the political stand-off with the president, and trigger deadlock in a nation that faces serious economic challenges.

A divided leadership could be vulnerable to Russia, keen to limit Kiev's western integration and pull it into an economic union of former Soviet republics.

"It's not acceptable for Ukraine . . . to fall further under Russia's influence. This will put off European integration for many years. All sides need to avoid this scenario," says Mr Chaly.

Voting intentions
August 2012 (%)



Source: Kyiv's Razumkov Centre

Reforms will be needed to stimulate growth

Economy Recession has hit the nation hard. *Neil Buckley* and *Roman Olearchyk* consider why and look at hopes for recovery

Price drop: Kiev residents walk past a sale sign. The country has a more uncertain economic outlook compared with that of the years before the global financial crisis
Bloomberg

Five years ago, Europe's banks were rushing into Ukraine, paying billion-dollar prices to buy its banks in a push into what was considered one of the most promising emerging markets.

Today, many of those banks are drowning in bad debt, and winding down once-aggressive retail banking operations; the European parent banks are deleveraging and, in some cases, exiting Ukraine altogether.

Germany's Commerzbank, for example, sold its Ukrainian subsidiary Forum bank this summer to a domestic oligarch at an undisclosed price, after paying about $1bn for it five years earlier.

Troubles in the eurozone played their part. But the exodus also reflects a more uncertain economic outlook compared with that of the years before the global financial crisis.

After a decade of impressive growth, Ukraine's economy was one of the hardest-hit in the 2009 recession, and contracted by 15 per cent. That level of decline was worse only in the much smaller former Soviet Baltic republics which, unlike Ukraine, implemented stiff austerity measures while they kept their currencies pegged to the euro.

Ukraine has returned to moderate growth since then, but has still not regained all the ground it lost in 2009.

With steel accounting for about 40 per cent of exports and frozen credit keeping domestic growth at depressed levels, Ukraine's economy remains highly vulnerable to external shocks. Growth bounced back to 4.2 per cent in 2010 and accelerated to 5.2 per cent last year, helped by recovering industrial exports and a pick-up in domestic demand and investment.

But the weakening eurozone environment has taken its toll, with industrial production growth slowing sharply in recent months, prompting many economists to cut their forecasts for this year. Russia, Ukraine's other big market, is showing some signs of slowing too.

"We have found that Ukraine is very responsive both to developments in Russia and in the eurozone. If eurozone gross domestic product goes down by 1 per cent, for example, Ukraine's goes down by 2 per cent," says Alexander Pivovarsky, economist at the European Bank for Reconstruction and Development.

The EBRD is expected to cut its current 2.5 per cent growth forecast for Ukraine this autumn.

Other factors are contributing to the slowdown, including a worse agricultural harvest than last year and the end of a government-financed construction boom in preparation for hosting the Euro 2012 football championship.

Iryna Piontkivska, an economist at Troika Dialog, an investment bank in Kiev, says Troika has already trimmed its 2012 forecast to 1.5 per cent and may cut it further. She adds that growth is being held back by an unfavourable policy mix.

In common with many economists Ms Piontkivska cites an exchange rate policy that aims to keep the hryvnia stable against the dollar, despite pressure on the currency. That has led to very high interest rates and largely choked off credit growth this year.

The policy also means that since much trade is with the eurozone and Russia, if the dollar strengthens the euro and rouble weaken, making Ukraine's exports less competitive.

Allowing the currency to depreciate in the run-up to next month's parliamentary elections would be politically sensitive. However, many economists believe that, once the election is past, the central bank will allow some devaluation and move to a more flexible rate, possibly a gradually widening "corridor" against a basket of currencies.

That could allow interest rates to fall and stimulate credit growth, helping fuel a growth rebound next year – provided the external environment does not deteriorate still further.

Lower-than-projected 2012 growth means the budget deficit will be higher than the 1.8 per cent of GDP originally planned, though there may be scope to reduce some planned discretionary spending before the year-end.

> 'If eurozone GDP goes down by 1 per cent, for example, Ukraine's goes down by 2 per cent'

Sovereign debt, at about 35 per cent of GDP, is not problematic. But, with Ukraine due to repay $5.6bn to the International Monetary Fund during next year – and a $1bn eurobond maturing in June – many economists believe it will have to renew co-operation with the IMF. That will probably be in the form of a new stabilisation programme since the existing but suspended $15.6bn programme expires at the end of this year.

Again, once next month's parliamentary election is past, the government may have a period when it could push through reforms that the IMF has long demanded, including raising gas prices towards international levels. That would reduce the subsidy to Naftogaz, the gas monopoly, which sells gas to households for less than it pays for Russian imports.

