



**The Effect of Privatization on Social Welfare in Ukraine:
The Practical Experience of SigmaBleyzer**



February 13, 2003

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Executive Summary

It is the opinion of SigmaBleyzer that privatization has had a positive overall effect on the quality of life and social welfare of the Ukrainian people. Salaries at privatized companies have increased significantly, sometimes by as much as three or four times. Wage arrears at privatized companies have been paid off faster, in greater amounts, and are currently lower (often by more than 50%) than at non-privatized companies. Tax revenues from privatized companies also exceed those from non-privatized companies. While privatization is still ongoing in Ukraine, these facts clearly indicate the positive dynamics in privatized sectors of the economy.

SigmaBleyzer manages three funds (Ukrainian Growth Funds or UGF) that collectively invested over \$100 million in a portfolio of more than 85 privatized companies. Of these investments, approximately ten were controlling stakes. At these companies, SigmaBleyzer was able to help turnaround struggling businesses that had been privatized. These included the Sevastopol Shipyard (SSY), Poltava Confectionery, the Makiivka Pipe Rolling Plant, the Zaporizhya Meat Processing Plant, and others. We have seen the difference that a private investor can make at every one of these companies. And while the results to date differ for various companies in the UGF portfolio, many would have gone bankrupt without privatization.

The examples of Sevastopol Shipyard, Poltava Confectionery, Berdyansk Agricultural Machinery, and the Melitopol Tractor Hydro Units Plant, described in this paper, will show how a company turnaround can improve the lot of the average citizen. The improvement of these companies created jobs, improved local tax collection revenues, helped local small and medium businesses grow, and increased consumer spending. Yet these turnarounds positioned the companies for even greater future growth. These trends are expected to accelerate as the companies continue to grow. As a result, we expect to see an ever increasing gap between privatized and non-privatized companies.

But even at those companies that we do not control, there is significant evidence that suggests that privatization has played an important role in improving social welfare. Our portfolio companies' evidence shows how government debts and wage arrears declined significantly, money that went directly into people's pockets. Wages also appear to have increased, which is supported by national trends.

Privatization in Ukraine did not hit its peak until the 1996-1998 period, and therefore, only now is an effective analysis becoming possible at many companies. We believe that over time, the evidence will clearly show that privatization has directly improved social welfare, despite the knowledge that the privatization process could have been much more transparent. We also believe that had Ukraine elected a much faster privatization pace at an earlier stage of country independence (for example in the 1992-1994 time frame), the positive social impact would have been much more pronounced by now.

I. Privatization in Ukraine

Economic Background

When Ukraine declared its independence in August 1991, it became the second largest European country in landmass and the fourth largest in population, with 50 million people. Ukraine's agricultural soil is extensive and rich; it used to be the breadbasket of the former Soviet Union, providing a large portion of its agricultural needs. Ukraine also has good mineral resources (iron ore, coal) and an adequate infrastructure. It has a well-educated and skilled labor force, with a significant engineering and scientific foundation. All this permitted Ukraine to supply much of the heavy industry of the former Soviet Union.

Despite these favorable conditions, Ukraine has had one of the most difficult economic challenges in Eastern Europe, with a long economic recession that lasted eight years. From independence in 1991 up to 1999, gross domestic product (GDP) declined every year, with a cumulative decline of about 60%.

The recession in Ukraine from 1991 to 1999 lasted so long because the country's initial conditions after independence were quite unfavorable, with major structural weaknesses and an economy highly dependent on the other former Soviet Republics. The collapse of the Soviet Union cut these production and trade relations. In addition, the country had a large percentage of military industries (25% of all companies produced military goods), which found themselves without markets after the end of the cold war.

Furthermore, due to negligible energy costs during Soviet times, many industrial processes were very energy intensive (in the early 1990s, Ukraine consumed 6 times more oil per unit of GDP than Western Europe). Energy imports are still important; in 2002, import of oil and gas represented 40% of merchandise imports and 20% of GDP. These energy-intensive firms became unprofitable when energy costs increased 5-10 times after independence.

