Corporate Real Estate: Challenges and Practices in Ukraine

by

Victor Smetana

B.S., Finance-Real Estate
San Diego State University, 1989

Submitted to the Department of Urban Studies and Planning in Partial Fulfillment of the Requirements for the Degree of

Master of Science in Real Estate Development

at the

Massachusetts Institute of Technology

September, 2000

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Signature of Author

Department of Urban Studies and Planning
September 8, 2000

Certified by Sandra Lambert
Lecturer, Department of Urban Studies and Planning
Thesis Supervisor

Accepted by William C. Wheaton
Chairman, Interdepartmental Degree Program in Real Estate Development
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ABSTRACT  

Real property has been called the corporation's last undermanaged resource. However, during the past decade, companies have begun to concentrate more on what constitutes 25 to 40% of a typical corporation's assets. US corporate real estate assets amount to greater than $3 trillion and real estate expenses are typically second or third highest on the corporate ledger, only behind payroll and sometimes technology.  

Corporate executives have begun to realize the business value real estate can have. Facilities lacking the proper location, finance, design, or the proper amount of flexibility required to manage internal and external uncertainties can negatively impact the corporation's bottom line. Meanwhile, strategic planning increases in importance in the international setting due to the risks and rewards of executing business strategies increases at the international level.  

The collapse of communism in Central and Eastern Europe has opened twenty-eight countries to free markets. Corporations are hungry to expand into these markets which offer the opportunity of serving over 400 million customers. Uncertainties are heightened in transitional economies, making international corporate real estate management that much more challenging.  

This thesis research was a qualitative exploration of the corporate real estate challenges and practices in one particular transitional economy, Ukraine. Corporate real estate in Ukraine was found to be transactional in nature, not strategic. Almost all decisions are made locally. The challenges found in Ukraine center around an immature administrative infrastructure along with corporate efforts to control the costs associated with real estate. Although complex, the challenges found in Ukraine do not preclude participation in the market; rather, they merely impede the process.  

Thesis Supervisor: Sandra Lambert  
Title: Lecturer, Department of Urban Studies and Planning
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Special kudos go out to:

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Chapter 1
Introduction

Corporate Real Estate (CRE)- a management function in transition

Real property has been called the corporation's last undermanaged resource. ¹ However, during the past decade, companies have begun to focus on the following:

1) Real estate makes up 25 to 40% of a typical corporation's assets.²

2) US corporate real estate assets amount to greater than $3 trillion.³

3) Real estate expenses are typically second or third highest on the corporate ledger, only behind payroll and sometimes technology.⁴

Corporate executives have begun to realize the business value real estate can have. Facilities lacking the proper location, finance, design, or the proper amount of flexibility required to manage internal and external uncertainties can impact the corporation's bottom line. This is true whether the organization lacks the facilities to take advantage of a growing market opportunity or a long-term commitment was made to some unnecessary fixed assets. While the organization, its competitive environment, and the real estate market are constantly changing, the real estate manager must provide a sound, secure, and stable physical home for the business, balancing short-term needs w/ long term investments.⁵

Earlier research has shown that real estate can play a part in reducing costs, improving efficiency and productivity, accessing and retaining qualified employees, and satisfying employees.⁶ Reducing costs is usually the company's first goal in managing its real estate. Examples include repositioning or selling owned properties or negotiating favorable leases. A cost reduction goal requires the standardization of decisions by gathering data on the entire portfolio of properties. ⁷ The following are steps that can be taken to improve workplace efficiency:

- Reducing the space per employee through workplace redesign;
- Consolidating workplaces both to eliminate redundant amenities and to exploit physical adjacencies;
• Creating new workplace strategies, such as non-territorial offices, that intensify space use;
• Making capital improvements that reduce the time and cost of churn when new product teams are put in place; and,
• Collocating suppliers on-site with production processes.\textsuperscript{8}

Workplace productivity can also be improved in a number of ways. For example, team spaces can be designed to support product development that often takes place in cross-functional or cross-disciplinary teams.\textsuperscript{9} New technologies can be integrated into the workplace to improve productivity.\textsuperscript{10} Finally, customer interface can be increased by 1) deploying new technologies to employees working at home or at telework centers, and 2) by revamping point-of-sale workplaces to attract, more customers, improve customer service, and project a consistent product image in the marketplace.\textsuperscript{11} Employee satisfaction can be increased through work at home, by tailoring workplaces to the work that is done, and by involving employees in the planning and design of such spaces.\textsuperscript{12} Furthermore, workplace amenities and interaction areas support informal interaction and teamwork.\textsuperscript{13} Access to employees is important in industries where employees are scarce and is best gained through strategic planning for the corporation's entire portfolio.

More recent research has shown that, real estate can be a source of competitive advantage by providing additional innovative services, products, and delivery mechanisms designed to create value for business units.\textsuperscript{14} Such sources of competitive advantage include 1) economic value-added (EVA), 2) external customer access and satisfaction, and 3) business continuity. EVA justifies the cost of a business activity by comparing the cost of equity capital used for plant, equipment, inventories, and receivables, with the actual return.\textsuperscript{15} Business value can also be created as customers access corporate facilities for regular business, or for more sophisticated services such as sales presentations or product training. Facilities become marketing tools. Brand identity can be established through facility location and design.\textsuperscript{16} Finally, maintaining business continuity during corporate reconfigurations can be very complex. The ability to
support a business unit through expansion, contraction, or relocation can also add value to a business unit.

Through the examples given, it can be seen that real estate may have once been an undermanaged resource but it is now a resource in transition. The following exhibit summarizes the transition.

Exhibit 1-1

Paradigm Shift in Corporate Real Estate Management

<table>
<thead>
<tr>
<th>Paradigm</th>
<th>Traditional CRE-Management</th>
<th>Strategic CRE-Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management Philosophy</td>
<td>Custodial oriented view of real estate</td>
<td>Management oriented View of real estate</td>
</tr>
<tr>
<td>Planning Horizon</td>
<td>Short to medium-term decision making</td>
<td>Long-term decision making</td>
</tr>
<tr>
<td>Style of Thinking</td>
<td>Thinking in technical and property-by-property categories</td>
<td>Thinking in user and Portfolio categories</td>
</tr>
<tr>
<td>Behavior Pattern</td>
<td>Reactive</td>
<td>Proactive</td>
</tr>
<tr>
<td>Self Perception of CRE Manager</td>
<td>Engineer Caretaker</td>
<td>Problem-solver Strategist</td>
</tr>
<tr>
<td>Personnel Requirements</td>
<td>Experience</td>
<td>Experience and creativity</td>
</tr>
<tr>
<td>Degree of Information and Organization</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Performance Measurement</td>
<td>Implicit Performance criteria</td>
<td>Explicit Performance criteria</td>
</tr>
</tbody>
</table>

Source: Schaefers

Strategic CRE management takes a more formal systematic approach. This entails "moving beyond reactive and decentralized decision making, fragmented across the organization, towards a proactive, comprehensive and portfolio-wide management, well supported by adequate and timely information and the commitment of top management."18
Social, technological, and organizational changes are further transforming corporate real estate, making it more complex and challenging. Yet in changing times, where flexibility is demanded, real estate remains the same fixed commodity - expensive to build, maintain, and alter. When change makes future requirements uncertain, the fundamental challenge the organization faces is forecasting the future. Managing uncertainty is at the core of the real estate strategy dilemma.\textsuperscript{19}

Globalization of Business - Corporate Real Estate Challenges

Uncertainties are heightened in the global business environment, making international corporate real estate management that much more challenging. Some scholars believe that buffering an organization's operations from the effects of risk is a key responsibility of corporate real estate management.\textsuperscript{20,21} There are unique risks associated with international business including country, political, economic, currency, and cultural risks, along with industry and firm specific risks.\textsuperscript{22} The interrelationships of these risks is what increases the complexity of doing business internationally and, as a consequence, managing corporate real estate internationally. Each country has a different set of risks thereby making standardization much more difficult.

Very few corporations have truly international corporate real estate groups where strategy is created centrally for the entire portfolio. Strategic planning increases in importance in the international setting due to the risks and rewards of executing business strategies increases at the international level.\textsuperscript{23} There are a number of explanations for the lack of strategic planning in international CRE units, where it is needed most. The first reason is that domestic units first get drawn into international work due to specific projects like developing a building. Managing the project (strategic programming) detracts from the unit's ability to do strategic planning.\textsuperscript{24} Another reason for the lack of strategic planning internationally is the different ways a business unit and a CRE unit may think strategically. The complexities of business operations are most familiar to the business units themselves; keeping up with new technological advances that
ultimately impact facilities design is challenging. Therefore in working together there may be differing goals and objectives. For example, in developing a manufacturing plant, the business unit employees will likely focus on the latest equipment advancements whereas the CRE unit may be concerned merely with the location and financing of the facility. The final reason for the lack of strategic planning in international CRE units is that change takes place so quickly in the international arena that gathering the necessary data to plan on a global scale is difficult. Keeping up with short-term facility demands is often challenging enough.

Along with the lack of centralized real estate strategic planning in international CRE units, there are gaps in the real estate services provided internationally. CRE units may provide a limited number of services, or provide services to a limited number of business units or geographical areas or to a limited number of property types. This suggests that much of the international real estate is being managed at the business unit level. With that being the case, and the local business unit lacking real estate experience and knowledge, one would expect the role of the external real estate service provider to be heightened in the international arena. (Lambert mg global 91-92)

**Purpose and Methodology of Thesis**

The collapse of communism in Central and Eastern Europe has opened 28 countries to free markets. Corporations are hungry to expand into these new markets which offer the opportunity of serving over 400 million new customers. Countries in transition from planned economies offer tremendous business opportunities for foreign companies, but at the same time present tremendous challenges. As the largest sized country in Europe, second only to the European section of the Russian Federation, Ukraine is no exception. Its population ranks fourth largest in the continent. Its 51 million inhabitants have just begun to taste the goods a free market affords.
This thesis will explore the real estate challenges corporations face when entering Ukraine. The research was a qualitative exploration comparing and contrasting information collected from nineteen interviews with other related available data. This approach was deemed most appropriate based on limitations in the sources of data available and the scope of a thesis research project. This thesis considers the following questions:

1) What are the real estate challenges corporations face when doing business in Ukraine?

2) What strategies have been adopted to overcome those challenges?

The importance of this work lies in the fact that although international business is a growing trend and transitional economies offer rapidly growing business opportunities for corporations, no research could be found about corporate real estate in transitional economies let alone Ukraine. Due to this, the thesis will rely heavily on the information obtained through interviewing corporate real estate executives doing business in Ukraine. Over 250 foreign companies are doing business in Ukraine. At least forty of these are Fortune 500 or Global 500 companies.

The thesis will be organized as follows. Chapter 2 will introduce the topic of international business. There will be a brief overview of international business including recent history, the reasons for the growth of international business, and followed by a description of the forms of international business, focusing on foreign direct investment (FDI). To conclude chapter two, the question, why does FDI occur as opposed to less risky investment forms, will be explained. Chapter 3 will discuss transitional economies, and will act as a bridge between the discussion on international business and Chapter 4, which will include a brief historical overview of Ukraine, a description of contemporary challenges associated with doing business in Ukraine, and a review of the Ukrainian real estate market. Chapter 5 will summarize the data obtained from nineteen interviews and other related available data; interviews were held by phone with eleven US-based corporations in Ukraine, six real estate service firms doing
business in Ukraine, and two American real estate consultants with experience in Ukraine. Conclusions will follow in Chapter 6.

