Entering the Ukrainian market:
Potentials and Challenges for German corporations

Course of study: Cross-Border Management - The German-Ukrainian Perspective

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Abstract

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After destruction of Soviet Union the economy of Ukraine was in lingering depression. But during last 3-5 years its economic potential is growing. Now Ukraine is one of the most successful of the former Soviet states in attracting the foreign investment needed to restructure its economy. The main question for foreign investors is how it is better for them to enter the Ukrainian market successfully. The first chapter of the project tells readers what they should take into account doing business in Ukraine. Here is shown that today Ukraine has the huge potential for foreign investments. Here it is shown economic and political aspects of doing business in Ukraine, how business culture influences on businessmen and what they should do to avoid misunderstanding clinching a deal. Besides here readers can know what possible discrepancies in legislative base of Ukraine they can meet and how FDI in Ukraine is developing today.

The second chapter describes 4 main FDI theoretically. There are: 1) exporting into the Ukrainian market; 2) Licensing in Ukraine; 3) Joint venture and 4) Foreign subsidiary. Here readers will be able to know what every type of FDI means, what advantages and disadvantages it has, and how to control risks each of them. This chapter answers on the main definition of the problem only theoretically. But practical examples everyone can see at the third chapter of this project. Here is shown what joint companies between Ukraine and Germany exist and how they are developing now. In this chapter is described how BMW company exports its production onto the Ukrainian market, how agricultural joint ventures deal in Ukraine, what subsidiaries in textile market exist and how franchising in Ukraine is developing now. Here we tried to give examples of effective developed companies to show investors what they will be able to achieve if they take into account all notes and cautions described in this project.
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INTRODUCTION

Now Ukraine is one of the most successful countries in Central-Eastern Europe with a developing market economy. No wonder, many businessmen try to turn Ukrainian market to their advantage. More often than not, the success they score exceeds their expectations. Their business ventures have proved that exposure to Ukrainian markets is a profitable affair. The Japanese, American and South Korean companies, which have gained firm foothold in Ukraine and enjoy a resounding success here, furnish a good example for this.

When we re-read works of the experts, who analyzed Ukraine from the point of view of its perspectives for investors, we noticed that all experts unanimously declare that Ukraine is a country with an enormous potential. It has an educated population, rich natural resources and well-turned geographical location. And really, Ukraine with its 48-mln population is one of the biggest markets of the Central and Eastern Europe, therewith also not very mastered by foreign investors. The qualitative rate of the Ukrainian market is considered to be positive, seeing the acting law of Ukraine about the foreign investments, as also active reforms, directed on the macroeconomic stabilization, privatization, development of private proprietorship and liberalization of the Ukrainian market. As a positive arguments may be considered the reached agreements of Ukraine with the International Monetary Fund, the World’s Bank, the UNO and other international organizations. The international representations of USA, Great Britain, Canada, etc. are already working in Ukraine, what shows the increasing tempo of the international cooperation.

That is why, on our opinion, we want to learn Ukrainian market in details and advice representatives of German corporations how it is better for them to enter and invest their assets in definite companies (fabrics, plants etc.) of Ukraine to gain a profit and, at the same time, help to development of Ukrainian economy. We think that in Ukraine there are a number of reasons for encouraging FDI (Foreign Direct Investments). First of all, we want to notice that attracting of FDI to Ukraine has been a priority for the Ukrainian government since independence and continues now in the government’s efforts to promote Ukraine as a destination for foreign capital. By the way, during the last 10 – 12
years Ukraine has experienced a lack of domestic savings and investments, determined by macroeconomic factors. Another thing is that due to a history of centralized investments in the Soviet era, Ukraine struggles to shift investment decision making to the individual company level. FDI will contribute to a more accurate placement of capital into companies with a need rather than a centrally planned system. FDI should also stimulate the inflow of technology and the know-how exchange.

Ukrainian’s foreign investment “necessity” is significant in everything from agriculture to telecommunications. The Ukrainian government has suggested that Ukraine needs around 40 billion dollars for its economic restructuring. However, during the last years Ukraine has received only a fraction of what expected. The total sum of FDI in Ukraine is only 4.9 billion dollars. But Poland has received investments approximately 39 billion dollars during 1990 – 1999 (data of the Polish Embassy in Ukraine).

When gathering theoretical information about Foreign Direct Investments we looked through dozens of Russian, Ukrainian and mainly English sources. We found a lot of useful information in public and university libraries. Internet helped us not only to find interesting articles but to cooperate with some firms and clarify certain matters which our project contains.

We think that German corporations will be able to increase the highest index of FDI if they know peculiarities of Ukrainian market and legal control basis to do success business in Ukraine. So, we hope that our project will help to German representatives to know what the Ukrainian market can propose them, what legal barriers they can meet there and what the first steps businessmen should do to enter the Ukrainian market successfully.
1 PECULIARITIES OF THE UKRAINIAN MARKET

1.1 Developing of the Ukrainian Market

Having analyzed the Ukrainian Market’s developing during its independence, we have noticed that now the modern economic mechanism of Ukraine looks much better than in the beginning - middle of 90th years.

Development of a macroeconomic situation in Ukraine for last years is characterized by overcoming of many negative tendencies and formation of economic growth’s conditions. In comparison with 90-s the dynamic of gross domestic product (GDP) in 2001 has considerably increased, namely up to 9,1 %, that has considerably affected development of economy of Ukraine in the beginning of XXI century. By the way, this success has been achieved due to low rates of inflation.

Besides we want to note that positive economic changes are accompanied by reduction of unemployment, which in the end of 2001 made 3,7% though in the beginning of that year was 4,2 %. Real incomes of the population have increased for 9,0%. And for the first time for last years the wages rose sufficiently faster (on 19,3%)\(^1\).

There are some positive changes in an agriculture industry of Ukraine. For 2 years volumes of manufacture have increased for 20,7%, investments – for 80%. The crisis period in the industry has been overcome in 1999 and already in 2001 the volume industrial production has grown for 14%.\(^2\)

Besides the positive moment in modern economic mechanism of Ukraine is also that there was a reduction in a level of shady Ukrainian economy (no legal): from 40 % in 2000 up to 34 % in 2001, and also – reduction of a public debt from 37 % from GDP in the end of 2000 up to 31 % in the end of 2001.\(^3\) But as for corruption in Ukraine we singled the certain part in our project because German investors should know that almost all Ukrainian market is under corruption.

\(^2\) See The State Committee of Statistics of Ukraine
\(^3\) See The State Committee of Statistics of Ukraine
Having maintained by the President of Ukraine the market mechanisms of development’s stimulation of such industries as vessel industry, air, auto, the space industry, some manufactures of a military-industrial complex have considerably sped up the development of mechanical engineering, which is the leading in the maintenance of scientific and technical process in the country. The growth in this area in 2,5 times more than the general growth in the industry of Ukraine.⁴

Productivity of qualitative changes in the industry shows the increase in efficiency of labour. Its growth in January-March of 2002 has exceeded 7%. However there is stable a price situation in the market of an industrial production. The prices of manufacturers have increased on 0,7 % (the last year – on 1,1 %).⁵

In conditions of a monetary and credit policy the industry constantly increases the contribution of investment resources for maintenance of manufacture’s increase. Volumes of bank crediting of the industrial enterprises in January-March of 2002 in 1,3 times more than last year’s.⁶

In spite of the positive changes which have occurred in development of Ukrainian economy for last couple years, it is necessary to note that consequences of a deep economic crisis of 1990-1999 years are still far from being eliminated. And though the economy of Ukraine has already become on the level of stabilization, there are a lot of vital economic problems to be solved.

1. First of all it is the low standard of life (60% of Ukrainians are poor people and beggars; the average salary is 50$ per a month, pension – 20$ per a month).
2. At about 85% of state enterprises don’t work or work with a capacity of 10-15%.
3. Technical and technological manufactures are developed very bad;
4. In the modern economic mechanism of Ukraine we can also watch prints of domestic economy prevail, etc.

⁴ See Electronic Ukrainian News (22 May, 2002)
⁵ See Electronic Ukrainian News
⁶ See Electronic Ukrainian News
1.2 Doing Business in Ukraine

1.2.1 Economic Aspects of Doing Business in Ukraine

Almost all sectors in Ukraine considered good for investment (now or in the future) face the same business environment, one that is complicated by over-regulation, burden some tax structures, inconsistent application of laws, and a lack of respect for the sanctity of the law. Sustainable macroeconomic growth will remain tied to overall structural changes such as tax reform, deregulation, privatization, budget austerity, and greater openness to trade. Nevertheless, recent economic growth is slowly strengthening Ukrainian purchasing power. Assuming that economic growth and domestic investment continues, Ukrainian based companies can be expected to import higher-quality Western (and German either) capital goods to modernize and expand their production capacity. Imported durable consumer goods such as shoes, clothing, and electrical household goods will likely witness continued demand in the future, although their market share has been threatened by the higher relative cost of imported goods caused by depreciation of the local currency prior to the year 2000. However, the recent development on the foreign exchange rate is alleviating this pressure. Since early 2000, the stable nominal exchange rate and the strong inflationary differential between Ukraine and dollar-based economies has caused a significant de facto real appreciation of the hryvna. Demand continues as well for imported non-durable goods like foodstuffs, candies, and other grocery items.

1.2.1.1 The Leading Sectors in the Ukrainian Economy

Agro business and the food processing and packaging sectors have been among the more rapidly growing sectors of the economy, and remain areas of potential growth in the future. The sector’s potential will dependent on the government’s commitment to transparent privatization and land-reform policies in agriculture, particularly through passage of a land code that was pending in the parliament in June of 2001. Many farm producers remain heavily indebted to the government for past deliveries of agricultural inputs, limiting ability to sustain growth in the agricultural sector.

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7 Мар’єнко А.В.(1999), р. 34-44
8 See Embassy of Ukraine in Japan (2002)
The energy sector is another major area for potential investment. Ukraine’s decaying electricity grid, as well as needed investment in power generating facilities and the country’s energy extraction and transit systems, could potentially attract substantial sums of foreign investment. The successful privatizations of six regional electricity distribution companies (in Ukraine they are called “oblenergos”) in April of 2001 was the first, and significant step towards improving Ukraine’s energy industry and towards increasing transparency and reducing corruption in the sector. This action was also the first truly large-scale privatization performed in Ukraine according to internationally accepted standards of transparency and fairness. In encouraging development, recent attempts to circumvent the transparent privatization process by stripping energy sector companies targeted for privatization of their most valuable assets have been stopped by the Ukrainian government.9

Aviation complex is one of the leading sectors in Ukraine too. Ukraine belongs to 8 countries of the world (according to the statistic of Ukrainian’s Embassy), which have necessary scientific-technical potential for creation and production of competitive aviation equipment. Among the main enterprises are ASTC named after Antonov, State Design Bureau “Pivdenny”, Production Association “Pivdennyi” Machine-Building Plant named after Makarov, Kharkiv State Aviation Production Enterprise, Kyiv State Aviation Plant “Aviant” and OJSC “Motor Sich”. Passenger and transportation aircrafts, known in the world under brand name “An”, rocket-carriers and space apparatus of different determination are created and serially manufactured here.10

Telecommunications and information technology are important growth sectors as well. The privatization of Ukrtelekom, the national telecommunications monopoly, was held in 2002. The potential of Ukraine’s highly qualified technical workforce has been increasingly recognized by foreign investors as well.

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9 See Embassy of Ukraine in Japan (2002)
10 See Embassy of Ukraine in Japan (2002)
1.2.1.2 Special Economic Zones in Ukraine

Doing business in Ukraine German investors should know where special economic zones (SEZ) are in Ukraine. Since 1992 the law on the framework and principles for SEZs was made redundant by the series of specific laws for the certain SEZ. In 1999 the government decided not to establish new zone, but in 2000 it created the new SEZ (Interpol Kovel SEZ) near the Polish border. This SEZ was registered officially and it gave opportunities for foreign investors to set up new business.

SEZ may enhance exports and investment to Ukraine. Under Ukrainian Law “On Special (Free) Economic Zones” adopted in 1997, there are three types of special economic zones in Ukraine:\(^{11}\)

1) Special (free) economic zones;
2) territories with a special investment regime;
3) territories of priority development.

Main objectives of SEZ and territories of priority development functioning are:
- creation of new jobs;
- foreign trade enhancement;
- foreign investment attraction;
- active exchange of knowledge and technologies;
- broadening of export base or import substitution, etc.

According to the statistics of 2002, eleven free and special economic zones and nine territories of priority development were in operation in Ukraine, including Syvash SEZ (in Northern Crimea), Azov (in Donetsk region), Donetsk (18 towns in Donetsk region), Zakarpattyja (Zakarpatska region including autoport “Chop” on Ukrainian-Hungarian border), and Port “Reni” (in Odessa region).\(^{12}\)

Moreover if the foreign investors want to organize new company in one of these areas they are generally obliged to invest a designated sum (from US$ 200 000 to US$ 1 million). All investment-related projects would typically have to be aimed at job

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\(^{11}\) See the Ukrainian Law “On Special (Free) Economic Zones” (1997)

\(^{12}\) See The State Committee of Statistics of Ukraine
creation, the introduction of new technologies and environmental protection. Usually the life of the SEZ ranges from 5 to 60 years.\textsuperscript{13}

In 2002, about 909 million dollars of investment (both domestic and foreign) were attracted to SEZs. Over 5,000 investment projects valued at 2.8 billion dollars were signed in 2002 to be implemented in these zones and territories. Last year, over 90,000 jobs were either created or preserved due to these special investment conditions.

