

## Vladimir Dukhnenko, Andrei Blinov Undervalued Country

There are no regions in Ukraine with either minimal or maximum risk level, and this highlights the potential for profitable investment into any Ukrainian region

### Ukraine's Investment Landscape



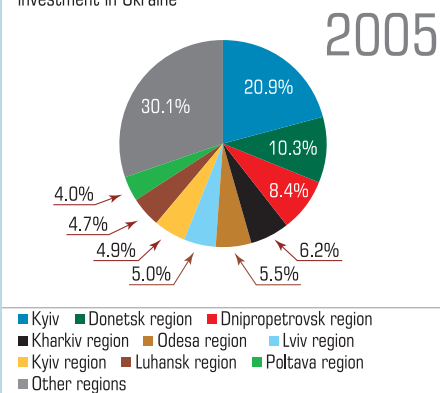
Ukraine's favourable geographical location in the heart of Europe, its high education level, advanced research and technology base, and cheap labour make it an ideal location for companies targeting Western and Central European markets on the one hand, and the markets of Russia and other CIS countries, on the other. However, the foreign capital flow into Ukraine has so far been rather unimpressive. The country's S&P credit ratings are fairly low: BB/Stable/B for local currency, and BB-/Stable/B for foreign currency, which is 2–3 grades below investment grade. This fact makes many potential foreign investors cautious about investing in Ukraine. Attaching one rating grade to the whole country, however, obscures the big regional differences, and in many cases the investment potential thus looks

much more optimistic from a regional perspective. We will argue that the investment attractiveness of many of the country's regions is, in fact, grossly undervalued.

*Expert Ukraine* conducted its own independent research and calculated a rating of Ukrainian regions' investment attractiveness. Its goal is to assess the investment attractiveness of Ukraine's regions by correlating each region's investment potential and risk. As a rule, in countries with developed market economies, investors require information about investment risks and creditor rights in case of bankruptcy. In the Ukrainian context, investment risks are too high, and this scares investors off. To tackle this problem, we decided to correlate the level of investment risk with the value of each region's economic potential, or its hidden potential. This comprises the principal virtue of our approach,

Fig. 1  
Half of all investment goes into five Ukrainian regions

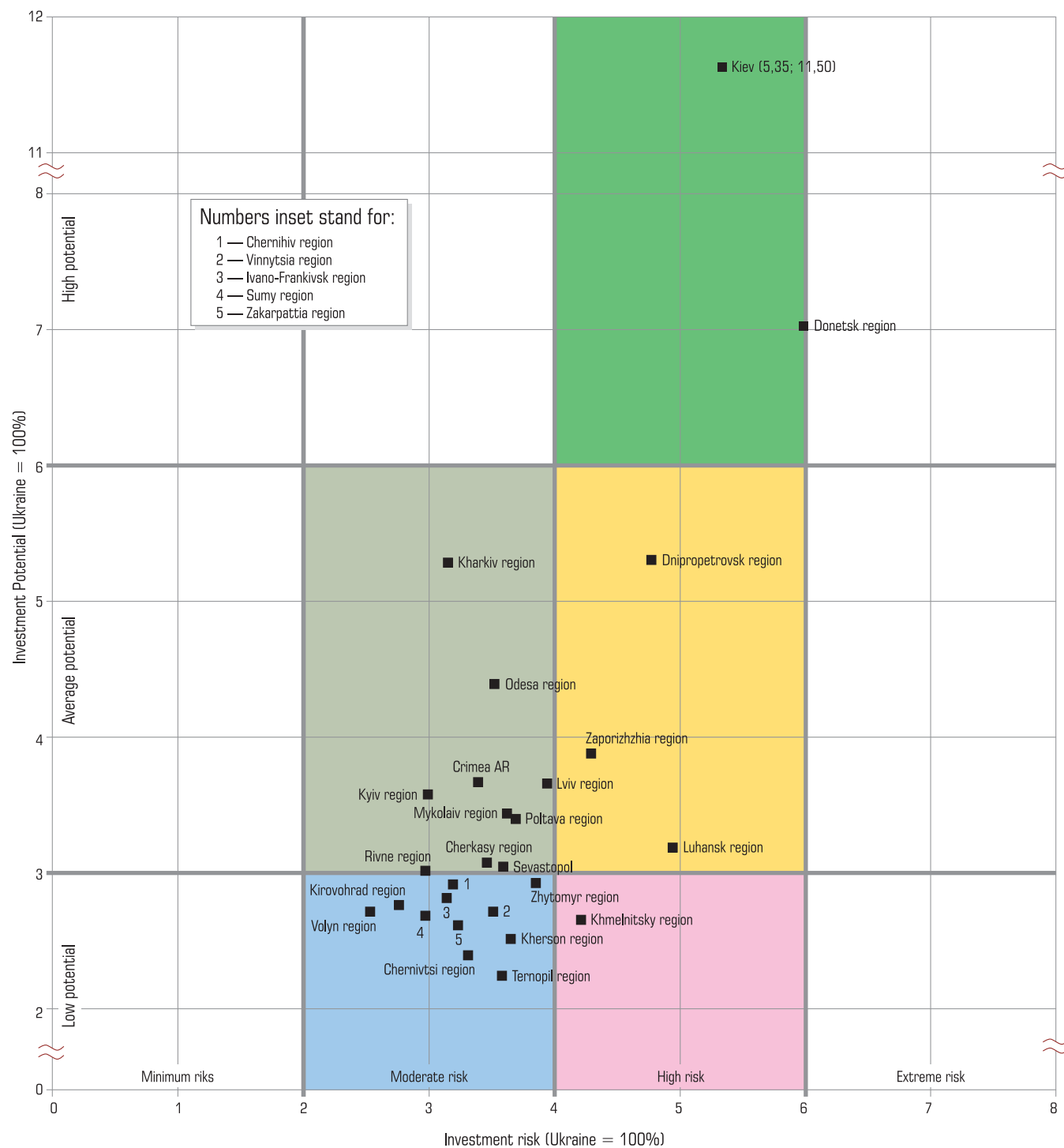
Region's proportion as a percentage of total capital investment in Ukraine