Please note that to preserve anonymity, all identities will remain confidential with the exception of the featured Coca-Cola case.
Chapter 2
International Business

History
An explosion in international trade began in 1965.\(^3\) After twenty years of reconstruction following the devastation of WWII, foreign activity rose. Between 1965 and 1995, foreign direct investment (FDI) increased nearly 900% at a 9.5% annual increase.\(^4\) FDI is loosely defined as a significant investment from an investor into another country in any form of capital be it money, assets, technology, etc. whereby a significant amount of control/influence over the investment remains with the investor.\(^5\) Most of this outward investment (97%) came from the seven leading industrialized nations (the United States, United Kingdom, West Germany, Japan, the Netherlands, France, and Canada). The inward investments went mostly (60%) to those same countries.\(^6\)

Reasons for Growth of International Business

The following are a number of reasons for the growth of international business:\(^7\)

1) Market Expansion- As a firm's ability to produce surpasses their domestic market's demand, they expand.
2) Resource Acquisition - Certain inputs, such as materials, labor, capital, or technology may be scarce locally.
3) Competitive Forces -Economies of scale force organizations to grow when their competition grows just to be able to compete.
4) Technological Change - Advances in communications, transportation, and information processing have made managing distant businesses easier and thus facilitated expansion.
5) Social Changes - Consumers' willingness to purchase foreign made products has increased. Certain cultures that shunned foreign products are now more open.
6) Government Trade and Investment Policies - Trade and investment barriers have relaxed in places such as transitional economies.
The listed reasons for international business growth include supply factors, demand factors, and political factors. Market expansion is a demand factor meaning there is opportunity to take advantage of unmet demand. Social changes are also demand factors in that consumers' willingness to purchase foreign made products has increased. The relaxing of trade barriers is a political factor which can impact foreign business. Resource acquisition, competitive forces, and technological change are supply related issues impacting foreign business; supply factors are related to a firm's efforts to control costs. One form of analysis that will take place later on is to examine what factors were the motivators for foreign companies to enter the Ukrainian marketplace.

**Forms of International Business**

There are a number of forms of international business, which can be broken down into three categories. Exhibit 2-1 outlines in detail the tradeoffs associated with a number of forms of entry into foreign markets. The first category of international business is trade, consisting of import and export. Since the focus of this report is on U.S. corporations doing business in Ukraine, the attention here will be on exporting, in this case to Ukraine. If a firm offers products or services and perceives a demand internationally, oftentimes the least risky and least costly method of selling the product overseas is by export. Three forms of export include indirect, direct, and intracorporate transfer.

The second group of forms of international business discussed will be a group loosely termed contractual agreements. Seven different forms of entry are included. The common trait they share is that they do not require a presence in the host country, or, as in the case of the turnkey construction contract and the management contract, are for contractually stated periods of time. Alliances, the first form of contractual agreement, are rapidly growing, number in the tens of thousands, and include cooperative agreements that can take many forms such as sharing, exchanging, or developing new proprietary technology. They usually entail the transfer of technology in exchange for something else, such as access to new markets or human capabilities.
<table>
<thead>
<tr>
<th>ENTRY MODE</th>
<th>POSITIVES</th>
<th>NEGATIVES</th>
<th>WHEN USED</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Exporting</td>
<td>Good 1st Foreign Experience</td>
<td>Lack of Local Expertise</td>
<td>1st Foreign Venture</td>
</tr>
<tr>
<td></td>
<td>Limited Risk</td>
<td>Lack of Local Presence</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Proprietary &amp; Marketing Control</td>
<td>Possible Import Barriers</td>
<td></td>
</tr>
<tr>
<td>Indirect Exporting</td>
<td>Limited Risk</td>
<td>Less Control of Marketing</td>
<td>When Gaining Foreign Experience is</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Lack of Local Expertise</td>
<td>Not a Concern</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Lack of Local Presence</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Possible Import Barriers</td>
<td></td>
</tr>
<tr>
<td>Alliance</td>
<td>Less Risky, Costly</td>
<td>Dependent on Commitment/Incentives</td>
<td>Quick Access w/ Less Cost</td>
</tr>
<tr>
<td></td>
<td>Quick Access</td>
<td>Lack of Control</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Access to Local Expertise</td>
<td>Conflicts with Partner</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Increasing Popularity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Licensing</td>
<td>Low Cost Commitment</td>
<td>Weak 1st Foreign Experience</td>
<td>Strong Country Property Rights</td>
</tr>
<tr>
<td></td>
<td>Limited Costs/Risks</td>
<td>Limited Returns</td>
<td>Protection</td>
</tr>
<tr>
<td></td>
<td>Import Barrier Circumvention</td>
<td>Need Attractive Proprietary</td>
<td>Import Barriers or FDI Restrictions</td>
</tr>
<tr>
<td></td>
<td>Minimized Political Risks</td>
<td>Technology/Company Name</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Rapid Access &amp; Expansion</td>
<td>Lack of Marketing Control</td>
<td>Small Volume</td>
</tr>
<tr>
<td></td>
<td>Low Political Risks</td>
<td>Risk of Creating a Competitor</td>
<td></td>
</tr>
<tr>
<td>Franchising</td>
<td>Same as Licensing</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Form of Licensing</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Ideal for Easily Transferable Production Processes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contract</td>
<td>Low Cost, Quick Entry</td>
<td>Difficult to Find Manufacturer</td>
<td>Export Restricted or Too Costly</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>Marketing Control Retained</td>
<td>Risk of Creating a Competitor</td>
<td>Market Too Small for FDI</td>
</tr>
<tr>
<td></td>
<td>Good for Small Markets</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Import Barrier Circumvention</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Turnkey Construction Contract</td>
<td>Offers Access to Market</td>
<td>Complex Negotiations</td>
<td>Typically w/ Host Governments</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Involves Costs and Time</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Political Risks</td>
<td></td>
</tr>
<tr>
<td>Management</td>
<td>Low Risk</td>
<td>Modest Income</td>
<td>In Conjunction w/ JV or Turnkey</td>
</tr>
<tr>
<td>Contract</td>
<td></td>
<td>Not a Permanent Position in Market</td>
<td>Projects</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Countertrade</td>
<td>Sometimes Only Way to Enter Market</td>
<td>Currency Risk</td>
<td>Currency Scarce or Convertibility</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Lacking</td>
</tr>
<tr>
<td>Greenfield Investment aka Wholly Owned Subsidiary Internal Expansion</td>
<td>Full Control</td>
<td>Riskiest, Costliest, Slowest</td>
<td>Historically Most Successful</td>
</tr>
<tr>
<td></td>
<td>Start w/ Clean Slate</td>
<td>Lack of Local Expertise</td>
<td>Offers Period of Acclimatization to</td>
</tr>
<tr>
<td></td>
<td>High Profit Potential</td>
<td>Lack of Local Recognition</td>
<td>New Culture</td>
</tr>
<tr>
<td></td>
<td>Gain Market Knowledge Through Experience</td>
<td>Political Risk</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Managerial Complexities</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Potential Government Restrictions</td>
<td></td>
</tr>
<tr>
<td>Joint Venture</td>
<td>Shared Risk &amp; Cost</td>
<td>Loss of Control</td>
<td>Quick Access w/ Less Cost</td>
</tr>
<tr>
<td></td>
<td>Typically Encouraged by Host Government Access to</td>
<td>Conflicts w/ Partner</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Local Expertise and Knowledge</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Speedy, Easy Market Entry</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merger &amp; Acquisition</td>
<td>Shared Responsibilities Access to Local Expertise</td>
<td>Costly, Risky</td>
<td>Quick Access to New Market/</td>
</tr>
<tr>
<td></td>
<td>Speedy Market Entry</td>
<td>Political Risk</td>
<td>Factor Inputs</td>
</tr>
<tr>
<td></td>
<td>High Profit Potential</td>
<td>Managerial Complexities</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Possible Government Restrictions</td>
<td></td>
</tr>
</tbody>
</table>

Source: Griffin
Alliances are typically formed between medium to large sized multinational enterprises (MNEs), are popular in high tech manufacturing and information service companies, and can be put in place between companies in the same field of work or from different steps of the same value-added chain.

Other forms of contractual agreements fall under the category of licensing and include licensing itself, as well as franchising, contract manufacturing, and the two just mentioned, turnkey construction contracts and manufacturing contracts.

1) Licensing involves a form of payment for the use of a company's intangible assets such as trademarks, patents, know how or brand name.

2) Franchising is a form of licensing, which also includes some form of technical, management, and marketing assistance.

3) Contract manufacturing is the combination of licensing and investing in a foreign country whereby a contract is made with a foreign firm to manufacture a product for the sale in the target country of elsewhere.

4) A Turnkey construction project involves producing a foreign project and includes customization of the product to the point where operations can begin. This type of deal is typically made with a host country.

5) A Management contract involves the management of a facility or business on a contractual basis and usually is used in conjunction with a joint venture, which will be discussed shortly, or a turnkey project.

The final form of entry included here, as a contractual agreement is the countertrade. Actually a form of payment, countertrade is the purchase of goods or services paid for with other goods or services (as in barter) or with the processing or refinement of the goods received (as in counterpurchase or buy-back).
We have examined trade and seven forms of contractual agreements, and will end the discussion on forms of entry into foreign markets by introducing foreign direct investment. FDI was previously defined as a significant investment from an investor into another country in any form of capital be it money, assets, technology, etc. whereby a significant amount of control/influence over the investment remains with the investor. FDI's importance to nations and the global market economy is increasing.

Exhibit 2-2

<table>
<thead>
<tr>
<th>World FDI</th>
<th>(Millions of Dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflows</td>
<td>$219,421</td>
</tr>
</tbody>
</table>


The current trend in multinational enterprises is not on acquiring natural resources or seeking out local markets, but rather "to restructure or rationalize existing investments to capitalize on the benefits of global or regional economic integration, or to acquire additional technological, organizational or marketing assets to more effectively pursue, maintain or advance a global competitive position." FDI can be divided into the following three categories:

1) New investment in property, plant, or equipment (Internal Expansion, Greenfield Investment, or Wholly Owned Subsidiary)

2) Purchasing existing assets (Merger & Acquisition)

3) Joint Venture

Historically, the main form of entry into foreign markets was through internal expansion. Also known as a greenfield investment or a wholly owned subsidiary, this form is still numerically significant. As a percentage of the world wide sales of multinational enterprises (MNEs), those accounted for by fully owned subsidiaries continues to rise.
There has been an increase in mergers & acquisitions (M&A) activity since the mid 80s, particularly in the case of distant investments.\textsuperscript{52}

Exhibit 2-3

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|}
\hline
\hline
219.421 & 253.506 & 328.862 & 358.869 & 464.341 & 643.879 \\
\hline
\end{tabular}
\caption{Worldwide Cross-border M&A Sales (Majority Foreign-owned) (In Billions of Dollars)}
\end{table}


Due to the complex nature of calculating annual equity form of FDI, there is insufficient data to establish a clear relationship between FDI and cross-border M&A.\textsuperscript{53,54} For the purposes of this report, it can be said that M&A activity is growing, and, as a form of FDI, has advantages and disadvantages as indicated previously in Exhibit 2.1.

Data from the US, Japan, and the UK from the early 90s, indicates that the number of joint ventures has been expanding more rapidly than that of wholly owned affiliates.\textsuperscript{55} A joint venture is the creation of a business entity by at least two entities, each of which has a significant amount of equity interest and influence in the running of the venture. The reasons for the increase in joint ventures and other forms of alliances have to do with competitive advantage. Companies can gain advantage by sharing costs of research and development. Technology changes so quickly that it is very expensive to keep up. Also by sharing technology, companies can invent products more rapidly.\textsuperscript{56}

**Foreign Direct Investment Theory - Why Does It Occur?**

A particularly relevant way of looking at FDI in relation to the thesis is to examine Dunning's \textit{Eclectic Theory}. Investing in a foreign country is full of risks. There are numerous ways to participate in international business without having an actual presence in a foreign country. The following theorizes about why FDI occurs from a supply side perspective.

According to Dunning's \textit{Eclectic Theory}, foreign corporate investment is linked to \textit{Ownership, Location, and Internalization Advantages (OLI)}. 

19
Ownership advantages suggest that a domestic competitive advantage can be used as an advantage to enter foreign markets and gain market share. For example, brand name recognition, superior proprietary information, or economies of scale would all be reasons why a firm would exploit a competitive advantage in foreign markets.\(^{57}\)

Location advantages are those gained from being in a foreign country versus being at home. For example, it would be an advantage to produce in a foreign country with high import tariffs and low labor costs versus producing domestically with more expensive labor and paying the high import tariffs.