Although the initial fall in GDP was amplified by unfavorable initial conditions, the slow economic recovery from 1991 to 1999 was also due to the very slow, piecemeal, and uneven implementation of economic reforms. This was due to lack of political consensus and to opposition from some groups in Parliament and vested interests. In fact, the structural weaknesses of Ukraine during Soviet times meant that major corporate restructuring was needed after independence. Unfortunately, from 1991 to 1995, very little was done: the Government followed a "preservation" strategy. That is, it tried to maintain the status quo through the payment of large, direct subsidies to state enterprises. Relying on Government subsidies for their existence, state-owned enterprises had little incentive to restructure themselves or privatize, and remained largely inefficient. These Government subsidies led to large fiscal budget deficits, monetary financing of these deficits, and hyper-inflation. During 1992-1993, with total fiscal expenditures at about 65% of GDP, the fiscal budget deficit reached 25% and 16% of GDP, respectively. The monetary financing of these deficits led to very high annual rates of inflation, which peaked in 1993 at 10,160% and which remained above 100% per annum in 1994 and 1995.

In 1994, Leonid Kuchma was elected President on the basis of a reform agenda. During 1996-1998, progress was made in many areas of economic reforms: prices and international trade were liberalized; small & mass privatization programmes were advanced significantly; the National Bank of Ukraine (NBU) was strengthened and monetary policy was implemented wisely; a new currency (Hryvnia or

UAH) was introduced successfully in September 1996; inflation was reduced to 10% by mid-1998; the exchange rate was maintained within a narrow corridor around 1.9 UAH per dollar from 1995 to mid-1998; Ukraine accepted IMF obligations under Article VIII (which requires foreign exchange convertibility for current account payments); and a new Constitution was approved in 1996, which guaranteed private property and market-based principles for the country's economy.

However, the fiscal budget deficit was not brought under control, remaining at about 6% of GDP from 1996 to mid-1998. From 1991 to 1998, fiscal budgets were prepared unrealistically, with overestimated revenues and excessive expenditures. In addition, the tax base was reduced by innumerable privileges and exemptions. Through the end of 1997, these fiscal budget deficits were financed by foreign borrowings. External debt increased from \$4.4 billion in 1994 to \$11.5 billion in 1998. Domestic Government short-term obligations (Treasury bills) increased to UAH 10 billion (\$5.2 billion equivalent) during the same period. Although the absolute size of foreign debt was not excessive, this debt was of short maturity. Therefore, the level of annual debt service payments was quite high, reaching \$3.2 billion in 1998, which put heavy pressure on Government finances.

During 1998, the Asian Crisis, large repayments on foreign debt, and delays in implementing fiscal and structural adjustments in Ukraine changed investor perceptions of the country. Furthermore, structural reforms had not reached the critical mass needed to revive confidence, investment and growth on a sustainable basis. In mid-1998, the Russian Financial Crisis accelerated capital outflows from Ukraine. Foreign reserves declined from \$2.3 billion at the beginning of the year to about \$1.0 billion by mid-year. With international reserves declining rapidly, the NBU had to stop selling foreign exchange in September 1998. The results of the financial crisis were far reaching, including a depreciation of the Hryvnia from about 1.9 UAH/US\$ in December 1997 to 3.4 UAH/US\$ by the end of 1998.

Despite the severity of the 1998 financial crisis, Ukraine was able to deal with it successfully and without resorting to the printing of money. The country was able to negotiate the volunteer restructuring of its public debt. But most importantly, from September 1998, the fiscal budget accounts were kept close to balance. The deficit for 1998 was contained at 2.1 % of GDP (compared to 6.8% in 1997). In the following years, Ukraine has been able to maintain fiscal discipline, with fiscal deficits below 2% of GDP. The control of large fiscal deficits has been a significant achievement, since they were the major source of Ukraine's economic imbalance in the past.

