Ukraine FDI report

2011

Ernst & Young
Quality In Everything We Do

Contents

Foreword

The Ukraine Foreign Direct Investment (FDI) report is produced by Ernst & Young. It is based on Ernst & Young 2011 European Attractiveness Survey results, Ernst & Young 2011 proprietary European Investment Monitor database and market research.

Key findings on Ukraine's FDI attractiveness

1. Europe's share of actual FDI inflows (in US$b) was 26% (first place) in 2010[1], which is equal to its share of world GDP. However, Europe's recovery remains mixed and tentative.
2. Ukraine ranks 10th in Central and Eastern Europe (2006–2010) for the number of FDI projects (178) and number of jobs created (7,487).
3. In 2010 Ukraine attracted 31 projects and created 1,150 jobs.
4. Ukraine is the 3rd largest recipient for FDI in financial services in Central and Eastern Europe (2006–2010).
5. The Ukrainian industrial sector grew by 11.5% in 2010, but Ukraine attracted only 3% of all industrial FDI into Central and Eastern Europe.
6. The largest investors in Ukraine are the USA, the EU countries and Russia.
7. Reforms: investors expect improved infrastructure, increased stability and transparency, investment in talent and innovation.

1. "Global and Regional FDI Trends in 2010", Global Investment Trends Monitor, UNCTAD, 17 January 2011.

Competing in a converging world

The world as it is: Emerging markets growth

Europe's share of actual FDI inflows (in US$b) was 26% (first place) in 2010[2], which is equal to its share of world GDP. However, Europe's recovery remains mixed and tentative.

In 2010, emerging markets collectively represented more than half of FDI globally[3]. The growth in the value of FDI in China was sustained because investors there are benefiting from stable returns on investment.

After the global economic crisis, the gap between growth rates in emerging and developed economies widened as rapid growth in key developing markets has driven the global recovery. In 2010, GDP in China grew by 10.3%, in India by 10.4%, in Brazil by 7.5% and in Russia by 4%. The European Union grew by 1.8%.[4] The divergent rates of investment growth between emerging and developed markets reflect a shift in the global economy. The emerging markets are an increasingly important source of growth as they offer a growing number of accessible consumers to investors. This rebalancing offers more investment opportunities and favors large emerging economies. Despite seeing increased value in emerging markets, investors in 2011 continued to perceive Central and Eastern Europe (including Ukraine) as the third most attractive region for investment projects (29%).

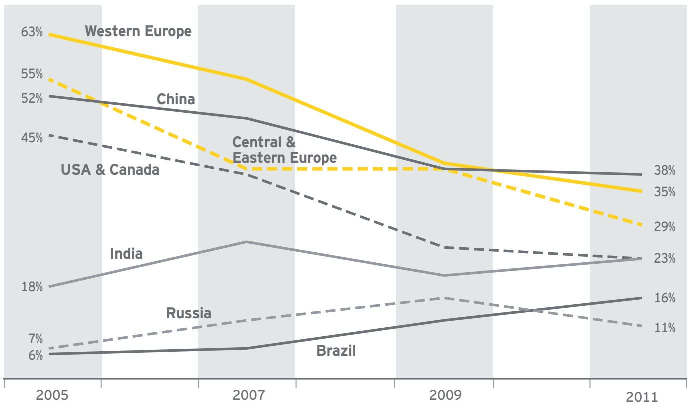
When deciding where to invest in 2011, global investors considered the critical factors to be: transport and infrastructure (63%), telecommunications infrastructure (62%) and the transparency of the political, legal and regulatory environments (62%).

Europe as it is perceived: a contender

In 2011, no region was a significant leader in terms of perceived attractiveness. This is illustrated by the difference in the spread of scores in 2005 as compared with 2011. In 2005, the most attractive region scored 63% and the least attractive scored 6%. In 2011, the spread was between 38% and 11%, reflecting a more converging world in which emerging markets have become increasingly attractive FDI destinations.