Internalization advantages explains why a firm wouldn’t just export its products or use some other form of "indirect investment" such as franchising or licensing versus actually physically entering the market. The principle reason is transaction costs. The costs of physically entering a market must be compared with the costs of contracting with another business through franchising, licensing, or exporting. Costs include negotiating, monitoring, and enforcing contracts.\(^{58}\) When the costs associated with monitoring external contractors or the risk of losing proprietary information becomes too high, a firm would choose to internalize the function.\(^{52}\)

International Business Synopsis

A number of reasons, theories and examples of international business have been introduced. It is difficult to pinpoint why a company chooses to invest as it does, because of the numerous related issues involved. It is typically a compilation of reasons that result in particular business strategy, and not one factor like acquiring natural resources or seeking out local markets as noted previously. As part of the data analysis in chapter 5 the factors motivating the interviewees to invest in Ukraine will be reported on as well as the form of entry used in entering Ukraine and any real estate related implications.
Chapter 3

Transitional Economies

In a Competitive Global Economy

The opportunities have never been better for MNEs to expand into foreign markets. Businesses from all around the world are investing globally. Corporations are entering new markets, yet international business is full of difficulties and choices. The collapse of communism in Eastern Europe, for example, has resulted in the opening of vast new markets. Although there is great opportunity in Eastern Europe, all of its countries are competing amongst one another for the foreign investment that will aid in their development. In fact, as a result of the globalization of business, all the countries in the world are competing against one another. The competitive nature of globalization has been studied, theorized and written about by many scholars. However, until recently the theories had not been quantified. Theories about intercountry competition were espoused, yet there weren't any score cards, just generalizations about the determinants for being competitive.

Recent heuristic econometrics has developed the missing scorecards. Based on scholarly literature about determinants of economic growth, the World Economic Forum, with the help of Michael Porter, Jeffrey Sachs, and Andrew Warner, tested eight indicators as forecasters of medium to long term economic growth within countries. The eight indicators are as follows:

1) Openness to foreign trade and investment
2) Government policy
3) Financial Institutions efficiency
4) Infrastructure quality
5) Technological advancement and absorption
6) Management quality
7) Labor market competitiveness
8) Institutional quality

These indicators were used to create a linear model that would explain the annual average growth of a country during 1998.64666
The result was the Global Competitiveness Report of 1999. The World Economic Forum has been reporting on competitiveness for a number of years and the study has grown to rank 59 countries. Countries are added based on the size of their economy, availability of reliable data and geographic distribution. Seven transitional economies are on the list with Hungary and the Czech Republic being ranked the highest (38th and 39th respectively) and Ukraine and Russia being ranked the lowest (58th and 59th).

As part of a study for the United States Agency for International Development (USAID) to interpret patterns and determinants of transition, Jeffrey Sachs constructed a benchmark to measure competitiveness of transitional economies based on the Global Competitiveness Report. While at the Harvard Institute for International Development (HIID), Sachs developed this as a tool for USAID to prioritize financial assistance and allocate it where it would have the greatest impact. This allocation was based on the theory that the better a country’s rank in an indicator or sub-indicator, the more likely any further assistance would be subject to diminishing returns. With the results of the study, USAID could tailor their assistance to where it would do the most good, track progress in reform, and set up benchmarks as a guide to determine when to start and stop funding.

Exhibit 3-1 on the following page compiles both the Global Competitiveness Rankings and the Transitional Economies’ rankings and illustrates how competitive the transitional economies are in comparison to the countries in the global report. Not only are these competitiveness rankings of benefit to USAID and other Assistance programs, but they are also beneficial to the countries as a benchmark for identifying areas in need of most improvement. More related to the topic at hand, however, is the benefit to foreign investors such as corporations. The reports are a compilation of quantitative and qualitative factors that can be used by corporations in choosing where to locate affiliates.
Comparison of Transition Country Competitiveness with the Rest of the World

Exhibit 3-1

Global Competitiveness Report Rankings 1999

Best

Singapore
United States
Hong Kong
Taiwan
Canada
Switzerland
Luxembourg
United Kingdom
Netherlands
Ireland
Finland
Australia
New Zealand
Japan
Norway
Malaysia
Iceland
Sweden
Austria
Chile
Korea
France
Belgium
Germany

Worst

Spained
Portugal
Israel
Mauritius
Thailand
Mexico
China
Philippines
Costa Rica
Italy
Peru
Indonesia

Hungary
Czech Rep.
Poland
Estonia
Slovenia
Lithuania
Latvia
Slovakia

El Salvador
South Africa
Vietnam
Egypt
Venezuela
Brazil
India
Ecuador
Colombia
Bolivia
Bulgaria
Zimbabwe
Ukraine
Russia

Another interesting compilation of information addressing competitiveness of the nations included is Nations in Transit 1998. This report rates 28 transitional economies for 11 categories including Political Process, Civil Society, Independent Media, Government and Public Administration, Rule of Law, Corruption, Privatization, Macroeconomic Policy, Microeconomic Policy, Democratic Reform (unweighted average of first five categories), and Economic Reform (unweighted average of last three categories). An explanation for each country is also included in the report.

Nations in Transit 1998 Ratings Summary

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Notes: ratings are on a one-to-seven scale, with a one representing the highest and a seven representing the lowest level of progress. Corruption was rated "A" to "D", with an "A" representing the highest level of progress, or least amount of corruption. 

Source: Freedom House
These three reports provide data regarding the existing state of business in the nations included in the reports. The Nations in Transit ratings summary examined twenty-eight transitional countries on the basis of the eleven factors noted. The Global Competitiveness Report and Benchmarking Competitiveness in Transitional Economies together show how the transitional economies compete against the rest of the world. The data regarding Ukraine paints a challenging business environment and is presented here as background information about Ukraine.

**Foreign Direct Investment Trends in Transitional Economies**

In 1992, the Organization for Economic Co-operation and Development (OECD) conducted a survey of roughly 300 companies to assess the factors that western companies considered before making investment decisions in twelve Central and Eastern European (C&EE) and Former Soviet Union (FSU) countries, including Ukraine.

Traditional advantages such as low labor costs, cheap resources, and investment incentives, though considered, were not primary motivators for investing, and were perceived as short-term benefits only. Many corporations anticipated that privatization of core industries would lead to opportunities to create satellite businesses that support those core privatized businesses. This is consistent with the reasons influencing foreign investing introduced earlier. While most corporations are focusing on demand factors (market expansion), supply factors (labor and resources) and political factors (investment incentives), the primary factor however in companies interviewed by OECD for investing in transitional economies appears to be market expansion.

The OECD survey found the following constraints involved in corporate investments in these countries:

1) Central bureaucratic, administrative and legislative issues,
2) Protracted and complex negotiations or approval procedures,
3) Frequent changes of government officials and difficulties in finding the decision makers who would accept responsibility,
4) Inconsistent views and policy changes,
5) Conflicting information from different ministries,
6) Government strategies being ill defined, ambiguous, and lacking a determined long-term strategy. 

These challenges merely impeded the investment process rather than prevented it.

UK Company (Construction and Development): “The internal politics of the Czech Republic dragged it out a lot. What we did buy was very different from what we started to buy. The mixture of politics and bureaucracy - you need 44 permissions to do something.”

US Company (Construction & Property Development Company): There are three principles [barriers] under the general headings of lack of understanding and perception of bureaucracy: 1) A lack of clear title and emergence of former owners. We had a former owner come forward and her claim was valid. It delayed the opening and we had to reach an accord. 2) In many cases there is an unwillingness of the bureaucracy both the local and federal to be helpful to private business. They don't see it as their business to help private business. At best they are neutral and at their worst they are obstructive. They are suspicious just because these companies are there. 3) The business of getting the bureaucracy to agree to what their obligations are and to fulfill them. These kinds of things create a moving target. The laws change daily and extra costs appear which you hadn't expected; legal, tax, VAT, sales tax which you find are different after the fact.”

Other problems included slowly developing business infrastructure in areas of banking, communications, and distribution, human resource inadequacies, changing legislative framework, and ineffective judicial apparatus for enforcement of existing laws. The constraints identified are similar to those mentioned in the competitiveness reports previously, suggesting that these countries present a challenging environment in which to do business.
Austrian Company (Construction and Property Development): "Problems of mentality the people there just don't understand how critically we see it all. They don't understand anything about write-off, risks etc. The people just think 'planned economy' they haven't changed their way of thinking yet."\(^7\)

UK Company (Construction and Property Development): "Decent financial information on potential partners is difficult to get due to the lack of a commercial infrastructure."\(^8\)

Austrian Company (Construction and Property Development): "The people just don't understand a market economy. They have other expectations, their attitude is still completely different."\(^9\)

**Investment preferences**

The joint venture form of investment was previously noted as gaining in popularity in the global business environment. The most popular form of investment in the transitional economies studied by OECD was the joint venture. Ninety out of 174 responses to the OECD survey preferred joint ventures due to local knowledge and contacts, immediate access to domestic market, ability to acquire certain operations of the local company and thus reduce initial investment requirements, ability to gain market share and presence.\(^10\)

Acquisitions were used 39 times, with the foreign company being a majority owner in 31 cases, while greenfield developments were used 37 times. The main reasons given for acquiring operations were to gain market share, acquire an existing brand name, to develop own brand names, and to speed up entry at a lower cost than greenfield developments. Greenfields were chosen when companies sought 100% ownership or were unable to locate other opportunities, like appropriate partners. Overall, minority shareholdings in companies were not preferred and only chosen when: 1) corporations wished to position themselves in a market in order to be best placed to take advantage when it developed, 2)
Corporates were adopting a risk averse entry into a market, 3) Corporates were investing as part of a consortium.\textsuperscript{83}

The reasons given for selecting joint ventures and acquisitions appear to address the constraints of doing business in transitional economies mentioned in the previous section. Essentially the constraints mentioned, referred to inadequate administrative and business infrastructure. The responses here regarding reasons for choosing a particular form of entry such as a joint venture indicate that speed of access to the market was a concern as was local contacts and knowledge. This suggests that entering the market in other forms would not be speedy or that a lack of local contacts may also hinder business progress. Both issues point to either inadequate administrative or business infrastructure; this is consistent with general foreign investment theory which suggests that joint ventures and M&A are speedier forms of entry into new markets versus a greenfield investment.

A survey of 79 US business executives, which was completed by three US business school researchers in August of 1990, ranked modalities most likely to exploit East European markets.\textsuperscript{84} The following are the rankings from 1990's survey:

1 Exporting from West European subsidiary  
2 Exporting from the US  
3 Licensing  
4 Bartering  
5 JV w/ US minority interest  
6 Countertrade  
7 JV w/ US majority interest  
8 Wholly owned subsidiary

What the ratings appear to indicate is that the respondents felt that the least risky forms of investment would be those preferable. The highest rated form of direct investment, the joint venture was rated fifth. Numbers were not available to compare the amounts of business that took place in the above forms of business, since the survey took place. One interesting side note though is that between 1993 and 1998, the amount of annual FDI that flowed into Central and Eastern Europe nearly tripled.
Country popularity

When asked what countries companies did business in or were considering, Hungary came in first followed by Czech Republic, Poland, Slovakia, Russia, and Ukraine. German and US-based companies were particularly interested in Ukraine. The OECD survey is corroborated by another source, which states that most joint ventures registered between 1988 and 1991 were in Poland and in Hungary and in the service sector, although only 10% of these joint ventures were operational in 1991. It was noted that some Western manufacturers switched locations of ventures from the Iberian Peninsula & Greece to Central and Eastern Europe to take advantage of lower wages and transport costs and in some cases well trained skilled labor force. This may suggest a demand for locations with low cost labor and transport costs such as Ukraine. Results since the survey indicate a few changes. Poland, in 1996 became the region's most popular country for foreign investment. Russia, on top in 1997, was hurt the worst as a result of its loan defaults in 1998; its FDI dropped 60% that year. Otherwise the region as a whole gained 26% from 1997. Since 1993, Hungary's rank has fallen from number one to fifth place; Lithuania and Romania have both climbed the ranking scale.
Exhibit 3-3

FDI Inflows, by region and country, 1993-1998

(Millions of Dollars)