Barring further global economic deterioration, Ukraine seems set to muddle through.

However, in the long term, putting its economy on a more stable footing will require boosting investment from levels that, for example, are only a fraction of what neighbouring Poland has accumulated.

"It's no secret that we feel Ukraine has strong potential for volatility," says Mr Pivovarsky of the EBRD. "It needs to completely revamp its industrial base. It needs to attract investments that are going into new sectors. There is a three-year EBRD strategy to support all these things over the medium-term horizon, but it is very difficult in a weak business environment, with slightly unpredictable macroeconomic policies."

Economists and businesses say the country needs to reduce the influence of profit-skimming domestic oligarchs, and cut red tape and bureaucracy, to attract both more foreign investment and stimulate domestic small businesses.

But after some initial achievements, progress on an ambitious government package to improve the business environment has largely stalled.

The fear is that only another round of crisis could release the political will to deal with the underlying issues holding back Ukraine's economy.

Good relations with EU and CIS are 'vital'

Interview
Mykola Azarov
Ukraine Prime Minister

The right-hand man to President Viktor Yanukovich talks to **Neil Buckley**

Ask Mykola Azarov whether Ukraine is moving back towards Russia and the prime minister chooses his words carefully.

"About one-third of our trade is with the European Union; about 40 per cent of our trade is with countries of the [ex-Soviet] Commonwealth of Independent States," says the silver-haired chairman of Ukraine's Regions party. "For us, it is vital to have good relations, *both* with the EU and with the CIS."

Ukraine has moved forward on both fronts in the past year. It completed negotiations on a political co-operation and trade deal with the EU – but that remains unsigned because of the imprisonment of former prime minister Yulia Tymoshenko. Kiev has also signed a free-trade agreement coming into force on September 23 with the CIS, of which Ukraine is an observer member.

Given the frosty EU relations, might Ukraine go beyond its CIS deal and join the customs union Russia has created with Belarus and Kazakhstan, as Moscow is urging?

"It is very important for us to find our own approach, our own formula, for our relationship with the customs union," says Mr Azarov delicately.

Wanting to maintain good relations with former Soviet republics is perhaps natural for Mr Azarov, born in Kaluga in Soviet Russia in 1947. He received a geology doctorate from Moscow State University, and settled in Donetsk, in the then Soviet republic of Ukraine, only in 1984.

He became an MP 10 years later, and from 1996 headed the state tax administration.

For the past decade, he has been seen as right-hand man to Viktor Yanukovich, today's president, twice serving as finance minister and first deputy prime minister when Mr Yanukovich was premier. He headed Mr Yanukovich's presidential campaign in 2010, and was rewarded with the premiership.

That has left him closely associated with subsequent developments that have driven a wedge between the EU and Kiev, including Ms Tymoshenko's jailing.

He insists Ukraine is misunderstood. Ms Tymoshenko, he says, is guilty as charged of abusing her power as prime minister when negotiating a 2009 Russian gas deal. "[Tymoshenko] absolutely illegally concluded an agreement that was extremely unequal," he says. "It caused us not only great economic losses – and we are talking billions of dollars – but goods produced in our country lost competitiveness."

PM Mykola Azarov

He adds he had never before seen an agreement "in which the position of Ukraine was so unequal – and which it could not even exit. This agreement gave Russia huge leverage to influence Ukraine."

Ms Tymoshenko's camp claims Mr Yanukovich's party, with Ukraine's then-president Viktor Yushchenko, sabotaged an earlier deal she had brokered with lower prices.

Mr Azarov suggests some European countries have been happy to use Ms Tymoshenko's imprisonment as a pretext to freeze the signing of the EU deal.

"It wasn't us who created this obstacle," he says. "We know that in the EU there are supporters of the integration of Ukraine into the EU and there are opponents."

Some countries, he notes, did not even want a reference to Ukraine's "European perspective" – or possibility of future membership – in the text.

> 'If you are against falsification, why are you against webcams in the polling stations?'

Future relations with the EU will depend in part on how next month's parliamentary elections are judged – and Mr Azarov insists they will be free and fair. Numerous European observers will get unfettered access, he says.

Ukraine, adds Mr Azarov, has even equipped all polling stations with webcams.

"The most interesting thing is that whatever we do to conduct really free and fair elections is met with resistance by our opposition," he says. "They are already announcing ahead of time that the elections will be fake. So I ask a very simple question. If you are against falsification, why are you against webcams in the polling stations?"