However, different views and opinions persist in 2003 as to the future fate of these zones and territories. While the International Money Fund experts suggest curbing their activities or eliminating them altogether, so far the Ukrainian Government has taken no steps to do so because of their importance to the country’s economy at the present stage. The adequate solution is being sought now based on broad international experience.

\textbf{1.2.2 Political Aspects to do Business in Ukraine}

\textbf{1.2.2.1 General Review}

General foundations of political system of Ukraine are defined by its Constitution. In accordance with its organic law, Ukraine is a sovereign and independent, democratic and social state.

Ukraine is a unitary state, which territory is integral and inviolable. The state has a single citizenship. The state language is Ukrainian.

The Constitution of Ukraine designates the President as the Head of State, acting on its behalf. The President is a guarantor of national sovereignty, territorial integrity, adherence to the Constitution, human and civil rights and freedoms. The President is elected by the citizens of the state on the basis of equal and direct universal suffrage through secret vote.\textsuperscript{14}

On June 28, 1996 the parliament of Ukraine (Verkhovna Rada) reasserted the course of political reform of a new Constitution. The new Constitution recognizes the right to

\textsuperscript{13} See Ukraine Investment Profile (2001), p.9
\textsuperscript{14} See Embassy of Ukraine in Japan (2002)
private ownership of land and property, strengthens provisions on the rule-of-law, and provides for a more independent judiciary, promising more effective legal protection for investors. It could also help facilitate the full passage of a long-delayed new Civil Code, with a Western-style commercial code.15

The principles expressed in the Constitution, while laying the groundwork for market-economy reforms, have not yet been fully put into practice. Lack of legislation in many areas of economic activity, as well as the absence of a reliable system to enforce existing legislation, are obstacles to achieving an investment climate that will attract substantial foreign investment. Key questions such as land ownership, land purchase by foreigners, privatization conditions, and taxation reform remain unresolved.

1.2.2.2 Corruption and Bribery in Ukraine

Corruption is a social phenomenon that has a clearly defined political coloring. Over the last ten years, corruption has not only become a characteristic trait of today’s politics in many countries. Some analysts believe that corruption is the main political problem for the end of the 20th century: “Every ten years bring at least one new area of political studies. In the 70s, this was terrorism, in the 80s — the ecology; in the 90s, it became corruption”.16 Now Ukraine lies in the list of corrupt countries as Nigeria, Cameroon etc. Corruption and crime inhibit legitimate business activity and foreign investment in Ukraine. The President of Ukraine Kuchma has declared the fight against organized crime one of the top priorities of his administration, but with little or no effect to date.

There is a broad understanding of these problems within Ukrainian official circles and a general consensus among reformers on the need to ensure that foreign investors are greeted with a more favorable legal and regulatory climate. The hard work of translating that consensus into law is one of the most important challenges facing the Ukrainian political system today. Ensuring that these laws are effectively executed is a comparable challenge.

15 Ukraine Investment Profile (2001) p.7-10
16 See Holmes L. (1996) p.3.1
1.2.3 Business Culture in Ukraine

Ukrainians have specific particularities of behavior in business. It is stipulated by the mentality of Ukrainians, economy of country, historical heritage. Having learned some aspects of business culture and behavior certain country you will be able to achieve successful results in business interrelations.

Ukraine, like most of the Slavic countries, has a culture that initially deals with strangers rather formally and suspiciously. However, once goodwill is detected the relationship warms up quickly. Male business visitors will be met with a firm and formal handshake, while more regular visitors will most likely receive a bear hug from male counterparts and a peck on the cheek from females. Visiting female managers will generally receive a polite handshake until a true friendship develops. After that, hugs and kisses abound.

As it was mentioned earlier, Ukraine is plagued with corruption. As a part of a poor nation, Ukrainian business people find themselves often having to make the choice not between honesty and riches, but between dishonest dealing and survival. Added to the poverty is a very short track record in free market systems. Many Ukrainian businesses have only scant familiarity with the developed world’s sense of service and contract adherence. In a land that has been ruled in the past by raw political power, and presently by violence and thuggery, contract requirements seem trifling by comparison. A lack of contract law and a legitimate court system only exacerbate the problem. The most honest person in the world would find it difficult to maintain integrity under Ukrainian circumstances.17

The most typical feature of everyday life in Ukraine is glastnost, which has encouraged contention among citizens of Ukraine. They are not obsessed with their jobs, as in other parts of the world. Workers often arrive at their jobs late or not at all; they take long lunch breaks and then leave early. Ukrainians expect their friendships, with the responsibilities and trusts they entail, to extend to business relationships as well.

17 Global Road Warrior (2000)
Ukraine has a long history of bureaucracy and hierarchical social structures. People who are in charge wield their power in slow but powerful strokes. All decisions come from the top, and information only flows in one direction: up. Foreign sellers visiting Ukraine can expect to deal with lots of “gatekeepers” before they get access to real decision makers. Visiting buyers, on the other hand, can (and should) demand an audience with the boss.

Middlemen are an established part of Ukraine economic and political life. “Who you know” counts for a lot, and that knowledge costs money. Germans should perform some due diligence before doling out fees to consultants or, at the very least, avoid paying until results arrive. But if they can not guarantee their access, they end the conversation. Fake “connections” are commonplace, and do not be fooled by business cards and job titles. Trust is good, but verification is best.

Business meetings will start off being very formal in both tone and execution. Business card exchanges and welcoming speeches will be conducted in somber tones. Germans may find that Ukrainian business people, especially the big bosses, adopt a very stern demeanor at the negotiating table — at least at first. This dour atmosphere lasts longer when the Ukrainians are in one of their rare buying modes. When selling or looking for investment, the atmosphere will warm up very quickly. It is at this phase that visitors must be on guard for Slavic charm and vodka. Ukrainians like to mix business with pleasure, especially when it will help lower the price they have to pay.

Everything in Ukraine is negotiable, from major contracts to buying a shirt. Like many impoverished people, Ukrainians have sharply honed bargaining skills and are masters of the quid pro quo approach to concessions. Even when in the weakest of selling positions, a Ukrainian manager will still attempt to bargain.

Ukrainians are a proud people and will be highly resentful if they feel they have been unduly “minimized” at the negotiating table. Visiting companies should be advised to keep this in mind when assessing their negotiating needs. Even conceding a small point may save a great deal of trouble in the future. It is worth remembering that contracts are of little use here, so, business is conducted on a personal relationship basis.
1.3 Incentives for Investors/Companies to Enter the Ukrainian Market

1.3.1 Legislative Bases of Foreign Direct Investments in Ukraine

Since Ukraine was independent in 1991 Ukrainian foreign investment legislation has changed with disturbing frequency.

Foreign investment activity is regulated by the Law of Ukraine “On the Regime of Foreign Investments” adopted on March 19, 1996. According to this Law foreign investments include all kinds of assets invested by foreigners into the investment objects.

Foreign investments can be made in the form of:

- hard currency;
- Ukrainian currency, in case of re-investment into the objects of primary investment, or into any other investment object according to the Law of Ukraine subject to profit tax paid;
- any movable and real estate;
- securities in hard currency;
- monetary claims in hard currency which are guaranteed by the first rate banks;
- rights of intellectual property whose value in currency is estimated in accordance with the laws of the country-investor and confirmed by expert evaluation in Ukraine, including copyright, useful models, industrial patterns, trade marks, know-how, etc.;
- rights to do business including the rights to explore natural resources granted by law or contracts whose value in hard currency is estimated according to the legal procedures of the country-investor or international trade practice;
- any other assets according to the Law of Ukraine.

On October 23, 1997, the “Law on Company Profit Tax” canceled the five-year tax exemption for all companies registered after this date. Meanwhile, top Ukrainian government officials assured foreign investors that there were no more automatic tax

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18 See the Law of Ukraine “On the Regime of Foreign Investments” (19 Mar 1996)
19 See the Law of Ukraine “Law on Company Profit Tax” (23 Oct 1997)
exemptions and that Ukraine would sign special agreements providing large foreign investors with tax and other privileges on a case-by-case basis.

The current foreign investment law includes:

1) Registration of foreign investment with local authorities is required;

2) Foreign investment includes:
   - creating joint ventures;
   - acquiring stock in existing enterprises;
   - creating wholly-owned foreign subsidiaries;
   - acquiring real estate such as apartments, houses, land use rights;
   - acquiring property rights by purchasing securities and stock of enterprises with such property rights;

3) Foreign investors are guaranteed unhindered and immediate rights to repatriate their profits abroad, but only after the investor pays a 15% repatriation tax and other mandatory payments in Ukraine;

4) Any in-kind foreign contributions imported for a company’s statutory fund are exempt from customs duties. All import duties must be paid if an enterprise sells, transfers or otherwise alienates the contributed property for any reason, including the termination of activities;

5) Foreign investors are granted general protection of Ukrainian intellectual property rights, and the right to decide whether to seek patent registrations in Ukraine or abroad.

It has become apparent to investors that the country’s foreign investment legislation is sorely lacking in predictability. Recent amendments to legislation clearly demonstrate that guarantees to foreign investors can be retroactively revoked. The law extends rather minimal favorable treatment and guarantees to all types of foreign investors, including physical and legal entities.

According to the Resolution of the Cabinet of Ministers of Ukraine No.112 (January 30, 1997) “On Approval of the Regulations on the Procedures for State Registration of
Contracts on Joint Investment Activity with the Participation of Foreign Investors\textsuperscript{20} agreements (contracts) on production cooperation, joint production without setting up a new entity signed by Ukrainian companies with foreign investors in conformity with Ukrainian legislation are subject to state registration as well.

The enterprises with foreign investments enjoy some customs privileges. The assets imported as an investment are exempt from custom duties.

The draft legislation “On Licensing of Certain Kinds of Business Activity”\textsuperscript{21} was approved by Parliament on June 1, 2000 and signed by the President a month later. The document outlines the licensing procedure, including reasons for revocation of licenses. According to the document, the Cabinet of Ministers is to create a special permitting and licensing authority, determine the fee itself (which will go into the state budget), and define procedures for payment. The duration of the licensing procedure is supposed to be reduced from 30 days to 10 days. However, the list of activities subject to permitting and licensing remains virtually unchanged (with only legal practice removed from the list).

\subsection*{1.3.2 Foreign Direct Investment in Ukraine today}

Today the urgency of use of foreign direct investments in economy of Ukraine is obvious. The aspiration to the openness of economy, increase of competitiveness of national manufacture, a gain of trust in the world market, the participation in the international financial exchange causes necessity of creation of conditions for attraction of foreign investments.

The popular magazine “Times” with the link of International Investment Bank JP Morgan shows the statistic data, according to which Ukraine gave back the foreign investors the profit of 57.1\% last year. It was the highest result among other countries.

\textsuperscript{20} See the Resolution of the Cabinet of Ministers of Ukraine “On Approval of the Regulations on the Procedures for State Registration of Contracts on Joint Investment Activity with the Participation of Foreign Investors” (30 Jan 1997)

\textsuperscript{21} See the draft legislation “On Licensing of Certain Kinds of Business Activity” (1 June 2000)
In the table 1.1 “Times” shows the short list of the best and the worst indexes (the high indexes mean attractive country for investment and low indexes – not attractive).

Table 1.1 – Indexes of investment attractiveness in different countries.  

<table>
<thead>
<tr>
<th>The highest indexes</th>
<th>The lowest indexes</th>
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</thead>
<tbody>
<tr>
<td>Country</td>
<td>Index</td>
</tr>
<tr>
<td>Ukraine</td>
<td>57,1%</td>
</tr>
<tr>
<td>Russia</td>
<td>55,8%</td>
</tr>
<tr>
<td>Nigeria</td>
<td>36,3%</td>
</tr>
<tr>
<td>Ecuador</td>
<td>30,5%</td>
</tr>
<tr>
<td>Cot Devour</td>
<td>29,5%</td>
</tr>
</tbody>
</table>

The Ukrainian index proves that Ukraine is a potentially attractive country for investments as it has a large market, developed infrastructure (though it needs in modernization now), high educational level of the population, highly skilled labour force, favorable geopolitical position.

According to the Ukrainian State Statistics Committee, as of April 1, 2003 the total volume of direct foreign investment into Ukraine since 1992 reached 5604,6 billion dollars.  

Besides we want to notice that the FDI came to Ukraine from 112 countries. Investments were intended for 7794 enterprises, both state and private. The most attractive location for investments in Ukraine are Kiev (1309,1 million dollars), Kiev region (340,8 million dollars), Donetsk region (305,3 million dollars). The total statistics for FDI in Ukraine is shown in the table 1.2 and 1.3.  

22 See Ukrainian News (8 January, 2002)  
23 See The State Committee of Statistics of Ukraine  
24 See the State Committee of Statistics of Ukraine
Table 1.2 – Total Foreign Direct Investment since 1998 – 2002 years.

<table>
<thead>
<tr>
<th>Total Foreign Direct Investment</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>$747mln</td>
<td>$471mln</td>
<td>$593mln</td>
<td>$531mln</td>
<td>Over $700mln</td>
<td></td>
</tr>
</tbody>
</table>

Table 1.3 – Foreign Direct Investment in Ukraine from different countries.