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<td>105</td>
<td>90</td>
<td>109</td>
<td>505</td>
<td>401</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>653</td>
<td>868</td>
<td>2,561</td>
<td>1,429</td>
<td>1,301</td>
<td>540</td>
</tr>
<tr>
<td>Estonia</td>
<td>162</td>
<td>214</td>
<td>201</td>
<td>151</td>
<td>267</td>
<td>581</td>
</tr>
<tr>
<td>Hungary</td>
<td>2,339</td>
<td>1,146</td>
<td>4,453</td>
<td>1,983</td>
<td>2,085</td>
<td>1,935</td>
</tr>
<tr>
<td>Latvia</td>
<td>45</td>
<td>214</td>
<td>180</td>
<td>382</td>
<td>521</td>
<td>274</td>
</tr>
<tr>
<td>Lithuania</td>
<td>30</td>
<td>31</td>
<td>73</td>
<td>152</td>
<td>355</td>
<td>926</td>
</tr>
<tr>
<td>Moldova</td>
<td>14</td>
<td>28</td>
<td>67</td>
<td>24</td>
<td>72</td>
<td>85</td>
</tr>
<tr>
<td>Poland</td>
<td>1,715</td>
<td>1,875</td>
<td>3,659</td>
<td>4,498</td>
<td>4,908</td>
<td>5,129</td>
</tr>
<tr>
<td>Romania</td>
<td>94</td>
<td>342</td>
<td>420</td>
<td>265</td>
<td>1,229</td>
<td>2,063</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>1,211</td>
<td>640</td>
<td>2,016</td>
<td>2,479</td>
<td>6,243</td>
<td>2,183</td>
</tr>
<tr>
<td>Slovakia</td>
<td>168</td>
<td>245</td>
<td>195</td>
<td>251</td>
<td>177</td>
<td>466</td>
</tr>
<tr>
<td>Ukraine</td>
<td>200</td>
<td>159</td>
<td>267</td>
<td>521</td>
<td>624</td>
<td>743</td>
</tr>
</tbody>
</table>


Synopsis of Transitional Economies

The opportunities for FDI in transitional economies center around three factors: 1) low-cost, highly skilled labor force, 2) an abundance of natural resources, and 3) market share potential. In 1990, the Former Soviet Union, Hungary, Poland, the Czech Republic, Slovakia, Bulgaria, and Romania, with a total population of over 400 million, received the same amount of investment as Ireland and Norway combined, each with a population of 5 million. The growth in Central and Eastern Europe has increased at nearly twice the rate of that of Ireland and Norway combined since 1990. The initial enthusiasm, however, has been replaced with a greater awareness of the challenges of doing business in a transitional economy including:

1. Uncertainties about legal instabilities
2. Ownership restrictions
3. Currency inconvertibility and supply constraints
4. Absence of the required legal accounting and financial infrastructure
This is compounded by the need for reform in many areas including: the areas of institutional structure, management, access to foreign markets, entrepreneurial and work culture, organizational capabilities and monetary incentives to efficiently utilize and upgrade resources and capabilities.  

It is not appropriate to over categorize or generalize about the region because each country is in a different stage of developing their economy, political system, and institutional framework. The next chapter will include details from the competitiveness reports in order to give a more detailed background on the business environment in Ukraine.
Chapter 4
Ukraine

History

Very little is known about this country whose history dates back to the first millennium BC. Highlights of its early history include the introduction of Christianity by Volodymyr the Great in 988 and the legendary freedom fighting Cossacks dating back to the 15th century. The Cossacks were constantly defending the fertile Ukraine, once known as the "Bread Basket of Europe".

Through the centuries, Ukraine fell under control of numerous other empires. Entering World War I, Ukraine was under the Russian and Austrian Empires. With the collapse of these two empires, Ukraine once again gained independence in 1918, albeit short-lived. The Bolsheviks conquered most of Ukraine in 1922. The western territories were occupied by various countries, mostly Poland, until World War II when all of Ukraine became a part of the Soviet Union.

History has shown, with Hungary, Poland, and the Czech and Slovak Republics, that the shorter the period of time a country falls under communist control, the easier the transition to a market economy. Western Ukraine came under communist control after WWII, much later than Eastern Ukraine. After the 1991 declaration of independence from the former Soviet State by all its republics, a democratic system of government was formed with a free market economy. By most expert accounts, Western Ukraine accepted the free market system more openly and based on the experiences of the countries mentioned, should have an easier transition to a market economy.

Transition Since Independence

Since 1991, Ukraine has destroyed its nuclear stockpiles, adopted a new constitution, and developed its own armed forces, currency, banking system, and stock exchange. It is slowly privatizing government-owned land and enterprises, and has curbed hyperinflation rates that reached as high as 10,155% per annum in 1993.
Ukraine has a parliamentary form of government with a presiding president. The most powerful parties in parliament are the following: Communists, Narodny Rukh "People's Movement", Greens Party, People's Democratic Party, Hromada "The Masses" Party, Progressive Socialists, Socialists, Agrarian Party, and the Social Democratic Party. Ukraine is a member of the United Nations, the IMF, the World Bank, and NATO's Partnership for Peace.

The transition from an authoritarian political system to a democratic system in all of Ukraine continues to be difficult, nine years after independence. Rich in natural and human resources, geographical location, and to a lesser extent transportation and utility infrastructure, and industrialization, it would appear as though the future should be bright. Yet gross domestic product, (GDP) has dropped every year since the declaration of independence. There is hope however, since GDP grew the first half of this year.

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP (% annual change)</th>
<th>Exchange Rate (Hryvna:US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>-13.7</td>
<td>-</td>
</tr>
<tr>
<td>1993</td>
<td>-14</td>
<td>-</td>
</tr>
<tr>
<td>1994</td>
<td>-22.9</td>
<td>-</td>
</tr>
<tr>
<td>1995</td>
<td>-12.2</td>
<td>-</td>
</tr>
<tr>
<td>1996</td>
<td>-10.0</td>
<td>1.8</td>
</tr>
<tr>
<td>1997</td>
<td>-3.2</td>
<td>1.9</td>
</tr>
<tr>
<td>1998</td>
<td>-1.5</td>
<td>3.4</td>
</tr>
<tr>
<td>1999</td>
<td>-0.4</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Department of Foreign Affairs and International Trade, Ottawa, Canada, http://www.dfa-ita.gc.ca/eng/geo/europe/87268-e.htm

Investment in Ukraine

Climate

Between 1987 and 1997, industrial output in Ukraine decreased by an annual average of 16.4%. The manufacturing sector contracted by an annual average of 15.9% and the service sector shrunk by an 8.6% annual average. Production suffered due to outdated, inefficient, and poorly maintained equipment. Enterprises, operating without subsidies received in the planned economy have been in dismal financial states in the new market economy,
unable to pay wages let alone invest in new equipment. Financing for investment in the outmoded capital stock is unavailable due to the immature banking system. As domestic assets deteriorate, and financing is not available domestically, foreign aid or investment is relied upon to provide financing and other inputs for economic growth.

**Privatization - an Opportunity for Investment**

One way foreign investment can take place is through privatization, the process whereby government owned property is relinquished to the private sector. Funds from the sale of property go to the government and can be used to pay other obligations of the government. More importantly, privatization can be used as a tool for reform. By selling companies to capitalized investors, the deteriorated stock of assets can begin to be updated. Management know-how is also a consideration. By selling to investors with managerial or technological knowledge, the base of knowledge in the country is raised. Productivity, quality and international competitiveness improves.

There were several aspects of privatization in Ukraine that ran counter to the theory explained above. First, many small businesses, were leased or sold to workers, lacking not only management skills, but also the necessary working capital. Many are on the verge of bankruptcy. Second, many Ukrainian businessmen took advantage of contacts and weak laws in privatizing enterprises in obtaining ownership of companies. Finally, large state enterprises in Ukraine sometimes retain a state holding of 80% or more of the joint stock company. "Strategic enterprises", those in the areas of defense, heavy industry, transport, and communications offer the best prospects for FDI, but remain off limits to privatization. So far, no foreign company has acquired a privatized enterprise, and investors often complain of difficulties in determining whom to deal with when negotiating a joint venture.

**Impediments to Investment in Ukraine**

There are many advantages of foreign investment for a host country, however, there are significant challenges that foreigners face when investing in
Animosity towards foreign investors is one. Part of the reason is mistrust.

"They love investment but hate investors."

(According to an Investor in Ukraine who, for four years, fought for an investment of $50 million US Dollars that would save several hundred jobs but has still made no headway. Meanwhile the investment project is on the verge of bankruptcy.)

In a meeting with the "German Advisory Group with the Ukrainian Government in Kyiv" in August, 1997, Ukrainian President Kuchma asked about the reasons behind the low levels of foreign investment in Ukraine. The German Advisory Group, led by Felicitas Mollers, interviewed twenty companies that had $540 million US Dollars invested in Ukraine, over one-third of all FDI in Ukraine at that time. Companies representing 11 industries and 8 countries, 10 from Germany, were asked about the impediments to investing in Ukraine. The following chart includes results from questions to companies investing in Russia and the Czech Republic, as well as the results for Central and Eastern Europe as a whole:
### Exhibit 4-2

#### Impediments to Investing in the Following Transitional Economies

<table>
<thead>
<tr>
<th>Rank</th>
<th>Impediment to Investing</th>
<th>Ukraine</th>
<th>C&amp;EE</th>
<th>Russia</th>
<th>Czech</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Legal Uncertainty</td>
<td>100</td>
<td>37</td>
<td>70</td>
<td>-17.2</td>
</tr>
<tr>
<td>2</td>
<td>Unsatisfactory transport infrastructure</td>
<td>97.5</td>
<td>-4.4</td>
<td>14.2</td>
<td>-31</td>
</tr>
<tr>
<td>3</td>
<td>Government failure to abide by commitments</td>
<td>90</td>
<td>-42.4</td>
<td>-30</td>
<td>-92.8</td>
</tr>
<tr>
<td>4</td>
<td>Government control and remnants of command economy an impediment</td>
<td>80</td>
<td>21.2</td>
<td>60</td>
<td>-35.8</td>
</tr>
<tr>
<td>5</td>
<td>Lack of telecommunications infrastructure</td>
<td>80</td>
<td>-16.6</td>
<td>14.2</td>
<td>-31</td>
</tr>
<tr>
<td>6</td>
<td>Lack of support from the authorities</td>
<td>75</td>
<td>1.2</td>
<td>33.4</td>
<td>-7.2</td>
</tr>
<tr>
<td>7</td>
<td>Corruption</td>
<td>75</td>
<td>-19.8</td>
<td>-8.7</td>
<td>-72.2</td>
</tr>
<tr>
<td>8</td>
<td>Obtaining planning permission takes too long</td>
<td>60</td>
<td>-56.4</td>
<td>-46.6</td>
<td>-40.8</td>
</tr>
<tr>
<td>9</td>
<td>Poor economic scenario</td>
<td>55</td>
<td>20.2</td>
<td>72.8</td>
<td>-57.2</td>
</tr>
<tr>
<td>10</td>
<td>Difficulties with local banks</td>
<td>10</td>
<td>-26.4</td>
<td>-20</td>
<td>-38</td>
</tr>
<tr>
<td>11</td>
<td>Inadequate distribution infrastructure</td>
<td>5</td>
<td>-20.4</td>
<td>22.2</td>
<td>-31</td>
</tr>
<tr>
<td>12</td>
<td>Delivery reliability and punctuality deficient</td>
<td>5</td>
<td>-6.6</td>
<td>42.8</td>
<td>-28.6</td>
</tr>
<tr>
<td>13</td>
<td>Difficulty obtaining real estate</td>
<td>0</td>
<td>-19.6</td>
<td>-10</td>
<td>-31</td>
</tr>
<tr>
<td>14</td>
<td>Low productivity</td>
<td>-10</td>
<td>7.2</td>
<td>60</td>
<td>7.2</td>
</tr>
<tr>
<td>15</td>
<td>Organized crime</td>
<td>-10</td>
<td>-36.4</td>
<td>-34.8</td>
<td>-85.8</td>
</tr>
<tr>
<td>16</td>
<td>Environmental constraints</td>
<td>-15</td>
<td>-74.8</td>
<td>-68.4</td>
<td>65.4</td>
</tr>
<tr>
<td>17</td>
<td>Workers’ quality awareness too low</td>
<td>-15</td>
<td>-20.4</td>
<td>-4.8</td>
<td>-24.2</td>
</tr>
<tr>
<td>18</td>
<td>Unreliability of staff</td>
<td>-50</td>
<td>-54.6</td>
<td>-30</td>
<td>-48.2</td>
</tr>
<tr>
<td>19</td>
<td>Poorly trained labor</td>
<td>-60</td>
<td>-43.6</td>
<td>-20</td>
<td>-38</td>
</tr>
<tr>
<td>20</td>
<td>Low level of staff commitment</td>
<td>-60</td>
<td>-60</td>
<td>-40</td>
<td>-42.8</td>
</tr>
</tbody>
</table>

Note: Scores are the balance between affirmative and negative replies in %.
Source: *Ukraine at the Crossroads*, 146-7.