Investors see China as the world's most attractive investment region in 2011, with a score of 38%. Western Europe ranks a close second in 2011 with a score of 35%. Central and Eastern Europe (including Ukraine) ranks third, with 29%. The decline in Central and Eastern Europe's attractiveness is less attributed to a loss of attractiveness than to the relative increase in the attractiveness of other global regions.

What are the most attractive places in which to establish operations?



Respondents gave three responses (this graph shows responses since 2005)

Total respondents: 812.

Source: *European Attractiveness Survey 2011*.

The graph above reveals that the attractiveness of world regions is converging. Yesterday's leading regions – Western Europe, Central & Eastern Europe and North America – are now only contenders, while rapid growth economies are increasingly dominant. Despite this upset in global FDI trends, the leaders in 2005, Western Europe, Central and Eastern Europe and China, remain the leaders today, just with a lower market share.

FDI can no longer be taken for granted. Countries and regions are in heated competition to attract investment projects that create jobs, bring technology and boost the local economy.

2. "Global and Regional FDI Trends in 2010," Global Investment Trends Monitor, UNCTAD, 17 January 2011.
3. "Global and Regional FDI Trends in 2010," Global Investment Trends Monitor, UNCTAD, 17 January 2011.
4. IMF World Economic Outlook (WEO), April 2011.

Ukraine's true FDI value

Recovery of FDI activity in Central and Eastern Europe

In 2010, the number of FDI projects rose by 22% to reach 925 FDI projects (creating 65,372 new jobs) across the 22 countries of Central and Eastern Europe[5], marking a recovery in investment in the region, which had been thrashed by the global financial crisis in 2008–2009.

FDI activity in Central and Eastern Europe is dominated by industrial investment projects. The automotive, machinery equipment and logistics sectors account altogether for 26% of the FDI projects received in Central and Eastern Europe in 2010. However, business services and the software industry alone generated 12% of FDI projects in 2010 in the region.

The FDI leaders in Central and Eastern Europe are Russia, Poland, Hungary and the Czech Republic. Despite their increase in attractiveness, Central and Eastern European countries remain dwarfed by Western European countries like the UK, France and Germany in the number of FDI projects.

The United States, Germany and the United Kingdom remain the leading source countries for FDI projects in Central and Eastern Europe. Investment from India and China accounts for only 2% of total projects received.

Central and Eastern Europe: a fragmented competition landscape

Just like the global FDI market, Central and Eastern Europe tends to be more and more polycentric. The region hosts clear FDI leaders and challengers.

The leaders: The ranking of Central and Eastern European countries is dominated by Russia, Poland, Romania, Hungary and the Czech Republic. Apart from Russia, these countries have been courting investors for the past 10 years with attractive policies and burnished credibility, through European Union Membership and aggressive FDI promotion strategies. In particular, they have developed an investment profile that matches their strengths: they remain industrial (65% of FDI projects), while attracting a significant number of large-scale BPO (business process outsourcing) operations (72% of all BPO projects across Central and Eastern Europe).

Ukraine plays a challenger role within Central and Eastern Europe. From 2006 to 2010, Ukraine ranked 10th both in the number of investment projects (178) and the number of jobs created (7,487). In 2010, Ukraine did not improve its FDI position: the country attracted 31 FDI projects and 1,150 jobs. In fact, the total value of FDI inflows in 2010 declined by 9% to an estimated US$ 4.15 bn[6].

5. Including Russia and Turkey.

6. "Ukraine: Market Snapshot," ING, 21 February, 2011.

Ukraine's uncertainty regarding its investment climate limits investor enthusiasm[7] and undermines its true investment potential. A combination of inflation[8] and a contraction of GDP of more than 15% in 2009[9] made investors nervous about opportunities in Ukraine. Liquidity, although improving, is another concern for investors, as banks have begun only tentatively to resume corporate lending, restricting opportunities for investors and their domestic partners to establish business activities[10]. As regards the business climate, corruption, delays in customs and slow VAT refunding have become more rampant[11].

