Ukraine

Private Sector Financing And The Role Of Risk-bearing Instruments

November 2013

Private Sector Financing In The Eastern Partnership Countries And The Role Of Risk-bearing Instruments

Country report: Ukraine

November 2013

Business & Finance Consulting

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EPTATF VISIBILITY

"The present study was commissioned by the European Investment Bank (EIB). The study is financed under the ***Eastern Partnership Technical Assistance Trust Fund, EPTATF****. This Fund, which was established in 2010, to provide TA for investment projects (pre-feasibility studies and feasibility studies, institutional and legal appraisals, environmental and social impact assessments, project management and borrower support), develop local capacity as well as financing upstream studies and horizontal activities. It focuses on the four priority sectors energy, environment, transport and telecommunication with climate change and urban development as cross-cutting issues."*

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List of acronyms used in this report

BFC	Business and Finance Consulting
EBRD	European Bank for Reconstruction and Development
CAR	Capital adequacy ratio
CIDA	Canadian International Development Agency
CPI	Consumer price index
EU	European Union
FDI	Foreign direct investment
GDP	Gross Domestic Product
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
GUF	German-Ukrainian Fund
IFC	International Finance Corporation
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IT	Information technology
KfW	Kreditanstalt fur Wiederaufbau
MFI	Microfinance Institution
MSME	Micro, Small or Medium Enterprise
NATO	North Atlantic Treaty Organization
NBU	National Bank of Ukraine
NPL	Non-performing loan
OECD	Organization for Economic Cooperation and Development
PPP	Purchasing power parity
SDC	Swiss Agency for Development and Cooperation
SME	Small or Medium Enterprise
TA	Technical assistance
US	United States
USAID	United States Agency for International Development
WB	World Bank

About this report

This report is one of a series of reports produced by Business & Finance Consulting GmbH (BFC) for European Investment Bank (EIB) as part of the project "Private Sector Financing In The Eastern Partnership Countries And The Role Of Risk-bearing Instruments." The series of reports includes individual country reports on Armenia, Azerbaijan, Georgia, Moldova, and Ukraine, as well as a synthesis report which considers the results from all five countries. The purpose of the project is to assess the financing needs of SMEs in the Eastern Partnership countries and identify market failures that prevent the development of the SME sector.

The project was carried out from June 3, 2013 to November 1, 2013 by a team of four experts from BFC. Onsite visits were conducted for each country in order to meet with representatives from financial institutions, development institutions, the government, and other relevant actors who can comment on the SME sector and its access to finance. The visit to Ukraine took place from June 25 to July 5, 2013, during which time meetings were held with representatives from 27 organizations, including 20 local financial institutions, 6 development institutions and the central bank.

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1. EXECUTIVE SUMMARY

Ukraine is a country with much opportunity for SMEs. An abundance of rich agricultural soil, a large supply of high caliber technical talent, and an environment set for energy efficiency improvements creates vast potential for SME growth. Unfortunately, economic contraction and political risks have created a poor investment climate, and the financial sector continues to struggle in the aftermath of the global economic crisis. As a result, the supply of SME finance is limited. Although political and economic uncertainties temper the demand for SME finance, there is still a significant negative gap between its supply and demand.

Economic and political situation: The economy entered a double-dip recession after a brief recovery period following the financial crisis. Continued economic contraction and threats of currency devaluation tighten local markets and discourage investment. Conflict among political parties driven by opposing pressures from Russia and the West creates instability and further contributes to a poor investment climate, hindering SME development. Ukraine's potential entry into an Association Agreement with the European Union in late 2013 would be a major boost for SMEs, opening up trade opportunities and stabilizing their operating environment following a long period of uncertainty.

Financial sector: The banking sector is yet to recover from the global economic crisis. Balance sheets remain weighed down by crisis-time non-performing loans due to difficulties with collateral recovery driven by a dysfunctional court system. Lending rates are high (up to 20%), diminishing the viability of most potential capital investments by SMEs. Despite healthy deposit growth in recent years, credit growth has remained stagnant. Because foreign currency lending and local currency devaluation were major drivers of crisis time credit defaults, the central bank has enacted measures to essentially stop foreign currency lending.

Non-bank financial institutions account for a relatively small portion of the financial system. Microfinance is virtually non-existent, but credit unions address the market segment typically served by MFIs (small businesses in rural communities). Leasing companies, while few in number, offer good financing alternatives to the transport and agricultural sectors. The private equity sector is small and relatively inactive: just one private equity fund has been raised since the crisis. Venture capital and the startup ecosystem are in their nascent stages.

Supply and demand gaps: There are 77,776 registered SMEs in Ukraine, consisting of 57,587 small and 20,189 medium enterprises. Demand for MSME finance is tempered by the poor investment climate and high interest rates. SMEs involved in agriculture are the only ones showing strong demand for bank financing, primarily for working capital purposes. A new tax law adopted in 2011 increased tax rates and administrative burden for SMEs, driving many of them out of business or into the grey economy, contributing to further demand reduction.

Supply of MSME finance largely consists of short-term bank financing, with limited offerings from leasing companies, credit unions, private equity funds, and venture capital firms. Trade finance for SMEs in the form of letters of credit and guarantees is limited overall and the activity is highly concentrated among a small number of banks; in terms of products, guarantees are most commonly used, with LCs being much less common. Financial institutions suffer from a lack of local currency financing – a need that could be met by IFIs. Other opportunities for IFI intervention include investment in private equity funds and financing of agricultural leasing. Overall, a significant SME financing gap exists in Ukraine, particularly notable for loans, creating an impediment to SME development.

2. MACROECONOMIC ENVIRONMENT

Conclusion:
Economic decline and political instability are major impediments to SME development.

Key findings:

- *The Ukrainian economy contracted significantly during the global financial crisis, and entered another recession in 2012 after showing signs of recovery*
- *Ukrainian incomes are rather low, but relatively evenly distributed, and extreme poverty is virtually non-existent.*
- *Agriculture is an important industry for SMEs, as about 60% of Ukraine's agricultural land is held by small and medium sized farmers*
- *An unfavorable tax policy adopted in 2011 has significantly impaired SME performance*
- *The signing of an Association Agreement with the EU in November 2013 would provide a major opportunity for SME growth*

The current economic and political environment is generally unfavorable for SME development. The Ukrainian economy has suffered a double-dip recession following the global financial crisis. Economic contraction, disadvantageous tax policies, fears of currency devaluation, and political instability contribute to a difficult operating environment for SMEs, discouraging investment and growth. The signing of an Association Agreement with the EU could significantly improve the investment climate for Ukrainian SMEs, adding stability and increasing export opportunities.

Key macroeconomic indicators for the country are presented in Annex 1.

2.1 Economic development and growth

Ukraine's economy was deeply affected by the economic crisis of 2008-09. Although GDP growth resumed in 2011, it once again stagnated in the second half of 2012, entering a double-dip recession. Real GDP shrank by a massive 14.8% in 2009, grew by 4.2% in 2010 and 5.2% in 2011, and shrank by 0.2% in 2012. The primary drivers of the most recent decline were reduced world demand for steel (a major export for Ukraine) and lack of precipitation, which caused a 4.0% value added decline in the agricultural sector.[1] Negative growth continued into the first two quarters of 2013, driven by declining industrial output.

Ukrainian incomes are rather low, but relatively evenly distributed, and extreme poverty is virtually non-existent. GDP per capita amounted to EUR 5,727 in terms of purchasing power parity in 2011, a fraction of Russia's EUR 16,539 and Poland's EUR 15,908. This relatively low per capita income and the resulting low discretionary income, along with minimal growth since 2008, have a negative effect on SMEs specializing in consumer products and services. Ukraine's Gini coefficient, at 25.6% as of 2010, is among the lowest in the world, suggesting rather even income distribution (Russia's 2009 coefficient was 40.9%, as a point of comparison). The top 10% of the population earned 21.5% of income as of the same year, a relatively low figure compared to other countries. Extreme poverty (as measured by the percentage of population living on less than $1.25 per day based on purchasing power parity) is virtually non-existent – the figure amounted to 0.1% as of 2009 and 0.0% as of 2010.[2]

[1] World Bank. *Ukraine Economic Update.* April 2013.
[2] World Bank DataBank

Official unemployment rates, at 8.1% in 2012, down from 8.6% in 2011, are moderately high but are in line with those of developed nations such as the United States and the United Kingdom. It should be noted, however, that over half[3] of the population is estimated to be employed in the informal economy (including those working in largely untaxed agricultural production, about 17% without agriculture), according to a 2009 study. Participation in the informal economy is said to have further increased[4] as a result of the economic downturn. Many university graduates have trouble finding employment that matches their skills[5] and end up underutilized – an issue that could be addressed through increased startup and SME activity.

2.2 The structure of the economy

Ukraine's largest economic sectors include trade (15.6% of GDP for 2012), manufacturing (12.8%), transport (10.1%), and agriculture (7.9%). Agriculture and heavy industry are historical drivers of Ukraine's economy – the country generated over a fourth of the entire Soviet Union's agricultural production prior to its breakup, and produced a variety of unique equipment such as large diameter pipes and vertical drilling apparatus.[6] Ukraine's top export is steel, and the economy is vulnerable to global steel price fluctuation.

Agriculture is an important industry for SMEs, as about 60% of Ukraine's agricultural land is held by small and medium sized farmers[7]. Export potential for agro-products is immense, as Ukraine has about a third of the world's most productive black soil, and over half of the country is arable land, but underdeveloped land ownership legislation and slow adoption of modern farming practices and technology have stifled the development of this sector.

The role of state owned enterprises in Ukraine's economy has been diminishing as the State Property Fund of Ukraine carries out its privatization mandate (with about EUR 1 billion in assets scheduled to be sold in 2013). Continued privatization of entities such as condominium management services may provide growth opportunities for SMEs.[8]

2.3 Inflation and asset prices

Ukraine experienced double-digit consumer price inflation during the financial crisis years of 2008 (22.3%) and 2009 (12.3%). Consumer price inflation slowed in the following years as the economy recovered and actually dropped to a negative 0.2% in 2012. Falling food prices, flat utility prices, tight monetary policy, and decelerating economic activity drove the low inflation rates. The consumer price index went up by a mere 0.2% in the first two quarters of 2013 due to stable food and utility tariffs, but is projected to increase to 5-8% for the coming years.[9] The high inflation of 2008 and 2009 was particularly detrimental to consumer-facing SMEs, such as service providers and vendors. The recent reduction in inflation (and growth in discretionary incomes) has come along with growth in consumer spending, providing SMEs with renewed opportunity.[10]

[3] Commander, Simon, et al. (2009) *A model for the informal economy with an application to Ukraine*
[4] Based on sentiments gathered during onsite meetings
[5] World Bank. *Ukraine Overview*
[6] CIA. *The World Factbook, Ukraine*
[7] IFC (2013), *IFC, Austria and Bayer Partner to Increase Ukraine Farm Productivity*
[8] Ukraine Gateway. *State Property Fund of Ukraine*; KyivPost (2013), *Ukraine's Privatization Plans for 2013 on Verge of Failing*;
[9] World Bank (2013), *Ukraine Economic Update*
[10] Euromonitor International (2012), *Ukraine's Household Income Bounced Back, But 2012 Remains Uncertain*

The real estate market experienced a bubble that burst in 2008-2009. Prices in markets like Kiev dropped by over 40% between 2008 and 2010[11] and construction activity largely ceased. The market appeared to show signs in 2012, but supporting industries such as construction and construction materials have continued to perform poorly. Stock market performance has generally followed GDP growth patterns, bottoming out during the financial crisis, improving in 2010-11, and declining again in 2012-13.