Five of the top seven impediments are related to administrative infrastructure, indicating that the biggest impediment to doing business in Ukraine for these companies is the government. Along with administrative infrastructure, unsatisfactory transport infrastructure (ranked 2nd), lack of telecommunications infrastructure (5th), obtaining planning permission takes too long (8th), difficulties with local banks (10th), and difficulty obtaining real estate (13th) are all real estate related challenges which will be addressed in chapter 5.

Earlier in chapter 3 on transitional economies, it was noted that Ukraine ranked 58th out of 59 countries that were included in *The Global Competitiveness*
Report. The report ranked a country's competitiveness by forecasting its medium to long-term economic growth potential based on the following eight indicators:

Exhibit 4-3

**Ukraine's Ranking in the Eight Variables of the Global Competitiveness Report**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Ukraine's Rank Out of 59 Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Openness to foreign trade and investment</td>
<td>58</td>
</tr>
<tr>
<td>2) Government policy</td>
<td>48</td>
</tr>
<tr>
<td>3) Financial Institutions efficiency</td>
<td>59</td>
</tr>
<tr>
<td>4) Infrastructure quality</td>
<td>59</td>
</tr>
<tr>
<td>5) Technological advancement and absorption</td>
<td>54</td>
</tr>
<tr>
<td>6) Management quality</td>
<td>55</td>
</tr>
<tr>
<td>7) Labor market competitiveness</td>
<td>21</td>
</tr>
<tr>
<td>8) Institutional quality</td>
<td>56</td>
</tr>
</tbody>
</table>

The following is a list of just a few of the specific subvariables measured by The Global Competitiveness Report. Subvariables that were considered to be liabilities for Ukraine include the following with Ukraine's rank out of 59 in parenthesis:

**Openness**
- Access to foreign capital markets (56)
- Hidden import barriers (56)
- Tariffs and quotas (58)

**Government**
- Tax evasion (57)
- Tax system (59)
- Government bureaucracy (59)

**Finance**
- Financial regulation & supervision (56)
- Sophistication of financial markets (57)
- Access to credit (58)
- Country credit rating (59)

**Infrastructure**
- Roads (56)
- Private investments in infrastructure (56)
- Air Transport (57)
- International telephone service (57)
- Cellular telephones (58)
- Telephones and fax machines (58)
Motives for Investing in Ukraine

With such a dismal outlook for the attractiveness of the Ukrainian landscape as place to do business, it would seem highly unlikely that investment would take place. The German Advisory Group's survey that researched the impediments to investing in Ukraine also investigated the motives. The following exhibit compares results of Ukraine with Central and Eastern Europe as a whole, Russia, and the Czech Republic.

The ratings of Ukraine's competitive advantages and disadvantages are consistent with the survey of twenty foreign companies noted earlier in this section. The primary advantage of investing in Ukraine was labor market competitiveness. While labor costs have been viewed, as a supply factor which influence foreign investment decisions (see chapter 2), the OECD report in chapter 3 on transitional economies indicated labor costs were not a primary influence in investing in a country.
The twenty interviewees were given twelve motives to score; three were sales related and the other nine were cost or location related. The results are very clear in the case of Ukraine. The three sales-related motives ranked first, second and fourth. The conclusion is that the primary reason for companies to undertake the difficulties associated with direct investment in Ukraine is market opportunity. Another reason to invest in Ukraine as opposed to exporting to Ukraine is to avoid import barriers. Meanwhile cost and locational considerations are not significant reasons for investing in Ukraine.

The findings here are consistent with what was found in chapter 3 with investment in transitional economies. Companies were interested in speed to market and concerned about administrative and business infrastructure. Those companies participating in the OECD survey found the joint venture the best route to enter the market. Chapter 5 will examine some of the real estate impacts associated with this form of investment.
FDI in Ukraine

Exhibit 4-5

FDI Comparison between Select Central and Eastern European Countries, 1998

<table>
<thead>
<tr>
<th>Country</th>
<th>Total Running Volume of FDI (Millions of Dollars)</th>
<th>Population (Millions)</th>
<th>Per Capita FDI (In Dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belarus</td>
<td>466</td>
<td>10.2</td>
<td>46</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>1,352</td>
<td>8.1</td>
<td>167</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>13,457</td>
<td>10.3</td>
<td>1307</td>
</tr>
<tr>
<td>Estonia</td>
<td>1,822</td>
<td>1.5</td>
<td>1215</td>
</tr>
<tr>
<td>Hungary</td>
<td>18,255</td>
<td>10.2</td>
<td>1790</td>
</tr>
<tr>
<td>Latvia</td>
<td>1,488</td>
<td>2.5</td>
<td>595</td>
</tr>
<tr>
<td>Lithuania</td>
<td>1,625</td>
<td>3.7</td>
<td>439</td>
</tr>
<tr>
<td>Poland</td>
<td>21,722</td>
<td>38.6</td>
<td>563</td>
</tr>
<tr>
<td>Romania</td>
<td>4,250</td>
<td>22.6</td>
<td>188</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>13,389</td>
<td>147.7</td>
<td>91</td>
</tr>
<tr>
<td>Slovakia</td>
<td>2,062</td>
<td>5.4</td>
<td>382</td>
</tr>
<tr>
<td>Ukraine</td>
<td>2,801</td>
<td>51.1</td>
<td>55</td>
</tr>
<tr>
<td>Total</td>
<td>82,689</td>
<td>311.9</td>
<td>265</td>
</tr>
</tbody>
</table>


The chart shows that in absolute terms, up to 1998, Ukraine received the 6th highest cumulative amount of FDI (stock) of the select countries listed. However, Ukraine ranked 2nd to last in terms of per capita FDI allotment.

The sources of this inward FDI stock into Ukraine are Europe (31%), United States (18%), Russia (7%), Korea (7%), and Cyprus (5%). The percentage amount invested in Ukraine from Europe was at the bottom of the percentage scale in comparison to other Central and Eastern European countries.

The sectoral distribution, into which FDI is flowing, is broken up into primary (agriculture and mining) sector (4%), secondary (or manufacturing) sector (43%), and tertiary (or services) sector (40%). This data is consistent with data from other Eastern and Central European countries.
Ukrainian Real Estate

There is "BC" and "AC" in Ukrainian real estate markets- meaning before crisis and after crisis. The Russian government's default on its debts in mid 1998 produced a downward spiraling effect on business in general in Russia, which reached Ukraine months later. The result was a turning point for the real estate markets in Ukraine.

Office Market

"BC", real estate prices were soaring as a result of a lack of supply of "class A style" space. International corporations and government agencies were saturating the market. During 1998, development began to alleviate the space disequilibrium. A huge oversupply resulted which was exacerbated by the financial crisis. Market rates dropped "AC" and began to stabilize in early 2000. Office rates, which peaked "BC" at between $50-100 USD per square meter per month ($55-110 per square foot per year), tumbled to $20-30 USD per sq. m. per month. There remains an oversupply of space where, at the present time with the worst quality and locations can currently be leased for $5. Demand is typically for 2,000 to 5,000 square feet of space; lease terms range between one to five years.

Office space falls into three distinct categories: 1) modern amenitized, which resulted from new construction 2) local government owned, and 3) converted apartment space. The first category is used by multinational enterprises while the latter two categories, are occupied by the remaining 95% of users consisting of local companies and government.

Residential Market

Similar to office space, supply has outpaced demand and prices have dropped. Typical purchases require full payment in advance. New construction affords larger, better-planned units with a variety of financing options all at a higher price. According to Nadiya Moiseyenko, Director of Key Realty in Kyiv, the biggest problem in the real estate market is the lack of large, high-quality residences. For example, a remnant from the soviet system is communal apartments. Ms. Moiseyenko explains that these units housed up to 5 families
each having one private room, sharing one toilet, one bathroom (tub and sink), and a kitchen with one stove per family. Expatriates prefer large high-quality units close to the city center. Ukrainians tend to purchase the unrenovated apartments then fix them up, as opposed to Westerners who buy ready to move into space at a premium.

The chart below shows the prices for apartment in Kyiv. Please note the steep rent gradients. As you move from the city center, prices drop dramatically.

Exhibit 4-6

<table>
<thead>
<tr>
<th>City District</th>
<th>One-room apartment</th>
<th>Two-room apartment</th>
<th>Three-room apartment</th>
<th>Cost per sq. meter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Center</td>
<td>18,000</td>
<td>30,000</td>
<td>53,000</td>
<td>673</td>
</tr>
<tr>
<td>Pechersk</td>
<td>15,000</td>
<td>21,000</td>
<td>33,000</td>
<td>460</td>
</tr>
<tr>
<td>Podol</td>
<td>12,000</td>
<td>17,000</td>
<td>25,000</td>
<td>360</td>
</tr>
</tbody>
</table>


Fraudulent transactions are not uncommon. One example is renting apartments to multiple tenants with fake documents. By signing up multiple tenants with up front deposits and rent fees, fake landlords can escape with large profits. A form of misrepresentation that occurs intentionally as well as unintentionally, is when the lessor does not possess clear title to the property being leased.

**Manufacturing Space Market**

The manufacturing space market is not adequately developed. Most manufacturing transactions occur through privatization of soviet plants in need of total rehab. Most space is multi-story, has low ceilings, and is poorly ventilated, obsolescent space. If plants are needed, however at present there is not a strong demand for developing manufacturing plants due to the market immaturity/environment.

**Warehouse Space Market**

There is a glut of poor quality, soviet style warehouse space, however, modern warehouse space is also almost nonexistent and rents for $5 USD per
sq. m. per month. Warehouse space tends to follow more developed markets. Full-height loading bays, serviceable storage racks, flooring suitable for forklift trucks are scarce luxuries.

**Retail Space Market**

Retail space offers the developer the best opportunity since quality space is almost nonexistent. The top-notch city center space goes for $130 per square meter a month, but drops off drastically all the way down to $40 due to the steep rent gradient in the city center.

Early entrants into the retail market include Benetton, Reebok, Adidas, Lee/Wrangler, Hugo Boss, Nike, Levi's, and McDonald's, which has 30 restaurants throughout Ukraine with expansion plans for 85 more in the next five years. The supermarket concept is already being developed. Future trends include the development of Big Box retail outlets and the redevelopment of old Soviet style department stores. The caveat is the small but increasing number of customers with purchasing power.

**Hotel Space Market**

An important part of the business infrastructure deficiency has been the lack of a quality hotel in Kyiv. Plans for a 288 room Hilton Hotel and the Radisson SAS were supposed to change that. However, dogged by government approval bureaucracy, these projects remain stifled. While other hotel operators are investigating opportunities the Hotel Intercontinental may be the first hotel finished sometime in 2001. Officials believe that the hotel additions will improve the impressions international business executives have of Kyiv as a business center.

**Synopsis**

The real estate data for Ukraine indicates that there does not appear to be any difficulty in obtaining office space. This contradicts the literature reviewed which states that obtaining real estate is an impediment to doing business. This does not mean, however, that the real estate available is adequate to meet the needs of companies that are making investments in Ukraine. Companies from both the service and manufacturing sectors have been interviewed about the
types of space they use. Their challenges and practices will be compared against the data just reviewed related to the real estate space markets in Ukraine.
Chapter 5
Data Analysis - Managing Corporate Real Estate in Ukraine

Insights

When my research on corporate real estate in Ukraine began, I expected to find the lack of real estate expertise at the local business level. Managing corporate real estate for a large multinational enterprise on a global scale is highly complex. Few companies have truly international real estate units which centrally create strategy, or even standards, for all their business units, and property types. Therefore, it was assumed that the local business units of large multinational firms managed their own real estate in conjunction with a real estate group at regional headquarters or by themselves. Due to the lack of real estate expertise or experience at the business unit level in Ukraine, it was felt that external real estate service providers would play an important role in the management of corporate real estate in Ukraine. This was not the case in the majority of companies interviewed.