<table>
<thead>
<tr>
<th></th>
<th>The sum of FDI (as for April 1, 2003), USD million</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>5604,6</td>
<td>100,0</td>
</tr>
<tr>
<td>including</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The United States</td>
<td>982,4</td>
<td>17,5</td>
</tr>
<tr>
<td>Cyprus</td>
<td>541,6</td>
<td>9,7</td>
</tr>
<tr>
<td>The United Kingdom</td>
<td>533,3</td>
<td>9,5</td>
</tr>
<tr>
<td>Germany</td>
<td>414,2</td>
<td>7,4</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>401,1</td>
<td>7,2</td>
</tr>
<tr>
<td>The Russian Federation</td>
<td>334,8</td>
<td>6,0</td>
</tr>
<tr>
<td>British Virgin Islands</td>
<td>359,3</td>
<td>6,4</td>
</tr>
<tr>
<td>Switzerland</td>
<td>283,5</td>
<td>5,1</td>
</tr>
<tr>
<td>Austria</td>
<td>226,1</td>
<td>4,0</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>172,1</td>
<td>3,1</td>
</tr>
<tr>
<td>Other countries</td>
<td>1356,2</td>
<td>24,1</td>
</tr>
</tbody>
</table>

From the table 1.3 we can see that the sum of FDI in Ukraine from Germany till the April 1, 2003 formed 414,2 million dollars (5,8 %) of the total input of FDI in the Ukrainian economy.
1.3.3 Factors Contributing to Investment Attractiveness of Ukraine

One can often hear that it is difficult to do business with Ukraine. While for a newcomer it may, to some extent, be true, these difficulties need not be exaggerated, either. The main business risk is the same as everywhere: reliability of business partners. Macroeconomic risk is characteristic of all emerging markets. Another risk is the purchasing power of the population which has to be increased to develop production, otherwise people will not be able to buy goods. As far as political risks are concerned, the results of 2002 parliamentary elections in Ukraine and change of Government have boosted investor confidence. The current situation in the country is the most stable we have had over the past years both from the political and economic standpoint.

The priorities of the new Government of Ukraine that came to power in November 2002 are following: reduction of the tax burden on businesses, introduction of special regimes of investment activities, including concessions, individual product sharing agreements. All of the above should result in additional direct foreign investments of approximately one billion US dollars annually. Our goal is to help to restore a positive image of Ukraine, and there are three arguments which support this stance:

1) 48 million of population (this is closer to the size of France);
2) a great amount of raw materials (fertile black soils, minerals);
3) high level of education coupled with relatively low labor costs.

A number of specific business development opportunities should evoke specific interest in the context of long-term stable growth of all sectors of our economy and significant improvement of conditions for investment and entrepreneurial activities in Ukraine.

The cost and quality of labor in Ukraine are among the most advantageous in Europe. Ukrainian professionals are known for their technical and engineering skills, making them valuable production employees. Literacy rate in Ukraine is 99%.

Besides because of Soviet legacy there is a stereotype that Ukrainians have not enough professional skills compared with their Western counterparts, but this opinion has been
steadily narrowing over the last decade. Dozens of thousands of Ukrainians have improved their managerial skills through western-sponsored educational and professional exchange programs.

With time, the country’s highly motivated entrepreneurs and managers have acquired necessary skills and migrated to high-growth sectors of the economy. Entrepreneurs who began by reinvesting some excess capital into small firms have transformed themselves and their businesses into highly competitive and effective players in the regional marketplace.

Another significant change is that many Ukrainian business people have come to realize the value of incorporating best business practices. They believe that using international practices and standards is the best way to maximize the opportunities of the market and make real and legitimate profit. Corporate governance is the vehicle through which a company’s strategic objectives are set, shareholder and management interests are aligned, and resources are allocated. Until recently, the whole idea of corporate governance was vastly underdeveloped and underutilized in Ukraine. As business transitioned, they saw a number of disputes between shareholders, which reaffirmed the critical importance of having corporate governance in place. As a result, businesses in Ukraine have started discussing and utilizing effective corporate governance standards.

Infrastructure in the country has also changed tremendously over the past decade. In early 1990s, a visitor to Ukraine would likely see buildings requiring major repair, few basic hotels, unreliable transportation schedules, and problems with electricity, water, and communications. This all complicated the life of investors and the daily operations of businesses.

1.4 Conclusion
Perhaps no other country in the former Soviet Union region has experienced such a large gap between economic performance and potential as Ukraine. Endowed with good natural resources, superb agricultural land, a well-educated population, ethnic peace, and a strategic location in Europe, Ukraine was positioned to be one of the most
successful of the former Soviet states in attracting the foreign investment needed to restructure its economy.

The information given in this chapter tells all investors what they should take into account doing business in Ukraine. Here is shown that today Ukraine has the huge potential for foreign investments.

Now investors can notice marked improvements in infrastructure. Rail transportation has improved, including upgrades to both passenger and cargo railways throughout the country. Air transportation has seen similar development, with six metropolitan areas now open to international flights. In telecommunications several private companies have risen to provide competitive, quality services. The cellular field has also seen the tremendous growth, with the industry now supporting more than 3 million subscribers. Finally, the banking sector continues to reform, albeit slowly. While still in an early stage of development compared to Western standards, the banking system now provides efficient and reliable payment clearing.

But despite improvements and developments in Ukraine, there is still significant work to be done, with some crucial areas requiring immediate efforts to sustain and advance economic growth. One of the most important areas is adherence to the rule of law and improvement of the judicial system and enforcement. This is necessary to set a legal framework for honoring private property rights, contractual obligations, and corporate agreements. Corporate governance is another issue that requires continuing efforts to broaden acceptance.

The unstable legal environment of early 1990s caused some problems for foreign investors. Over the past years, the solutions have been found for a number of investment disputes with foreign businessmen.

Ukraine’s business environment is complex and challenging, but it presents unprecedented opportunities to investors who can align the needs of the Ukrainian market with their needs, combine local expertise with the best international practices, and use a practical, hands-on approach in developing the market. The country does offer
long-term investment potential for those who understand the region and follow a careful risk-tolerant program of development.
2. DIFFERENT TYPES OF MODES OF ENTERING THE UKRAINIAN MARKET

There are various modes a German investor can use to expand its activities in the Ukrainian market. Depending on the mode of entry, there are different risks for a German investor doing business in Ukraine. The following section explains the advantages/disadvantages, the risks associated to the various mode entry and also measures to control these risks so as to avoid costly mistakes and opportunistic behavior. Lastly, practical examples of German firms already doing business in the Ukrainian market are also given.

2.1 Exporting into the Ukrainian Market

2.1.1 Definition of Exporting

Exporting is one means by which a German firm or investor can expand its activities into the Ukrainian market. This requires domestic production of the said product in the German plant, domestic administrative control of the production process by German nationals and then shipping or exporting the products into the Ukrainian market for sales.

The exporting activities of a German investor into the Ukrainian market can be described in a time line as follows:

<table>
<thead>
<tr>
<th>T-0</th>
<th>T-1</th>
<th>T-2</th>
<th>T-3</th>
</tr>
</thead>
<tbody>
<tr>
<td>German and Ukrainian firms contract to produce and sell</td>
<td>German firm produces in Germany</td>
<td>Ukrainian firm sells in Ukraine</td>
<td>Ukrainian firm collects profile and pays fixed amount to the German producer</td>
</tr>
</tbody>
</table>

Fig. 2.1 – The exporting activities of a German investor into the Ukrainian market.

From above diagram, we assume that in time T-0 the German investor contacts a Ukrainian sales agent or local partner to sell it’s products in the Ukrainian market. In time T-1 the German firm produces the said product at home in Germany, in T-2, the
products are exported into the Ukrainian market for sales by the Ukrainian sales agent and finally in time T-3 the price of the product are collected by the sales agent and a fixed amount paid to the German investor.

2.1.2 Advantages of Exporting into the Ukrainian Market for a German Investor

2.1.2.1 Cost of Establishing a Production Plant in Ukraine

Since production is carried out in a production plant in Germany, the German investor avoids the huge investments costs which might normally be required for the establishment of a new plant in Ukraine.\(^{28}\) This is a cost saving for the German investor as such capital requirement for exporting into the Ukrainian market is very low.

With a population of nearly 50 million people, Ukraine is in a close proximity to markets of the central and western Europe.\(^ {29}\) With such a huge domestic market for there are opportunities for a German investor to increase its sales revenue, profit base and market share by exporting its products into the Ukrainian market. It is important to note that exporting into the Ukrainian market is not just profitable for large German multinationals, but many small and medium size German investors/firms (small in terms of number of workers and capital) can also benefit form such moneymaking opportunities (increase sales revenue, profits and market shares).

2.1.2.2 Experience and Location Economies

Producing in Germany and exporting into the Ukrainian market may help the German firm achieve experience curve and location economies\(^ {30}\). The export strategy of a German firm should be built around simple principles. One of this strategy is known as “FIDO” which stands for First In (to the Ukrainian market) defeats others\(^ {31}\).

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\(^{27}\) See Wolff/Luca (2003); slide 13
\(^{28}\) See Hill, C. W. (2000); pp. 434
\(^{29}\) See Ukraine 2002 Country Commercial Guide

\(^{30}\) See Hill, C. W. (2000); pp.434
\(^{31}\) See Hill, C. W. (2000); pp.488
With it’s huge population, Ukraine can be considered as a potential economic star. Like most of the countries in the former Soviet Bloc, Ukraine is in a transition period. Considering the fact that there might be economic and political difficulties associated with such transition economies leading to unreliable business climate, few foreign firms might be wanting to enter this market because of fears. However, the German firm/investor should use this as an opportunity to enter the market at this early stage so as to gain brand loyalty and experience in Ukrainian business practices. Since doing business in Ukraine is different form doing business in Germany, the essence of FIDO is to enable the German exporter to gain an advantage over other exporters by getting into the Ukrainian market first and learning about Ukraine and how to sell there before other exporters (first mover advantage).

2.1.3 The Disadvantages of Exporting into the Ukrainian Market for a German Investor

2.1.3.1 High Import Tariffs
Exporting into the Ukrainian market form Germany might be uneconomical because of high tariffs and numerous other non-tariff barriers to trade, including a range of technical and phytosanitary regulations and inspection procedures. Ukraine is not yet a member of the World Trade Organization but has applied to join, and is trying to harmonize their tariff system the WTO requirements. Ukraine employs a two-tiered system of general (full-rate) tariffs and preferential (partial-rate) tariffs. Imports from Western countries are usually assessed preferential tariffs, which vary according to the types of products imported. Import duties largely depend on whether a similar item to that being imported is produced in Ukraine, and if so, the rate tends to be higher. Though Ukraine has a preferential tariff system, their level of protection is still relatively high compared to other countries which are already members of the WTO. Importers face value added tax (20%), import taxes (ranging from 0 to 20%) and fees, and, if applicable, excise taxes (up to 300%)\(^{32}\). Their relatively high tariff level makes the prices of German exports to rise and becomes even more expensive to sell in the Ukrainian market thus affecting the sales and profit potential of the German investor.

\(^{32}\) See Ukraine 2002 Commercial country guide
The impact of tariff on the profit and sales of German investor can be explained in the following graph.\(^\text{33}\)

\[\text{Fig. 2.1 – The impact of tariff on the profit and sales of German investor.}\]

Let us assume S and D to be the Ukrainian demand and supply curves of a certain product produced and exported by a German investor. P is assumed to be the price of the said product before tariff and \(P'\) is the price of the said product after tariffs. SS is the supply curve before tariff and \(SS'\) is the world supply curve after tariff has been imposed. The total demand of the said product is Q4 of which Q1 is supplied by domestic suppliers and \((Q4 - Q1)\) supplied by the German firm. With tariff, the total quantity demanded is reduced to Q3 and at the same time the demand for German exports reduces to \((Q3 - Q2)\). This reduction in quantity demanded as a result of high levels of import tariff has an effect on the profit, sales and the market share of the German firm. However, a draft Customs Code as well as continuing accession negotiations with the World Trade Organization (WTO) offer hope for easier import procedures and lower tariff and non-tariff barriers in the coming years.

\(2.1.3.2\) High Transportation Cost

Though Ukraine is in a close proximity to most markets of Central and Western Europe, high transportation costs can also make exporting from Germany to Ukraine uneconomical particularly for bulky products.\(^\text{34}\) When transportation costs are added to production costs, total cost increase thus it becomes unprofitable to ship certain products over large distances. This increase in cost might limit/reduce the amount of profits to be earned by the German investor.

\(^{33}\) See Nanchane (ST-2003): strategic trade theory and Neo-Protectionism
2.1.3.3 Delegation of Sales Activity to Local Partner
Another disadvantage of exporting arises when the German firm delegates it’s marketing/sales activity to local Ukrainian sales agent.\(^{35}\) Because of high rate of corruption and little trust for Ukrainian business people there is the possibility that the local agent might carry and sell the products of other competitors against the wish of the German investor. This will affect both the profits and sales revenue of the German firm.

2.1.3.4 Cheap Labor Cost
Exporting from the German plant might not be an appropriate mode for the German investor to enter the Ukrainian market. This is so because of the availability of cheap labor in Ukraine, thus it becomes profitable to produce and sell in Ukraine than to produce and export into the than exporting from Germany.