2.4 Balance of payments

Ukraine's trade deficit has grown in the past few years, with the imbalance increasing from -2.9% of GDP in 2010 to -8.4% in 2012, driving the change in the current account balance from -2.2% to -8.4% over the same timeframe. A drop in world demand for steel, a major export for Ukraine, has been a significant driver of this trend.[12] These figures also reflect a missed opportunity for agricultural exports, which would be a large boost for the SME sector. Ukraine experienced a trade surplus in the first half of 2013 due to gas import rationing, but this practice does not appear sustainable, and the trend is likely to reverse.

Concerns about the sustainability of Ukraine's macro framework and the perception of a poor investment climate temper outside investment and reduce financing options for Ukrainian SMEs. The financial crisis of 2008 and 2009 further reduced investor appetite for emerging market investments, including Ukraine. Given continued uncertainty in the Eurozone, this trend is unlikely to reverse in the near future. Net foreign direct investment decreased from 5.9% of GDP in 2008 to 4.4% in 2011, highlighting this trend.

The Hryvnia (UAH) has been unofficially pegged to the USD since 2005. The original peg was at UAH 5 per USD, but was devalued to UAH 8 per USD in 2008 as a result of the financial crisis. The currency peg has restricted the NBU's ability to conduct expansionary monetary policy, keeping financing costs high for SMEs.

2.5 The fiscal situation

Subsequent to a post-financial crisis recovery, central bank reserves have followed a downward trend, declining from 25.4% of GDP in 2010 to 13.9% in 2012. Maintaining the currency peg despite tightening access to global debt markets has come at the expense of dwindling foreign reserves, which reached a six-year low of around 2.5 months of imports in June 2013. The trend drives continued fears of currency devaluation, undermining the investment climate for SMEs. In July 2013 the NBU significantly raised its foreign currency reserve requirements in an attempt to force down local demand for foreign currency.

Ukraine's budget deficit amounted to 4.5% of GDP in 2012, up from 2.8% in 2011. Public debt increased from 35.9% of GDP in 2011 to 38.8% in 2012. While this level is sustainable, further increases may lead to additional inflationary and revenue collection pressures, which may be unfavorable to SMEs.

A new tax code adopted in 2011 was intended to downsize the informal economy and fight corruption, but also had the effect of increased taxes and administrative burden on individual entrepreneurs. The removal of a simplified tax system previously in place for small businesses made them subject to the state pension tax and arduous reporting requirements. A large portion of

[11] Global Property Guide (2010). *Ukraine Real Estate Market Shows No Sign of Recovery*
[12] World Bank (2013), *Ukraine Economic Update*

Ukraine's small businesses terminated operations or entered the grey economy in anticipation of the law.[13]

2.6 The political situation[14][15]

A lack of political stability is a major impediment to SME development. Post-Soviet Ukraine has a history of political infighting, driven by opposing pressures from the country's Russian and western neighbors. The potential signing of an Association Agreement with the EU later in 2013 could open up European markets to Ukrainian SMEs and significantly improve the investment climate in the country.

Relationship with Russia: Ukraine's political and economic situation is significantly affected by its relationship with Russia. Much of the internal conflict within Ukraine has occurred as a result of opposing pressures from Russia and the West. Russia has severely opposed Ukraine's potential NATO membership, threatening to target its missiles at Ukraine if the country were to join NATO and accept a US missile defense shield. President Viktor Yanukovych, who is widely viewed as a pro-Russia player, shelved NATO membership plans after coming into power in 2010. The previous government of Yulia Tymoshenko was seen as more pro-western: a free visa regime to the EU and a potential application for EU membership were seriously discussed during that time.

Ukraine's dependence on Russian gas imports is a major political risk, as Russia has been said to use gas prices to apply political pressure on Ukraine. Most of Russia's vast gas exports to the EU travel through Ukraine, and Ukraine has been accused of and essentially admitted to diverting Russian gas intended for export for its own use during difficult winters. Disputes between the Ukrainian and Russian gas companies (Naftogaz Ukrainy and Gazprom) have had the effect of threatening the gas supplies of several European countries, which rely on Russian gas imports transported through Ukraine. Ukraine is widely criticized for providing significant gas subsidies to its population, a practice it cannot easily end for political reasons.

EU Association Agreement: Ukraine is on the verge of signing an Association Agreement with the European Union. Provided that Ukraine is able to meet the agreed upon requirements, including eliminating selective justice, reforming election legislation, and demonstrating progress in implementing European standards, the agreement will be signed in November 2013. The Ukrainian government has repeatedly expressed a commitment to meeting the EU's requirements, passing a number of anti-corruption laws and amending the Criminal Code. The signing of the Association Agreement, along with a Free Trade Agreement, would open up European markets for SMEs, providing significant growth opportunities.

The incarceration of former Prime Minister Yulia Tymoshenko, who is serving a seven-year term for corruption and embezzlement associated with a Russian gas-pricing deal she signed while in office, is a sticky point with the EU. Officials believe that releasing Ms. Tymoshenko would be an important step toward securing the EU Association Agreement, as her incarceration is widely believed to be an example of selective, politically motivated justice practiced in Ukraine.

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[13] OECD, et al. (2012), *SME Policy Index: Eastern Partner Countries 2012: Progress in the Implementation of the Small Business Act for Europe*, OECD Publishing.

[14] Please refer to the Confidential Report for more information.

[15] BBC News (2008), *Russia in Ukraine Missle Threat;* forUm (2013), *Abruzov: Association with EU is a Strategic Choice for Ukraine;* iStockAnalyst (2013), *Outside View: Tymoshenko, Ukraine and the EU*; Euronews (2011), *EU Feels Let Down by Ukraine over Tymoshenko*; BBC News (2009), *EU Reaches Gas Deal with Ukraine*; BBC News (2006), *Ukraine "Stealing Europe's Gas"*

3. FINANCIAL SECTOR OVERVIEW

Conclusion:
The financial sector is dominated by banks, with marginal contribution from credit unions, leasing firms, private equity funds, and venture capitalists. The banking sector was severely affected by the global financial crisis, and credit growth has not resumed.

Key findings:

- *The banking sector suffered as a result of the financial crisis, and credit growth has not resumed*
- *The microfinance sector is very small, but credit unions fulfill the role typically played by MFIs*
- *Private equity and venture capital activity is low: just one private equity fund has been raised since 2009 and very few venture capital investments are made annually*

3.1 Financial sector overview[16]

The Ukrainian financial sector is dominated by banks, with 176 banks operating as of 2012. Traditional microfinance is virtually non-existent, but credit unions generally play the role typically filled by MFIs in other economies, reaching rural areas and providing unsecured relationship-based lending. A small number of leasing companies primarily serve the transportation and agricultural sectors. Private equity firms are relatively inactive due to a poor investment climate, and venture capital is still in its nascent stages. The banking sector is still struggling to unload the bad loans that emerged during the financial crisis, and credit growth has not resumed.

Number of financial institutions by type

Type of institution	2012	2011	2010	2009	2008
Banks	176	176	176	182	184
Microfinance institutions	1	1	1	1	1
Leasing companies	21	23	19	19	18
Credit unions	617	613	659	755	829

Sources: NBU, MIX Market, State Commission for Regulation of Financial Services Markets of Ukraine

The overall level of financial intermediation has been declining on the credit side, in line with stagnant credit growth. Bank loans amounted to 57.9% of GDP in 2012, compared to 83.6% in 2008. Deposits, however, have increased in proportion to GDP during the same timeframe, growing from 37.7% in 2008 to 40.2% in 2012.[17] The very high interest rate environment is likely the major driver of this trend.

3.2 Banking sector

3.2.1 Structure

The Ukrainian banking sector consists of 176 licensed banks[18], most of which are locally owned. Total assets amount to EUR 106.9 billion as of January 1, 2013, a 25.4% increase from 5 years prior. The number of banks actually declined from 184 during the same time period due to failures and consolidation associated with the financial crisis of 2008 and 2009, with many European banks leaving the Ukrainian market in response to the crisis. Home Credit Group, Societe Generale, Swedbank, Commerzbank, and Erste Bank have all sold their Ukrainian subsidiaries. The number of

[16] Please refer to the Confidential Report for more information.
[17] NBU Data
[18] See Annex 5 for a list of the largest banks in Ukraine by asset size.

bank branches declined even more dramatically following the crisis, dropping from 1,706 in 2008 to just 730 in 2011, although the trend of opening limited-service outlets instead of full-service branches may be somewhat responsible for these figures. Banks are the predominant player in Ukraine's financial sector, representing 68.4% of financial sector assets as of January 1, 2012.

	2012	2011	2010	2009	2008
Number of banks	176	176	176	182	184
Number of bank branches	n/a	730	1,053	1,469	1,706
Bank assets (EUR millions)	106,973	102,377	89,102	76,889	85,311

Sources: NBU, World Bank

As of January 1, 2013, just 22 of Ukraine's banks have 100% foreign capital, and another 29 have some foreign capital. Government bank ownership is limited to just two institutions (Oschadbank and Ukreximbank), but they are the second and third largest in the country and represent 15.4% of total bank assets as of January 1, 2013. The government nationalized four banks during the crisis, and has sold one of them to private buyers, intending to sell two more and leaving one as a "bad bank".[19]

Bank assets are moderately concentrated. The five largest banks account for 38.6% of all bank assets, and the largest bank, Privatbank, makes up 15.3% on its own as of January 1, 2013. The five-bank concentration has steadily grown in recent years, increasing from 31.6% as of January 1, 2009.

3.2.2 Performance

Since the financial crisis of 2008 and 2009, banking sector performance has improved, returning to profitability. Laws have been strengthened to reduce currency devaluation-driven credit risk, but much of the problem credits that emerged during the crisis have remained on bank balance sheets, and NPL ratios remain high. Capitalization and liquidity are adequate, but credit growth remains stunted.

Capital adequacy: Capitalization is high. The banking sector's average regulatory capital adequacy ratio (equivalent of Basel II total capital adequacy) has remained well above the minimum of 10% in recent years, beginning 2013 at 18.1%. The ratio dipped to 14.1% in the financial crisis year of 2008, but improved thereafter, largely due to the NBU's recapitalization of several troubled banks. The system-wide ratio of equity to total assets steadily increased since the crisis, beginning 2013 at 15.0%.

Profitability: Banking sector profitability suffered due to the financial crisis, with sector wide return on assets bottoming out at negative 4.4% in 2009. The banking sector remained unprofitable until 2012, when a small return on assets of 0.5% was posted. Return on equity has followed a similar pattern, bottoming out at negative 32.5% and recovering to a low 3.0% in the most recent year. The sector-wide Net Interest Margin actually peaked at 6.2% in 2009, declining steadily to 4.5% in 2012, but the margin decline was offset by reductions in loan loss provisions.