Decision Making Process

For all the companies I spoke with, the decision making process takes place in Ukraine without any outside input or interference. In some cases it was noted that a company had the advisory services of a regional headquarters available to them. On of the most striking aspects of the decision making process, however, was the assortment of different employees regarded as being in charge of real estate. I spoke with sales directors, logistics supervisors, human resource coordinators, public affairs representatives as well as directors of the company. In no case did the employee making real estate decisions have a position that was real estate related. Terry Pickard, a real estate service provider in Ukraine for over eight years, recently noted that the employee in charge of facilities "already has a full time job to do on which his further corporate career will be judged, so [facilities management] is regularly put to one side while he concentrates on more important issues." An example from Pickard that illustrates how undermanaged corporate real estate in Ukraine can be is the "expat" on a 3 year corporate rotation being in charge of facilities. His medium to
long-term mistakes will become the responsibility of his successor long after his
tour ends. The following is an another example cited by Pickard.

Exhibit 5-1
A marketing manager signed an office lease to the dismay of his director who
canceled the contract resulting in a cancellation penalty. The marketing
manager signed another lease for 5 years with options on the whole building.
They spent $30,000 building cubicles on an open floor plan and installed a
telephone network as well. A new director was appointed who did not like the
office so a supposed American specialist from Russia was called in to find a
new office in Ukraine. At the end of 1998, they signed a contract for 3 years
starting June 1999, at $40 per sq. m. with 2 years prepayment.
They didn’t move in until July 1999, and the old landlord won a
settlement of $750,000 for breach of contract.
Total cost - possibly close to $2 million.

While this research did not reveal such inefficiencies, the lack of real
estate expertise in the local business units was apparent.

Real Estate Service Provider Usage
As evidenced in the preceding example, often times those responsible for
managing corporate real estate in Ukraine are inexperienced and untrained. It
would reasonably follow that, without in-house real estate expertise, corporations
would use real estate service providers. This is not what the interviews indicated.
Upcoming Exhibits 5-2 and 5-3 show that almost all of the respondents have
used brokers for one service or another. However, this type of usage was
infrequent and often times the company would end up finding space on their own.
When the manufacturing companies developed properties, they had construction
and project management needs that were outsourced. Legal services were used
as well. For example, one company changed the company business entity from a
consortium to an LLC in order to transfer the rights to the property from the State
to the business entity. Another example of a legal service used would be an
evaluation of the title to confirm that there are no entities, other than the so-called
designated owner, that have legal interests in the property.

The hesitance to use a broker for tenant representation was found to
center around the cost of such services and the ability of the companies to
handle the job themselves. Unlike in the United States, where often times the broker's fee is paid by the landlord or seller, in Ukraine the tenant typically pays for the broker's services over and above the sale price or rent to be paid. This was especially the case prior to the crisis when demand outstripped supply. However, now with supply being greater than demand in most markets such as office space, it is not uncommon to see landlords pay the broker's fee. On the other hand, one of the brokers interviewed noted their clients are primarily repeat customers or referrals that pay their fees. For example, this broker is able to obtain information on the availability of popular, large, high-quality apartment space is in demand, based on past relationships and referrals. Apparently to their customers, the fees are worth the service.

Along with the cost of broker representation, the ability to handle the job themselves was another reason for the lack of reliance on real estate service providers. Two points were made to support this. First, for most companies in Ukraine, the primary real estate function is administering the lease or finding new office space. Before the crisis, finding space may have been difficult, but now it is not in most cases. Furthermore, if a company merely needs a small office, then it shouldn't be too difficult and, in many cases, the larger real estate service providers do not even take on that scale of assignment. An exception to this might be performing work on behalf of an important client outside Ukraine. One service provider noted that their minimum space request required in order to get involved is 150 square meters (approximately 1500 square feet), with exceptions as explained.

One final point learned from interviews is that the real estate service provider market appears to be bifurcated. There are international agencies and local agencies. By most accounts, DTZ and Colliers, two international full service real estate companies, dominate the market. Services provided include brokerage, property management, evaluations, consulting, and tenant representation. There are smaller foreign agencies that have both foreigners and locals on staff. Foreign companies use them as well. However, the local real
estate service providers do not appear to be competing with the foreign real estate service providers.

Form of Entry into Ukraine and Real Estate Strategy

Exhibit 5-2 summarizes the forms of entry of the seven service sector companies interviewed.

Service Sector

<table>
<thead>
<tr>
<th>Company Number and Type</th>
<th>Form of Entry</th>
<th># of Sites</th>
<th>How Has Real Estate Been Obtained</th>
<th>Use of Real Estate Service Providers</th>
<th>Types of Services Used</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Service Sector</td>
<td>Internal Expansion - Rep. Office for Marketing only</td>
<td>1</td>
<td>Purchased</td>
<td>Yes</td>
<td>Broker &amp; Tenant Rep</td>
</tr>
<tr>
<td>2</td>
<td>Internal Expansion - Rep. Office for Sales, and Distribution</td>
<td>1</td>
<td>Leased</td>
<td>Yes</td>
<td>Broker &amp; Tenant Rep</td>
</tr>
<tr>
<td>3</td>
<td>Internal Expansion - Rep. Office for Sales, and Distribution</td>
<td>2</td>
<td>Leased</td>
<td>Yes</td>
<td>Broker &amp; Tenant Rep</td>
</tr>
<tr>
<td>4</td>
<td>Internal Expansion -</td>
<td>1</td>
<td>Leased</td>
<td>Yes</td>
<td>Broker &amp; Tenant Rep</td>
</tr>
<tr>
<td>5</td>
<td>Internal Expansion -</td>
<td>1</td>
<td>Leased</td>
<td>Yes</td>
<td>Broker &amp; Tenant Rep</td>
</tr>
<tr>
<td>6</td>
<td>Joint Venture - 50/50 w/ Local Company</td>
<td>2</td>
<td>Leased</td>
<td>Yes</td>
<td>Broker &amp; Tenant Rep</td>
</tr>
<tr>
<td>7</td>
<td>Franchise</td>
<td>25</td>
<td>Leased</td>
<td>No</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Source: Author

Although six of seven companies are noted above as using real estate service providers, the use is actually limited. Companies may enlist the help of a broker but will still continue to search separately and often times find space on their own. What is most interesting from the data collected is that the interviewed companies used a number of unique variations on established forms of entry discussed earlier. And, not surprisingly, all but one leased in the current market.

The seven service sector companies interviewed entered via Internal Expansions, Joint Ventures, and Franchising. Five companies chose internal
expansion. Of those five, however, there were unique strategies for entering the
Ukrainian market. One company expanded internally through a representative
office strictly involved in marketing with no sales activity taking place within
Ukraine. Two companies expanded internally into Ukraine and leased
representative offices involved in the sales and distribution process with no direct
sales at their office. Two others expanded internally and are open for business at
their offices. Two enterprises chose different routes into Ukraine. One company
formed a 50/50 joint venture with a local partner. The final service company did
not actually invest directly in Ukraine. Instead the multinational enterprise found
an agent in Ukraine to carry out its business in the form of a franchise. The local
agent carries all the risks attributable to being in Ukraine, and is fully responsible
for the procurement of the necessary real estate involved in carrying out the
business of the franchiser.
Manufacturing Sector

Exhibit 5-3

Form of Entry and Real Estate Strategy for Manufacturing Sector Companies

<table>
<thead>
<tr>
<th>Company Number and Type</th>
<th>Form of Entry</th>
<th># of Sites</th>
<th>How has Real Estate Been Obtained</th>
<th>Use of Real Estate Service Providers</th>
<th>Types of Services Used</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>Manufacturer</td>
<td>Joint Venture - Developed a Greenfield Project</td>
<td>1</td>
<td>Developed</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Joint Venture/ License Agreement - with Local Privatized Manufacturer</td>
<td>~13</td>
<td>Developed, Leased, and Acquired Through Joint Venture</td>
<td>Yes</td>
</tr>
<tr>
<td>10</td>
<td>JV/Consortium - with State-Owned Company</td>
<td>1</td>
<td>Acquired Through Joint Venture</td>
<td>Yes</td>
<td>Attorney</td>
</tr>
<tr>
<td>11</td>
<td>Internal Expansion- 1) entered Ukraine as representative sales office originally; 2) registered as Ukrainian company, 3) acquired another company</td>
<td>3</td>
<td>Leased and Acquired through buying another company</td>
<td>Yes</td>
<td>Broker &amp; Tenant Rep</td>
</tr>
</tbody>
</table>

Source: Author

Of the four manufacturing companies interviewed, three entered Ukraine by way of joint ventures, but took distinct routes in setting up shop. One company formed a joint venture, with a privatized company that was completing a manufacturing plant. At the same time, another company formed a consortium with a state-owned company, which already had facilities.

The third manufacturer formed a joint venture in the same year as the previous two manufacturers. A Ukrainian legal entity was formed to develop a greenfield manufacturing plant. Land was leased from a lessee of the state, and a multi-use manufacturing facility was constructed. Later, the manufacturer obtained a perpetual use certificate issued by the local administration which is a
right to the land that is legally mortgageable and transferable with certain use restrictions.

The fourth manufacturer entered by way of internal expansion slightly earlier than the other manufacturers. This enterprise entered, however, as a representative sales office only. Once the representative office became an official Ukrainian entity, it purchased a manufacturing business in Ukraine and now manufactures, imports, exports, and sells products in Ukraine as well.

In comparing the forms of entry and real estate strategies for the respondents, patterns are visible. A majority of the service sector companies entered by expanding operations from within as a wholly owned subsidiary, while the manufacturers entered Ukraine by way of a joint venture in three of four cases. The service sector companies preferred to lease their space while the manufacturers acquired their facilities through development, leasing, purchasing, or acquiring through joint ventures. One final note, no interviewed company, or company doing business in Ukraine that participated in the OECD survey, merged with or acquired a Ukrainian firm while still a foreign entity. One of the interviewees, however, acquired a firm after entering Ukraine and registering as a Ukrainian entity however. The laws on such matters are inconsistent and this appears to have adversely affected the merger and acquisitions of Ukrainian companies.

**Space Procurement Decisions**

A majority of the respondents were lessees. When asked why they chose leasing as the means for procuring real estate, the top four responses were cost, corporate policy, investment/political risk and flexibility. The respondents felt that it was less expensive to lease versus buy. This appears to be true since financing is difficult to obtain in Ukraine and is very expensive. It is also common for corporations to have blanket policies related to leasing versus owning. The fears related to investment or political risk include 1) committing to a long term investment when the company position in Ukraine is uncertain, 2) the risks involved with selling the property when exiting the market, and 3) the ever
present fear of the communist party returning to power and the potential loss of property value or the property all together. The last reason why companies favored leasing was for flexibility. The Ukrainian marketplace is very unstable; companies are growing at tremendous speeds; but two years ago, with the Russian financial crisis, most companies were retrenching. Therefore, in a dynamic market such as Ukraine, flexibility to change with the market is important.