From 2000 to 2002, in addition to broadly satisfactory fiscal and monetary policies, the Ukrainian Government implemented a number of important economic reforms. They included progress in the privatization of large state enterprises, with six energy distribution companies privatized successfully in 2001; land reform in early 2000 that transferred land ownership to individual farmers and started the issuance of land certificates and titles; the elimination of unwarranted government interventions in the agricultural market and its commercialization; elimination of barter in utilities, with cash collections in the energy sector increased from about 12% in 1999 to 85% of sales in early 2001; significant reduction of barter in international trade; simplification of business registration requirements; reduction in the average number of inspections of businesses by government agencies from about 70 per year in 1990 to about 30 at present; introduction of European import certification standards, with mutual recognition of certifications; improvements in customs procedures to align them to European standards; approval of the Laws on Banks and Banking Services; approval of the Criminal Code; approval of the Budget Code that set clear and transparent formulas for the transfer of funds to local governments; introduction of Personalized Accounts in the Pension system; and successful external debt restructuring including the Paris Club and the gas debts with Russia and Turkmenistan.

The control of the fiscal deficit and the implementation of these economic reforms have had a major impact on the economy, with GDP growth of 5.9% in 2000, 9.1% in 2001, and 4.1% in 2002. Furthermore, since the beginning of 2000, the country has had positive foreign trade and current account balances. The foreign exchange rate has been quite stable at about 5.4 UAH/US\$ since early 2000. Foreign reserves increased from \$1 billion in early 2000 to \$4.3 billion in January 2003. The size of external public debt declined significantly, now representing only 25% of GDP.

But not everything is right in Ukraine. Additional significant improvements are still needed to sustain long-term growth. In particular, there is a need to revive the level of investment in the economy. Given the high level of un-utilized capacity, economic growth has been based on better utilization of existing investments. However, beyond 2002, growth based on improved utilization of existing capacity will be limited. Therefore, in order to continue the high rate of growth, new and significant additional investment will be necessary, particularly foreign investment since domestic savings are low.

The level of foreign investment has, however, remained low. A recent study carried out by the International Private Capital Task Force (IPCTF) under the Chairmanship of SigmaBleyzer outlined specific policy measures to attract more foreign investment into Ukraine. The study recommended a number of specific measures in nine policy areas, which are listed below according to their statistical impact on the flow of foreign direct investments. The individual impact of these policy measures was quantified from statistical analyses carried out in a sample of 50 countries. The nine policy areas are as follows: (i) liberalize and deregulate business activities; (ii) provide a stable and predictable legal environment; (iii) enhance governance and reform public administration; (iv) remove international capital and foreign trade restrictions; (v) facilitate financing of businesses by the financial sector; (vi) reduce corruption; (vii) minimize political risks; (viii) improve country promotion and image; and (ix) rationalize investment incentives. Based on this study, the Government developed an Action Plan in all of these areas. The successful implementation of this Action Plan would make privatization of the remaining large state enterprises more plausible.

A Short History of Privatization

The process of privatization began in 1992 and was aimed at transforming the country from a centrally planned economy to a market economy, increasing the private sector share of industry, and finding strategic investors to speed up the development of industries and companies. The privatization process has continued to evolve over time, with three distinct phases. It started at a modest pace that lasted from 1992 to 1994. It accelerated during its Second Stage from 1995 to 1998, when almost 70% of all privatizations were carried out. About 80% of the industrial sector is now privatized. In the current Third Stage, the remaining privatization consists of the largest state enterprises, principally in electricity distribution, telecommunications and metallurgy. There are also large state enterprises in fertilizers and petrochemicals.

First Stage (1992 -1994)

During this period, the main form of privatization was the leasing of entire property complexes by the employees of the companies, with full ownership transferred at the end of the leasing period. Privatized enterprises were mostly companies in the food and light industries. In many companies, “strong” directors, who did not want to lose control, took advantage of this form of privatization. The formal holders of the lease and owners of shares were employees, but in reality they were controlled by top managers. In fact, even though most companies were leased and sold to employees, the money that backed these employees was from a small circle of richer managers.

This form of privatization did not guarantee efficient ownership or management. Traditionally, state enterprises were just production units, without any sales, marketing or financial functions. Most managers therefore were not equipped for their new role. Only those enterprises able to deal in a market economy and financial matters were able to do better. The social effect of this stage of privatization, namely employment, salaries and common welfare, depended principally on the ability of the management to operate in this new business environment. The destiny of these companies and their employees, as well as the impact of these companies on GDP growth and welfare improvement, depended on the company management's ability to maneuver through the emerging market conditions of the time.