FDI in CEE 2006–2010

Rank	Country	FDI projects 2006–2010	Share of total	Jobs created
1	Russia	740	16%	55,768
2	Poland	719	16%	85,003
3	Romania	572	12%	49,409
4	Hungary	495	11%	49,873
5	Czech Republic	416	9%	47,055
6	Bulgaria	247	5%	18,167
7	Slovakia	243	5%	37,179
8	Turkey	231	5%	20,532
9	Serbia	200	4%	25,636
10	Ukraine	178	4%	7,487
	Other	580	13%	25,504
	Total	4,621	100%	421,631

Source: *Ernst & Young European Investment Monitor, 2011.*

Sectors of investment in Ukraine: a diversified portfolio

3rd FDI destination for financial intermediation: over the past five years, the Ukrainian financial sector has attracted the most investment projects (13% of total FDI into Ukraine). In fact, Ukraine ranks 3rd as a destination country for financial services in Central and Eastern Europe, behind Russia and Poland (which received 18% and 14% of the projects respectively).

Developing industrial attractiveness: logistics (10% of total FDI projects in Ukraine) and food production (9%) are the second and third principal draws for FDI in Ukraine. However, the country has not yet reached its true potential: the industrial sector grew at 11.5% in 2010 compared to 4.2% for the national GDP[12], while Ukraine attracts only 3% of industrial FDI in Central and Eastern Europe[13].

FDI in Ukraine by business sector 2006–2010

Rank	Sector name	FDI projects 2006–2010	Share of total	Jobs created
1	Financial Intermediation	24	13%	590
2	Logistics	17	10%	361
3	Food	16	9%	1895
4	Insurance & Pension	13	7%	25
5	Non-metallic mineral products	13	7%	400
6	Business services	12	7%	14
7	Software	10	6%	202
8	Fabricated metals	6	3%	133
9	Plastic & Rubber	6	3%	0
10	Automotive	5	3%	2030
	Other	56	31%	1837
	Total	178	100%	7487

Source: *Ernst & Young European Investment Monitor, 2011.*

7. "Ukraine: Market Snapshot," ING, 21 February, 2011.
8. Country Report: Ukraine, Economist Intelligence Unit, August 2010.
9. Country Report: Ukraine, Economist Intelligence Unit, August 2010.
10. Country Report: Ukraine, Economist Intelligence Unit, August 2010.
11. "Reforms in Ukraine: Assessing Current and Potential Progress," Ukrainian Economy, Dragon Capital, 6 April, 2011.
12. "Ukraine Chart Book: Economy Starts 2011 on a Positive Note," Economics comment, VTB Capital, 1 April 2011.
13. Ernst & Young European Investment Monitor.

Ukraine's true FDI value

Top investors in Ukraine

Over the last five years, the top investors by investment project to Ukraine have come from the USA (12%), Germany (12%), Russia (10%) and France (8%). By value in 2010, the largest investors in Ukraine come from the EU (54%) and from Russia (15.6%). The value of investment from both the EU and Russia declined in absolute terms in 2010 from 2009 levels[14].

Ukraine's relationship with Russia is very important to the stability of its investment climate and macroeconomic environment. In particular, Russia is a major trade partner of Ukraine and provides Ukraine with much of its natural gas[15]. Relations with Russia have improved, increasing the stability of Ukraine's economic outlook[16].

Primary investors in Ukraine

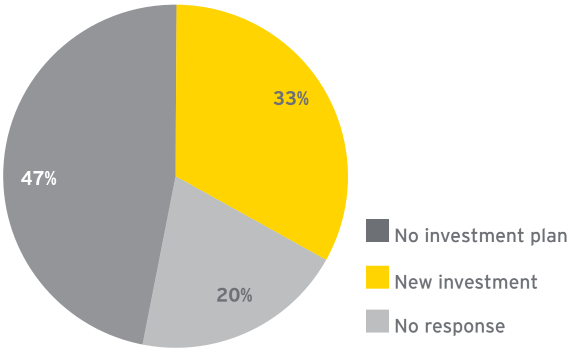
Rank	Country	FDI projects 2006-2010	Share of total	Jobs created
1	USA	22	12%	213
2	Germany	21	12%	728
3	Russia	17	10%	510
4	France	14	8%	358
5	Switzerland	11	6%	1,750
6	Poland	11	6%	1,900
7	Sweden	7	4%	37
8	Austria	7	4%	17
9	United Kingdom	7	4%	550
10	Finland	6	3%	146
	Other	55	31%	1,251
	Total	178	100%	7,487

Source: *Ernst & Young European Investment Monitor, 2011.*

Opportunities and challenges

33% of global leaders say they intend to expand existing operations or establish new operations in the enlarged Europe in 2011.