Real Estate Challenges in Ukraine

Exhibit 5-4 compares the real estate challenges of the thesis interviewees with challenges identified through the review of the surveys completed by OECD, and by the German Advisory Group. The first survey explored challenges associated with doing business in transitional economies while the second survey identified challenges of doing business in Ukraine. The challenges from the surveys are listed above on the left while the challenges noted during the interviews are listed on the left below the surveys' challenges. Notes corresponding to the challenges are included on the right. The following chart summarizes information gathered related to the challenges identified.
## Exhibit 5-4

### Real Estate Challenges in Ukraine

<table>
<thead>
<tr>
<th>Challenges Noted From the Literature</th>
<th>Notes on the Challenges</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Administrative Infrastructure</strong></td>
<td></td>
</tr>
<tr>
<td>• Planning permission takes too long</td>
<td>True but takes long in US too</td>
</tr>
<tr>
<td>• Government/legal uncertainty</td>
<td>Laws amended often Inconsistent implementation</td>
</tr>
<tr>
<td>• Bureaucratic issues</td>
<td>Impossible to identify person in charge</td>
</tr>
<tr>
<td>• Government failure to abide by promise</td>
<td>Revoked 5 year tax exemption for JVs</td>
</tr>
<tr>
<td>• Corruption/bribery</td>
<td>Payoffs for approvals</td>
</tr>
<tr>
<td>• Animosity towards foreign investors</td>
<td>Unhelpful, disinterested</td>
</tr>
<tr>
<td><strong>Unsatisfactory transport infrastructure</strong></td>
<td>Need funding for repairs</td>
</tr>
<tr>
<td><strong>Lack of telecommunications infrastructure</strong></td>
<td>Progress being made</td>
</tr>
<tr>
<td><strong>Budgets and financing</strong></td>
<td></td>
</tr>
<tr>
<td>• Difficulties with local banks</td>
<td>Financing unavailable</td>
</tr>
<tr>
<td><strong>Property rights</strong></td>
<td>Mostly leasehold but laws are changing</td>
</tr>
<tr>
<td><strong>Difficulty obtaining real estate</strong></td>
<td>Not so much anymore</td>
</tr>
</tbody>
</table>

### Challenges Noted During the Interviews

<table>
<thead>
<tr>
<th>Budgets and financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Cost</td>
</tr>
<tr>
<td><strong>Property Rights</strong></td>
</tr>
<tr>
<td><strong>Parking/Location</strong></td>
</tr>
<tr>
<td><strong>Telecom Infrastructure</strong></td>
</tr>
</tbody>
</table>

Sources: Ukraine at The Crossroads 146-157, Author's Interviews
Challenges Noted From the Literature

Planning permission takes too long - A number of respondents confirmed that the development process in Ukraine requires over 100 separate approvals. The timeframe however does not appear to be any longer than in the US. The challenges are different though.

Government/legal uncertainty - Complaints include uncertainties of interpretation of laws, postponement of the introduction of laws, inconsistent legislation, interpretation and application of laws, lack of coordination between authorities and authorities' inability to interpret the nuances of the laws.¹⁰⁵

"We employ four people who do nothing but collate and evaluate the latest legislation. The laws are amended so frequently that the officials themselves are often not familiar with them." (Multinational company with branches in over 100 countries)¹⁰⁶

One reason for these legal difficulties of course is the unique situation of transitioning to a market economy. Another reason however, is the sheer bulk of laws created. For example 26 decrees were issued in 1996, for just the cosmetics industry. In comparison, Germany has only one law for this industry.¹⁰⁷

One result of the number of laws created is inconsistency among them. For example, one law noted that foreign entities can fully own existing Ukrainian companies or newly formed subsidiaries. A later law contradicts this by stating that in a particular industry such as publishing, a foreign company is limited to only 30% ownership of enterprises in Ukraine.¹⁰⁸

Bureaucratic issues - One French respondent to the OECD survey commented on his experience in a transitional economy,

"Impossibility to identify the people responsible, decision makers who change and change their minds. The prevalent 'lobbyism' - all sorts of influences on the decision-makers from all directions which have made the situation even more difficult."¹⁰⁹
Government failure to abide by promise - Companies that registered as joint ventures by January 1, 1995 were promised tax exemptions for 5 years. Two years later the exemption was revoked.110

Corruption/bribery - Jeffrey Sachs, former Director of Harvard's Institute for International Development has been quoted as stating that anyone interested in doing business in Ukraine should be prepared to pay up to fifty bribes: for electricity, land, water, and police protection, etc.111 Much was mentioned in the literature as well as in the interviews about bribery and government corruption.112,113 A number of interview respondents suggested bribery and corruption are common and expected, with one individual suggesting that this was so commonplace that it could be budgeted for on the balance sheet.

Animosity towards foreign investors - The literature was quite negative about the attitudes of government civil servants. The government does not appear to convey an understanding or appreciation of the benefits derived from foreign investment. They certainly do not act as though they are in competition with all the other transitional economies for a company's business. It appears as though government authorities intentionally discourage foreign investment. For example, an export license takes three weeks to obtain in Ukraine, whereas in other competing countries it takes a couple of hours and no more than a day.114

However, one interviewee suggested quite the opposite. It was suggested that foreigners coming to Ukraine are very arrogant and that they should try to fit into the Ukrainian procedural system instead of complain. Another interviewee noted that they did not have any difficulties with real estate matters, rather, there was a protocol that needed to be followed.

Unsatisfactory Transport Infrastructure

Roads are there. The problem lies with the construction technology and equipment needed to improve roads crossing the border from Poland to Lviv, to the industrial Black Sea region in the south, and to Moscow to the north.115
Railways are there as well and connect all the major cities but on a wide gauge track; thereby creating delays due to switching to the narrower European track.\textsuperscript{116}

\textbf{Telecommunications infrastructure}

Progress is being made on this front. Telecommunications in the former Soviet Union has always lagged behind western countries. In 1998, Ukraine ranked second at 18.3 among Commonwealth of Independent States in number of phone lines per 100 inhabitants with 18.3.\textsuperscript{119} However, Kyiv’s density, of 39.4 per 100 inhabitants approaches the European average.\textsuperscript{120} A number of joint ventures have been created to address deficiencies in Ukrainian infrastructure. Infocom, a Ukrainian-German JV, is developing and maintaining networks, and providing document telecommunications services. Utel, a Ukrainian, German, American, Dutch JV, is improving national and international long distance services. A Ukrainian, Dutch, Danish, and German JV called Ukrainian Mobile Communications is building, operating and maintaining the wireless network.

\textbf{Budgets and Financing}

There is no competitive financial network in which the best businesses get the financing. The private sector accounts for less than 2\% of the financial sector’s assets, and are owned by enterprises entirely for the use of the parent enterprise and not for making loans to private-sector borrowers.\textsuperscript{121} Investors need to work with foreign banks since the local banking system is incapable of providing venture capital. Total available loan capital in the Western Ukraine region is estimated at no more than $500,000. As the memory of hyperinflation is still fresh (1993), loans are usually for 3 to 5 months only with interest at 70-75\%.\textsuperscript{122} Rates that high are sure to impact investment in real estate.

\textbf{Property rights - Real Estate Law}

One of the biggest disagreements among legislators is over privatization of land. While some feel that land reform and privatization are the keys to economic development, others are very resistant to the ideas. And until recently, only buildings could be owned privately, while urban land underneath the buildings remained the property of the state. Prior to 1991, foreigners were forbidden to purchase any type of real estate interest. Private owners of buildings
were given the right to occupy the underlying land for a nominal fee indefinitely. Many real estate users are uncomfortable with leasehold interests in land, for the simple reason that after the end of the lease term, the land, and often times more importantly, everything improved on the land, reverts to the lessor of the land. Real estate law in the past allowed for ownership of building.

Recent developments have taken place in the area of property rights. President Kuchma's Decree No. 32/99. "On Sale of Non-Agricultural Land Parcels," dated January 19, 1999 became effective the following March. It authorizes land with buildings or unfinished construction to be privatized. Land excluded from privatization includes inter alia agricultural land, land to be used for personal residences, and reserve and park lands. According to the draft of the new Land Code, dated 4/21/00, foreign citizens, legal entities, and states can only own non-arable land. As indicated before, numerous laws are being created and amended on an ongoing basis.

**Difficulty Obtaining Real Estate**

Acquiring a site in Western Ukraine is no problem due to abundance of idle and disused state enterprises in the region. However, many investors choose to rent factory premises, in order to minimize losses incurred from rapid disinvestment in the event of sudden political or economic collapse. A foreign factory owner says, "This must never be ruled out in Ukraine. We hope to be doing business here for more than 10 years from now, but decided to pay $15,000 per year rent for our premises, although the sale price was only $120,000. Just now, the risks are too high to commit that sum of money; which does not take into account the bribes you need to pay here and there to acquire premises in the first place." Costs in Western Ukraine are below average and there is no restriction on foreign ownership on a leasehold basis. Good quality farmland can be obtained for about $3,000 per hectare (2.471 acres), while office space in Lviv, the region's commercial center, ranges from $3 to $40 per sq meter ($0.28 to $3.74 per sq. ft.) per month.

The situation in Kyiv, where most business takes place is rather different than the previous example of Western Ukraine. "BC", (before the financial crisis
in 1998), demand outpaced supply of high quality office space. Real estate was very difficult to obtain. However, overconstruction coupled with a drop in demand, due to retrenchment of businesses after the financial crisis, resulted in an oversupply of space. Space is now more affordable and more readily available. This is the case with leasing space. Purchasing real estate remains difficult primarily due to the lack of available financing. As suggested however, by the previous quote from the factory owner in Western Ukraine, the demand for purchasing real estate by businesses in Ukraine does not appear to be very high. Besides financing difficulties, the reason according to real estate service providers is flexibility. Companies want the ability to expand and contract with the market. Perhaps more importantly, leasing is the exit strategy used to minimize exposure to the omnipresence of political risks.

Chapter Synopsis

The real estate challenges are dependent on the form in which real estate is obtained. An enterprise can develop property, buy facilities, lease space, or acquire, or joint venture with, a company that already has the necessary facilities. In acquiring property through a joint venture or an acquisition of a company, the real estate facilities are included. The facilities likely need to be updated, however the procurement of the facility is by default. One other suggestion mentioned during the interviews was to evaluate the seller's right to the property they are selling. It may be the case that there is no clear title.

Those respondents that had developed property had more complicated challenges than simply cost that was the big complaint of the lessees. There are a number of challenges associated with greenfield developments. They entail a lot more work and preparation than leasing or purchasing a ready to use facility. One enterprise developed a greenfield site in 1994 after selecting a site. The investment group worked with the local administration, presented feasibility studies, and determined the expected use of local infrastructure such as roads and utilities.

One of the challenges of development mentioned was the difficulty in obtaining approval of the construction and engineering plans. The reason for this
was that the foreign consultants used were not familiar with local standards. Therefore, local engineers and constructors needed to be hired.

The more difficult problem which the same developer had was with dealing with the European Bank for Reconstruction and Development (EBRD) which subsidized the venture. Three separate legal opinions were necessary along with financial and accounting documentation that resulted in soft cost overruns. Hard costs on the other hand were within budget including numerous change orders.

A number of interesting points were made during the chapter which will be summarized here. First, real estate appears to be undermanaged in Ukraine. Often times the real estate transactions are handled internally due to modest needs of the small offices typically found in Ukraine, as well as the costs associated with using a service provider.

The preferred form of entry for the service sector companies was internal expansion while it was the joint venture for manufacturing companies. The form of entry for the manufacturers was their preferred form of procuring property, while the service sector companies preferred to lease property. The four reasons given for leasing were cost, corporate policy, investment/political risk and flexibility. Leasing was not only the easiest form of obtaining space, but the best strategy for such an unstable market.

Exhibit 5-4 shows that the information collected from the interviews is partly inline with that from the literature reviewed. The German Advisory Group research showed that legal and government impediments were the greatest constraints on doing business in Ukraine. The OECD study similarly concluded that "central bureaucracy and administrative and legal issues" were external constraints of FDI in transitional economies. The thesis interviews show that "administrative infrastructure" was high on the list of real estate challenges mentioned by our respondents.

The one inconsistency was that cost was the biggest real estate challenge in Ukraine but was not mentioned by the surveys. One explanation could be that the survey questions were focused on doing business in general while the
interviews were strictly focused on real estate challenges. Whereas cost is always an issue in real estate, it typically isn't when discussing impediments to doing business unless it is in the perspective of financing.

Another point worthy of note, is that prices for similar office space have dropped over 50% in the last two years in Kyiv. Yet the biggest real estate challenge suggested by the interviewees was cost. Costs have dropped since the crisis but operating within budget constraints will always be a challenge.

In comparing the transitional economy information with the thesis interview a number of similarities were found. First, there are administrative infrastructure constraints which may slow the speed to market for a potential foreign investor. Second, the motives for investing according to the surveys showed that market opportunity was a major influence in investing in the region similar to what was found in the interviews. Finally, when those two points are looked at together it is apparent that the joint venture is a logical form of entry into the market which was what was found in the surveys and in the interviews. Therefore forms of entry can have real estate implications that should not be overlooked.