2.1.4 Risk of Exporting into the Ukrainian Market for a German Investor:
Doing business in Ukraine is different from doing business in Germany. These differences come as a result of difference in institutional framework: implicit institutional framework which includes the laws and regulations, the explicit institutional framework which includes the culture, language, and religion etc. Difference in corporate Governance structure which is concerned with the laws regulating various forms of contract. All the above parameters have an effect on the behavior of the Ukrainians.\(^{36}\) Thus, selling in the Ukrainian market becomes more complex than selling the products in at home. The Ukrainian government sets rules regulating business transactions thus exporting in Ukraine will be regulated by the host country’s business rules. Considering that there might not be any specific investment made by the German investor (construction of a production plant, purchase of a state owned firm), the risk of exporting arises from information asymmetry between the partners of the export contract. The asymmetry information comes as a result of the

\(^{35}\) See Hill, C.W.(2000); pp.435

\(^{36}\) See Wolff/Lucas (2003): Session I, Slide 10
difference in the amount of information between the German investor and the local sales agent that is (environmental and preferences).

The Ukrainian Institutional framework (Bureaucratic Legal System / Communism), varies significantly from those of Germany (Free market System). Since laws and regulations passed by governments at all levels, (local or state) influences the way business activities are carried out in Ukraine, the behavioral expectation of the Ukrainian business people varies also from those of German business people and depend on their historical background/environment and the preferences of the individual business people.

Since the Ukrainian sales agent has full information about their culture and their preferences, there is high risk of opportunistic behavior, pursuing own interest against the interest of the German investor. This information asymmetry can be Ex ante, before the sales contract is signed with the local Ukrainian sales agent or ex post after the contract has been signed. This can be presented as follow:

**Fig. 2.3 – Informational asymmetry Ex ante and Ex post.**
2.1.4.1 Adverse Selection Risk of Finding a Local Partner

As in any foreign country, a local partner or representative can provide valuable insight and commercial intelligence that might otherwise be missed by the German investor. A local representative can be especially helpful in newly emerging markets, where a strong business information network has yet to develop. However, before entering into a distributorship or agent agreement, German investors are advised to keep in mind the following points:

While the extent of information on Ukrainian companies has improved slightly, there is still a significant dearth of background data and credit histories on potential Ukrainian distributors. This presents the greatest obstacle to finding reliable, competent local partner. In order to obtain a due diligence report on a potential Ukrainian partner, a German company is advised to contact either a law firm or use the services of the Dun&Bradstreet. Because of the above reasons, the Ukrainian sales agent might have vital information such as their credit history and others which the German investor might not have or even find difficult to obtain. This might lead to adverse selection risk where the wrong sales person might be selected. Also due to weak corporate governance laws and courts’ track records on adjudicating commercial problems, care should also be taken when choosing distribution and marketing partners, and when establishing joint ventures with Ukrainian companies. Dispute settlement can prove difficult, expensive, time-consuming and ultimately unfair.

2.1.4.2 Contract Negotiation

Negotiating a contract with a Ukrainian agent provides a means by which the German firm may initiate, carry on and or terminates it’s operations in Ukraine. As explained in the introduction, at the very initial stage of the negotiation process, foreigner are treated as a stranger and suspiciously. Negotiating a contract with a Ukrainian might be difficult because of their dishonest attitude. It becomes difficult for the German partner to predict the decisions or action of the Ukrainian partner in the negotiation process.

37 See Wolff/Lucas (2003): session 1, Slide 14
38 See Ukraine 2002 Country Commercial Guide
Also because of difference in the language and communication style, it might be very difficult to negotiate efficient contracts.

2.1.4.3 Contract Writing

The other source of risk might occur when writing the contract. About 80% of the population speaks Ukrainian while about 20% speak Russian. Language as part of the Ukrainian cultures differs significantly from the German language. Writing in the Ukrainian language and using the Ukrainian alphabet will be very difficult and will require a translator to do this which might be very costly not very reliable.

Because of the difference in the amount of information posed by both parties, with the Ukrainian partner having more information about their culture and preference, there is the risk of incomplete contracting. An incomplete contract is one that does not contain all the necessary contingencies. Even if the German partner might have knowledge of the Ukrainian partner’s preferences, it might be difficult to predict their future business relationships because of lack of trust and dishonesty. With a very weak and unreliable judicial system, the Ukrainian partner can take advantage of this and behave opportunistically.

2.1.4.4 Moral Hazard

Moral hazard is an ex post information asymmetry risk that occurs after a contract has been signed. The information asymmetric risk occurs because of the difficulty of the German investor to monitor and evaluate the actions of the Ukrainian partner. Since cheating, corruption and dishonesty is partially the culture of most Ukrainian business people, there is the risk that sales persons might carry the products of other competitors against the wish of the German investor.

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39 See Ukraine 2002 Country Commercial Guide
40 See IM I & IM II Lectures
2.1.4.5 Country Specific Hold up Risk

The country specific hold up risk comes as a result of the actions taken by the Ukrainian governments. The Ukrainian government sets rules and laws regulating business transactions in Ukraine. These laws might have adverse effects on the exporting activities of the German firm if the host country’s government decide. The German firms’ hold up risk can refer to profits, which the Ukrainian government might not allow to be transferred to Germany.

2.1.5 Controlling Behavioral Risk in Exporting

The adverse selection risk resulting from informational asymmetry between a German and a Ukrainian firm can be controlled in the following ways:

The German investor can control the information asymmetry risk by reducing information asymmetry\textsuperscript{41}. This can be done by collecting as much information as possible concerning the Ukrainian partner. Also learning the Ukrainian culture, language, laws will provide the German firm with information on how to better handle negotiations and also work with Ukrainian business people thus reducing adverse selection risks. Hiring a translator might be another possibility though it might be very costly.

Also using selection mechanisms such as signaling via certificates and screening via contract menus or test\textsuperscript{42} will enable the German investor to sort and access the different partners, for example past business records or financial situation of the partners. Base on their personal judgment they can be able to determine which partner to deal with.

The moral hazard risk can be controlled by monitoring the actions of the Ukrainian partner or setting standards to evaluate their actions\textsuperscript{43}. Monitoring might be costly and even inefficient in the case of the Ukraine because of their cheating attitude. Incentive systems such as sales bonus payment can be designed (payment based on sales) to

\textsuperscript{41} See IM II handouts (ST-2003): Session 1, Slide 23
\textsuperscript{42} See IM II Handouts (ST 2003): Session 1, slide 23
\textsuperscript{43} See IM II Handouts (ST 2003): Session 1, slide 23
motivate the agents, co-ownership of assets with the local partner. This makes the local partner to feel like part of the company.

2.2 Licensing in Ukraine

2.2.1 Definition of Licensing

If production capacity or a lack of resources don’t allow import, another interesting possibility for German investors in the Ukraine market is to give a licensing agreement. A company (the licensor) grants the rights to intangible property to another company (the licensee) to use in a specific geographic area for a specified period\(^\text{44}\). There are different sorts of licensing possibilities like the Know-how license (entrée to knowledge like production technology), trademark license (the right to use a brand name or symbol) and patent license (permission to use a technology that is protected by a patent), the U.S. Internal Revenue Services classifies additional methods as the copyright for music, literature and films. Especially in East European countries there is a mixed form of patent and know-how license cause most licensees cannot start a production without support from the licensor\(^\text{45}\).

The charge fee a licensee must pay can be a fixed amount (lump sum), a quantity-dependent fee or a profit participation (royalties), Daniel/Radebaugh also mention a “front-end” payment to cover fix costs like transport and consult costs\(^\text{46}\).

![Diagram](Image)

Fig. 2.4 – Licensing between a German and a Ukrainian firm.\(^\text{47}\)

From above diagram, we assume that at a time T-0 the German investor contacts a Ukrainian firm and sign a license agreement. After the signing the German partner

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\(^{44}\) See Daniels/Radebaugh (2001); pp. 489

\(^{45}\) See Wesnitzer (1993); pp. 53

\(^{46}\) See Daniels/Radebaugh (2001); pp. 492

\(^{47}\) See IM II handouts. (ST 2003); slide 15
delivers the production concept or/and the patent (T-1). In T-2 the Ukraine company produces and sells and after the first earnings the German partner gets his royalties (T-3).

An important part of license treaties is the contract duration and the territory borders (only for special countries).

The advantages and disadvantages of licensing are follows:

2.2.2 Advantages of Licensing

2.2.2.1 Market Knowledge

The enormous lack of knowledge of the East Europe market is a main reason for German companies to find a licensing partner in this region. Especially in fast developing technologies it can be important to get a quick entry in a market without the need to know a lot about the market. The partner firm in the Ukraine already has this knowledge and can use it to build up a stable market share of the product and are able to handle the local governmental administration. Especially in the Ukraine it seems to be an important factor, knowing who has administrative power, but also to know, where “additional money” can fasten processes. Wesnitzer mentions, that a lot of firms also use the licensing strategy to test firms in East Europe for a further acquisition.

2.2.2.2 Resources

If the licensor is not big enough or does not have enough resources, licensing is a good strategy. Especially small or middle-sized firms often do not have the resources to send managers to a foreign country or can approve additional fix costs. Instead of running the risk of losing the overview and losing investments in the Ukraine, the company gives this risk to the Ukraine partner. The fast return of investment (of money spent for Research and Development – R&D) vindicates the loss of control over production and marketing processes and still leaves the opportunity to get closer with the partner.

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48 See Segura (2002); SigmaBleyzer
49 See Wesnitzer (1993); pp. 246
50 See Wesnitzer (1993); pp. 198
2.2.2.3 Extension of the Life Cycle of Products

The differences in lifestyle between Ukraine and West Europe is still very high. The need for consumer goods and quality electric articles (washing machine, oven, television, etc.) is growing\textsuperscript{51}. By giving away a license for older German technology (like a fridge), the Ukrainian manufactures can produce these goods and the licensor can still earn money for already amortized R&D money\textsuperscript{52}. In this case the risk of giving away secret technology is very low. There isn’t even a need to give away a brand license – the risk of losing the companies good name does not exist.

2.2.2.4 Avoidance of Transport Costs

The Ukraine is an interesting, fast growing market. Transport costs were already used as an argument against exporting – in this case licensing is a possible solution for companies that do not want to build up a wholly owned subsidiary. Particularly when there is a need for a high number of transports of heavy, big machines with a low price per unit. Another reason seems to be that the road and railway infrastructure in the Ukraine are getting more and more to a bottleneck in the development of this country. The ICPS used several diagnosed indicators that show a dangerous stagnation of building activities. 130 000 km of the 175 000 km roads must be reconstructed, 49% of the capital stock of the railway organization are obsolete. Gleam of hope is the “International Transport Corridor number 5” and the area around the Black sea harbor Odessa were several endeavors have been made to ease the situation of transport\textsuperscript{53}.

2.2.3 Disadvantages of Licensing

The following part concentrates on the general disadvantages of Licensing. Disadvantages like adverse selection of local partners (2.4.1) and moral hazard problematic (2.4.4) have been mentioned already, also several other points like contract writing (2.4.3), ect.

\textsuperscript{51} See Clemment (2002)
\textsuperscript{52} See Meffert und Althans (1982); S.124
\textsuperscript{53} See Clemment (2002); pp. 46
2.2.3.1 Market Distance

“Grace is given of god, but knowledge is found in the market”\textsuperscript{54} - this sentence should stay in mind of every investor that wants to enter a market in the near future. A big problem of a licensing strategy is the distance to the customer and the lack of knowledge about the development of the market. Competitors that are in touch with the market can react faster to the wishes of the clients. Especially in emerging markets it can be a big strategically advantage to know more about changes and new influences. Licensing means a total give away of this important market touch, the licensee is know the toehold in the international strategy of the licensor. For Backhaus/Büschken/Voeth this disadvantage can be avoided through a very good relationship and communication standard between the licensee and the licensor\textsuperscript{55}. But such relationships must grow and need time.

2.2.3.2 Control and Production Quality

With giving away a license, the licensor always gives away other parts of his company: his technology, his management knowledge, his production systems or his name. There are several situations were giving away such “secrets” can end into problems. Main problem is the distance between licensor and licensee, not only geographical but also from the point of knowledge. Does the licensee tell the right sales numbers? Is my partner able to hold the quality standard he agreed to? Is my knowledge safe?

Primarily in the still underdeveloped technical manufactures of East Europe, the control of quality seems to get more and more important for licensors. Capital Expenditure in the equipment of the licensee is often a must for a German partner. Institutions like TÜV Nord\textsuperscript{56} or TÜV Rheinlandpfalz\textsuperscript{57} have decerned this need and expand their business horizons into the Ukraine. The quality problem gets even more important if the licensor is planning to expand into this market within the next years or gives away his name – a bad quality of his licensed products can destroy a name for years. Wesnitzer

\textsuperscript{54} freely adapted from Arthur Hugh Clouth (1848); pt. 4, l. 159
\textsuperscript{55} See Backhaus/Büschken/Voeth (2001);
\textsuperscript{56} See www.tuev-nord.de/1863.asp (2003)
\textsuperscript{57} See http://www.tuv.com/en/ukraine.html
describes a solution in particular for emerging markets: the more the company is able to build up a partnership, the more the licensor also appears as a strategical investor – the more successful is the partnership\(^{58}\).

Fig. 2.5 – The possibility of control in different partner forms\(^{59}\).