The Regions party-led coalition, he believes, will emerge with its majority intact – despite close-run opinion polls – because of its record of economic recovery since 2010.

"We have something to be proud of," he says. "In [the past] two and a half years we have done something in just about every town and village."

Without progress on the Tymoshenko issue, better relations with the EU seem a distant prospect. But Mr Azarov says Ukraine is prepared to wait until Europe is more ready to embrace its neighbour.

"For us, relations with the EU have a strategic nature," he says. "This is our long-term perspective. It's not a sprint, it's a long-distance race. And in the course of this, all sorts of situations can arise."

Struggle for identity

Continued from Page 1

the deepest slumps on the planet, its economy shrinking by 15 per cent. Little surprise, perhaps, that Mr Yanukovich – whose initial, disputed, presidential victory in 2004 was overturned by the Orange uprising – was able to beat Ms Tymoshenko in the next election in 2010.

Senior members of his administration insist his rule has since been misperceived and misrepresented. Allegations of democratic backsliding are, they insist, propaganda put out by the opposition.

They add the imprisonment of the former prime minister and several one-time allies results from a clampdown on corruption that has caught politicians from all parties in its net.

"For 20 years almost every government official presumed they would never be asked to answer questions about their actions," says Ukraine's foreign minister, Kostyantyn Gryshchenko. "This is now changing . . . and in [Ms Tymoshenko's] case there was a flagrant breach of the law."

But the only top-level politicians so far convicted are all from Ms Tymoshenko's circle, making this appear to be "selective justice".

External assessments of Ukraine's development have also been negative. Jose Manuel Pinto Teixeira, the former EU ambassador to Kiev, said Mr Yanukovich had re-established "vertical power". Washington-based Freedom House has called Ukraine one of only two European countries – with Hungary – that is becoming less democratic.

Though the government in 2010 launched an ambitious business reform programme, the World Bank ranked Ukraine 152nd out of 183 countries in its Ease of Doing Business index in 2011, down three places.

Mr Yanukovich was originally seen as a tool of certain oligarchs, who helped finance his election campaign. But since 2010, there are signs he has tried to turn the tables and put himself at the top of the pyramid – as Russia's Mr Putin did in the early 2000s.

The remaining independent media and many Ukrainians have begun speaking of the "family", a group around the president seen to have installed senior loyalists in several ministries and key public bodies. Anders Aslund of the Peterson Institute for International Economics, a long-time Ukraine-watcher, says an "oligarchic regime" has become a "family regime".

Ukrainian media have highlighted the expanding business interests of Mr Yanukovich's eldest son, Oleksandr, with the Ukrainian edition of Forbes magazine this year estimating his worth at $99m.

In written answers to the FT this summer, Ukraine's president said his family's property had been publicly declared and appointments were entirely merit-based.

"I have always emphasised competency, technical capabilities and dedication to hard work," said Mr Yanukovich. "My appointments reflect these standards. Whom the appointments know is not relevant. This is no different from the approach [of] any modern democratic government."

Oleksandr Yanukovich has denied his wealth or business success has any connection with his father.

Ukrainians will deliver a verdict on the ruling coalition led by Mr Yanukovich's Regions party in elections next month – a test of relations with the west.

With the two leading parties running close in opinion polls, the government is under international pressure not to resort to manipulation. Many citizens doubt assurances the poll will be fair.

But Mr Aslund says the 2004 Orange uprising proved Ukrainians are not as ready as Russians to accept undemocratic rule. "The big hope for Ukraine is the parliamentary elections," he says. "Ukrainian voters have repeatedly surprised by their clear insight and courage to stand up to the incumbent power."

Ukraine

‘Risky’ state also has its attractions

Foreign Direct Investment Widespread corruption and weak investor protection by a flawed judiciary has left the country in 152nd place of 183 countries in a World Bank ranking, but the nation has much to draw investors, says *Roman Olearchyk*

It is little surprise that Ukraine has attracted only a quarter of the more than $200bn of foreign investment that has poured into neighbouring Poland. The former Soviet republic's investment environment can be intimidating. Domestic and foreign businesses are often choked by bureaucracy and the past two years have seen a resurgence of mafia-style “raider” attacks.

A combination of widespread corruption and weak investor protection by a flawed judiciary has left Ukraine at 152nd out of 183 countries in the World Bank's most recent Ease of Doing Business ranking.

Yet on the ground, investors' experience in this vast and promising economy of 45m consumers on the EU's eastern border is not all doom and gloom.