**Coca Cola Beverages Ukraine**

According to a report from the U.S. Embassy in Kyiv, dated March 2000, Coca Cola is the leading foreign investor in Ukraine in terms of capital invested having expended over $200 million since 1994. The following case on Coca-Cola's experience in Ukraine caps the data analysis chapter by examining the key real estate-related points made in the chapter including the corporate real estate decision making process, service provider usage, form of entry into the country, real estate strategy and finally real estate challenges.
Decision Making Process

The Coca-Cola Company is the world's leading manufacturer, marketer, and distributor of nonalcoholic beverage concentrates and syrups. Headquartered in Atlanta, Georgia, The Coca-Cola Company's products are manufactured and sold in nearly 200 countries around the world. The Company is registered in all the countries it has a presence in, and is represented in Ukraine by a representative office, Coca-Cola Ukraine.

An office is rented by its representative office Coca-Cola Ukraine from its bottling partner in Ukraine Coca-Cola Beverages Ukraine at their bottling plant in Brovary, Ukraine. Coca-Cola Beverages Ukraine, manufactures, sells and distributes products of The Coca-Cola Company in Ukraine.

The Central Europe and Eurasia Group of The Coca-Cola Company, based in Vienna encompasses 32 countries. They coordinate strategic direction for the business for the representative offices in these countries.

Coca-Cola Beverages Ukraine is the bottling company which has a licensing agreement to bottle and distribute Coca-Cola in Ukraine. Coca-Cola Beverages Ukraine manufactures, sells and distributes products of The Coca-Cola Company in Ukraine and adheres to corporate standards in making real estate decisions and uses Coca-Cola Vienna as an advisor.

Form of Entry and Real Estate Strategy

Coca-Cola Amatil, a bottling partner of the Coca-Cola Company in Australia and Asia entered Ukraine as part of its expansion plans into Central and Eastern Europe. In 1994, Coca-Cola Amatil formed a joint venture in western Ukraine with Kolos Brewery of Lviv which had a partially completed soft drinks factory. Together they created Coca-Cola Amatil Ukraine. The Coca-Cola Company licenses Coca-Cola Amatil Ukraine to bottle and distribute Coca-Cola products in Ukraine.

A joint venture was the ideal form of entry into the Ukrainian market. "Lviv was chosen for the site essentially because Kolos Brewery possessed a partially completed soft drinks factory that could be adapted to meet Coca-Cola Amatil's stringent selection criteria and be developed within a tight timeframe," says company's public affairs director Barry Bluffer. "Lviv offers highly qualified and enthusiastic workers. Local government is interested in attracting new investment to combat unemployment and it is willing to assist in the fast track processing of development applications for worthwhile projects."

Since completing its factory in 1995, Coca-Cola has moved from partial to full ownership and has continued to expand production. Coca-Cola Amatil divested itself from it's central and eastern European operations. A new company, Coca-Cola Beverages, Ltd. was created. Coca-Cola Beverages recently merged with Hellenic Bottling Company to create Coca-Cola Hellenic
Bottling Company. From its Lviv bottling plant, Coca-Cola Amatil manufactured soft drinks for distribution and sale throughout Ukraine. In 1998 an additional factory and office complex was constructed in Brovary 50 kilometers from Kiev. Since that time manufacturing has ceased at Lviv due to the downturn in the market. Lviv is being used as a warehouse. There are 7-10 distribution branches consisting of warehouses throughout the country which are leased. Most regional warehouses are leased and have been outfitted to Coca-Cola’s specifications. The bottling plant in Brovary was a greenfield investment and includes all of Coca Cola’s office space in Kyiv. The Brovary complex is owned with a 49 year ground lease. The Lviv bottling plant was obtained through the original joint venture when Coca-Cola entered Ukraine. It is presently being used as a distribution facility.

Service Provider Usage
Coca-Cola Beverages Ukraine has used various real estate service providers over the years for services such as brokerage, tenant representation, construction management and project management.

Corporate Real Estate Challenges in Ukraine
Initially after independence, Ukraine was a new frontier. According to Sonya Soutus, Coca-Cola Communications Director for the company’s Central Europe and Eurasia Group, "The government wanted foreign investment but the Former Soviet Union was lacking in an administrative infrastructure to accommodate all the needs of foreign investors. This was created. There was no tradition of rent agreements with foreign entities. This was very new and administrative routines had to be developed."
"Things improved - renting office space was made easier, leasing has become a lot easier - a process has been developed for notarizing contracts. The people have been wonderful, it's just the structure that has been at times difficult. The people are adaptable - while the system can be cumbersome."

The Coca-Cola case provides significant insights into the corporate real estate experience in Ukraine. Coca-Cola may be one of the most intense users of real estate of U.S. companies in Ukraine. It owns as well as leases properties. Its warehouses are typically rehabilitated whether they are leased or not. Coca-Cola entered the country through a joint venture which provided Coca-Cola both entry to the country as well as manufacturing facilities. As a manufacturing
company, the use of a joint venture for entering a country is consistent with literature reviewed about transitional economies and about Ukraine.

Their primary reason for entering Ukraine was market opportunity. This is also consistent with the literature reviewed. The administrative challenges they have faced are similarly consistent with the results of the interviews and surveys. Finally, Coca-Cola is an example of an enterprise that requires significant real estate services. However, similar to industry-wide trends in international real estate, they still are making decisions locally, but with the help of a variety of real estate service providers.
Chapter 6
Conclusions

Real estate may have once been an undermanaged resource, but it is now a resource in transition. In the U.S., corporate real estate units are making the transition from traditional service providers to strategic planners. That may be so in corporate America, but in Ukraine, most decisions are made locally, typically by someone whose primary job is in another area of expertise. Any real estate services that are needed are transactional in nature, not strategic. Yet, although there is a lack of expertise locally, the companies interviewed appear to be succeeding with the most important objectives of corporate real estate. First, by leasing property in Ukraine, companies are buffering themselves from uncertainties. Second, the real estate executives remain focused on costs. When this research began, the feeling was that there would be an important role for service providers in a decentralized environment. However, it appears as though the internal staff is managing on its own with occasional support from decentralized regional headquarters, and has relegated external service providers to a secondary role. This research focused on accumulating data in Ukraine, at the business unit level. To continue this area of research, it would be interesting to go back to the CRE staffs at corporate headquarters and research their side of the international corporate real estate management story.

Ukraine offers market, supply, and political reasons for direct investment. First, there is market opportunity. Next, there is low labor costs. Finally the import barriers further incentivize direct investment in the country. According to the thesis research, from surveys and the interviews, the favorite forms of entry into Ukraine are joint ventures and internal expansion. The service sector companies interviewed preferred internal expansion, while the manufacturing companies searched out joint venture partners that already had facilities. Ukrainian law does not encourage the acquisition of Ukrainian companies by foreign entities explaining the lack of mergers and acquisitions to this point. It might be
interesting to further research the relationship between forms of entry into foreign countries and corporate real estate.

Much of the literature that was reviewed mentioned examples or studies that took place a number of years ago, certainly prior to the financial crisis in 1998. Significant changes have taken place over the nine-year period since independence. The most apparent change is that there is a glut of office space in Kyiv, after the overbuilding and the retrenchment following the financial crisis.

As a former centrally planned and centrally owned country, the government used to own most everything. This is slowly changing through privatization which will offer the opportunity to acquire state owned companies and property. The real estate implications of privatization in a formerly centrally planned economy from a corporate standpoint would also be interesting research.

A lot of interest has been shown in Ukraine during the last nine years. The initial enthusiasm after Ukraine's independence has been replaced with a greater awareness of the challenges of doing business in Ukraine. The challenges found in Ukraine, are consistent with those found in other transitional economies. Although complex, the challenges found in Ukraine do not preclude participation in the market; rather they merely impede the process.
Endnotes

4 O'Mara, 3.
5 O'Mara, 5.
7 Lambert, Generating 5.
8 Lambert, Generating 6.
9 Lambert, Generating 6.
10 Lambert, Generating 6.
11 Lambert, Generating 6.
12 Lambert, Generating 6.
13 Lambert, Generating 6.
15 Lambert, Managing 70-4.
16 Lambert, Managing 71.
19 O'Mara, 20.
20 O'Mara, 5.
21 Lambert, Managing 30-1.
23 Lambert, Managing 64.
24 Lambert, Managing 64.
25 Lambert, Managing 64.
26 Lambert, Managing 64.
27 Lambert, Managing 76-7.
28 Lambert, Managing 91-2.
30 World Bank Group.
31 World Bank Group.
32 World Bank Group.
36 Fombrum, 24.
38 Griffin, 108-113.
39 Griffin, 419-20.
40 Griffin, 86-94.
41 Griffin, 94.
42 Griffin, 95-6.
43 Griffin, 98-101.
46 Griffin, 419-20.
48 Dunning, Globalization 292.
51 Dunning, Globalization 299.
52 Dunning, Globalization 294.
53 Please note that it is incorrect to assume that all cross-border M&A is FDI. FDI is the sum of equity capital, reinvested earnings and intra-company loans invested in a foreign country. Since M&A is often financed outside the host country, the equity capital portion of the M&A may be much less than the reported value of the merger or acquisition. Also the equity capital investment can be spread out over years.
The eight indicators of competitiveness are evaluated qualitatively as well as quantitatively by using over 170 subvariables.

The equation is: $G_i = \alpha + b \times C_i - c \times Y_i$, where $G_i$ is the annual average growth of country "i", $C_i$ is the competitive index and $Y_i$ is the log of per capita income of the country in 1992. "$Y_i" is used to take into consideration the generally accepted principle that poorer countries tend to grow faster than richer countries assuming similar levels of competitiveness.

Schwab, Porter, and Sachs, 96-8.

The eight indicators of competitiveness are evaluated qualitatively as well as quantitatively by using over 170 subvariables.


Please note multiple responses from some respondents.

OECD, 9,20.

OECD, 11.

OECD, 37.

OECD, 37.

OECD, 37.

OECD, 36-9, 55.

OECD, 39.

OECD, 45.

OECD, 55.

Please note multiple responses from some respondents.

OECD, 10,29-32,124.

Dunning, Globalization, 235.

Dunning, Globalization, 222.

Dunning, Globalization, 226.

Dunning, Globalization, 227.

Dunning, Globalization, 227.
Embassy of Ukraine in Canada, Doing Business in Ukraine: Guide for Foreign Investors accessed 6/26/00

Lexis-Nexis Academic Universe, Country Reports accessed 7/26/00


Freedom House, Annual Survey of Political Rights & Civil Liberties accessed 7/19/00


OECD, 11,37.

Felicitas Mollers, "Foreign Direct Investment in Ukraine - Experiences Taken from Reality", Ukraine at the Crossroads, eds. Axel Siedenberg and Lutz Hoffman (New York:Physica-Verlag, 1999) 142.

Mollers 147.

Please note there are two common spelling versions for the capital city of Ukraine - Kyiv and Kyiv.

UNCTAD, 434.

The new construction has resulted in an increase in the level of quality of office space for example, modern elevators, heating, ventilation, and air conditioning (HVAC), electrical systems, floorplates, and management.

Sergey Sergiyenko, personal interview, 8/7/00.

University of Denver School of Real Estate and Construction Management, The Global Real Estate Project accessed 7/19/00


Mollers, Foreign, 150-1.

Mollers, Foreign, 150.

Mollers, Foreign, 151.

Mollers, Foreign, 151.

OECD, 37.

Mollers, Foreign, 152.

Volodymyr Zviglyanich, "Ukraine's economic crisis:is there light at the end of the tunnel?", PRISM, 1/23/98 4:2 <www.jamestown.org.pubs>

Schwab, Porter, and Sachs.


Mollers, Foreign, 155.

Stewart, Land 46-7.

Stewart, Land 46-7.

Schwab, Porter, and Sachs.

120 Kettaneh 96-9.
121 Shen 165-83.
122 Stewart 46-7.
123 Ankel.
124 Dow Jones Interactive, Cabinet Approves Draft Law on Land Ownership as reported in Eastern Economist Daily, 4/24/00.
125 Stewart 46-7.
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