The graphic shows the possibility of control in different partner forms. A last problem should be mentioned that concentrates on the point what happens, if a licensing partnership does not succeed. Several reports criticize the behavior of the Ukraine court when foreign companies proceed against a Ukraine partner\(^{60}\). Judges often are influenced by patriotic tendencies, the duration between the file of an action and the

\(^{58}\) See Wesnitzer (1993); pp. 193
\(^{59}\) See Clemment (2002)
\(^{60}\) See Office of the United States Trade Representatives (2002)
final conviction can take years and even than it is not guaranteed that it will be enforced proper. German companies should be aware of this problem.

2.2.3.3 Intellectual Property Rights (IPR)

The security of a company’s knowledge is always a very serious problem, especially when planning to give it away to another company that maybe get a potential competitor in the worst case. To protect such information the World Trade Organization (WTO) has a catalogue of demands that have to be fulfilled when entering the WTO. The Ukraine has applied for membership and the German Ministry of Economy and Technology sees a big development in the right direction – but still there is a long way to go. The Office of the United States Trade Representatives describes a serious piracy problem and the United States have designated the Ukraine as a Priority Foreign Country\(^61\) in March 2001 and sanctioned it in an amount of $75 Million on December 2002. The Office of the US Trade Representatives mentions also several problems with the law enforcement\(^62\). Companies that give away a patent should have enough time and financial reserves to keep up a longer court procedure.

2.2.5. Conclusion

Licensing is an easy way to get a refinancing of research and development costs. Especially when it is possible to give away older technology that is easy to produce, licensing seems to be a procedure with nearly no risk. Because licensing nearly does not need any management, production or capital resources it is a great possibility primarily for small and middle-sized companies. A successful licensing strategy starts with the choice of the partner, and especially in East Europe it seems like licensing is more partner addicted than in other regions. A well running partnership between the German licensor and the Ukraine licensee has great options for further cooperation or even a full market entry – if wanted. It might be, that at the beginning the efforts for starting a

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\(^{61}\) Priority Foreign Countries (PFC): Against these countries the United States Trade Representatives can initiate unilateral investigations with 30 day’s notice. If the violations continue, the country will be sanctioned. (Taken from the Script of Prof. Nachane (2003): The Economics of the WTO; Lecture in Magdeburg SS03, slide 16)

\(^{62}\) See Office of the United States Trade Representatives (2002)
licensing program with a Ukraine partner are higher than in other East European countries, but the huge potential of this country justifies these efforts. It is from enormous importance to keep the risk side in focus. The legal system is not in the condition as it should be to guarantee a stable business procedure. Especially the protection of intellectual property rights is a big problem and makes it insecure, to export sensitive knowledge to the Ukraine. But the Ukraine government is working on these problems and the appliance for membership in the WTO gives a confident feeling about the further development of the Ukraine market.

2.3 Joint Venture

2.3.1 Definition of Joint Venture

Joint ventures, including those between Ukrainian and Western partners, became popular in Ukraine immediately after the start of the transformation to a market economy. They were viewed as a compromise between the customary form of business oriented towards national ownership and the necessity to attract foreign investors and learn foreign business practices. A number of privileges and benefits, including tax exemptions, were offered as incentives to establish joint ventures.\(^{63}\)

In Ukraine’s legislation the term “joint venture” has two meanings:

1) Joint ventures are enterprises established primarily to pool assets of different owners and are of mixed-type ownership;

2) Joint ventures are based on the common capital of Ukrainian and foreign business entities, as well as on joint management and common distribution of results and risks.\(^{64}\)

In practice, however, the term is used for new business entities set up by Ukrainian and foreign founders. This may come about as a result of a foreign investor’s interest in a Ukrainian enterprise (taking possession of stocks and part of its authorized capital).

The availability of a foreign investor is a prerequisite for the founding and functioning of a joint venture. Definite peculiarities exist with the possible participation of state-

\(^{63}\) See Ukraine 2002 County Commercial guide

\(^{64}\) See Ukraine 2002 County Commercial guide
owned enterprises in creating joint ventures. According to existing laws in Ukraine, the State Property Fund of Ukraine and agencies to which this fund delegates its authority are entitled to establish joint ventures on behalf of state-owned enterprises.65

2.3.2 German-Ukrainian Joint Venture

From the above definition, a joint venture between a German and a Ukrainian firm is possible if it meets the conditions given above. Though most joint ventures are 50/50 that is for example a combination of a German investor and a Ukrainian investor. However the number of partners to a joint venture can also vary with more than two partners. In this paper, we will concentrate on a 50/50 joint venture between a German investor and a Ukrainian partner.

The joint venture contract can either be separate or common ownership. In the case of common ownership, both partners contribute their share of the total cost and also negotiate prices together. The profits are shared according to the 50/50 sharing rule already stated in advance when the contract was signed while in the case of separate ownership the partners agree to do a project as visible partners and negotiate separate prices. In both cases, the partners still have total control of their cost after the joint venture contract has been signed.

The joint venture contract between a German and a Ukrainian base firm can be draw on a time line as follows:66

<table>
<thead>
<tr>
<th>T-0</th>
<th>T-1</th>
<th>T-2</th>
<th>T-3</th>
</tr>
</thead>
<tbody>
<tr>
<td>German and Ukrainian firm sign a joint venture contract</td>
<td>both deliver share of cost 50/50</td>
<td>both produce and sell</td>
<td>both firms share the profits</td>
</tr>
</tbody>
</table>

Fig. 2.6 – The joint venture contract between a German and Ukrainian firm.

From the above time line, we assume that the German and Ukrainian partners enter into a joint venture contract in time T-0, both deliver their share of the cost in time T-1. In

65 See Wolff/Lucas (2003); Slide 12-16
66 See Wolff B./Lucas (2003); slide 12 &16
time T-2 they both produce and sell the said products and finally in T-3 profits are collected and share according to the sharing rule 50/50.

2.3.3 Advantages of a German Ukrainian joint venture

2.3.3.1 Local Partner knowledge
A German Ukrainian joint venture will enable the German investor to benefit from the Ukrainian partners’ local knowledge of competitive condition, language, culture, political. Ukrainian business practice are quite different from those of German. Taking advantage of the cheap and skilled labor force, the best and successful German-Ukrainian joint venture should involve the German investor providing the technological know how and product while the Ukrainian firm provides marketing expertise and local knowledge needed for competing in the Ukrainian market. This will also enable the Ukrainian partner learn German business style/practice.

2.3.3.2 Shared Risk
Like most of the of the former Soviet block, Ukraine is undergoing transition. The rules of law remains in it’s infancy, courts remain weak and are subject to political pressure, the basis of corporate governance is weak. With an ever evolving political system, unreliable judicial system, there is a high risk of doing business in Ukraine. In case of any risk, the total exposure is then shared between the two partner. In risk might even be reduced significantly if the other partner happens to be the state or other persons playing an influential rule in the Ukrainian decision making process.

2.3.3.3 Shared Cost
According to transparency international, Ukraine is ranked 85-th on the list of most corrupt countries of a total number of 102. The lower the potion, the higher the corruption level. The Corruption perception index for Ukraine is 2.4. The CPI score ranges between 10 (highly clean) to 0 (highly corrupt). Also a world bank study published in 2002 ranked Ukraine among the worst Eastern European nations in terms

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67 See Hill, C. W.(2002); pp. 144
68 See Ukraine 2002 Country Commercial Guide
of both administrative and state corruption. The world bank defines administrative corruption as the taking of illegal payments. While state corruption is defined as occurring when politically influential individuals or groups use their power to appropriate for themselves section of the economy. A survey conducted by the International financial corporation (IFC) says 100% of all firms indicated they were compelled to pay unauthorized fees to obtain government service such as permits.

Also, large part of Ukrainian infrastructure date back to post World War II period. Economic decline, investment cutbacks, and insufficient service charge have led to deteriorating state of the infrastructure.

Bribery leads to additional costs of investment and increases the total investment cost. Also because of poor infrastructure, additional cost might be needed for construction. Thus Entering a joint venture contract with a Ukrainian firm enable them to share this total cost which either of them might not be able to support alone.

2.3.4 Disadvantages of a Joint Venture
2.3.4.1 Lack of Control over Know-How and Technology
A joint venture between an German and a Ukrainian firm implies the sharing of knowledge and expertise which to achieve a competitive advantage over other firm. However because of lack of trust in the society there is the risk of the German partner losing control over their technological know-how. For example the Ukrainian firm can quickly learn the technological know thus competing with their German partner in other markets, and on the other hand, the German firm can also quickly learn the marketing techniques of how to sell in the Ukrainian market and also establish their own distribution channels.

70See Ukraine 2002 Country Commercial Guide
71 See Ukraine 2002 Country Commercial Guide
72 See Ukraine 2002 Country Commercial Guide
2.3.4.2 Less Control over Ownership

A 50/50 joint venture between a German and a Ukrainian firm implies shared control and ownership rights of all the assets. Because of shared ownership and control, German investor cannot implement total control, co-ordinate activities and apply instructions from the head office in Germany.

As already explained in the introduction, Ukrainians are not obsessed with their jobs, like taking longer breaks and they leave early from work while the Germans are hard-working and require little supervision. Because of this culture Ukrainians will prefer to free ride on the Germans leaving to do all the work after all they get half of any profits earned. The German investor will face reduce incentive to invest in optimal technological process that can lead to cost reduction because they do not have total control on the profits earned thus the Ukrainian population ends up using outdated technology.73

2.3.4.3 Conflict of Interest

There is always a battle for control between the investing parties to a joint venture. Each party tries to pursue their individual interest even at the cost of the other partners. As one partner has increased access to the other knowledge and know-how, it depends less on the other parties expertise thus increasing the bargaining power of the partner concerned. This increase in bargaining power often leads to conflicts over control of the joint ventures strategy and goals.

2.3.5 The Risk for a German Investor Entering into a Joint Venture Contract with a Ukrainian Firm

The risk of a joint venture contract between a German and a Ukrainian depends on the type of ownership (common or separate ownership). However no mater the type of ownership, producing and doing business in Ukraine differs from that in Germany. This is because of difference in institutional framework (culture, language and legal system)

73 Wolff/Lucas (2003); Slide 12-15
cooperate governance structure which has an influence on the behavioral expectation of all Ukrainian business people.

Taking into consideration these differences, operating/producing in Ukraine is a more complex task for the German investor because management tools and styles applied in Germany might not lead to costly mistakes if applied in Ukraine. The risk for a German investor can be classified as follow:

Ex ante behavioral risk: Adverse selection
Ex post behavioral risk: Moral Hazard
Hold up risk

In a German-Ukrainian joint venture, there might be two contract partners whose behavior have to be predicted:
- The Commercial partner in the joint venture.
- The Ukrainian Government.

2.3.5.1 Adverse Selection

The adverse selection risk of a joint venture contract between a German investor and a Ukrainian might occurs as and result of asymmetry information between the two partners concerned. That is the amount of information posed by the both parties before the joint venture contract is signed might be different (hidden characteristics/hidden information).74

Because of the very high level of corruption in Ukraine, Ukraine can be considered as a very low trust culture. As already explained in the introduction, Ukrainian people find themselves often having to make the choice not between honesty and riches but between dishonest dealings and survival. In a country where corruption is part of their culture and where every most individual are struggling to be dishonest in order to survive, it becomes even more difficult to get actual information about the characteristics of the Ukrainian partners. In this case, the Ukrainian partner has more information then the German partner. This difference in the amount of information has an adverse effect on the writing of the joint venture contract thus leading to incomplete contracting as a result of certain missing items.
As a result of the above reasons, there is a very high risk of opportunistic behavior on the part of the Ukrainian partner who might want to take advantage of this information difference. Coupled with the weak system of justice that exists in Ukraine, a bridge of contract might not be taken very seriously.

2.3.5.2 Moral Hazard
Moral hazard occurs in a situation where the partners cannot monitor and access the actions of the each other after the contract has been signed (hidden action/hidden information). It might be difficult for the German investor to access the Ukrainian partner if at all they are putting in the required effort needed in the joint venture or they are pursing their own interest as opposed to the interest of the joint venture.

2.3.5.3 Hold up Risk
A number of privileges and benefits including tax exemptions have been offered by the Ukrainian government to encourage the establishment of joint venture contracts in Ukraine.

Also another specific feature of the joint ventures’ joint venture legislation should be noted: The special regime of protecting founder right and interest which are determined at the legislative level. This legislation stipulates that foreign investments in Ukraine are not to be nationalized state administration. Despite all these measures taken by the Ukrainian government, it becomes even more apparent to investors that the country’s foreign is sorely lacking in predictability.\(^{75}\)

Though the government has taken and made all the above measures and others to encourage and protect ownership rights, there is still a potential hold up risk for the German invest. After the contract has been signed and specific investment made, there is a potential risk that the Ukrainian partner might decide to hold up the German investor by making additional demands which were otherwise not stated in the contract.

\(^{74}\) See Wolff/Lucas (2003); Slide 24
\(^{75}\) See Wolff/Lucas (2003); Slide 24
because they know the German partner has sunk costs and has very little outside options.

The Ukrainian government sets rules and regulations which regulate business practices in Ukraine. With the lack of predictability of these rules there is also a behavioral risk caused by the government which might try to intervene into the joint venture activities. There is also the risk that the government might set or change laws which might have adverse effects on the functioning of the joint venture. Examples of this rule might include rules regulating and preventing the amount of profits the German investor might be allowed to transfer back to Germany.