Ukraine looks “risky” from the standpoint of “high fiscal pressure, taxes, corruption and the malfunctioning court system”, says Anna Derevyanko, managing director of the Kiev-based European Business Association. “Nevertheless, attractive margin rates that are much higher than in other developed countries make Ukraine an alluring destination, despite all the risks.”

Investors “have done well in less regulated sectors” such as fast-moving consumer goods, construction materials, manufacturing, retail and banking,” she adds.

> ‘For Kraft, Ukraine is one of the top 10 priority markets – on a par with Brazil, China and India’

“Generally the strategic investors that entered the market already in the 1990s or early 2000s . . . have done very well along with the economy that expanded 6 times over the past decade in US dollar terms,” adds Tomas Fiala, chief executive of Kiev-based investment bank Dragon Capital.

Take the experience of burger chain McDonald's. Launching 72 restaurants nationwide since 1997 and still expanding, it is so far the only international fast-food giant to have established itself. A weak franchising tradition and lack of reliable logistics and standards have kept competitors out, though insiders say KFC and other big companies are about to make a move.

Appetite for investment: a McDonald's in Kiev. The fast-food company has spent more than $200m on outlets in the country, and rivals such as KFC could soon follow Bloomberg

McDonald's more than $200m investment has shown that the appetite of Ukrainians is among the highest worldwide. “Ukrainian restaurants are among the busiest in the world,” says Ian Borden, vice-president for the group in eastern Europe. One Ukrainian restaurant ranks as the chain's 2nd in the world – two more are in the top 20 of more than 33,500 restaurants.

“In 2011, McDonald's restaurants in Ukraine were visited by 10m visitors more than in 2010. In the coming years we plan to open several restaurants per year,” he adds.

Furniture seller Ikea failed to enter Ukraine after struggling for nearly a decade to purchase land rights, but during the same period Germany's Metro Cash & Carry has pumped more than €500m into opening more than 30 stores. It plans to open two more by the end of this year.

Since 1995, Kraft Foods has pumped $200m into domestic food sector acquisitions and green field investments.

It is now represented in Ukraine by more than 13 brands in five product categories, from potato chips to coffee, chocolates and biscuits.

Success in Ukraine has led to its Kiev office being designated as a local hub for 11 countries, spanning eastern Europe and central Asia.

“Over 2008-2010 Kraft Foods has doubled the business in Ukraine and new markets in eastern Europe and central Asia,” said Taras Lukachuk, a vice-president at the food company who heads operations in Ukraine and also oversees 11 other markets in eastern Europe and central Asia. Mr Lukachuk said that 2011 turnover in this broad region increased to $610m from $500m in 2010. He says that for Kraft: “Ukraine is one of the top 10 priority markets – on a par with Brazil, China and India.”

So what is the secret to succeeding in Ukraine? “The country is a high-beta economy; the timing of entry as well as the length of the investment horizon is important,” says Mr Fiala.

He adds: “Over the long term, most investors do well, as long as they remain conservative during the boom times and do not abuse leverage. In general, the market is less developed and competitive than central Europe, allowing for better growth rates and margins.”

Mr Lukachuk says: “Issues arise, but they are not big enough to review investment plans; long-term planning is critical. You cannot enter Ukraine and expect to have a very profitable and promising business in a year or two . . . We didn't cut staff [in the 2009 economic crisis] but rather exploited this opportunity to make additional investment, and when the crisis was over we turned out to be stronger.”

Jorge Zukoski, president of the American Chamber of Commerce in Ukraine, says smart companies understand that there are “certain rules of the game that need to be followed to be successful”.

Mr Zukoski's “must” list includes: not paying bribes and building positive relationships with partners, regulators and policy makers. Also, finding sectors more amenable to foreign investors, such as “fast-moving consumer goods, telecommunications and data transmission, banking and financial services, agriculture, audit and legal services, as well as retail”.

Tax breaks introduced this summer for the IT sector are attractive, Ms Derevyanko says, adding that investment-hungry sectors also include infrastructure projects, green and renewable energy, and tourism.

Outsiders boost power sector

Energy

Kiev is heading for independence from Russian supplies, writes *Roman Olearchyk*

Ukraine has seen some positive foreign investment news this year, with Kiev opening up an underinvested but promising energy sector that has long dominated by domestic oligarchs.

If successful, the projects could bring in badly needed billion-dollar investments, and wean a natural gas guzzling economy off increasingly expensive Russian imports. Last month, officials granted a consortium led by ExxonMobil of the US, Royal Dutch Shell and Romania's OMV Petrom rights to sign a production-sharing agreement for hydrocarbon exploration in a vast territory off its Black Sea coast.