Still, many companies that were taken over and controlled by their managers succeeded and, as a rule, the financial results of these companies were positive, despite the economic crisis. Financially, they performed better than other enterprises that remained in Government hands. However, this could be explained by the fact that during this period the companies taken over by their managers were the most economically attractive prior to privatization.

On the other hand, there are very few successes of companies that had broad ownership by their employees. Many businesses that were privatized in this way generally did not survive long until a richer group of managers took them over, generally forcing many people out of work.¹ There are a few success stories such as Mariupol Ilichev Steel or the Kharkiv Biscuit Factory, but most ended in asset stripping or bankruptcy.

The effects of this "lease-with-an-option-to-buy" stage of privatization on the social and political situation in Ukraine were controversial, as by then the economy of the country was already faced with a system-wide crisis. On the one hand, the employees of the privatized enterprises could keep their jobs. But ownership was concentrated in the hands of a few privileged former managers. As a result of this stage, over 11,000 Ukrainian companies were (partly or wholly) privatized (see Table 2). It was also during this First Stage that a legislative base was established upon which all future privatizations would be organized. The government passed laws on the privatization of small, medium, and large state companies.

Second Stage (1995-1998)

During this period, a total of 70,526 enterprises were privatized throughout the country (representing about 70% of all privatizations since 1991). About 60% of the privatizations during this Second Stage (i.e., 42,000 enterprises) consisted of small enterprises, many of them in trading activities. They were sold principally to the employees and managers of the firm. The rest (28,000 enterprises) were medium and large enterprises that were sold both to employees and also to the public through the *Mass Privatization Program*.

The *Mass Privatization Program* was initiated and substantially completed during this period. The program began in 1995 when all Ukrainian citizens received the right to obtain privatization certificates (also known as vouchers); a special type of security that could be exchanged for shares of state companies sold in special privatization certificate auctions conducted by the National Certificate

¹ There are few statistics from this time that back up such conclusions, but these were SigmaBleyzer's observations of the process.

Auctions Network.² Another type of security used in these privatizations was the compensatory certificate, which was issued to cover the losses incurred by the holders of deposits in the State Savings Bank under the Soviet Union or during hyperinflation from 1991 to 1995.

Essentially, the voucher and certificate auctions worked as follows: 150-250 companies were put up for sale every month. This number grew to over 500 per month by the end of this phase. The owner of a voucher could apply to purchase shares of any company that was put up for sale. The size of each applicant's stake was then determined by the total number of applicants for that company (none were refused). At the completion of the auction, the new shareholder would receive documents certifying all shareholder rights. From 1994 to 2000, a total of 7,272 enterprises were privatized through voucher auctions, some of which were offered for sale several times due to the continuing privatization process (see table 1). A total of about 20,000 transactions took place. Over 8,000 of these transactions were for small and medium sized state companies. By the end of this phase, enough companies had been privatized so that the stock market reached a critical mass. It is at this time that we began to see people and companies trading shares on over-the-counter exchanges.

Table 1: Number of Times Companies were Offered for Sale on Certificate Auctions (by Stake Percentage)

	0-5%	5%-25%	25%-50%	50%-75%	75%-100%	Total
1994	8	62	85	37	15	207
1995	83	455	487	231	39	1,295
1996	591	3,073	1,572	257	20	5,513
1997	945	4,335	1,569	178	25	7,052
1998	1,549	3,963	898	59	3	6,472
1999	41	144	27	0	0	212
2000	85	147	9	0	0	241
Total	3,302	12,179	4,647	762	102	20,992
%	15.7%	58.0%	22.1%	3.6%	0.5%	100%

Source: SigmaBleyzer

The Mass Privatization program had other unanticipated side effects. Ukrainian citizens could not purchase vouchers in large enough quantities to influence the management of their companies, as the legislative base did not (and still does not) provide for cumulative voting or other forms of protecting minority shareholder rights. Shareholders have significantly fewer mechanisms than in the West to protect their various rights. Furthermore, many Ukrainian citizens sold their certificates. In fact, in the early to mid 90's, high inflation rates led to increased poverty. Since people needed money immediately to buy food or pay for housing, it was more beneficial for these people to sell their privatization certificates to companies that purchased them for 2 to 8 hryvnas (Approximately \$1 to \$4 at the time), less than their par value of UAH 10. Having acquired a sufficient number of certificates, these companies took part directly in competitions and auctions. As in Russia, the result for Ukraine was that only a small number of people became real owners. They were able to influence the management and operations of the companies, but in many cases at the expense of a large number of un-protected minority shareholders. The Mass Privatization program may have succeeded in transferring a large number of enterprises to the general public and creating incentives for the companies to improve operations. But it failed to create sound corporate governance in most enterprises, particularly the protection of minority shareholders.