Liquidity: Liquidity is adequate based on regulatory standards, with sector wide regulatory liquidity ratios (quick, current, and short term ratios) exceeding regulatory minimums by at least 30% as of the beginning of 2013. Sector-wide deposits experienced healthy growth prior to the financial crisis, but shrunk by 8.9% during 2009. Rapid deposit growth has since resumed, with year over year

[19] Bank Kyiv, Ukrgazbank, Rodovid Bank and Nadra Bank were nationalized. Nadra Bank was sold to a private local investor in 2011, and the government has confirmed its intention to sell Bank Kyiv and Ukrgazbank, with Rodovid Bank being transformed to a "bad bank".

increases ranging from 15.1% to 27.5% in the following three years. Because loans have not experienced similar growth rates, the ratio of loans to deposits has steadily improved, declining from a very high 229.8% in 2009 to 143.9% in 2012. The peak loan-to-deposit ratio was achieved through significant funding from international banking groups during the boom preceding the crisis. International capital has since largely left the Ukrainian market.

Credit risk: Credit quality declined drastically as a result of the financial crisis, with sector-wide nonperforming loans growing from 3.9% in 2008 to 15.3% in 2009 according to World Bank estimates. One of the major drivers of credit quality deterioration was currency devaluation coupled with a high volume of foreign currency lending. The banking sector has been slow to unload its troubled assets, and credit growth has been minimal, with just a 6.0% total increase between 2008 and 2012 compared to 25.4% bank asset growth during the same timeframe. NPL ratios have remained high, peaking in 2010 and declining to 14.1% by 2012. Loan loss reserve coverage amounted to a seemingly adequate 17.3% of gross loans in 2012, but Moody's and Fitch have estimated sector wide impaired and restructured exposures to be as high as 55-60% of gross loans, putting the apparent adequacy into question. [20]

Market and other risk: Currency devaluation-driven credit risk was a major factor in the loan quality problems that emerged during the financial crisis, when around a 38% devaluation in the second half of 2008 significantly reduced the repayment capacity of foreign currency borrowers.[21] The NBU has attempted to address this issue going forward by requiring 100% provisioning for foreign currency loans to borrowers without foreign currency income streams, which has worked to reduce exposure to such risk since the crisis. Foreign currency loans still amount to a sizeable 37.2% of total loans as of January 2013, prolonging the system's sensitivity to currency devaluation.

3.2.3 Regulation and state support[22]

Regulation and state support of the banking system is improving. Bank regulations generally follow international standards. Capital adequacy standards are based on Basel II, and IFRS financial statements have been required since 2012. The government proactively dealt with the banking crisis, nationalizing several banks, and adopting new regulations to prevent future problems. One of the nationalized banks has been sold off to investors, and the NBU has developed an exit strategy for the others, including a "bad bank" to manage the NPLs. The largest remaining issue is problem loan resolution, which is obstructed by a dysfunctional court system.

Problem loan resolution: Problem loan resolution faces several obstacles. Banks named Ukraine's dysfunctional court system as one of the top barriers to doing business: the legal process for collateral recovery is arduous and can take as long as five to seven years, and corporate insolvency legislation does not allow for out-of-court settlement[23]. Tax obstacles to restructuring, writing off, and selling bad loans also exist. As a result, bank balance sheets continue to be weighed down by problem loans.

Loan grading and reserve calculations: The NBU amended its credit grading and provisioning requirements in 2012. In particular, the new rules require that loans with 50% of the debt more than 90 days past due must be graded loss.

Foreign currency activities: The NBU has taken several steps to reduce bank operations in foreign currency. Following the financial crisis, the NBU severely restricted foreign currency lending,

[20] UkraineBusiness Issue 8 (2013), *Banking Sector in Ukraine: Trends , Progress and Outlook*
[21] The Economist (2008), *The Battle in Ukraine to Stop the Currency Plummeting*
[22] NBU, onsite meetings, IMF staff reports
[23] IMF (2012), *Ukraine Staff Report*

requiring 100% provisioning for foreign currency loans to borrowers without foreign income streams. This significantly curbed foreign currency lending. In July 2013 the NBU significantly raised reserve requirements on foreign currency deposits, aiming to reduce foreign currency deposit rates, thereby making them less attractive (in addition to increasing its reserves).

Corporate Governance: While corporate governance requirements meet international standards, many of Ukraine's smaller banks are widely believed to engage in a significant volume of connected lending[24], placing the quality of regulatory oversight into question.

The list of prudential ratios for banks applied by the central bank is presented in Annex 3. A short description of key regulations is presented in Annex 4.

3.2.4 Funding

Bank balance sheets are predominantly funded by customer deposits, which made up 62.4% of total liabilities as of January 1, 2013. Almost two thirds of these are retail deposits, which tend to be rather short term. Bank deposits add another 22.3%. The remaining 15.3% is primarily made up of other financial liabilities, other funds raised, and subordinated debt. Over half of overall liabilities are denominated in foreign currency, which is mirrored across the various funding types. Ukrainian banks continue to have limited access to local and foreign borrowing markets, periodically raising funds through bond issues.

Local currency retail deposit rates were 14.7% for three months and 17.4% for one year, compared to 3.9% and 5.9% for EUR denominated deposits as of June 17, 2013. The high deposit rates drive SME loan rates of up to 20%, a major impediment to credit growth. The interbank credit market charged 2.1% for overnight transactions as of the same date.[25]

Despite the flight of foreign banks from Ukraine that occurred as a result of the financial crisis, parent company funding remains an important source of funds among Ukrainian banks. Among the largest banks benefitting from parent support are Raiffeisen Bank Aval (Austrian subsidiary), Ukrsotskbank/UniCredit (Italy), and Sberbank and VTB (Russia). Parent company deposits funded 28.9% of Raiffeisen Bank Aval's assets at year-end 2012. Similarly, 28.4% of Ukrsotskbank's assets were funded by parent company deposits and loans.

3.3 Microfinance sector

3.3.1 Structure[26]

The Ukrainian microfinance sector is very small. As of 2011, microfinance providers had just 15,684 borrowers with about EUR 180 million in outstanding loans. Mix Market lists just two active entities involved in microfinance for the entire country. The largest of these is ProCredit Bank, which has a full banking license and provides the vast majority of microloans in the country. HOPE Ukraine is a part of an international faith-based organization, and provides a small number of microloans (less than USD 2 million in total loans as of 2012).

3.3.2 Performance

The microfinance sector's performance was severely affected by the financial crisis, and micro lending has been on the decline since that time. For example, ProCredit Bank's portfolio shrank by 27.9% from 2008 to 2009, with write-offs of 3.8% in 2009 and another 1.76% in 2010. HOPE

[24] IMF (2012), *Ukraine Staff Report*
[25] NBU
[26] Mix Market. *Ukraine Market Profile*

Ukraine's credit portfolio peaked in size in 2008 and shrank after writeoffs of 9.9% and 16.1% of total loans in 2009 and 2010, respectively.[27] Microfinance loan growth has remained sluggish since the crisis, in part due to local currency funding constraints.

3.3.3 Regulation

HOPE Ukraine is registered as a non-bank financial institution regulated by the State Commission for Regulation of Financial Services Markets of Ukraine (the supervisor of all non-bank financial institutions, including credit unions and insurance companies). The relevant law is the Law of Ukraine on Financial Services and State Regulation of Financial Service Markets. The regulatory framework for NBFIs is limiting in that it prohibits customer deposit-taking and foreign currency lending – a major cause of the low number of MFIs in Ukraine. ProCredit Bank is a fully licensed bank regulated by the NBU.

3.3.4 Funding

The main funders for Ukraine's microfinance sector are Oikocredit, a Netherlands-based international cooperative, and ResponsAbility Global Microfinance Fund. In addition to providing funding to HOPE Ukraine, Oikocredit funds credit unions and agricultural cooperatives. Kiva, a US-based peer-to-peer lending facilitator, is also a source of funding for HOPE Ukraine. A lack of local currency funding is a major constraint for HOPE Ukraine's growth, as the organization cannot legally accept deposits and loans must be made in local currency.

3.4 Private equity and venture capital

3.4.1 Sector overview

Ukraine's private equity sector is small, and investment activity has declined following the financial crisis. Committed capital and active capital were estimated at just 0.5% and 0.4% of GDP for 2010, respectively[28], and little growth has occurred since that time. The largest private equity firms in Ukraine are Horizon Capital, Advent International, Sigma Blazer, Euroventures, Dragon Capital, and Icon Private Equity. Just one new equity fund has been successfully raised since the crisis: a USD 57 million fund focusing on medium-sized companies in industries such as hygiene products and pharmaceutical manufacturing was successfully raised by Dragon Capital with funding from EBRD and other IFIs. Other firms have had trouble raising additional funds due to poor performance of pre-crisis funds (lacking successful exits).[29]

Venture capital activity in Ukraine is low, with just a few players and sparse investments. The most prominent firms (AVentures, TechInvest, Dekarta Capital, Vostok Ventures, US-based TA Venture) have made just a few investments in recent years. TechInvest has stopped pursuing growth stage investments and solely focuses on seed investments of around USD 10,000. A few of Ukraine's large businessmen and other prominent figures have also made periodic investments in technology companies: for example, Victor Pinchuk's EastOne Ventures invested in Pokupon in 2011. Leonid Chernovetskiy, the former mayor of Kiev, recently started a new investment company, committing USD 750 million in venture funds.[30]

[27] MixMarket. *Cross Market Analysis*
[28] OECD, et al. (2012), *SME Policy Index: Eastern Partner Countries 2012: Progress in the Implementation of the Small Business Act for Europe*, OECD Publishing.
[29] Information from meetings with Dragon Capital and Euroventures; Z-Ukraina (2011), *Largest Direct Investment Funds in Ukraine* (in Russian)
[30] AVentures Capital, *Yevgen Sysoyev: 'Ukraine IT-Startups: The Most Attractive Companies to Invest in'*; Eastonegroup.com (2011) *EastOne Announces the Completion of a Transaction with Pokupon*, onsite meeting with TechInvest; Chernovetsky Investments, *Ukrainian Venture Funds: Who Should Startups Go to for Money*

3.4.2 Ecosystem[31]

Ukraine's startup ecosystem is slowly developing, with several accelerators and incubators offering seed funding ranging from USD 15,000 to 50,000, mentorship from Russian and western experts, and access to the global startup community. Kiev-based GrowthUp business incubator is the largest among its kind, having funded 300 projects. Victor Pinchuk, a prominent businessman, has funded EastLabs, an accelerator that offers workspace and education in addition to seed funding. Overall, Ukraine's startup ecosystem is commonly criticized for overreliance on volatile donor funding. Links between intellectual property developed within universities and entrepreneurs are thin, and the government does not provide much visible support to new ventures.

3.4.3 Regulation[32]

Venture funds are subject to the Law on Collective Investment Institutions, passed in 2001. The law was essentially written to cover mutual funds, and defines "venture funds" as closed ended non-diversified funds with looser diversification standards than diversified funds. The law does not explicitly cover private equity investments, creating a legislative gap for the industry but nonetheless allowing for its existence. Collective Investment Institutions are supervised by the Securities and Stock Market State Commission. Aside from the prohibition of foreign ownership of Ukrainian farmland, foreign investment restrictions are minimal, and foreign investors face no meaningful disadvantages relative to local investors. Ukraine participates in over 40 bilateral agreements on cooperation and mutual protection of investments, providing protection for foreign investors.

3.5 Other financial sector institutions

3.5.1 Leasing companies[33]

The Ukrainian Leasing market consists of 21 companies (as of 2012), many of which are associated with large banks. Typical leasing services cover commercial and passenger motor vehicles, sea and air transport, construction equipment, agricultural equipment, and technical and production equipment. The portfolios of the leasing companies combined to EUR 1.3 billion (vs. 106.9 billion in bank lending) as of 2012, and the five largest players accounted for 69.5% of this figure. VTB, the largest leasing portfolio holder, accounted for 25.9% of the total as of the same date.