2.3.6 Controlling Business Risks in Ukraine
Given the difficulties of doing business in Ukraine, it is advisable the German company to perform its own feasibility study before starting a project in Ukraine. Numerous opportunities in Ukraine carry a significant level of risk. The first step in undertaking a project in Ukraine is knowledge – knowledge of costs, risks, and returns. Two principal risk factors are involved: commercial and legal. Most of the risks are legal, permission related, and practical. Business tools applied in Germany might not be applicable in the Ukrainian market. Applying this the German style of doing business in Ukraine might lead to costly mistakes. The nuances and various possible interpretations of Ukrainian laws, rules, and regulations make it almost impossible for one person to understand all the possible ramifications. In order for a contract to be truly enforceable in Ukraine one should have a lawyer, an accountant, and an interpreter even if you are fluent in Ukrainian or Russian.

Official State statistics are often unreliable, and understanding market dynamics in Ukraine comes down to informed opinion. Local surveys and “experts” should be treated with some caution, as their objectivity can tend to be blurred by vested interests.

There is no viable system for checking the financial status of a Ukrainian partner, and information on bona fides of potential Ukrainian partners should be treated with care. It
is not a practice in Ukraine for banks to provide information on the financial status of their clients. 76

The above risks for a German investor entering a joint venture contract with a Ukrainian firm can only be reduced in the following ways.

The adverse selection risk resulting from information asymmetry can be reduced by learning and acquire knowledge about the joint venture partner. As said above, since there is no viable system to check the financial status of most Ukrainian firms, the German firm should be very careful and can use selection mechanisms such signaling via certificates or screening via contract menus and tests to help in sorting and selection of the right partner:

The hold up problem resulting from specific investment can be reduced by a vertical integration in the form of a merger or acquisition with the Ukrainian partner. Such integration gives the German investors ownership right and control on all the assets and profits that may results from using the assets. Thus with the German investor faces undiluted incentives in investing in optimal technological process aimed at reducing the costs because they have rights to all profits resulting from the investments. The German investor does not have to depend on the Ukrainian partner any longer.

The German investor can also reduce the risk of hold up by avoiding specific investment in Ukraine. Rather than engaging in joint venture contracts with Ukrainian firms, the German partner can use other means of entering the market such as Exporting Licensing or Franchising which does not require any specific investment.

Finally, the joint venture partners might decide to redesign their joint venture contract to suit the present business situation. This contact should state which partner manages which part of the operations, how will each partner buy from, sell to or use intangible assets that comes from the joint venture, methods of testing quality and geographical limitation on the use of assets.

76 See Ukraine 2002 Commercial country guide
Contracts are hardly being followed in Ukraine and it is even worthless to put your fate in the hands of the unpredictable Ukrainian courts. Recent court decisions, rulings, and regulations have shown that unless contracts in Ukraine contain very specific detail they may be totally unenforceable. The letter of a contract is more important than its intent, which like “industry standards” or other such concepts is not readily recognized in Ukraine. Only the written word and the specific subject, as defined by law, have meaning. Because of these reasons, designing a new contract will hardly help in reducing the problem of Hold up associated with a German Ukrainian joint venture contract.

In entering into a business partnership with the State, it is highly recommended that the German investor ensure the State has put all of its decision-making powers in the hands of an independent manager.\textsuperscript{77} This also reduces the risk of government intervention into the management of the joint venture and ownership rights.

\textbf{2.3.7 Conclusion}

Ukraine constitutes a new, emerging, and unexploited market. With the huge population of about 48 million inhabitants and cheap labor cost, there is a huge potential for a German investor to increase profits, sales and revenue. Taking into consideration the various amendment and actions make by the Ukrainian government, and also considering the fact that the country is changing from communism and bureaucratic to a more free market system confirming to more western style, there is a good advantage of the German investor to enter the Ukrainian market. Early entrant will also provide a German investor first mover advantage over other late entrants. This enable the German firm to collect and establish information on how to operate in the Ukrainian market and also enable them to establish a competitive advantage over all other competitors.

Doing business in Ukraine differs significantly from doing business in Germany. The German investor has to be conscious of these differences so as to avoid costly mistake

\textsuperscript{77}See Ukraine 2002 Country Commercial Guide
that might occur as a result of ignorance. These differences come as a result of
different institutional framework, culture, language and corporate/contract law system
between Germany and Ukraine. These differences in effect have an influence on the
behavioral expectation of Ukrainian business people.

For a German firm to succeed in such a transitional economy with an ever evolving
legal system, it has to make important decisions on which mode of entry to use. The
investor has to weigh the costs, benefits and the risks associated to the various entry
mode and should choose the one with the lowest cost, risks and at the same time with
the highest predicted revenue and profit.

There are also potential risks of doing business in Ukraine. Depending on the entry
mode selected by the German investor, there might be two contract partners who’s
behavior has to be predicted in: the commercial or business partner in Ukraine and the
host country’s government. The adverse selection, moral, hazard and hold up risks
comes as a result either information asymmetry between the partners or one sided
specific investment risks.

There are very interesting sectors in the Ukrainian market. The decision on which
sector to invest in depends on the type of product. The practical example section
explains examples of German firms already functioning in the Ukrainian market.

2.4 Foreign Subsidiary and Foreign Branch
Foreign subsidiary is defined as a legally, separate company even if the parents
(investors) owns all of the voting stock(full-scale subsidiary)\textsuperscript{78}. A foreign branch
whereas is a company part where the parents must own 100% of the companies stock
and is not legally separated from the parents company\textsuperscript{79}. In East Europe we will
primarily meet the foreign subsidiary cause of the legally independent creditors or
judges don’t have access to the other resources of the investing company. Wesnitzer
does not make these differences, in his book he defines only two types of direct

\textsuperscript{78} Daniels/Radebaugh (2001); pp.541
\textsuperscript{79} See Daniels/Radebaugh (2001); pp.541
investment: Joint Ventures and foreign subsidiaries. In the following part there will be no differences made between branches and subsidiaries, additionally the ownership structure will be without any partners (100% ownership). This type of investment means that the investor has two different possibilities entering the new market. The first one is to build up a new company or to acquire a already existing firm.

Fig. 2.7 – Subsidiary between a German and Ukrainian firm.

There is one important question when opening a foreign subsidiary: does the host country’s government allow to transfer money? The law of foreign investment from April, 25, 1996 is the most important law for foreign investors. This law gives them the same status as Ukraine companies and means a lot more security for foreign investors. It allows the transfer of profits to the home country and it also guarantees the ownership rights of foreign investors. An additional security is the investment treaty between Germany and the Ukraine from 1996 which provides cover for German investments. The only different between foreign investors and Ukraine investors is that foreign investors are not allowed to buy Ukraine ground. Like several other East European countries, the Ukraine introduced this law as an protection against a foreign buy-out. Foreigners can rent territory for 50 years with a guaranteed extension. These legal bearings of the case are basically preconditions to invest in a country.

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80 See Wesnitzer (1993); pp. 54
81 See Wolff/Lucas - IM II (ST 2003); slide 17
82 See [http://www.ukraine-business.de/Gesetze/Auslandische_Investitionen/auslandische_investitionen.html](http://www.ukraine-business.de/Gesetze/Auslandische_Investitionen/auslandische_investitionen.html)
83 See [http://www.botschaft-ukraine.de/_validation/investitionsbedingungen.htm](http://www.botschaft-ukraine.de/_validation/investitionsbedingungen.htm)
2.4.1 To Acquire or to Set Up a New Operation

An important strategic decision when planning to open a subsidiary in a foreign country is the decision to acquire or to open a new operation. Several reasons strengthen argumentation for acquiring a already existing company. The most important argument is the safe of time. The avoidance of inefficiencies during the start-up period and the immediately cash-flow\textsuperscript{84} are the most important reasons for Daniels/Radebaugh to enter the market with an acquisition. Further they mention the possible difficulties of finding equivalent employees and the difficulty of transferring special resources to the new operation\textsuperscript{85}. Volkhart Vincentz from the Osteuropa-Institut München and a member of the German consulters group in the Ukraine notes the problem of the requirement of credits from Ukraine or foreign financial institutions for an investment. Because the high assessment of risks of doing business in the Ukraine, fund raising often gets very difficult or inefficient\textsuperscript{86}. If the German company is planning to use the brand of the Ukraine company it can safe a lot of marketing costs and use the already existing customer relations\textsuperscript{87}. But of course there is one important part when thinking about acquiring a company in the Ukraine: a desired company must be existing.

The time of the real big market reorganisation in East Europe after the opening of the borders seems to be over. A lot of former state owned enterprises (SOE) have been divested and privatised and it seems that the “high-potentials” are already sold out. But several sources like the European Investment Bank\textsuperscript{88}, the East European Institute in Munich\textsuperscript{89} and the International Centre for Policy studies\textsuperscript{90} mention that because the slow reform speed in the nineties there is still a great lack of privatisation in the Ukraine. But when taking over a Ukraine company, German entrepreneurs should be aware of that a take over means also a take over of the old problems like old machines, inefficient management structures or a bad working moral. When building a new manufacture it is possible to save a lot of modernisation costs. Especially firms with a high-tech

\textsuperscript{84} See Daniels/Radebaugh (2001); pp.281
\textsuperscript{85} See Daniels/Radebaugh (2001); pp.281
\textsuperscript{86} See Vincentz (1999) taken from an article for the newspaper “Monitoring investitsinoi dyial’nosti v Ukraini”, 1999
\textsuperscript{87} See Daniels/Radebaugh (2001); pp.281
\textsuperscript{88} See Europbank Investment Guide Ukraine (2001); ISSN 1470-3963
\textsuperscript{89} See Clemment (2002)
\textsuperscript{90} See Policy Studies (2000); pp. 43
knowledge are adapted to newest machines. Companies can introduce their corporate identity and their management structure without taking the risk, that the old management resist against the “new style” Also the choice of the location can be very important cause the Ukraine government has installed several special economic zones. Running for subventions most governments prefer to support new investments\textsuperscript{91}. When making the decision “Buy-versus-build”\textsuperscript{92} these thoughts must be considered.

2.4.2 Advantages of foreign subsidiary

2.4.2.1 Partner independence

A problem, that repeats through all topics that have to do with other companies: how can I trust my partner. In this case the advantage just is that there is no partner. No moral hazard problem, no questions of adverse selection – just you and your company. For a lot of companies this seems to be the best opportunity, especially when there are special corporate particularities. Managers questioned why they would prefer a wholly owned subsidiary often answered that they do not want to compromise in important questions\textsuperscript{93} like the marketing strategy of a brand, the usage of the earnings (Answer of a manager: They (in this case a polish partner) prefer to built a pool than to invest in R&D)\textsuperscript{94} or the quality level. The disadvantage of less knowledge of the market can be moderated through a good mixture of local and German managers. Companies like FESTO in Bulgaria try to use only local managers (also in leading positions) – and are very successful with that polycentric strategy. East European partners often hope to get a part of the profitable trade with western countries to get devices. For the German investor this could mean a loss of market power in its own country because the Ukraine products might be cheaper\textsuperscript{95}. By investing in a subsidiary the investor can follow is own aims and collect all of the earnings – also an important argument when looking at a developing market.

\textsuperscript{91}See Daniels/Radebaugh (2001); pp.281
\textsuperscript{92}See Daniels/Radebaugh (2001); pp.280
\textsuperscript{93}See Wesnitzer (1993); pp.255
\textsuperscript{94}See Wesnitzer (1993); pp.265
\textsuperscript{95}See Wesnitzer (1993); pp. 255
2.4.2.2 Higher Earnings Possibilities

Building up a manufacture in the Ukraine means no only taking the whole risk, but also taking the full earnings. On the one side risks are getting lower and lower, formerly problems like political instability, visa restrictions or currency fluctuations are not existing anymore, on the other side the potentials are growing and get a strong support through the Ukraine government. Special economic zones like Donetsk give strong incentives to the investor and make it easier to invest – and to get a higher return of investment (ROI). The decision to use the Ukraine as a basis for export business to other East European countries can be a high profitable operation. Alexei Sekarev talks about good conditions for trade with Russia\(^96\) as well as trade with Moldavia, Belarus, etc. The low level of wages makes it possible for the German investor to produce products for a price, people can afford.

2.4.3 Disadvantages of Foreign Subsidiaries

2.4.3.1 Commitment of Resources

Investing in a new country on its own always means making a big step. But it is not only the risk; also the commitment of home resources can become a problem. Capital resources must be used to acquire a company and to modernize it or to build up a new operation. But also the commitment of manager resources to make the investment run profitable can mean less productivity on the home market and a loss of market shares. Especially middle sized companies are running danger that they have to spent too much of their capital cover or that managers get lost in details of the foreign investment and cannot concentrate on their job.

The allowance to do business is still to come with licenses attached and it is reported that the process to get or not to get a license sometimes seems to be arbitrarily\(^97\). SigmaBleyzer compared the time spent on regulatory issues in several East European countries and got a discouraging result for the Ukraine.

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\(^{96}\) See Alexei Sekarev (1995/96)
\(^{97}\) See Vincentz (1999)
Especially German managers that are used to rules between governmental authorities and companies will have to face a new world. “The East European countries are new markets, where the rules have to get established first”\textsuperscript{99}. Wesnitzer mentions this after interviewing German managers that are running investments in the Ukraine. Corruption is still a big problem – no matter if to get a license or to get an “insurance” (mafia slang) for your properties. In the Ukraine this can make 7 % of the revenues, compared with only 2% in Poland or 4 % in Russia (see Fig.2.9).