Ukraine's environment and natural resources minister Eduard Stavitsky says the Skifska field holds reserves of 200bn-250bn cubic metres (bcm) of gas, and could eventually produce 5bcm a year. Industry experts say the deep water project could reach commercial production in seven years.

“We have a unique understanding of the Black Sea geology,” ExxonMobil, a newcomer to Ukraine, said in a statement. “We are actively working in the Romanian sector of the Black Sea where, jointly with OMV Petrom, we announced a gas discovery earlier this year.”

Ukrainian officials say ExxonMobil, Shell and other partners in the offshore project have pledged to pay a $300m upfront premium upon signing of a production-sharing agreement within one year. The investors have pledged to invest $200m in the initial exploration phase, but billions more could flow in should commercially viable reserves be found.

News that Ukraine has brought in two of the world's largest energy companies to help unlock offshore oil and gas comes just months after Kiev's government picked Shell and Chevron of the US to lead large-scale onshore exploration using fracking and other non-conventional means. Estimated to have Europe's fourth-largest shale gas reserves, Ukraine has until this year kept international energy majors at a distance. Production sharing agreements for both the onshore and Black Sea projects are expected to be signed within a year.

“We have studied Ukraine's hydrocarbon potential in some detail and believe the country can provide more energy resources from its domestic production,” says Graham Tiley, general manager of Shell Ukraine Exploration and Production. “We are pleased the Ukrainian government has decided to attract reputable foreign investors to develop its hydrocarbon potential through open and transparent tenders.”

The long-delayed tenders show Kiev's leadership is keen to break national dependence on Russian gas imports, and that it is not entirely turning its back on the west.

Andriy Klyuyev, Ukraine's national security chief, made this point clear in a September 5 Beyondbrics column published by the Financial Times: “Ukraine holds a vital role in powering Europe by providing reliable access to current sources, exploring new shale and offshore reserves, and helping to transition to renewable. The commitment of the energy majors shows that Ukraine is open for business and is a testament to our efforts to transform our economy,” Mr Klyuyev said.

> Disputes between Kiev and Moscow have twice since 2006 disrupted European supplies

Dig deep: experts hunt for Ukrainian shale gas sites Bloomberg

“Closer collaboration . . . will allow Western investors to tap an emerging market . . . and strengthen Europe's connections with eastern Europe to balance the region's complex relationship with Russia.”

With Russian imports flowing at 40bcm annually, Ukraine's gas bill in recent years has reached $12bn and above.

That is a tall order for a nation with a vulnerable economy and shaky budget revenues. Ukraine produces a further 20bcm domestically. A 5bcm annual contribution from the Black Sea combined with fresh onshore finds would be most welcome.

In addition to stabilising Ukraine's domestic energy balance, big hydrocarbon finds could improve the stability of Russian gas flows through Ukraine's vast transit pipeline to Europe. Price disputes between Kiev and Moscow have twice since 2006 disrupted European supplies.

In refusing Viktor Yanukovich's repeated requests to reduce gas import prices to lower levels, Gazprom appears, ironically, to have helped to change Ukraine's investment policy for the better.

“A new and very important industry sector has been opened for foreign investors on a large scale,” says Jorge Zukoski, president of the American Chamber of Commerce in Ukraine.

He adds: “These projects, if successful, will be a big paradigm shift for Ukraine helping the country to take a giant stride towards energy independence while at the same time providing an opportunity for the government to prove to the world that they can attract and retain multibillion-dollar investment projects.”

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Companies still look westward for cash

IPOs London has been a top destination for initial public offerings, writes *Jakub Parusinski*, but Warsaw is also proving popular, while expectations from a decade ago that Moscow could see companies flocking there to list still have yet to bear fruit

Ukraine risks swinging eastward geopolitically if relations with the EU continue to deteriorate, but even such a scenario is not likely to end a steady westward course taken by the country's companies searching for capital.

There were expectations a decade ago that a tepid home market would drive Ukrainian companies to list in Moscow, but Russia's markets have yet to land a single Ukrainian company listing.

London, the listing place of choice for Russian companies, has also became the top destination for Ukraine's largest businesses seeking to raise capital. In the past seven years, domestic giants such as iron ore producer Ferrexpo and chicken king MHP have cashed in by listing on the London Stock Exchange.

The bulk of the initial public offerings action in more recent years has involved mid-cap companies flocking to Warsaw, where conditions can be better tailored to meet their needs and there are relatively higher valuations. In 2011 Warsaw topped Europe's stock exchange ranking, hosting almost half of all of the continent's IPOs and coming in third worldwide.