Source: State Statistics Committee of Ukraine

Distribution of Ukrainian regions in the rating of investment attractiveness (2004)

Fig. 2



Source: Expert

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Investment potential and risk of Ukrainian regions in 2004

Table

Rank of potential	Risk rank	Region	Share in national potential, %	Share in national risk, %
1	26	Kyiv	11,50	5,34
2	27	Donetsk region	7,03	5,91
3	24	Dnipropetrovsk region	5,32	4,77
4	7	Kharkiv region	5,30	3,15
5	14	Odesa region	4,41	3,52
6	23	Zaporizhzhia region	3,90	4,29
7	11	Crimea AR	3,69	3,39
8	21	Lviv region	3,68	3,94
9	5	Kiev region	3,60	2,99
10	17	Mykolaiv region	3,46	3,62
11	19	Poltava region	3,42	3,69
12	25	Luhansk region	3,21	4,94
13	12	Cherkasy region	3,10	3,46
14	16	Sevastopol	3,07	3,59
15	4	Rivne region	3,04	2,97
16	20	Zhytomyr region	2,95	3,85
17	8	Chernihiv region	2,94	3,19
18	6	Ivano-Frankivsk region	2,84	3,14
19	2	Kirovohrad region	2,79	2,76
20	13	Vinnitsia region	2,74	3,51
21	1	Volyn region	2,74	2,53
22	3	Sumy region	2,71	2,97
23	22	Khmelnitsky region	2,68	4,21
24	9	Zakarpattia region	2,64	3,23
25	18	Kherson region	2,54	3,65
26	10	Chernivtsi region	2,42	3,31
27	15	Ternopil region	2,27	3,58

Source: Expert

which is genuinely novel for the Ukrainian market.

### Regional development

Ukraine's administrative system is divided into Autonomous Republic of Crimea (henceforth ARC), 24 regions and two special administrative cities — Kiev and Sevastopol. All regions and two administrative cities are locally self-governed and are accountable to national executive body — Cabinet of Ministers of Ukraine. Ukraine's legislative body is Verkhovna Rada, or Parliament. The exceptions are ARC which has its own Cabinet of Ministers and Supreme Council. Ukraine's administrative system is the legacy of the USSR.

For the sake of convenience, we grouped Ukraine's administrative units together into six investment zones: Kiev, northern, southern, central, western and eastern.