Companies must calculate these costs when planning an investment in the Ukraine also the East European Institute in Munich recognises an enormous betterment in both problems – corruption and bribery\textsuperscript{100}. These are signs for a further stability and should motivate for further investment.

\textsuperscript{98} See Segura (2002); pp.7  
\textsuperscript{99} See Wesnitzer (1993); pp. 207  
\textsuperscript{100} See Clemment (2002)
2.4.3.2 Low Productivity

When calculating production forecasts and outlooks for earnings managers must include the lower productivity of Ukraine workers. Different sources mention different numbers, the news agency AP uses the number of 50%\(^{102}\) work productivity compared to western colleges while the European Bank for Reconstruction and Development (EBRD) notes a productivity rate of 70%\(^{103}\). Several reasons like old machines, bad payment and bad management are reasonable for these circumstances but it seems like that there is a positive change of this factor. To reach the same level as in Western Europe still a long time will pass. Consulters of the EBRD forecast at least 15 years to reach that level what West Europe has today. But a good management and modern machines can equal this disadvantage.

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\(^{101}\) See Segura (2002); pp.9
\(^{102}\) See AP; article from the page: www.wsws.org/de/2002/jul2002/ukra-j20.shtml
2.4.4 Conclusion

Building up or acquiring a new operation in the Ukraine is a great opportunity – when the company has the resources. The chances in this growing market are confident and the possibility to use the Ukraine as a base for further expansions or exports into other East European countries makes a realization of profit likely. The question how to enter the market has to be considered carefully, this decision is the general basis for success. As said the Ukraine is still a market where rules have to be defined. A partner can help in some of these cases, but this goes always along with compromises. If the company has a good product and the management and money resources to persevere probable difficulties at the beginning, it should enter the Ukraine market on its own. Good Ukraine employees and a clear strategy will equalize problems like corruption and the missing of market knowledge.
3 PRACTICAL EXAMPLE OF COOPERATION BETWEEN GERMANY AND UKRAINE

3.1 Export

3.1.1 Car Market in Ukraine
One of the main profitable sectors of market in Ukraine for exporting from the side of Germany is car market. The quality of locally produced cars is much lower than quality of average car produced in Western Europe. Thus, the demand on foreign cars and for autoparts is growing.

The number of automobiles operating in Ukraine now approximates 4.5 million vehicles, which have an average age of 12.5 years. Of this amount, 500 thousand are western type used cars, although many are in poor technical condition, and 200-300 thousand are approaching end of useful life. Local automotive experts predict that demand for used share parts for such cars will increase strongly in the next year in Ukraine. Moreover, the number of used cars is increasing, due to their reasonable cost, which matches low income of most Ukrainian motorists. Of the 4-7 percent annual growth of cars owned by Ukrainians, an estimated 25 percent are used cars imported from Western Europe. The most popular Western brands are Volkswagen, Mercedes, Ford, BMW, OPEL, Fiat, Toyota, Nissan and Renault.

The Ukrainian market for used autoparts in Ukrainian cities is still in infancy. The main suppliers of used automotive parts in Ukrainian cities are automotive service stations, which buy crashed and obsolete used cars, and get them dismantled for spare parts. There is no big commercial salvage enterprises in Ukraine involved in large-scale automotive dismantling business. Kyiv, for example, has only tan of such stations. At the same time only few of service depots refurbish used spare parts. Beside these service stations, there are numerous small firms and individuals that buy crashed cars. Often they specialize in dismantling one car brand and network with one another on parts available. Automotive flea markets are also important. But not every used spare part is in high demand. The strongest demand is for front and back lights, bumpers, radiator grills, wheel disks and calipers, bonnet (hood) and trunk lid (hood), windshields, front glass, wings, trunk lids.
Rarely are suspensions from dismantled cars sold because of their poor condition (caused by bad Ukrainian roads), and engine parts (due to long life and reliability of Western-manufactured engines). Most in demand are parts for OPEL, BMW, and Volkswagen. Most of Western car brands have already authorized dealers, which have their own repair and maintenance centers in the major cities of Ukraine.104

Ukrainian car market is developing and gives the opportunities for foreign exporters to operate on it with great profit. According to the Ukrainian Market Review105 data, the supply volume of trucks (group 8704 in CC FER) produced in Germany into Ukraine exceeded USD 30 million in 2002, which was 45% higher than analogous figure of 2001. In the structure of import, the part of these goods takes about 2%. The volume of these articles exceeded 25 thousands tons.

Automobiles import (group 8703) in financial value exceeded USD 112 million that was 1.5 times more than analogous last year figure. In the structure of Ukrainian-German import, this commodity group takes about 6%. The import volume in physical terms came to 9.5 thousand meters. The leading subgroup – new automobiles and other vehicles for people transportation with engine volume more than 1,500, but not less than 2,200 cubes square meters in the quantity of 5 thousand meters and in value of more than USD 50 millions.106

3.1.2 BMW Company and Export of its Production onto Ukrainian Market

One of the most successful and popular Western brands which operate in Ukraine is BMW company.

In 1920 AWT Handels Gesellschaft mbH Vienna Company (Overall trustee of goods Ink.) was founded by the Austrian credit Institute of Trade and the Industry. First main activity of the company was devoted to diversified trade between the East and the West.

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104 See www.spareparts.com
106 See Ukrainians news www.ukrtop.com
Since the beginning of 80th the Trade House of Austria Creditanstalt Bank carries out its own activity using the name: AWT Handels und Finanzierungs AG Vienna. Its filial AWT Handels Gesellschaft mbH Vienna was founded then. AWT Handels Gesellschaft mbH Vienna (Austria) is the founder and owner of AWT Bavaria Kiev Company, which began to work in Ukraine since May 1997, after perspective contract has been signed between “AWT Handels Gesellschaft mbH Vienna” and VMW AG. Nowadays AWT Bavaria is the representative of BMW in Ukraine and one of the most important enterprises of its kind in the Eastern Europe.

For the last several years the dealer network of BMV has been successfully developed; stable sales, reliable and professional services were adjusted. Company facilities occupy about 4000 sq.m territory; its staff is more than 100 persons.

Clear profit of the company Bayerische Motoren Werke (BMW) (Germany) for the second quarter of 2001 year was EUR 525 mln. ($462), it is twice hire than in the last year. Growth of sales volume was the result of export. Ukraine is among of the biggest importers of BMW cars and autoparts.\(^{107}\) As was reported by the “Akkumylator news” BMW has increased volume of sales on 9%. For the first six months of 2001 year company sold 460 thousand cars. In Ukraine 1,7 thousand were bought.\(^{108}\)

As for the 2002 year the volume of sales for 9 months has increased to 20% and achieved record index. In spite of global decrease of automobile industry BMW has benefit. It is because of new automobile novelty – Mini. Volume of sales of trade mark BMW and Mini has increased for 20%. It was 805,8 thousands automobiles. In the last year during the same period this index was 671 thousand In Ukraine 2 thousands cars were sold in 2002 and 1,7 thousands cars in 2001. The most popular model Mini was sold in the quantity of 105 thousands in the world and 0,4 thousands were exported in Ukraine. The volume of export has increased on 25% in Ukraine and on 28% in the world.

\(^{107}\)See [www.carclub.com](http://www.carclub.com)
\(^{108}\) See [http://news.battery.ua](http://news.battery.ua)
According to the forecast made at Ukrainian-German the Chances and Risks of Open Society forum of young leaders by Wolfgang Schlimme, the Sales Director of BMW in Ukraine the 2003 official figures as to BMW car sales in our country should show 34% increase on the year. The German concern forecasts selling 4,800 BMW cars in Ukraine over the year 2003. Mr. Schlimme also said that since the beginning of the year 2002 2,241 BMW cars had been assembled at the Avtorotor plant in Kyiv as compared with 2,132 cars assembled over the whole year 2001.109

In conclusion, from the information below BMW concern is growing and developing all over the world. Its export in Ukraine is profitable as for the company as for the economy of this country (appropriate taxes on foreign cars bring profit in the property of the government).

3.2. Joint Venture
3.2.1 Agricultural Market in Ukraine
Agribusiness sector has been among the more rapidly growing sectors of the economy, and remain areas of potential growth in the future. The sector's potential will dependent on the government's commitment to transparent privatization and land-reform policies in agriculture, particularly through passage of a land code that was pending in the parliament in June of 2001. Many farm producers remain heavily indebted to the government for past deliveries of agricultural inputs, limiting ability to sustain growth in the agricultural sector. The market for pesticides in Ukraine is fairly large. According to the “Ukraine 2002 Country Commercial Guide”, the estimated annual size of the pesticides market in Ukraine is $200-225 million. The overall annual shortage in supply is currently estimated at 35,000 tons, needed to cover an area of 19 million hectares. Over 30% of the annual harvest is lost due to controllable insects, fungi and weeds.

In the last five years it has been increasingly difficult for Ukrainian agricultural producers to secure necessary pesticides and other agricultural chemicals. Local pesticide and agricultural chemical production meets only 20% of the country’s annual

109 See “Robsalt”, 29/06/2002
needs and is based upon the ability to purchase imported raw materials. While the local production of pesticides utilizing local compounds is expected to meet 15% of the total demand in 1998 and 25% by the year 2000, Ukraine will still need to rely on imported chemical compounds to meet the demand for pesticides. Despite the government's move to foster and increase the country's pesticide production base, a lack of capital and technology and unfavorable tax policies hinder such development. It is generally more economical to import pesticides than it is to produce them domestically by own means. The Ukrainian agricultural sector offers German companies opportunities in joint production or in simply providing the Ukrainian market with the necessary seeds, pesticides, and herbicides. Many farms have large debts owed to agrichemical companies, and the government tends to lay first claim of grain and produce; therefore, financing is a critical issue.\footnote{“Fermerskoe hosaistvo”, 5/09/2002}

Many opportunities are available for German companies in the Ukrainian agricultural machinery market. There is currently a critical demand for dependable farm machinery, due to the lack of reliable domestic manufacturing. The Germany currently holds 5% of the agricultural machinery market in Ukraine. The best prospect for German companies is to invest in the manufacturing of equipment in Ukraine. Simply exporting agricultural equipment to Ukraine can be costly: the Ukrainian government plans to increase import duties on agricultural machinery, has no plans to purchase equipment under government sovereign guarantee, and will support domestic manufacturing. In the beginning of 1998, Ukrainian farms had 361,000 tractors, 72,000 grain-harvesting combines, and 37,900 fodder-harvesting combines. The actual needs are for 515,000 tractors, 86,000 grain combines and 50,000 fodders combines. It should be noted that 60% of domestic agricultural machinery is fully-depreciated. The demand for basic farm machinery and equipment is quite critical. However, there is a dramatic difference between demand and the actual ability to purchase the machinery. Post estimates this rate (actual ability to purchase versus demand) at 50%. There are approximately 100 plants that manufacture a range of agricultural machinery. Generally, production rates at Ukrainian plants are running at 10-20% of capacity. This low percentage is due to a lack of working capital, the poor financial situation of farms, and a lack of new technologies. According to the
Ministry of Statistics, there are 15,739 agriculture enterprises, including collective agriculture enterprises (10,252), state agriculture enterprises (4,440), joint stock companies (699), and agriculture cooperatives (348). The main end-users of agricultural machinery are these agricultural enterprises, private farms (36,000), private distributors, and newly-established machinery stations. Both agriculture enterprises and private farms share similar problems, that is, a lack of working capital, price disparity, no access to affordable credit, a decrease in state support, and governmental interference in the farmer's decision-making process. There are many indirect barriers such as certification procedures, licensing, taxation, and lack of local financing.

Table 3.1 – Market size data (in $ millions):

<table>
<thead>
<tr>
<th>№</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>Total market size</td>
<td>425</td>
<td>430</td>
<td>495</td>
</tr>
<tr>
<td>2</td>
<td>Total local production</td>
<td>315</td>
<td>330</td>
<td>360</td>
</tr>
<tr>
<td>3</td>
<td>Total exports</td>
<td>100</td>
<td>100</td>
<td>104</td>
</tr>
<tr>
<td>4</td>
<td>Total imports</td>
<td>180</td>
<td>200</td>
<td>210</td>
</tr>
</tbody>
</table>

There are about 30 manufacturers of agricultural machinery in Ukraine, including two grain harvester producing plants in Kherson and Alexandra, one corn harvester producing plant in Kherson, six sugar beet harvester producing plants with the major one in Ternopil and three plants manufacturing tractors.

The existing stock of agricultural machinery includes 216 thousand tractors and 49 thousand grain combine harvesters. According to industry spokespeople, current depreciation of agricultural machinery and equipment is equal to 75% of total stock, so the need to replace basic farm machinery is becoming critical. However, the gap between need and ability to purchase is huge.
German-Ukrainian agricultural companies have a good reputation in Ukraine. For example, German-Ukrainian company “AGROS”. Its representative office is located in Bila Cerkva, with branch offices in Kyiv, Konotop, Gusatin, Zaporizhya.\textsuperscript{112}

\subsection*{3.2.2 AGROS Company and its Dealing at the Ukrainian Market}

Ukrainian firm AGROS was founded and registered by ministry of finance in 1991 in Ukraine. The dealing of AGROS has started from producing machinery, sale of spare parts, seeds and chemicals, growing of grain. This business was closely connected to the creating of contemporary service for techniques and to giving basic consultations as for innovations in Ukraine.