New contract volumes have fluctuated in recent years, dropping in 2008 and 2009 and resuming growth in later years. Contract maturities are rather evenly distributed between longer term (up to 10 years) and shorter term (less than 5 years). The transport industry is the heaviest consumer of leasing contracts, accounting for 57.4% of the total volume as of March 2013. Agriculture, construction, and services follow at 20.3%, 4.9%, and 3.3%, respectively.

Leasing companies are regulated by the State Commission for Regulation of Financial Services Markets of Ukraine. Unlike bank loans, leasing contracts can be issued in foreign currency without triggering cost-prohibitive provisioning requirements, making leases an attractive option for customers seeking lower rates and willing to take on foreign exchange risk.

Leasing companies are primarily funded through loans from banks and other companies (81.1% as of March 2013) as well as their own capital (18.6% as of the same date).

[31] Information from IFI and investment fund meetings: Startup Community in Russia and Ukraine, *Ukrainian Tech Accelerators and Incubators*
[32] Ukrainian Association of Investment Business; National Institute for Strategic Studies (2009), *The Use of Innovative Technologies in the Financial Markets of Ukraine* (in Ukrainian); TerraLex (2012), *M&A Overview: Ukraine*
[33] Ukrainian Union of Lessors; onsite meetings

3.5.2 Credit unions[34]

Credit unions are widespread in Ukraine, numbering 617 as of December 2012, and penetrate into rural communities not reached by banks. Credit unions had combined total assets of EUR 243.2 million (equivalent to 0.2% of total bank assets) and 1.2 million members at the end of 2012.

The sector-wide return on assets was 4.9% in 2012 and 3.6% in 2011, indicating continued recovery after the crisis. The only loss-producing year associated with the financial crisis was 2009, with a -10.6% return on assets. Over 60 credit unions failed in the fourth quarter of 2009. Credit union assets shrunk by 17.6% between the fourth quarter of 2009 and the first quarter of 2010, but rebounded almost completely by year-end 2010.

The Law on Credit Unions, enacted in 2001, defines credit unions as voluntary nonprofit organizations and names the State Commission for Regulation of Financial Services Markets of Ukraine as their regulator. Credit unions may only lend to their members, who must be physical entities. Nonetheless, 15-20% of credit union loans are made for small business and farming purposes, with the managing directors borrowing on the business's behalf. The NBU is currently working on an initiative that would allow it to take over regulation of credit unions with over EUR 1 million in capital, and remove the deposit licenses of smaller credit unions.

Customer deposits and member investments are the only funding source for credit unions, which limits their ability to issue longer-term loans. Due to regulatory difficulties with obtaining deposit licenses, only 30% of credit unions are allowed to accept deposits. The credit unions without deposit licenses are funded purely through member investments, quasi-deposit instruments that pay dividends similar to market deposit rates.

3.5.3 Stock exchanges[35]

Ukraine has eight stock exchanges, the largest of which is PFTS, established in 1997. Most of the other exchanges are regional (Crimean, Luhansk, Kiev, etc.), and many have majority Russian ownership. PFTS has market capitalization of about EUR 105 billion (79% of 2012 GDP), and typical daily volumes range from EUR 25 to 45 million. Over 1400 companies are listed on PFTS, with 175 tier 1 listings and 230 tier 2 listings as of August 2013.

The Ukrainian stock market is regulated by the National Securities and Stock Market Commission, which is responsible for approving minimal listing requirements for each exchange. To list a stock on PTFS, a company must have net assets of UAH 100 million (EUR 9.5 million), a six month trading record with a monthly average value of at least UAH 1 million (about EUR 95,000), minimum annual turnover of UAH 100 million, and minimum market capitalization of UAH 100 million. The required amounts are halved for the exchange's second tier listings. These thresholds are low enough to cover SMEs as per the definitions provided by the banks surveyed. Nonetheless, Ukraine's political risk and currency devaluation risks create a poor investment climate, making financing through IPOs a less accessible option for SMEs.

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[34] State Commission for Regulation of Financial Services Markets of Ukraine, meeting with the National Association of Credit Unions, Laws of Ukraine (Rada of Ukraine); Kommersant of Ukraine (2013), *Credit Unions Losing Deposits* (in Russian)

[35] PFTS Ua-Exchange; National Securities and Stock Market Commission of Ukraine; Price Waterhouse Coopers (2013), *An Overview of Ukrainian IPOs*; Asters Law (2011) *IPO on the Ukrainian Stock Exchange – Game Rules;* BFC bank questionnaires; Kyiv Post (2012), *IPO Market for Ukrainian Companies Closed, Investors Go to 'Serene Harbors'*

4. DEMAND ANALYSIS

Conclusion:
Despite a poor economic climate, demand for working capital finance and to some degree fixed asset investment funding continues to be exhibited by the SME sector. SMEs involved in agriculture exhibit the strongest demand.

Key findings:

- *Demand for SME loan financing is estimated at EUR 10.7 billion*
- *There are 77,776 registered SMEs in Ukraine, consisting of 57,587 small and 20,189 medium enterprises.*
- *MSMEs in Ukraine are major contributors to employment and economic output.*
- *SME performance has been negatively affected by economic contraction and unfavorable tax policies*
- *SMEs have been developing and implementing innovative models in the areas of information technology, agriculture, and energy efficiency, and significant growth can be expected from these areas*

4.1 Size and growth of the segment[36]

Size and definition of sector: According to 2012 government data, there are 77,776 registered SMEs in Ukraine, consisting of 57,587 small and 20,189 medium enterprises. In addition, there are 286,461 micro enterprises, so the total number of MSMEs is 364,237, which represents 94.3% of all enterprises in Ukraine.

MSME statistics, 2012

Category	Number
Micro	286,461
Small	57,587
Medium	20,189
Total MSMEs	364,237

Source: Ukrstat

The government defines small businesses as entities with annual turnover of up to EUR 10 million and up to 50 employees, and medium businesses as firms with annual turnover up to EUR 50 million and fewer than 250 employees. Micro businesses are defined as companies with fewer than 10 employees and up to EUR 2 million in turnover. The current official MSME definitions were implemented in 2012 along with a new law for state support for SMEs. The previous definition did not cover micro-enterprises and had lower turnover thresholds for small and medium businesses.

Government SME Definitions as of March 2012

Size	Definition
Micro	Up to 10 employees and up to EUR 2 million turnover
Small	Up to 50 employees and up to EUR 10 million turnover[37]

[36] Ukrstat; OECD, et al. (2012), *SME Policy Index: Eastern Partner Countries 2012: Progress in the Implementation of the Small Business Act for Europe*, OECD Publishing.
[37] The definition is not shown as 10-50 employees and EUR 2-10 million because only one of two criteria is required for classification into small.

Medium	Firms not covered under micro, small, and large definitions
Large	More than 50 employees and more than EUR 50 million turnover

Source: OECD SME Policy Index 2012

Importance of the sector: MSMEs in Ukraine are major contributors to employment and economic output. The share of medium, small and microenterprises in total employment in 2012 was 41.0%, 16.3%, and 10.3%, respectively, totaling 67.6% for all MSMEs. Medium, small and micro enterprises contributed to 42.0%, 10.9% and 5.0% of the volume of products sold by enterprises in 2012, respectively, for a total of 57.9%.

Accuracy of estimate: Official statistical reports do not take into account the large number of businesses operating informally. While there are no official figures for the size of the informal sector, it is estimated to employ over 20% of the population, with the majority working in micro and small enterprises, especially in agricultural production.

Growth rate: According to Ukrstat data, the total number of MSMEs declined by 1.2% in 2011 and 3.0% in 2012. The passing of a new tax code in 2011 caused the proportion of individual entrepreneurs to shrink from 84.0% of all businesses in 2010 to 79.6% in 2011. Correspondingly, the share of MSMEs to total businesses had remained stable around 99.5% for several years through 2010, but after the passing of the tax code has fallen to 94.3%.

4.2 Characteristics of SMEs

Sector: Manufacturing, trade, and agriculture are the most common industries among SMEs. Trade is especially popular with the small and micro segments (28.7% and 29.5% of businesses in the respective segments in 2012). Manufacturing is most common in the medium segment, accounting for 28.6% of businesses in that segment. A consolidation trend in agriculture will likely cause a decline in the number of small and micro agro-businesses, and growth in medium-sized ones. The information and communication industry, while accounting for just 2.2%, 3.8%, and 3.7% of medium, small and micro businesses, respectively, provides an excellent opportunity for growth in light of Ukraine's promising information technology sector.

The proportions of micro businesses involved in agriculture and trade are likely understated, as many of these are operating outside the formal economy. Based on official figures, wholesale trade generates a disproportionately large amount of revenue, accounting for 46.1%, 53.7%, and 54.8% of the sales of medium, small, and micro businesses, respectively.

Number of MSMEs by industry and size as of 2012

Industry	Medium	Small	Micro
Agriculture, forestry and fishing	15.6%	9.4%	13.7%
Manufacturing	28.6%	19.1%	10.7%
Construction	6.6%	10.5%	9.1%
Wholesale and retail trade	20.4%	24.8%	29.5%
Transportation and storage	6.3%	5.5%	3.7%
Accommodation and food services	2.1%	3.2%	2.5%
Information and communication	2.2%	4.0%	3.7%
Financial and insurance	2.5%	1.3%	1.3%
Real estate	3.7%	6.1%	8.9%
Professional, scientific, and technical	4.3%	6.1%	9.2%
Administrative and support service	4.9%	5.1%	4.0%

Other	2.8%	4.8%	3.6%
TOTAL	100.0%	100.0%	100.0%

Source: Ukrstat

According to the state statistical service, SMEs employed most of the country's agricultural and construction workers, as well as 74.8% of wholesale and retail trade workers in 2012. Similarly, SMEs accounted for 88.0% of the agricultural revenue, 91.3% of construction revenue, and 70.4% of wholesale and retail trade revenue for the same year.

Regional Distribution: SMEs are concentrated around urban centers. While Kiev is a major hub for economic activity, cities such as Kharkov, Odessa, and Sevastopol have also exhibited economic growth, as evidenced by significant net migration into their oblasts (areas). Cities such as Luhansk and Donetsk have had significant losses in population in recent years, indicating less economic opportunity.[38]

4.3 Performance[39]

The SME sector suffered significantly during the financial crisis due to Ukraine's severe economic contraction and currency devaluation. Many SMEs had used foreign currency debt to fund growth, and defaulted during the crisis. As a result, a large portion of Ukrainian SMEs has poor credit histories and is deemed un-creditworthy by banks. Consumer spending declined severely as a result of the crisis, affecting the viability of consumer product and service focused SMEs, and sales volumes are yet to return to pre-crisis levels for these businesses. Additionally, a large number of small businesses shut down or went into the grey economy as a result of the 2011 tax reform. The near-term outlook for consumer spending and resultant SME revenues is poor due to the double-dip recession and continued heavy debt burden. SMEs working in agriculture are considered to be the best performers with significant growth potential, while construction and construction materials, heavy industry, and metal trade companies are among the worst.