Kiev, Ukraine's capital, is the indisputable leader among the investment zones, and quite justifiably holds leading positions in aggregate investment potential (Fig. 2, Table). Its leading position can partly be explained by its capital city status, but Kiev also has the most diversified infrastructure, developed market institutions, a high concentration of financial and intellectual resources, and a highly competitive economy. Its industrial production is dominated by the power sector, food processing industry, chemical and petrochemical industries, mechanical engineering and metal working.

Kiev is furthermore the biggest railway, automobile and aviation hub. However, the capital's investment attractiveness is adversely affected by its low natural resources potential and its high environmental risk.

Donetsk, Dnipropetrovsk, Zaporizhzhia, Kharkiv and Luhansk regions form the eastern investment zone in our analysis. The eastern zone has the most developed industrial complex, with industry accounting for a higher share of economy than in any of the other zones in our survey. This region is also noted for its wealth of natural resources. It has a medium investment potential and a high risk-level due to negative regional financial trends, high crime rates, an adverse environmental situation, and high social risk (especially, in Dnipropetrovsk region). At 2004 year-end, the escalation of outstanding payables and receivables in Luhansk region was among the country's highest: 49.5% and 40% respectively. In Donetsk region, wage arrears at 2004 year-end constituted almost 30% of the national total. Dnipropetrovsk region also has high disease and mortality rates far in above those of other Ukrainian regions. In Luhansk region, wage arrears at 2004 year-end amounted to 11.5% of the national total, whereas the figure for Dnipropetrovsk region was 7% — a state of affairs which obviously incites social tension. However, thanks to the region's high level of industrial

development, unemployment remains at a moderate level.

The northern zone consists of the Kiev, Zhytomyr, Chernihiv and Sumy regions. Despite its proximity to the capital, Kiev region's investment potential only puts it in tenth place in our calculations. This can be explained by the high level of labour migration into the City of Kiev, which bolsters the capital's already robust financial and economic indicators while depriving Kiev Region of human capital. Similar trends impact on the other regions close to the centre of the country (Chernihiv, Zhytomyr and Sumy regions).

Cherkasy, Vinnytsia, Kirovohrad, and Poltava regions are grouped together to form the central zone, equally characterized by agricultural and industrial development. It is the site of power generation, mining, chemical fertiliser production, computer equipment manufacturing, automated lines and investment goods. The biggest industries in the region are food processing, mechanical engineering and metal works, electricity generation, and construction materials production. The central region has a medium investment risk rating; and, due to its undervalued investment status, it is likely to spark interest among investors.

The administrative units of ARC and Sevastopol, together with Odesa, Mykolaiv and Kherson regions, comprise the southern zone. At present, this part of the country has medium investment risk and potential. However, our estimates suggest that it is evolving into the principal locus of attractive regions likely to draw increased attention from investors in the nearest future. Odesa's potential, specifically, stands out from the group as already being comparable with that of Dnipropetrovsk and Zaporizhzhia regions. In general, this region is more attractive for the investors insofar as the risk of invested capital loss is considerably lower than in the regions with high risk. This region still lags behind the regions with high investment potential, due to its feeble industrial development and the deterioration of its agricultural sector. One of the southern zone's investment advantages is the recreational potential represented by hundreds of holiday resorts and sanatoriums.

The western zone is a mixture of administrative regions with different potential: on the one hand, some regions are on the rise, such as the ambitious regions of Volyn, Zakarpattia, Ivano-Frankivsk, Ternopil and Chernivtsy, which are all experiencing robust growth in industrial and agricultural production. On the other hand, the Lviv and Rivne regions, so-called basis regions, are economically more developed.

Overall, we believe that the western regions have so far been undervalued by investors, who tend to overlook the area's investment advantages: cheap labour, high potential for

recreational tourism, and close proximity to the EU. This part of Ukraine is marked by high unemployment rates and by the comparatively modest level of investments. The region's economy is dominated by the service sector, which was thriving in 1990s thanks to border trade. The region's industrial development is scant.

Khmelnytsky region has to be singled out in this group due to its average potential and high economic, financial and social risks. It has the fourth highest level of wage arrears (after Donetsk, Luhansk and Dnipropetrovsk regions) amounting to 5.1% of the national total. This in turn, is the result of adverse financial and business trends and social factors.