What are your investment plans over the next year in Europe?



Total respondents: 812.

Source: *Ernst & Young 2011 European Attractiveness Survey.*

In Ukraine, FDI inflows are expected to grow by 40% in 2011 to US$ 5.81 bn. This forecasted expansion in FDI is due to reforms carried out by the Ukrainian state and an improving climate for investment[17].

FDI opportunities will come from capitalizing on Ukraine's strength in manufacturing, its proven ability in services and growth opportunities from the BPO industry.

- **Push manufacturing and logistics**: 50% of FDI in Central and Eastern Europe is in manufacturing. However, Ukraine is not following this trend. Despite a manufacturing sector with enormous growth potential (14.9% in 2010[18]), the number of industrial FDI projects remains low (8 projects recorded in 2010).
- **Develop services:** 25% of FDI projects in Europe come from business services and software. However, in Ukraine, these sectors account for only 6% and 13% respectively of total projects in 2010.
- **Capture outsourcing**: there are major opportunities in the BPO industry. The sector has created 33,765 jobs across Central and Eastern Europe over the past five years. Ukraine has captured only 3% of them. This sector still offers huge potential for countries with educated populations and low labor costs, especially as other Central and Eastern European locations overheat.

14. "Ukraine: Market Snapshot," ING, 21 February, 2011.
15. "Ukraine Chart Book: Economy Starts 2011 on a Positive Note," Economics comment, VTB Capital, 1 April 2011.
16. *Country Report: Ukraine*, Economist Intelligence Unit, August 2010.
17. "Ukraine: Market Snapshot," ING, 21 February, 2011.
18. "Ukraine Chart Book: Economy Starts 2011 on a Positive Note," *Economics comment*, VTB Capital, 1 April 2011.

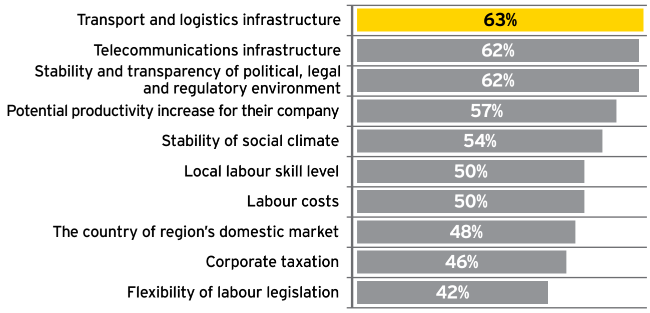
Reforms and expectations

Hard, soft and ambitious

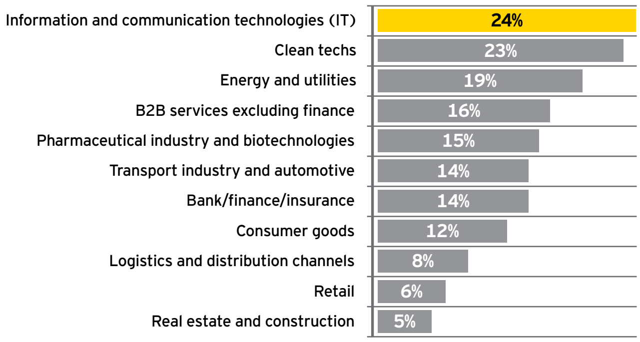
To improve the macroeconomic stability of Ukraine the government initiated an aggressive reform program in 2010[19]. This program has been in line with a loan from the IMF of US$ 15.2 bn, intended to stabilize the Ukrainian sovereign debt position[20] and as a result encourage growth prospects. The reform package includes: streamlining tax legislation, privatization of the energy sector and deregulation. Based on the current reforms, it looks likely that Ukraine will move up 23 to 33 points in the doing business ranking, but room for improvement remains.[21] To attract more investment, Ukraine should focus on the following conditions to attract more investment, namely:

- **Hard – Infrastructure:** For investors looking to invest abroad, transportation and logistics infrastructure is the most important criteria (63%). To improve its share of investment projects in Central and Eastern Europe, Ukraine must develop international standard infrastructure and clusters.
- **Soft – Stability and transparency:** 62% of investors insist that stability and transparency are key to attracting their investment projects. Going beyond the current reforms suggested by the IMF, Ukraine needs to improve its fiscal stability, especially in: investment and in property rights protections, financial markets development and business deregulation.[22] Investors expect more transparency in Ukraine, especially: reduced corruption, bureaucracy, customs clearance and pressure from tax and regulatory authorities.[23]
- **Ambitious – Talent & innovation:** Looking down the road, Ukraine should begin investing in talent and innovation to compete with European leaders in FDI. Investors clearly expect European growth to be driven by innovation-intensive sectors such as IT (24% of them) and cleantechs (23%).

What are the most important factors that a company takes into account when deciding on a location in which to establish operations?



Which business sectors will drive European growth in the next two years?



Respondents gave two responses. Total respondents: 812.

Source: *Ernst & Young 2011 European Attractiveness Survey.*

19. "Reforms in Ukraine: Assessing Current and Potential Progress," Ukrainian Economy, Dragon Capital, 6 April 2011.
20. *Country Report: Ukraine,* Economist Intelligence Unit, August 2010.
21. "Reforms in Ukraine: Assessing Current and Potential Progress," Ukrainian Economy, Dragon Capital, 6 April 2011.
22. "Reforms in Ukraine: Assessing Current and Potential Progress," Ukrainian Economy, Dragon Capital, 6 April 2011.
23. "Reforms in Ukraine: Assessing Current and Potential Progress," Ukrainian Economy, Dragon Capital, 6 April 2011.

Methodology

Ernst & Young 2011 European Attractiveness Survey is based on a twofold original methodology that reflects:

1. **The "perceived" attractiveness of extended Europe and its competitors by foreign investors.** We define the attractiveness of a location as a combination of image, investor confidence and the perception of a country or area's ability to provide the most competitive benefits for FDI. The field research was conducted by Institute CSA in January and February 2011, via telephone interviews, and based on a representative panel of 812 international decision-makers.

2. **The "real" attractiveness of extended Europe for foreign investors.** Our evaluation of the reality of FDI in Europe is based on Ernst & Young European Investment Monitor (EIM). This unique database tracks FDI projects that have resulted in new facilities and the creation of new jobs. By excluding portfolio investments and M&A, it shows the reality of investment in manufacturing or services operations by foreign companies across the continent.

Ernst & Young in Ukraine

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve potential.

Ernst & Young was the first professional services firm to establish operations in Ukraine in 1991. Our Ukrainian practice has 500 employees working in two offices located in Kiev and Donetsk.

Ernst & Young is dedicated to helping its clients identify and capitalize on business opportunities throughout Ukraine and the world. Our key market sectors are: Financial Services; Retail and Consumer Products; Industrial Products; Energy; Technology and Communications; Government, Real Estate, Transportation and Infrastructure.

Our professionals are recognized for their leadership, know-how and understanding of our clients' businesses. In our more than 20 years in Ukraine, we have provided critical information and resources to improve business performance and profitability.

Country and institutional development

Ernst & Young actively supports the development of the institutions and economies in which we operate. We participate and support the Investors Council under the auspices of the President of Ukraine.

Ernst & Young also demonstrates its leadership in the Ukrainian business community with the European Business Association, the American Chamber of Commerce in Ukraine, the Ukrainian Union of Industrialists and Entrepreneurs, the Reform Club and the US-Ukraine Business Council, and in interaction with Ukrainian legislative and ministerial processes affecting business.

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Ernst & Young is a global leader in assurance, tax and legal, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve potential.

In Ukraine Ernst & Young established its practice in 1991. Ernst & Young Ukraine now employs more than 500 professionals providing a full range of services to a number of multinational corporations and Ukrainian enterprises.

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