4.4 Institutional and regulatory issues

The Ukrainian business environment is generally unfavorable, with heavy tax, registration and licensing burdens. Although the government has been working to improve the business environment with measures such as new anti-corruption laws and reduced regulation for permits and taxation, implementation of adopted reforms has been slow. Private sector groups are generally not involved in the process of public policy design. Much of the dialogue remains highly concentrated within a small politically connected group of people (oligarchs), contributing to a less-than-favorable environment for SMEs. The Law of Ukraine on State Support of Small and Medium Entrepreneurship, amended in 2012, sets forth a framework for a wide variety of government support mechanisms to be implemented through annual action plans approved by the Cabinet of Ministers, but little has been done in terms of implementing measures. Onsite interviews revealed a general sentiment that the current administration's interest in developing the SME sector is low.

Doing business: Ukraine ranks rather low on the World Bank's doing business scale, but its position has been improving, going from 152 out of 185 countries in 2012 to 137 in 2013. The country ranks rather well for getting credit and enforcing contracts, and rather poorly for paying taxes and getting electricity, among others. The country's rank for starting a business jumped markedly in 2013,

[38] Ukrstat data
[39] Onsite interviews, Finance.ua (2013), *Survival at All Costs. Obstacles to Small Business Development in Ukraine (in Russian)*

moving to 50 from 116 in the prior year. Starting a business can be accomplished in 22 days, with costs and capital requirements significantly below those of OECD countries.[40]

Taxes: Ukraine adopted a new tax code in 2011 aimed at streamlining its tax system and reducing corporate income tax. The code is generally viewed as unfavorable to smaller enterprises, as it removes the simple flat tax scheme previously in place and incorporates small businesses into the general tax system, significantly increasing their administrative burden and tax costs. The monthly cost of the flat tax had been EUR 20 to 60, depending on the size and type of business. The new tax amounts to 25% of business profits. Ukrainian tax inspectors have a reputation for corruption, further complicating the situation. As a result of the code's adoption, many small businesses have either slipped into the shadow economy or given up their businesses. The Ukrainian tax administration estimated an about 44% reduction in the number of taxpayers for 2011, and the banking system lost $6.1 billion in withdrawals in the four months prior to the adoption of the code.[41]

Energy efficiency: Energy efficiency has become a popular topic in official policy documents and legislation, including action plans for implementation of cleaner production (2012-14) and environmental protection (2012-15). Residential housing is one area with significant opportunity for energy consumption reductions. Institutional barriers to improving energy efficiency of residential housing include contradictions in legislation concerning homeowner associations, the absence of state support, and the lack of state control over energy use.

Trade and access to markets: Government support for export activities of SMEs is limited. While an action plan to promote exports for SMEs was approved for 2009-11, no funds were allocated toward implementing the plan. Ukraine has made good progress toward reaching convergence with EU sanitary standards in anticipation of the future Association Agreement between the EU and Ukraine, setting the country up for agricultural export growth.[42]

4.5 Innovation

Ukrainian SMEs are pursuing innovation in the areas of information technology, energy efficiency, and agriculture. While government support for private sector innovation is limited, an ecosystem of incubators and education facilities is developing.

IT sector: The IT sector is a major source innovation and growth potential for Ukraine. In addition to a booming software development outsourcing industry, Ukraine is home to a series of successful web based startups serving both the local and international markets. Several successful companies have emerged in the areas of web based services (file hosting, education, photo sharing, payments), business-to-business and business-to-consumer ecommerce, software, and gaming. A significant concentration of highly qualified technical talent is a major competitive advantage for Ukraine.[43]

Box 1: Example of innovative SME: Jooble

Jooble (jooble.com) is the developing world's leading vertical job search engine, covering 56 countries, operating in 16 different languages, and reaching about 1 million users each day. The

[40] IFC and World Bank (2013), *Ease of Doing Business in Ukraine*

[41] Onsite meetings, The Epoch Times (2011), *Ukraine's New Tax Code Chokes Small Business*; British Business Club in Ukraine (2011), *New Tax Code – 2011 Ukraine*; KyivPost (2010), *Ukraine Adopts New Tax Code Among Protests*

[42] OECD, et al. (2012), *SME Policy Index: Eastern Partner Countries 2012: Progress in the Implementation of the Small Business Act for Europe*, OECD Publishing.

[43] GoalEurope (2013), *Ukraine IT Startups: Everything You Need to Know*

service aggregates job postings from all sources in one place making them easily searchable for job seekers. Headquartered in Kiev, the company was started by Roman Prokofiev, a Ukrainian IT entrepreneur, in 2006 and was originally financed by its founders. The Jooble tool was originally built for the Ukrainian market, beginning global expansion in 2008 after proving the model in Ukraine. The service is monetized through fees collected from online job boards and advertising revenue. Jooble believes itself to be the 3rd largest player in its market worldwide, competing with US-based Indeed, and Jobrapido, an Italian company.[44]

Agriculture: Known as Europe's breadbasket, Ukraine has vast agricultural potential, and the industry has recently begun to modernize, adopting innovations such as crop forecasting technology, improved seeds, and crop protection solutions. Viewed as a potentially significant means toward achieving global food security, the Ukrainian agricultural sector has received much attention from IFIs such as IFC, with significant funding being devoted to facilitating the adoption of modern technologies and farming practices, especially with respect to SMEs.[45]

Energy efficiency: Energy efficiency is another area with significant innovation potential for SMEs. Because residential housing is outdated and extremely energy inefficient, consuming 25% of the country's electricity and 40% of its heat energy resources according to IFC, reducing residential energy consumption is a particular focus. Several IFIs, including EBRD, IFC, and others, have invested in residential energy efficiency projects in Ukraine, covering both technical innovations such as individual heating substations, piping, and boiler equipment. SMEs have also been the subject of energy efficiency lending support, with the EBRD financing measures to reduce energy consumption by SMEs through Ukreximbank (a USD 50 million facility in place since 2011).[46]

Government support: Government support for innovation among SMEs is present but limited. There are a number of government-established technology parks and research centers in Ukraine operating under a state program promoting innovation infrastructure. The program envisages an integrated system of cooperation between the state and the private sector, but in practice, small businesses and higher education institutions do not collaborate and intellectual property created in state-supported environments is rarely commercialized[47].

Supporting environment: The support environment for SME innovation is developing. A growing number of business incubators (around 15 as of 2013, located in Kiev, Kharkov, Lvov, and other cities[48]) offer training and seed funding to participants. Many education providers, including universities and business lyceums, are also involved with entrepreneurship training. The State Unemployment Office provides free courses on starting businesses and one-time grants for starting a business to the unemployed. There is an angel investor network, the Association of Private Investors of Ukraine, with 50 registered investors, although it has not yet produced a significant visible impact.[49]

[44] Ain.ua (2003), *Roman Prokofiev, Jooble "We're not building a business we plan to pass on to our heirs"* (in Russian)
[45] IFC (2013), *IFC, Austria and Bayer Plan to Increase Ukraine Farm Productivity*; IFC (2012), *IFC Investment Climate for Agribusiness in Ukraine*; IFC (2010), *Promoting Energy Efficiency in Ukraine's Residential Housing*
[46] EBRD (2013), *Energy Efficiency Demo Projects in Ukrainian District Heating*; IFC (2013), *Promoting Energy Efficiency in Ukraine's Residential Housing*; EcoSeed (2009), *SMEs in Ukraine to get $50 Million Energy Efficiency Financing*
[47] Based on sentiments gathered during onsite meetings
[48] Science Park & Innovation Center Association's Directory
[49] Onsite interviews, OECD, et al. (2012), *SME Policy Index: Eastern Partner Countries 2012: Progress in the Implementation of the Small Business Act for Europe*, OECD Publishing.

4.6 Demand for finance[50][51]

Overview: Financial institutions describe demand for credit by SMEs as rather low, and largely limited to short-term working capital loans. Interest rates of up to 20% make most capital investment cost-prohibitive, and political uncertainty and pressure from tax authorities combine to create a rather unfavorable investment climate. Financial institutions reported that agriculture is the only sector with significant loan demand from SMEs, and that demand from other segments such as manufacturing, trade, and construction, is virtually non-existent. World Bank Enterprise surveys revealed that 38.9% of Ukrainian firms report no need for a loan, and that only 32.1% of firms use banks to finance investment. The surveys showed that 34.7% of Ukrainian firms believe access to finance to be a major constraint to doing business.

SME demand for non-loan instruments such as bank guarantees, letters of credit, and leases is low due to a lack of financial education in that segment. Banks do not appear to view SMEs as a target for non-loan products, and many of the banks surveyed only market guarantees to the SME segment. There is evidence of demand for agricultural equipment leasing on the micro to small scale in areas such as Crimea, but the supply of such services is too limited to make an inference on demand[52]. The high cost of loans and lacking availability of long term funding make equity an attractive financing alternative for the SMEs that are pursuing growth.

Estimate of loan demand: Total demand for MSME loans is estimated at EUR 12.2 billion, consisting of EUR 1.5 billion in micro loans, EUR 1.4 billion in small business loans, and EUR 9.3 billion in medium business loans. Excluding micro enterprises, the SME-only demand is EUR 10.7 billion. The high share of medium enterprises in total demand is particularly noteworthy. These figures were derived using loan volume breakdowns collected from eight MSME lenders, sector-wide breakdowns from the Ukrainian government statistical service, and World Bank estimates of firms not needing a loan. The calculation was made as follows:

Estimate of MSME loan demand

Step in Calculation	Micro	Small	Medium	Total MSME	Source
A. Number of businesses	286,461	57,587	20,189	364,237	State Statistical Service of Ukraine
B. Average loan size demanded (EUR)	9,433	45,286	672,273	n/a	BFC survey of local lenders
C. % of enterprises not needing a loan	45.0%	45.0%	31.6%	n/a	World Bank Enterprise Surveys
D. Total demand (EUR millions)	**1,485**	**1,433**	**9,277**	**12,195**	**= A * B * (1 – C)**

The demand estimate is only intended to give a general idea of the level of demand. The methodology of the calculation is simplistic and is based on a number of assumptions. Since there is no available survey data on the loan size demanded from SMEs, the average loan size disbursed was used as a proxy for loan size demanded, based on a survey of lenders. Each data source uses a different definition of SMEs, which reduces the accuracy of the estimate. There are no reliable data that could be used to estimate the demand for non-loan products, such as equity, leases and letters of credit.

[50] IFC and World Bank Enterprise Surveys
[51] Please refer to the Confidential Report for more information.
[52] Agro Capital Management interview

5. SUPPLY ANALYSIS

Conclusion:
The supply of financing to SMEs is generally limited to bank loans, with little ongoing availability of non-loan products. Supply of private equity is low due to a poor investment climate.

Key findings:

- *The total supply of SME loan financing is estimated at EUR 10.8 billion*
- *Long term bank funding constraints and high deposit rates largely limit bank lending to short-term working capital loans.*
- *Due to the generally strict collateral requirements of local lenders, the establishment of a guarantee fund which provides guarantees directly to SMEs could help spur increased SME lending.*
- *Supply of private equity is limited: only one small private equity fund has been raised since 2009*

5.1 Number and type of intermediaries

Banks are the primary financing source for SMEs. Their number declined from 184 in 2008 to 176 in 2010 due to financial crisis-era failures, and has remained unchanged since that point. Most Ukrainian banks officially offer SME loans, but many, including the largest institutions, have not developed SME-specific lending policies and procedures, and use corporate underwriting procedures for SMEs (with some exceptions such as ProCredit Bank). Following significant SME sector credit losses (driven primarily by foreign currency-driven credit risk) several Ukrainian-owned banks have shut down SME lending outright, choosing to focus on the corporate and consumer segments.