### Regional development differences

According to our calculations, there are big regional discrepancies in economic development: living standards in well-off Kiev are increasingly divergent from living standards in other regions. Over the past four years, this tendency has become more pronounced: according to official data, the capital is seven times richer than Ukraine's poorest region. There are, furthermore, considerable discrepancies in the regions' investment attractiveness, as reflected in national statistics in 2005. Five regions — Kyiv, Donetsk, Dnipropetrovsk, Kharkiv and Odesa received more than 50% of the total volume of investment (Fig. 1). These same regions provide three quarters of the total volume of Ukrainian company profits. One-tenth of profits come from Zaporizhzhia, Luhansk and Kyiv regions, which follow in the footsteps of the previous five regions.

Most other regions have few if any expectations of receiving investments from local company funds. Firstly, in roughly half of them, the share of profit-making companies is below the national average. Secondly, the problems of Ukraine's overall, unbalanced economic growth tend to be amplified in these regions (to the effect that even growth in industrial output and exports may prove insufficient to ward off investment crises, of which Khmelnytsky region is an avid example: there, fixed capital investment slumped by 45%, and construction activity plummeted by 33.9%).

For many investment projects targeting consumer markets, it is essential to have access to data on the region's solvency. In Ukraine, this may be a daunting task due to the fact that between one quarter and one half of the country's economic activity is unofficial. Therefore, spending may prove to be a more reliable indicator of real solvency than income. The largest gap between declared income and actual spending is observed in the highly urbanized regions and on Ukraine's western border.

### Regional policy problems

The Ukrainian government has been largely neglecting the issues of regional development. Major financial, intellectual and other

## Method of calculating 'Potential/Risk' rating

To account for the changing dynamics of the indicators under analysis, a 2000–2004 time range was selected. We also singled out the indicators and factors that we think most fully reflect and describe the Ukrainian regions' investment potential and investment risk. The ratings were calculated on the basis of 120 indicators (90 for assessment of investment potential and 30 for calculation of risk level), which were lumped together into a combined indicator set.

Investment potential describes a region's ability to attract investment and encompasses the following components: natural resources, labour, production, innovation, institutional-, financial- and consumer-factors. Investment risk describes the probability of loss of investment and profit, and consists of the following risk types: economic, financial, social, criminal, environmental, legislative, and political.

Each region's overall rank for investment potential and risk was calculated according to the size of the weighted total of this indicator against the Ukrainian national average. The impact of each component of potential and risk was evaluated by means of expert survey. Thus, for the investment potential, the experts recognised natural resources and social components as most significant; and economic and infrastructure components as least significant. Among risk components, political, legislative, economic and financial types of risk were deemed the most important.

The method of calculation also accounts for the possibility of the emergence of certain types of risk. Due to the similarity of regulatory frameworks in all regions (except for ARC), the regions were treated as having similar values of risk. Contrary to the fact that the Ukrainian Constitution guarantees local governance, local authorities in fact remain subjugated to the central authorities. The value of Crimea's administrative and political risks was elevated because this autonomous republic has the authority to pass legislative acts.

Finally, every region was attributed a rank. For investment potential, high rank was ascribed to regions with higher potential; and for investment risk, high rankings went to regions with lesser risks.

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## There are no regions in Ukraine with either minimal or maximum risk level

resources flow to Kiev, despite the fact that a number of Ukrainian cities, towns and villages have seen hardly any change or development over the past 15 years. The problem is that many of these are old Soviet-style one-company towns, meaning that the town can only hope to develop if the company is doing well. If the company is unprofitable, the whole town or even region sinks into depression.

The problems affecting Ukraine's regional policy have more to do with a lack of enforcement skills than with the absence of clear goals and priorities. The Programme of State Regional Policy adopted in 2001 lays out the most basic principles for the regions' development, but cannot of itself trigger the growth of the poorest regions. It has become clear under the current government that no unified administrative reform has been prepared by

Ukrainian bureaucrats. It should be added that there are a very few experts in the central government who are familiar with Western European experiences with regional equalisation and development programmes.

Unfortunately, Ukraine is not yet ready to start applying the mechanisms of regional economic equalisation, both because of the low importance attached to regional politics and because of some historical reasons. These include the low mobility of labour, as well as the post-socialist economic organisation, with weak local governance relying on recurrent intervention from Kiev and regional authorities. However, there are no regions in Ukraine with either minimal or maximum risk level, and this highlights the potential for profitable investment into any Ukrainian region. ■