During the period of his existence AGROS have invested in the agriculture of Ukraine $700000 and have connected with many agricultural companies and firms. For the last period AGROS has been cultivating several thousand hundreds of square metres soil. Since 2000 year AGROS has been a partnership in the frame of “German-Ukrainian agrarian project” according to the agreement of German and Ukrainian government. The aim of dealing of this partnership is producing and commercial dealing. Beside that AGROS give to another companies and firms service and supply production, which is the result of its dealing. Realizing of the goods of their clients and partners is another area of AGROS dealing. Due to its representation in Berlin company has opportunity to react quickly on client demands.

The main asserts of AGROS is 13836 thousands griven (1 dollar \(\approx\) 5.33 grivna), average income is 2373.2 thousands griven, the number of employees is 302.

AGROS is middle developed and perspective firm. Her economic achievements are growing especially after the partnership with German company. Since 2001 year the firm has brought considerable profit as for the Ukraine, as for the Germany.

\textsuperscript{111}See “Business Watch”, 6/11/2002
\textsuperscript{112}See \url{www.agros.com.ua}
The dealing of AGROS is rather resultative. The gross profitability rate 9% and continues to grow, by far exceeding the average gross profitability in industry (4.9%). AGROS is developing a program to increase grain product output by investing $120,000. Part of this investment will be used to develop the company. AGROS produced 90,000 tons of grain products in 2002, versus 74,000 in 2001. By 2005 and 2010, production is projected at 180,000 tons and 300,000 tons, respectively. To achieve this increased production, the company will introduce new production facilities given by German partner. In 2003 AGROS is planning to increase producing and selling spare parts for combines on 7%, versus 5% in 2002.

Producing and realization of seeds pesticides, and herbicides in 2002 was 17% higher than in 2001. During the term of existing AGROS has opened 5 branches in different regions of Ukraine, namely in Harcov, Ternopil, Ivano-Frankivsk, Chercassy, Chernovci.

In conclusion, agricultural sector of Ukrainian economy is full of prospects. But such country-in-the-making like Ukraine needs investment. The joint venture in this period of time is especially profitable for foreign investors, because of support of the government. It can be in the form of subsidy, tax concessions, or low regulation.\textsuperscript{113}

\textbf{3.3. Wholly Owned Subsidiary}

\textbf{3.3.1 Textile Market in Ukraine}

Domestic production of fabrics has decreased sharply in Ukraine. Before the collapse of the Soviet Union, the Ukrainian fabrics industry could almost meet the demand of domestic sewing factories. Now, Ukrainian fabric manufacturing producers are searching for sources of raw materials. Before the collapse of the Soviet Union in 1991, Ukraine possessed a strong textile industry with approximately 160 textile factories producing cotton, linen, wool, silk, artificial fabrics, and textile products. Nearly 30 percent of textile revenues went to the Ukrainian state budget. With the collapse of the supply system and the overall economic crisis in the country, the volume of fabrics

\textsuperscript{113} See www.agros.de
produced in Ukraine declined sharply: from 1,030,906 linear meters in 1991 to 81,584 linear meters in 1997. There are 33 factories which produce cotton fabrics in Ukraine. Donteks JSC (Donetsk), Kherson Cotton JSC, Chercassy Silk JSC and Voskhod JSC (Chernovtsy) are the leading companies in the cotton textile sub-industry.

Southern Ukraine was a major cotton-growing region of the former Soviet Union. This changed in 1956, when cotton fields were turned into corn fields, thereby destroying the domestic cotton-growing industry. As a result, Ukraine is becoming a net importer of cotton. Currently, the Ukrainian government is searching for ways of providing the domestic textile industry with cotton. The leading Ukrainian manufacturers of wool fabrics are: Cheksil OSC (Chernihiv), Donetsk Fabrics Factory, Troyanda JSC (Kyiv), Bohuslav Fabrics Factory (Kyiv oblast), Oteks OSC (Kharkiv), and Lazur JSC (Odessa). Domestic production of wool decreased from 48,617 linear meters in 1991 to 7,609 linear meters in 1997. The largest producer was Cheksil OSC which produced 6,237 linear meters of wool in 1997. The company operates 20 enterprises, six of which are factories, and the others specialize in marketing, export/import transactions, supply, energy, repair, construction, engineering, and transportation. Domestic production of silk declined from 184,111 linear meters in 1991 to 5,182 linear meters in 1997. The major Ukrainian producers of silk are: Kyiv Silk Integrated Plant, Darna Kyiv JSC, Kherson Cotton JSC, Chercassy Silk Integrated Plant, Volteks Silk Integrated Plant (Lutsk).114

Ukrainian textile firms that are not bankrupt have established direct supply links with western exporters or cooperate with Ukrainian traders/distributors of modern textile fabrics. Cotton fabrics are being imported from Russia, Uzbekistan, the United States, Germany, China, Pakistan, and Italy. Linen is imported from Russia and Belarus. Kyrgyzstan, Moldova, and Germany are the major suppliers of silk. Wool is imported to Ukraine from Belarus, Russia, Lithuania, Great Britain, Italy, Germany, and France. Artificial fabrics are supplied by Germany, China, Korea, Russia, Austria, Lithuania, the United States, France, and Italy. According to the May 1998 edition of the Ukrainian Business magazine, a few foreign suppliers of fabrics have established their

114 See www.agros.de
presence in the Ukrainian market and have developed their own distribution network. They are: Ulmia company (Germany), Mirolia company (Italy), Holland & Cherry (Great Britain), Ena Ukrainian-German JV, and the Czech-Ukrainian JV Gamayun. Foreign companies primarily focus on polyester, wool, cashmere, silk, viscose, and artificial fabrics. The Ukrainian companies Textil-Lux and Eolis are major local traders of fabrics. They import fabrics from the Czech Republic, Slovakia, Italy, Germany, Denmark, Holland, Great Britain, Lithuania, and Latvia.115

With production costs rising elsewhere in Eastern Europe, a growing number of Western European enterprises, primarily in the textile businesses, have turned to Western Ukraine in search of an inexpensive, ready workforce. In recent years, many have even moved production facilities to Ukraine. Western Ukraine is particularly attractive for textile, outsourcing ventures. However, textiles processing is one of the fastest growing industries with western investment in Western Ukraine. Dozens of Western firms have been rushing to subcontract their textile operations to Ukrainian-owned firms in the last few years.

3.3.2 Company Ulmia and its Dealing in the Ukrainian Textile Market

German textile company Ulmia has wholly owned subsidiaries in Ukraine. It is continuing its investment in new technology to ensure increasing quality and faster turnaround times. Ulmia aim is to consolidate its position as one of the prime textile finisher, not only in Germany, but internationally. So Ulmia has success. Steiger & Deschler GmbH using the “Ulmia” name is one of the first to process perlon for women’s fashion and underwear.116

Ulmia Ukraine, a local textile production subsidiary of German Ulmia, is one such firm. Last year, Ulmia invested $1 million into an existing textile plant in a village 20 miles from Lviv. The profit it has earned in the result was $3 million. The production costs of the firm are approximately evenly split between wages and benefits, production

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115 See Embassy of Ukraine (2002)
116 See www.ulmia.com
materials, and energy and overhead. Ulmia employed 2,300 people, and the average wage was 140-145 DM, which is close to the national average for this branch of the textile industry. The administrative personnel are around 100 people. There are plans to downsize on both the production and administration.

Government regulation of Ulmia in Ukraine is tough. The tax on the profit is about 40%. The quantity of the Ulmia outlets is about 145 in the world and 5 in Ukraine. The representative Ulmia office is located in Kyiv.

This textile company has average return of the capital about 15 % a year. Pay back period is about 1 year and 4 months, net present value of invested capital is 0.8 so it is good. According to the “Statistic of Ukraine” the index of profitability of Ulmia is 1.6. In conclusion, basing on this analysis, the dealing of Ulmia wholly owned subsidiary is profitable.
So, such kind of foreign direct investment is rather advantageous as for the host country as for the foreign company.117

3.4 Franchising in Ukraine
Franchising is not widespread in Ukraine. Western investments in Ukraine with franchising potential (i.e. McDonald's, Coca-Cola) are currently corporately owned, and very few Ukrainian businesses have recognized the potential for franchising.

McDonald’s has dominated the fast-food sector in Ukraine, but there are also other successful examples of franchising projects to be found, such as Express Personnel Services, Xerox copy centers, Kodak photo developing centers in Kyiv, Baskin Robbins and Dunkin Donuts in Kharkiv. In October 1997, the USAID Mission in Ukraine initiated a franchise development project managed and provided by SIBLEY International. Several pilot projects were selected including medical services, home repair/renovation outlets, wholesale and retail food distribution, and consumer electronics. The assistance has resulted in the establishment of eight franchises.
According to the FRANDATA Corporation, five sectors of business, which the mostly occupied by the franchising are:

- restaurants of “fast-food” – 18% of all franchising;
- retail – 14% of all franchising;
- service (sport and tourism including) – 12% of all franchising;
- automobile transportation and giving the service – 8% of all franchising;
- building – 7% of all franchising.

All these sectors are very perspective in Ukraine and need investment. German association of franchising (Boulevard de l’Humanité 116/2, B- 1070 Brüssel Tel. +32 - 2 - 520 16 07, Fax +32 - 2 - 520 17 35) forecasts current permanent increase for objects of franchising for future ten years on 10-15% every year\(^{118}\).

The Ukrainian market offers many opportunities for international franchising. However, as an entrepreneurial activity, franchising encounters the same general barriers that impede the establishment of small and medium businesses. These include taxation problems, high credit rates, crisis of nonpayment, unstable legislation, and over-zealous inspections of entrepreneurial activity by the state. The investment climate remains the major obstacle for franchises in Ukraine.

\(^{117}\) See Finance (18 Sep 2002)
\(^{118}\) See Ukrainian news (11 May 2002)
CONCLUSION

So, it is obvious that the economic situation and investment climate in Ukraine is far from perfection. The reasons for cautious attitude of foreign investors to Ukraine are well known and look as follows. At macro-level: general state of national economy, political, legal and economic instability and absence of transparent system for business activities. At micro-level: nature of relations between Ukrainian manufacturers, their foreign partners and state organizations, lack of experience in the field of cooperation with foreign partners, neglect of respective standards and values because of the national mentality. Different approaches of Ukrainian and foreign entrepreneurs to organization of the investment process, ways and methods used to study the market study and carry on business hamper attraction of FDI to Ukraine. The situation is gradually changing for the better, though many problems remain unsettled. At the same time, foreign investors are potentially interested in Ukraine having great advantages over other CIS states, inclusive of beneficial geographical location (sea ports and location on European transport intersection), reserves of some important natural resources, developed technological potential, educated and comparatively cheap manpower as well as potentially capacious domestic market.

The majority of western investors successfully work in the sphere of consumer goods production and trade, where influence of political factors on investment climate is relatively lower. Strong foreign and Russian companies capable of overcoming political risks operate on markets for capital goods and those tending to oligopoly. As a matter of fact, behavior of foreign investors can serve as evidence of adaptation of Ukraine’s economy to standard “rules of the game” in the world market and indicate the nature of its integration into the world economy. To estimate investment climate in Ukraine from the viewpoint of foreign investors it would be expedient to visualize future key directions of the Ukraine’s economic orientation, whether it would be towards Western Europe, the CIS or other countries. Since nowadays this orientation is not clear, it is possible to speak only about more or less favorable climate of investing in certain industry.
At the same time, the decade of accommodation of Ukrainian society to market economic conditions encouraged growth of investments on the part of domestic entrepreneurs. Taking into account the above-mentioned, we can state that at present, Ukrainian manufacturers enjoy more favorable investment climate than two years ago. As a matter of fact, investment environment differs from branch to branch. The analysis we carried out proves that investment climate is better in economic sectors having competitive advantages on domestic and foreign. However, strong dependence of Ukraine’s economy on foreign trade transactions due to relatively low purchasing power of domestic consumers deteriorates uncertainty related to assessment of business environment, adversely affecting investment climate in the country. On the other hand, a number of legal documents that can improve Ukraine’s investment climate have been passed recently, such as the law of Ukraine “On Mutual Investment Institutions (Unit Trusts and Corporate Investment Funds)”.

The Ukrainian market offers sound opportunities for exporters, and especially for investors. The overall in Ukraine can be estimated by the average consumption of two main end user groups: general consumers and contractors. Investment into the renovation of existing housing and the construction of new housing has served as an efficient way of saving money from inflation for many Ukrainians. Contractors are consumers of large volumes of building products, and tend to buy regularly. Some western consultants rank the Ukrainian construction market among the top four in all Europe in short-term market potential, and in the top two long-term potential. The market is becoming competitive. German, Italian, Scandinavian, French, and Spanish exporters are aggressively promoting their products in the Ukrainian market. Many well-known European brands are represented at construction shows frequently held in Kyiv. However, the system of distribution is still in the process of development. It consists of a collection of small, poorly-organized stores with low inventories. Even leading distributors cannot serve as one-stop shops, and consumers spend tremendous amounts of time searching for a choice in product, quality, and price. Price and quality often become a decisive factor in consumer preferences.
Ukrainian distributors tend to focus on high profitability, which can seriously impact the marketability of German products. To reduce prices and increase the marketability of products, several European companies have launched the joint manufacture in Ukraine.
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