Credit unions are a notable funding source for rural micro and small businesses, with 617 credit unions active in the country in 2012. Despite their restriction from lending to legal entities, credit unions provide working capital by issuing loans to small business managers as individuals. Although this method of borrowing is inconvenient because it prevents companies from appropriately accounting for interest expense, credit unions are widely used due to their rural reach and relationship-based approach to lending. Credit union loans for business purposes are estimated to be around 15-20% of total credit union loans[53], or roughly EUR 35 to 45 million of market-wide MSE lending. Funding from specialized microfinance institutions is relatively insignificant, with just one small MFI actively operating in the country.

Although small in volume, private equity is a good financing option for medium businesses looking to upscale. Several private equity firms remain active on the market despite a poor investment climate[54]. Although just one company (Dragon Capital) has successfully raised a fund since the financial crisis, significant potential for further such investment exists. Organizational and financial transparency among potential financing targets appears to be the largest investing barrier for private equity firms. Venture capital provides a very limited amount of funding to SMEs, with a single-digit number of venture deals closed each year.

Government support for SMEs is limited, although improving. The Law of Ukraine on State Support of Small and Medium Entrepreneurship, amended in 2012, sets forth several government support mechanisms to be implemented through annual action plans approved by the Cabinet of Ministers, and carried out through the Ukrainian Fund for Entrepreneurship Support and 23 regional funds (working under the national fund). Programs officially covered under the action plans include

[53] According to the Ukrainian National Credit Union Association (onsite meeting)
[54] See Annex 6 for details

interest rate subsidies, leasing subsidies, credit guarantees, microcredit funds for starting a business, loans for technology investment, financial support for energy efficiency improvements, and others. Implementation of the annual action plans has been limited due to inadequate resources.

One of the latest programs of the Ukrainian Fund for Entrepreneurship Support, administered solely through state-run Ukreximbank, amounted to EUR 1.1 million in preferential lending on preferential terms for the period of 2009-11. No government SME guarantee programs have thus far been put in place, and the government is widely criticized for not getting its various initiatives to the implementation stage.[55] Based on bank interviews, SME loan disbursements could be increased by around 10-15% with the introduction of a guarantee scheme which issues guarantees directly to SMEs as the final beneficiaries. One concern about a potential guarantee program is the timing of loss recognition and reimbursement due to Ukraine's extremely slow judicial collateral recovery process and lagging charge-offs.

5.2 Types of funding instruments[56]

Credit: Short-term credit is the most widely available funding instrument for SMEs. Short-term working capital loans and investment loans (up to 3, sometimes 5 years) are the core financial instruments available from banks. High interest rates (up to 20%) make borrowing for investment purposes somewhat cost prohibitive, but working capital lending remains active. Unsecured credit is only issued in small amounts, and hard collateral such as real estate, vehicles and machinery, and deposits, is generally required. Lending against accounts receivable and inventory as primary sources of collateral is not a common practice.

The size of credit union loans typically average EUR 650-750, and may reach up to EUR 9,000. Credit union loans are commonly unsecured and require 3rd party guarantees, and must be issued to individuals, not legal entities.

Letters of credit and trade finance guarantees: Use of instruments such as letters of credit and guarantees in support of trade finance is limited. Guarantees, many of which are in support of international trade, were the only instrument widely offered to SMEs by the banks surveyed, and volumes were generally insignificant outside of one bank (Ukrsotsbank, with EUR 57.7 million in guarantees and letters of credit combined). Onsite interviews revealed an industry belief that SMEs' lack the sophistication needed to make use of financing instruments such as guarantees, and trade finance products, and that education is needed in this area.

Risk Capital: Risk capital is available to established medium-sized businesses on a limited basis, primarily through private equity firms and angel-level seed capital providers. Companies working in information technology and consumer goods and services tend to be the most attractive funding targets. Some firms choose to take majority stakes of their investments, while others take minority stakes with board seats and veto power. The lack of successful exits by private equity firms since the financial crisis has been a significant limiting factor for growth in this industry.

There is some availability of seed funding from incubators and angel investors (typically amounting to USD 10-15 thousand). Funding from incubators typically comes with office space as well as business training and networking opportunities. Growth stage funding for startups is extremely limited, with just a few deals taking place each year.

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[55] Onsite interviews, OECD, et al. (2012), *SME Policy Index: Eastern Partner Countries 2012: Progress in the Implementation of the Small Business Act for Europe*, OECD Publishing.
[56] Onsite interviews, BFC bank surveys

5.3 Characteristics of funding recipients

SMEs engaged in trade, light manufacturing, and agriculture are the major recipients of funding. Among the banks surveyed for this study, trade is the industry segment receiving the most loans at 34.0% of the total, with manufacturing, services, and agriculture, accounting for 20.7%, 20.5%, and 14.9%, respectively. Agriculture is widely seen as the only industry with real growth potential, and is a major target for banks. The entire agricultural value chain (agricultural inputs, farmers, processors, distributors) is viewed as a growth area. Transportation and service businesses are generally not targeted due to lacking growth potential. Construction, building materials, heavy industry, and metal trade SMEs are generally not targeted due to their poor financial positions post-financial crisis. Outside credit unions and ProCredit Bank, medium (not small) businesses are generally targeted.

Private equity funds typically target established medium-sized businesses with little political affiliation. Consumer goods and services companies, such as retailers, pharmaceutical manufacturers, and food processors, are common investments. Web startups are typically the recipients of the little venture funding that is available. Leasing companies mostly work with medium-sized agriculture companies as well as transportation providers.

Funding recipients are typically concentrated in large urban areas such as Kiev, Kharkov, Dnepropetrovsk, Odessa, Donetsk, Zaporozhye, and Lvov, as well as Crimea. Rural areas are generally only served by credit unions, as banks (even SME-focused ProCredit Bank) have trouble justifying a presence there.[57]

5.4 Institutional and regulatory issues

Issues for banks: The regulatory infrastructure for banks is generally viewed as acceptable, but bureaucracy in its application is a constraint to doing business, with arduous licensing and paperwork requirements. Banks named an inefficient and corrupt court system as the most significant institutional issue impeding their performance. Some of the banks interviewed reporting judicial collateral recovery taking as long as five to seven years. These issues significantly impact the availability of credit to SMEs by slowing down banking activity and unnecessarily tying up bank assets that could otherwise be lent out.

Issues for non-bank financial institutions: There is no specific regulation for private equity or venture capital firms, creating potential for legal issues in the future (the law covering collective investment institutions does not explicitly cover issues specific to private equity, creating some ambiguity). The operations of credit unions are restricted to accepting deposits and issuing consumer loans, limiting their ability to serve SMEs. Further upcoming government restrictions on credit union deposit operations may further undermine their activities. Leasing companies are free to write contracts denominated in foreign currency, a competitive advantage against banks.

5.5 Funding of intermediaries[58]

A lack of long-term local currency funding for intermediaries is a significant constraint for SME funding growth. High deposit rates drive high loan rates, limiting the viability of anything other than short-term working capital loans.

Banks are primarily funded through retail deposits in the local market. Deposits tend to be short term and carry high rates: local currency retail deposit rates ranged from 14.3% for 3 months to

[57] Onsite meetings
[58] As gathered during onsite meetings, NBU

17.2% for one year as of July 2013. Other local currency funding sources are limited. Local currency debt securities are used by some of the banks (for example, ProCredit bank has EUR 19 million worth of 4-year bonds with a 13% yield currently outstanding), but the instruments amounted to just 0.3% of bank liabilities as of January 2013. Borrowing from IFIs is still a common practice, although the NBU's restrictions on foreign currency lending limit the usability of these funds, and very little local currency funds are available from IFIs. EBRD, IFC, and KfW are the most active lenders to financial institutions in Ukraine. Subordinated debt is a commonly used financing instrument for banks in Ukraine, making up 3.5% of bank liabilities as of the end of 2012. IFIs, especially EBRD, frequently use subordinated debt structures for bank financing. Government funding to banks for SME lending purposes is limited - the Ukrainian Fund for Entrepreneurship Support amounted to just EUR 1.1 million for 2009-11.

Local currency customer deposits are the only funding source for credit unions, similarly limiting the resultant SME credit availability to short term working capital loans. Funding constraints for leasing companies are slightly lower than banks, because lease contracts can be issued in foreign currency (unlike foreign currency loans, which require 100% provisioning).

Investors in Ukrainian private equity funds include IFIs, high net worth individuals, European and U.S. fund-of-funds, banks, private pension funds, and other institutional investors. Attracting investment for private equity has been difficult due to limited exits and low returns following the financial crisis, as well as the high degree of political and macroeconomic risk in the country. The only fund that was successfully raised after the crisis (Dragon Capital Europe Virgin Fund) was funded by the firm's own capital and IFIs.

5.6 Supply estimate[59]

The total supply of SME loan financing amounts to EUR 10.8 billion as of 2012. This consists entirely of bank financing, as contributions from other sources such as credit unions are marginal. The supply of microloans is relatively small at EUR 0.7 billion, resulting in a total MSME loan supply of EUR 11.5 billion. The estimate of the supply of loan financing available to SMEs was made by:

1. Estimating the proportion of SME loans in the total loan portfolios of eight financial institutions which responded to a survey
2. Multiplying those proportions by the total outstanding loan portfolios of all lenders

Estimate of SME loan supply at YE 2012 (EUR millions)

	Value
A. SME loans to total loans (survey)	13.9%
B. Total loans (EUR millions)	77,662
C. SME loan supply estimate (=A*B)	10,778

Source: NBU, BFC estimates

It is worth noting that because consumer credit granted for business purposes was generally excluded from survey results, the figures may be understated by this amount. Another element of inaccuracy in the estimates is introduced by the varying definitions of SMEs applied by the survey respondents.

The total supply of MSME loans from credit unions (which is nearly all micro) is estimated at just EUR 41 million[60], and the supply of ongoing private equity funding is very small, with just USD 57 million of new funds raised since the financial crisis of 2009. SMEs' portion of the market's EUR 1.3 billion in

[59] Please refer to the Confidential Report for more information.
[60] Based on estimates from the Ukrainian International Credit Union Association

leasing contracts is unknown, but it is likely small, as most leasing contracts are issued to large enterprises.

6. GAPS IN PRIVATE SECTOR FINANCING

Conclusion:
A significant SME financing gap exists in Ukraine, creating an impediment to SME development.

Key findings:

- *Urban medium sized businesses are the best supplied with credit, while smaller firms and entrepreneurs in rural areas appear underserved*
- *Meaningful opportunities for IFI intervention include local currency credit to banks, investment in private equity funds focusing on SMEs, and agricultural equipment leasing*

6.1 Gaps by instrument

Anecdotal evidence based on interviews with financial institutions suggests that there is a significant SME financing gap in Ukraine. This gap is heavily weighted toward loan financing, although the lack of significant supply of other instruments, such as equity financing, leasing, and trade finance products targeted toward SMEs suggests gaps in those areas as well.

The quantitative loan gap analysis produced results of EUR 10.7 billion for SME demand and EUR 10.8 million for supply, suggesting that there is no loan gap. However, the qualitative evidence of a substantial loan gap is considered more reliable than the qualitative analysis.