Smaller average deals mean the exchange still trails in terms of volume, but the Warsaw Stock Exchange has clearly emerged as the region's leader, outgrowing the Vienna-based CEE-SEG Group of central European exchanges.

Ukraine is part of the reason why. Though small by western standards – typical IPOs range from $30m to $90m – some names have grown into decent targets even for large buyers. Sunflower oil producer and grain trader Kernel set the record, raising $160m in 2007, but continued issuing and now boosts a free float worth more than $950m.

Moreover, the trend is clear as Ukrainian companies continue to sign up for public offerings despite the uncertain situation.

According to Serhiy Chorny, co-managing partner of Baker & McKenzie Ukraine, the international law firm is working on six Warsaw IPOs – covering such sectors as heavy machinery, construction materials and real estate – and two deals for London's alternative market.

"Basically, Ukrainian companies can choose from three markets – London, Frankfurt and Warsaw. But Frankfurt doesn't have the liquidity, and if you don't go for alternative markets, London requires bigger companies," says Ievgen Osypov, chief executive of IMC, a grain farmer and one of six Ukrainian companies to debut in Warsaw last year.

Tailoring its offer to Ukrainian issuers, the WSE spent years spreading the word and opened a representative office in Kiev in 2011, the first and only of its kind.

Ukraine now accounts for 12 of 47 foreign companies on the WSE.

"At first it was difficult to get Ukrainian companies even thinking about going public," says Andrzej Szurek, head of new markets at investor relations firm Inner Value, which advises several Ukrainian companies. "But they sowed the seeds for a long time, and started reaping in 2010."

Jacek Piechota, head of the Polish Ukrainian Chamber of Commerce and Poland's former economy minister, says: "Poland has had a special interest in Ukraine for 20 years now.

"Part of this is about cultural and historical ties, but it's also about how big the potential rewards are."

IMC's Mr Osypov says: "Warsaw is very active in Ukraine. There is a representative office in Kiev, it's easy to communicate or get information. No other stock exchange has this kind of presence."

Warsaw may better suit Ukrainian companies, argues Marek Buczak, foreign markets director at Quercus TFI fund, which manages about $500m. London-listed agribusinesses such MHP or egg producer Avangard fail to stand out.

> Ukrainian companies continue to sign up for share offerings despite the uncertain situation

They do not get the stable investments of Poland's pension funds. As a result, they usually get stuck at price to earning ratios of 3 or 4, while their Warsaw-listed counterparts can climb to 7 or 8, Mr Buczak says.

"When we invest in Ukrainian companies, we avoid Frankfurt – the liquidity is too low – while in London there are too many aggressive hedge funds and other big commodity companies," he adds.

Both platforms, however, continue to discount Ukrainian companies significantly. Mr Buczak names fear of economic instability, notably currency devaluation, and political risk as the culprits.

"Unofficially, many analysts also say they fear potential interventions, export restrictions, and so on, if the government feels it needs them," Mr Buczak says. "The elections are clearly not helping."

Communication is also a problem, experts say. Lawsuits over the most valuable asset of London-listed Ferrexpo spooked investors, particularly since the risk was downplayed in the prospectus.

But tight-lipped executives, unrealistic promises, failures to meet deadlines, and, in one case, the inability to explain the source of $66m in revenue, have also bruised the reputation of Ukrainian companies in Warsaw.

The first debuts were not so bad, said Mr Piechota, but recurring problems at two or three companies hurt the nation's image. To change this, seven WSE-listed firms came together last month to set up the Ukrainian Issuer's Club, which aims to improve investor relations and put some pressure on the underperformers.

"We can see a growing polarisation. On one side there is a group which is trying, recovering losses and growing, but others are just scraping the bottom," Mr Szurek says.

Habsburg jewel is a historic survivor

Tourism: Lviv

Jakub Parusinski finds a destination buoyed by Euro 2012 and hoping to reach the big league

A land time forgot: despite its population of 750,000 – on a par with Kraków – the city has maintained its quiet, idyllic charm Michal Parusinski

Prague and Krakow, overrun by tourists, may soon find a competitor in Lviv. just across Ukraine's border with Poland. The Unesco World Heritage site is gearing up to become the next hot destination for those in search of Habsburg splendour and good, cheap beer.

Among the cities of the former Austro-Hungarian Empire, Lviv stands apart. Central Europe's steps toward the EU came with a flood of travellers seeking medieval town squares, history and café culture.

But in Lviv, time stood still. Despite its population of 750,000 – on a par with Kraków – the city has maintained its quiet, idyllic charm. Farmers' markets appear each morning, trams run through the city's cobbled streets and the faithful still fill its 104 churches of numerous denominations.

The city is now seeking to move into the big league, buoyed by its experience as a host city for the Euro 2012 football championship.

A new airport and high speed train to Ukraine's capital Kiev make it more accessible to foreign tourists, 150,000 of whom came during the tournament.

Lviv has a long way to go. The city attracts 800,000 to 1m tourists a year compared with 8m to 9m for Krakow, says Oleksandr Kobzarev, head of the City Institute, a think-tank. Krakow has 20,000 beds, while Lviv has 6,000, or 10,000 including hostels, he adds.

City mayor Andriy Sadovyi hopes to increase tourist flows fivefold. "Not everyone is aware of the pearl of the east," he wrote by email from China, where he represented Lviv at the Nanjing World Forum of Cultural and Historical Cities. His other plan, to turn Lviv into a regional outsourcing and IT hub, is starting to pay off. Investment has poured in, says Mr Kobzarev, and major employers are working with universities to turn out professionals fast enough to meet expansion plans.

> A new airport and high speed train to Ukraine's capital make it accessible to tourists

Unlike other parts of Ukraine, Lviv has a thriving small and middle business sector, largely founded by people who worked in the west, earning capital and valuable experience, says Andriy Beyzyk, head of Western Ukrainian Management Consulting, which advises foreign investors. "People have more contact with western entrepreneurs, who find it more comfortable to work here [than in Eastern Ukraine]," he adds.

Just 60 kilometres from the EU border, Lviv is by far Ukraine's most European city. Following centuries of Polish and Austrian rule, it did not fall under Russian domination until 1939, making its Soviet experience closer to that of the Baltics. While other cities saw their centres warped by communism and cleansed of foreign influence, Lviv was simply draped in a veil of greyness, with the occasional coat of tawdry paint.

But as the paint peels, revealing old signs in German, Polish and Yiddish, so too the city is rediscovering its multicultural past, and capitalising on famous former residents. Tourists drop in for an espresso and a public whipping at the Leopold von Sacher Masoch café, named after the 19th century journalist who gave his name to a perversion.

A plaque marks the home of Ludwig von Mises, a founder of the Austrian School of economics. Meanwhile, the mayor says, historically themed cafés such as the Jewish Pub and Masonic Lodge have mushroomed. Sadly, no signs adorn the building of the former Scottish Café, where members of Poland's interwar Lwów School of Mathematics solved problems that would define today's society, winning what were then expensive prizes – wine, a goose or a bottle of fine brandy.

They included Stefan Banach, father of modern functional analysis, and Stanislaw Ulam, who provided the maths behind the Manhattan Project and invented the Monte Carlo method used in genetics and option pricing.

Yet solving some problems may be beyond the city's reach. Technical innovations and new infrastructure have eased pressure on the borders, but coming in by car remains a problem.

A study by the Batory Foundation, a Warsaw think-tank, found queues to leave Ukraine could last for 14 hours, with corruption weighing on inefficient organisation. "Ukrainian customs officers don't see taking bribes as a shameful act, do not fear penalties, and usually themselves indicate who should be paid and how much," it says.

Booming private trade is also adding to the lines. Estimates by Poland's Central Statistical Office put the level of "private export" by Ukrainians at $500m compared with $2.4bn in official trade.

According to Mr Beyzyk, VAT refunds make Polish products more interesting.

Mr Sadovyi concedes corruption is a problem but says he is doing what he can to minimise it.

Lowering costs is another challenge. An overpriced hryvnia – the result of government policy ahead of upcoming parliamentary elections – and low economies of scale keep prices high, says Mr Kobzarev. Despite average monthly salaries of about $340, four times lower than in Krakow, overall expenses are similar.

Yet Mr Kobzarev insists the city remains a steal compared to Ukraine's capital, Kiev, or even other regional centres, such as Dnepropetrovsk or Donetsk – tourism markets the city hopes to tap. "And compared to Moscow, it's practically free," he adds.

Room for profitable growth in the fields of black earth

Agriculture

The bread basket of Europe produces just a fraction of its potential yield, says *Mark Rachkevych*

Ukraine's "black earth" – the chernozem – is an amazingly deep, fertile soil whose prodigiously productive capacity led the country to be christened "the bread basket of Europe".

The country has close to a third of the arable land area of the whole EU, some 34m hectares, 70 per cent of which is black earth up to six metres deep.