6.2 Gaps by type of SME

Urban medium sized businesses are the best supplied with credit, while small and micro sized businesses are less targeted. Rural areas are generally underserved – the financing options for rural SMEs are generally limited to consumer loans from credit unions. The lack of availability of lower-cost, longer term financing for SMEs of all sizes is a notable issue. There is evidence of demand for agricultural leasing on the micro and small business levels, and this demand is unmet beyond certain geographical pockets such as Crimea. A separate study conducted by BFC, Finance in Motion, and the European Fund for Southeast Europe estimated a USD 8.7 billion (EUR 6.6 billion) financing gap for agriculture alone, with particular needs for seasonal loans, leasing, and value chain financing.

6.3 Gaps in funding of intermediaries

All of the banks surveyed reported a strong need for longer-term local currency funding. Local currency funding is primarily obtained through customer deposits, which tend to be rather short term. Because lending in foreign currency to customers without foreign income streams is no longer an option due to severe provisioning requirements for such loans, foreign currency funding has become less appealing to banks.

Credit unions and leasing companies also reported a need for longer-term local currency funding, although issuing lease contracts in foreign currency is not prohibited. Additional funding for leasing programs for agricultural machinery and equipment could significantly boost SME development in the agricultural sector.

Private equity funds have suffered from a lack of funding since the financial crisis, with just one small fund successfully raised since that time. Additional investment capital for private equity funds is much needed.

6.4 Potential and capability of IFIs to fill gaps

IFIs have a significant opportunity to address SME financing gaps by providing local currency funding to financial institutions and investing in local private equity funds. Several IFIs have participated in the equity investment model, but the volume of such investments has dwindled since the financial crisis. IFIs such as KfW (through the German Ukrainian Fund) and the European Bank for Reconstruction and Development have begun piloting local currency bank credit programs, and further development of such programs would be very beneficial. A small rural agricultural leasing project sponsored by the Canadian International Development Agency has been met with great demand, and could be used as a model for other IFIs. A summary of the major IFI financing initiatives follows below.

European Bank for Reconstruction and Development (EBRD): The EBRD provides the Ukrainian banking sector with long-term senior and subordinated loans and equity funding along with technical assistance. The MSME sector is one of EBRD's target areas. Total loan facilities to banks have amounted to over EUR 600 million since 2009 (ten separate facilities).

EBRD's newest MSME finance facility amounts to USD 100 million and includes three banks: Pravex Bank, Credit Europe Bank Ukraine, and Mega Bank. EBRD also provided a USD 50 million SME finance facility to Ukreximbank in 2011 with a focus on sustainable energy efficiency. EBRD's credit facilities typically come with a technical assistance component. For example, the most recent MSME finance facility included EUR 3.7 million for the implementation of MSME lending schemes with emphasis on product diversification, and the Ukreximbank facility includes energy audits and energy efficiency package development. EBRD also provided SME support through leasing by investing EUR 19.6 million into a Unicredit Leasing facility in 2009.

EBRD's current equity investments include UkrSibbank (original investment value of EUR 19.4 million), Megabank (EUR 20 million) and ProCredit Ukraine (EUR 8 million). The EBRD has also invested in private equity funds through firms such as Euroventures and Dragon Capital.

EBRD will soon be able to issue local currency bonds in Ukraine, which will allow it to on-lend to local banks in local currency, focusing on SME and municipal lending. EBRD is also currently working on a USD 100 million sustainable energy financing facility, which will be on-lent through local banks and leasing companies to private companies undertaking sustainable energy investments.

International Finance Corporation (IFC): IFC has several SME focused credit lines and guarantees outstanding to Ukrainian banks, leasing companies, and large agro-producers that indirectly benefit SMEs. Funding of SME-focused projects has amounted to over EUR 150 million.

IFC's SME-focused projects since 2009 include a EUR 11.3 million senior loan to Credit Europe Bank for expansion of SME lending and financing energy efficiency projects; EUR 7.5 million for on-lending to agricultural MSMEs through Megabank; EUR 52.5 million and EUR 13.1 million risk-sharing facilities with Raiffeisen Bank Aval and Credit Agricole Bank on receivables generated by Bayer in connection with sales of crop-protection products benefitting SME farmers; a EUR 7.5 million partially convertible loan to Euroleasing to support SME leases; and loan facilities to the country's leading poultry and grain producers that will indirectly benefit local contractor and franchisee SMEs. Technical assistance examples associated with these projects include help in building capacity for energy efficiency loan products and implementation of social and environmental management systems.

KfW and German Ukrainian Fund (GUF): GUF is a joint project between the central bank of Ukraine and the German government through KfW, specifically focused on SME support through bank loans. Partner banks include Megabank, Kyivska Rus, Kreditprombank, ProCredit Bank, Ukrainian Professional Bank, Zlatobank and Ukrgazbank. The GUF's foreign currency fund amounts to EUR 10 million and a pilot local currency fund amounts to EUR 2 million. The local currency program focuses specifically on SMEs involved in green tourism, agriculture, fisheries, small hotels, and light manufacturing. KfW has also extended larger SME focused credit lines directly to banks, the latest being USD 40 million to Ukreximbank. Technical assistance in the form of training is also provided to partner banks as a part of the program.

Swiss Agency for Development and Cooperation (SDC) and Swiss Investment Fund for Emerging Markets: The Swiss Investment Fund for Emerging Markets (as a part of the SDC's overall strategy for Ukraine) supports SMEs through investment in private equity funds, most recently through Dragon Capital's Europe Virgin Fund in 2010[61].

Canadian International Development Agency (CIDA): CIDA, along with Mennonite Economic Development Associates, has funded Agro Capital Management, a lease-to-own scheme provider for small and medium agro-businesses covering the areas of Crimea, Kherson, and Zaporozhye. Agro Capital Management reports high demand for its services and significant geographic growth potential.

US Agency for International Development (USAID): USAID's objectives for Ukraine include improving local government support for SMEs and promoting private sector business associations and advocacy groups. Recent SME-focused initiatives have included a one-stop shop project for business licensing and permits, aiming to reduce corruption and alleviate the bureaucratic burden for SMEs.

GIZ: A sister organization to KfW, GiZ provides advisory and capacity building services to businesses throughout Ukraine's regions, focusing on sustainable economic development and energy efficiency.

[61] Dragon Capital (2010). *Dragon Capital raises $45 million in the First Closing of Europe Virgin Fund*

ANNEX 1: MACROECONOMIC INDICATORS

Indicator	2012	2011	2010	2009	2008
GDP (nominal, EUR millions)	133,707	126,439	102,389	79,776	87,335
Population (millions)	45.6	45.6	45.8	45.9	46.1
GDP (nominal) per capita (EUR)	2,932	2,773	2,236	1,738	1,894
GDP (PPP) per capita[62]	5,727	5,432	5,033	4,777	5,509
Real GDP growth rate	0.2%	5.2%	4.2%	-14.8%	2.3%
Inflation rate (CPI)	-0.2%	4.6%	9.1%	12.3%	22.3%
Exchange rate (EUR, end of period)	10.5	10.3	10.6	11.4	10.9
Change in exchange rate	2.3%	-2.6%	-7.6%	5.5%	46.3%
Unemployment rate (official)	8.1%	8.6%	8.8%	9.6%	6.9%
Poverty rate (WB, $1.25 per day)	n/a	n/a	0.0%	0.1%	0.0%
Current account balance (% of GDP)	-8.4%	-5.5%	-2.2%	-1.5%	-7.0%
Trade balance (% of GDP)	-8.4%	-6.2%	-2.9%	-1.7%	-8.0%
Capital account balance (% of GDP)	n/a	6.4%	7.6%	5.0%	11.6%
Net FDI (% of GDP)	n/a	4.4%	4.7%	4.1%	5.9%
Central bank reserves (% of GDP)	13.9%	19.5%	25.4%	23.2%	25.6%
Public debt (% of GDP)	34.7%	36.0%	40.5%	35.4%	20.5%
Fiscal balance (% of GDP)	-4.5%	-2.8%	-5.8%	-6.3%	-3.1%

Sources: World Bank, IMF, Ukrstat, CIA factbook

Sectoral distribution of GDP (% of total)

Sector/activity	2012	2011
Agriculture, hunting	7.9%	8.5%
Mining	6.4%	6.7%
Manufacturing	12.8%	12.8%
Production/distribution of energy	3.6%	3.5%
Construction	2.7%	2.9%
Trade and repair	15.6%	15.6%
Transport	10.1%	10.2%
Education	5.2%	4.8%
Health and social security	3.9%	3.5%
Other activities and taxes	31.8%	31.6%
TOTAL	**100%**	**100%**

Source: Ukrstat

[62] World Bank and CIA Factbook; converted from USD using oanda.com

ANNEX 2: BANKING SECTOR INDICATORS

Banking sector indicators (NBU data)

Indicator	2012	2011	2010	2009	2008
STRUCTURE OF THE BANKING SECTOR					
Number of banks by type:					
Banks with foreign capital	51	51	55	51	53
Of which banks with 100% foreign capital	22	22	20	18	17
Banks without foreign capital	125	125	121	131	131
Total licensed banks	176	176	176	182	184
Number of state-owned banks	2	2	2	2	2
Assets of SOBs to total bank assets	15.4%	14.1%	14.0%	13.3%	11.4%
5-bank concentration ratio	38.6%	36.6%	36.8%	34.5%	31.6%
Bank branches per 100k population	n/a	1.6	2.3	3.2	3.7
FINANCIAL INDICATORS (EUR millions)					
Total assets	106,973	102,377	89,102	76,890	85,311
Total gross loans	77,376	80,143	71,410	65,277	72,981
Total net loans	63,965	64,810	57,333	54,583	68,522
Total deposits	53,767	47,817	39,229	28,405	32,900
Total equity	16,069	15,099	13,026	10,060	10,987
Total regulatory capital	16,979	17,329	15,218	11,862	11,337
Total net profit	465	-749	-1,232	-3,358	673
FINANCIAL RATIOS					
Capital adequacy:					
Tier 1 CAR	n/a	n/a	n/a	n/a	n/a
Total CAR	18.1	18.9	20.8	18.1	14.1
Equity to total assets	15.0	14.7	14.6	13.1	12.9
Liquidity:					
Loans to deposits	143.9%	167.6%	182.0%	229.8%	221.8%
Growth rate of deposits	15.1%	18.7%	27.5%	-8.9%	29.6%
Cash and equivalents to assets	2.7%	2.6%	2.8%	2.5%	2.2%
Profitability:					
Return on assets	0.5%	-0.8%	-1.5%	-4.4%	1.0%
Return on equity	3.0%	-5.3%	-10.2%	-32.5%	8.5%
Net interest margin	4.5%	5.3%	5.8%	6.2%	5.3%
Asset quality:					
Growth rate of loan portfolio	-1.2%	9.3%	1.0%	-5.7%	63.2%
NPL ratio (World Bank estimate)	14.1%	14.7%	15.3%	13.7%	3.9%
Others:					
Growth rate of total assets	6.9%	11.9%	7.0%	-4.9%	54.5%
Bank assets to fin. sector assets	n/a	68.4%	64.0%	66.4%	67.7%

Source: NBU

ANNEX 3: PRUDENTIAL RATIOS FOR BANKS

Ratio	Criteria	Banking system average as of 1/1/2013
Regulatory capital adequacy ratio[63]	No less than 10%	18.1%
Regulatory capital/total assets ratio	No less than 9%	14.9%
Regulatory capital/liabilities ratio	No less than 10%	18.3%[64]
Quick liquidity ratio[65]	No less than 20%	69.3%
Current liquidity ratio[66]	No less than 40%	79.1%
Short term liquidity ratio[67]	No less than 60%	90.3%
Maximum credit risk exposure per single counterparty/regulatory capital	No more than 25%	22.1%
Total large credit exposure/regulatory capital	No more than 800%	172.9%
Maximum credit exposure to single insider/share capital	No more than 5%	0.4%
Maximum aggregate credit exposure to all insiders/share capital	No more than 30%	2.4%
Investment securities issued by single entity/regulatory capital	No more than 15%	0.1%
Total investments in securities/regulatory capital	No more than 60%	3.5%

Source: NBU

[63] Regulatory capital to risk-weighted assets
[64] Ratio as of 1/2/2013
[65] Cash and cash equivalents and accounts receivable less short term investments divided by current liabilities
[66] Current assets divided by current liabilities
[67] Highly liquid assets divided by short term obligations

ANNEX 4: KEY BANKING REGULATIONS

Category	Brief description
Financial reporting standards	IFRS, required since 2012
Corporate governance standards	Corporate governance requirements are in line with international standards, including an independent supervisory board, audit committee, risk management committees, internal audit reporting directly to the supervisory board, etc.
Ownership restrictions	Acquisition of a 10% stake or larger requires approval of the NBU, with a notification and supporting documents sent 3 months prior to the intended transaction. Acceptable reasons for potential denial are broad, and include threatening the interests of depositors and creditors. Foreign entities wishing for to purchase a stake in a Ukrainian bank face additional administrative burden to gain approval.
Capital adequacy standards	Regulatory capital is calculated on the basis of Basel II. "Additional" (Tier 2) capital may not exceed 100% of "main" (Tier 1) capital.
Minimum capital requirements	UAH 120 million (EUR 11.4 million) at inception.
Interest rate caps or floors	Interest rates and commission fees may not be lower than the cost of services for that bank. Banks may not otherwise engage in unfair competition through interest rates.
Definition of NPL	NBU's definition of NPLs includes loans classified IV and V as per the loan classification criteria described below. International entities generally choose to rely on the World Bank's estimates for NPLs, as opposed to the NBU's figures.
Loan write-off policy	Write-offs of loans more than 90 days past due are allowed, but not required.
Loan classification and provisioning policy	Following a new provisioning policy in 2012, there are five numerical credit grades ranging from I – minimal risk to V – realized risk/hopeless. Relationships where more than 50% of the outstanding debt is past due over 90 days must be graded V. Consumer loans under USD 50,000 may be classified on a portfolio basis, using the number of days past due. All other loans must be evaluated on an individual basis. Provisioning for loans evaluated individually amounts to the difference between the book value of the loan and the present value of the expected cash flows for that loan, with the present value calculation outlined by NBU.
Deposit insurance	Deposit Guarantee Fund; UAH 200,000 maximum
Reserve requirements	Zero for local currency deposits and Russian Rubles. Foreign currency: 15% for demand deposits of individuals, 10% for demand deposits of legal entities, 5% for long term deposits, 10% for short term deposits, 5% for deposits of non-residents. (new decree as of July 1, 2013)
Foreign currency operations	Full (100%) provisioning is required for foreign currency loans to customers without export revenue.
Related party transactions	Transactions with related parties are limited based on the parameters listed in the previous table. Favorable interest rates on loans and deposits may be offered provided that the bank's financial position is not harmed as a result.

Source: NBU

ANNEX 5: LARGEST BANKS IN UKRAINE BY ASSET SIZE (APRIL 1, 2013)

Source: NBU

Rank	Name of bank	Assets (EUR)
1	PRIVATBANK	16,995,334,497
2	UKREXIMBANK	8,712,121,047
3	OSCHADBANK	8,377,348,274
4	RAIFFEISEN BANK AVAL	4,466,869,375
5	PROMINVESTBANK	3,963,590,231
6	UKRSOTSBANK	3,829,909,526
7	DELTA BANK	3,375,760,652
8	VTB BANK	3,120,439,142
9	FIRST UKR.INTERNATIONAL BANK	2,946,764,980
10	SBERBANK OF RUSSIA	2,868,033,146
11	ALFA-BANK	2,715,885,168
12	NADRA	2,711,189,298
13	UKRSIBBANK	2,513,853,434
14	BANK "FINANCE AND CREDIT"	2,310,769,984
15	UKRGAZBANK	2,062,111,411
16	OTP BANK	1,941,499,982
17	BROKBUSINESSBANK	1,690,672,367
18	VAB BANK	1,369,737,049
19	CREDIT AGRICOLE BANK	1,293,118,030
20	KREDITPROMBANK	1,071,144,728
21	ING BANK UKRAINE	1,043,302,607
22	FINANCIAL INITIATIVE	1,030,280,576
23	PIVDENNYI	1,016,349,580
24	IMEXBANK	936,624,297
25	BANK FORUM	904,755,809
26	RODOVID BANK	862,363,602
27	KHRESCHATYK	809,387,080
28	BANK CREDIT DNEPR	732,698,282
29	UNIVERSAL BANK	653,569,191
30	ERSTE BANK	637,201,078
31	BANK "KYIVSKA RUS"	560,372,675
32	BTA BANK	553,210,228
33	PRAVEX BANK	538,586,042
34	UNICREDITBANK	485,915,294
35	BANK 3/4	461,490,516
36	PIVDENKOMBANK	590,305,226
37	ZLATOBANK	588,402,273
38	CITYBANK	583,138,218
39	FIDOBANK	540,763,570
40	UKRINBANK	512,233,564
41	MEGABANK	479,210,553
42	DV BANK	470,902,970
43	UKRAINIAN BANK OF DEVELOPMENT	460,529,631
44	AKTABANK	451,362,641
45	UKRAINIAN BUSINESS BANK	448,817,781
46	UNION	430,998,155
47	KREDOBANK	405,464,751
48	MARFIN BANK	390,705,789

49	AVANT - BANK	371,875,925
50	DIAMANTBANK	359,790,258
51	TERRA BANK	354,874,179
52	PLATINUM BANK	352,875,601
53	UKRAINIAN PROFESSIONAL BANK	336,631,648
54	CLEARING HOUSE	336,230,656
55	CITY COMMERCE BANK	334,726,508
56	INDUSTRIALBANK	314,275,295
57	PIRAEUS BANK ICB	302,320,471
58	EUROGASBANK	293,836,347
59	SWEDBANK	277,875,186
60	RUSSIAN STANDARD BANK	313,014,992
61	BANK "NATIONAL INVESTMENTS"	292,595,918
62	ACTIVE-BANK	288,970,431
63	EXPRESS-BANK	281,994,064
64	TAScombank	251,900,292
65	BANK OF CYPRUS	251,076,931
66	FORTUNA-BANK	246,385,531
67	PROCREDIT BANK	235,725,496
68	BANK FOR INVESTMENT AND SAVINGS	234,012,486
69	FINBANK	233,300,644
70	BM BANK	232,354,165
71	BANK PERSHYI	231,848,741
72	IDEA BANK	231,454,613
73	KYIV	226,126,276
74	VOLKSBANK	211,996,626
75	EXPOBANK	211,360,989
76	ENERGOBANK	207,363,633
77	ACCENT- BANK	198,382,409
78	BANK "DEMARK"	192,226,521
79	BANK VOSTOK	190,220,152
80	BANK CAMBIO	182,056,966
81	ASTRABANK	179,894,701
82	MISTOBANK	178,918,792
83	DEUTSCHE BANK DBU	172,494,048
84	ARKADA	171,435,781
85	MERCURY-BANK	166,766,445
86	CAPITAL	158,975,455
87	EUROBANK	156,125,214
88	BANK NATIONAL KREDIT	155,588,817
89	FINROSTBANK	147,680,466
90	INTERNATIONAL INVESTMENT BANK	147,248,746
91	UKRAINIAN FINANCIAL WORLD	146,839,902
92	CREDIT EUROPE BANK	146,427,095
93	TK CREDIT	144,936,743
94	UNEX BANK	137,373,908
95	BANK "GOLDEN GATE"	135,241,450
96	PETROCOMMERCE-UKRAINE BANK	131,364,897
97	AVTOKRAZBANK	129,552,956
98	REAL BANK	127,765,805
99	POLTAVA-BANK	125,353,678
100	INTEGRAL-BANK	123,625,773

ANNEX 6: LARGEST PRIVATE EQUITY FUNDS IN UKRAINE

Company	Assets under management (USD billions)	Notes
Horizon Capital	0.7	Investment into a single company is limited to USD 15-40 million
Advent International	15	Investment into a single company is limited to USD 40-50 million (generally large project investments)
Sigma Blazer	1	No recent investments
Euroventures Management	0.2	No recent investments
Dragon Capital	0.15	Most recent fund raised
Icon Private Equity	1	Single-company investments of up to USD 50-200 million

Sources: Z-Ukraina analytics (in Russian); onsite meetings

ANNEX 7: PROSPECTS OF THE LARGE CORPORATE SECTOR

Large enterprises, a total of 698 as of 2012, made up just 0.2% of the enterprises operating in Ukraine, but accounted for 39.5% of the volume of revenues in the same year. Of these, 58.7% are involved in manufacturing, and another 24.8% work in wholesale and retail trade, with no other significant industry concentrations. The agricultural sector, while accounting for just 26 of the large enterprises, is viewed as important due to its significant growth potential and a noticeable trend toward consolidation in that industry. Large vertically integrated agricultural businesses currently operate on just 10-15% of Ukraine's arable land, and this number will likely increase significantly as land trade liberalizes. [68]

Based on opinions gathered at onsite meetings, corporate lending is viewed as one of the two currently viable growth areas for Ukrainian banks, along with consumer lending. According to the NBU, corporate lending rates averaged at 14.3% in local currency and 8.5% in EUR, compared to 26.9% and 12.5% for households as of August 2013 (small business loans are more and more frequently underwritten as consumer).

DFIs such as EBRD and IFC frequently invest in projects with large Ukrainian corporations. Recent examples include loans and equity investments for new agricultural plant construction, manufacturing facility modernization, acquisition of US Food and Drug Administration certification (pharmaceutical company), business expansion and operational improvements for a building material producer, and a shopping center chain's expansion, among many others. Investment in projects related to agriculture appears to be a particular focus.[69]

Large businesses have significant power in Ukraine, including influence on Ukrainian politics through participation in oligarchic groups with politicians. Ukraine's 14 large business groups control several key industries, such as metallurgy and media. The Privat group, Ukraine's second largest business group, controls PrivatBank, the largest banking institution.[70] Pocket banks, or banks used by enterprise groups for treasury operations and sources of inexpensive liquidity, are also a common practice in Ukraine.[71]

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[68] Ukrstat; Invest Ukraine. *Agricultural Industry*
[69] *EBRD, IFC project lists*
[70] Matuszak , Slawomir (2012). *The Oligarchic Democracy: The Influence of Business Groups on Ukrainian Politics,* Centre for Eastern Studies
[71] Barisitz, Stepan et. al. (2012), *Ukrainian Banks Face Heightened Uncertainty and Challenges,* Oesterreichische Nationalbank

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