In the past two years Ukraine has matched or topped yields of the Soviet era, reaping 40m-50m tonnes of grain and oil-bearing crops a year. It is one of the top producers and exporters of sunflower seed and oil, barley, wheat and corn.

But in a decade or so, investment and knowhow could double grain and oil harvests, says Peter Thomson, deputy chief executive of Ukrainian Agrarian Investments, owned by Moscow-based Renaissance Group, which farms 240,000ha on 62 estates.

"It's a farmer's heaven, the (ideal) climate . . . and phenomenally productively land," says Mr Thomson.

Its proximity to export markets in north Africa and Europe, well-developed rail network and warm sea ports offer strong logistical advantages. Production and labour costs are also lower than in the EU and land lease rates range from $35 to $90 a hectare, a fraction of Latin America's averages of $250 –$400, Kiev-based investment bank Concorde Capital says.

Production fell sharply after the USSR's collapse. The resurgence began later in the 1990s when multinationals such as Cargill of the US entered, investing vast sums to set up trading, production and logistics. But in the past decade, local agribusinesses, fuelled with cash from initial public offerings in London, Frankfurt and Warsaw, combined with affordable loans from the European Bank for Reconstruction and Development and the International Finance Corporation, have driven up agricultural production.

"It's the only economic sector that showed positive gains during and after the global financial crisis that hit in late 2008," says Bohdan Chomiak, a partner with Kiev's UkrAgroConsult consultancy.

And there is much more to come. Estimates vary, but agriculture experts say new agribusinesses with more than 50,000ha farm just 10-25 per cent of the nation's arable land.

They use modern farming techniques and methods such as up-to-date genetics, plant protection and machinery to implement a variety of business models from pure grain and oil seed farming to vertically integrated operations that produce eggs, poultry, and meat.

Mr Chomiak says: "The upside is there's enormous opportunity to improve the scale of business models in any agricultural sector."

Then there are the district kings with smaller farms of 10,000-15,000ha that are also improving efficiency, says Alex Lissitsa, president of the Ukrainian Agribusiness Club, adding: "Plus there are some 100 farmers working in Ukraine from Europe and the US introducing and producing goods using high technology."

But Concorde says the sector as a whole suffers from poor land management practices, lower application of fertilisers and outdated machinery, 70-80 per cent of which is fully depreciated and harms yields

Mr Chomiak adds that, because the farmland cannot be bought or sold,

Spade work: Ukranians still work family land by hand Reuters

only leased, it cannot be used as a commodity or collateral, which affects household and small farms.

Mr Lissitsa says this limits the availability of affordable loans in an environment where banks do not trust or understand farmers. He adds that educational institutes are not preparing students for the modern age or offering them practical skills.

Mr Chomiak says another constraint is an incoherent, inconsistent agricultural policy. "Government policies are holding back the sector with the land policy, with interventions on the export markets and widespread corruption."

However, since Ukraine became a full member of the World Trade Organisation in May 2008, the government has interfered to a lesser degree in the agricultural industry than it did in the past when, periodically, it restricted exports, says Oleksiy Demyanenko, an associate at Asters, a leading Ukrainian law firm.

Put together, Mr Chomiak estimates that the sector is working at only 40 per cent capacity, though he adds: "World capital is ready to mobilise and invest in Ukraine, especially private equity and sovereign wealth funds."

In spite of the hurdles, companies such as the domestic agriculture group Nibulon have found ways to cash in on Ukraine's natural endowments.

Nibulon is a large exporter of grains. It has built up a storage and logistics network, complete with inland and river silos, shipment ports and tug fleets to transport grain down the river Dnipro, Ukraine's historic trade route. Oleksiy Vadaturskyy, Nibulon's president told the Financial Times that, despite the absence of government support, he has still managed to expand his business "building on our own experience which has made us stronger".

Mr Vadaturskyy says: "Ukraine's leaders always say the right thing. But the people around them and those on the ground that implement policies do everything completely the opposite, and they are the main threat to business development."

However, it is only a matter of time before more expansion takes place, one European farmer in Ukraine says.

Jens Bruno, a business controller for Grain Alliance, a private corn, sunflower and soy grower backed by US and Swedish investments, says those who take a long-term strategy with a strict focus on productivity and efficiency will win out.

Mr Bruno says: "And the transportation network of storage facilities, ports and rail – they're all expanding. He adds: "It's only a question of time."

Future report »

Investing in Poland

How the euro crisis is affecting the nation

FT Special Report on October 22