² The Economist Intelligence Unit, Country Economic News, Feb 1, 2002.

Third Stage (1999 to the present)

After 1998, the remaining enterprises to be privatized consisted of firms in strategic and monopolistic sectors, including electricity distribution companies (known as oblenergos), metallurgical companies, telecoms, and petrochemicals. Unlike the two preceding stages, the main emphasis during the third stage has been to find strategic investors and raise privatization revenues for the state. As a rule, during these larger cash privatizations, large stakes in medium and large companies were privatized through tenders or the stock exchange. The government set a list of criteria that potential investors had to meet if they wanted to purchase shares in these companies. This process of privatization has been quite slow. Only a handful of these large companies have been privatized so far. In particular, six oblenergos were privatized in 2001, but controversies in these privatizations led to stagnation of the process.

Results of the Privatization

As shown in Table 2 below, from 1992 to 2002, over 100,000 state enterprises were privatized in Ukraine. Of these, about 25,000 were central state enterprises and 55,000 were municipal state enterprises (these companies employed 3.5 million people or 24.2% of Ukraine's work force in 2002). Over 10,000 open joint-stock companies were created, and 8,500 enterprises in the agricultural sector were reformed.

Table 2: Number of Companies Privatized, 1992 – 2002

Year	Small Companies	Medium/Large Companies	TOTAL
1992	32	11	43
1993	2,434	1,253	3,687
1994	5,338	2,010	7,348
1995	10,320	4,562	14,882
1996	17,480	8,803	26,283
1997	8,554	7,308	15,862
1998	6,080	7,419	13,499
1999	4,518	3,660	8,178
2000	5,137	1,737	6,874
2001	5,321	929	6,250
2002	674	100	774
TOTAL	65,888	37,792	102,906

Source: State Property Fund of Ukraine

Despite the significant economic decline that arose in the process of transition from state (planned) economy to market economy, privatization has led to the creation of a market-based economy in Ukraine. Currently the share of non-state companies is about 85%, and they produce 60% of the total volume of industrial output in Ukraine. The greatest success was in the food industry, light industry, pulp and paper industry, and woodworking industry, where the process of privatization has been virtually completed. In these sectors, growth rates are several times higher than in industry as a whole. For example, during 2001, when GDP grew by 9.1%, the fastest growing processing industries were wood and wood processing (which grew by 28%), machine building (18.8%), pulp and paper (18.2%), food industry (18.2%), and textiles/apparel (14%). In 2002, with GDP growth of 4.1%, these industries grew by about 8%. In certain industries, such as food, most privatized companies appear to have enjoyed relatively strong financial growth as well.

In addition to better financial results, the general perception is that the management of these privatized companies has improved since they were privatized.

Social Effects of Privatization

As noted earlier, the collapse of the USSR, the disruption of economic ties that existed before 1990 and the lack of economic competitiveness of state enterprises led to a sharp deterioration of the financial situation of Ukrainian companies. This led to major declines in production volumes, which resulted in the mass dismissal of workers in 1991-1995. It also led to the accumulation of large wage arrears. Furthermore, many state enterprise employees were working just “on paper”, since they were asked by their management not to attend work and were not receiving any salaries. They remained with the expectation that they may be recalled to work in the future, which, of course, never happened.

High unemployment levels in industry (up to 30% in 1995, according to some unofficial estimates) and significant wage arrears forced workers to master new professions, often a downgrade compared to their former skills (e.g.: doctors and engineers becoming taxi drivers or salesmen). The phenomenon of hidden employment in the shadow economy appeared at this time, though it already existed in some form before the end the Soviet Union. From 1992 to 1995, the number of people employed in the shadow economy doubled and was estimated at 10 million (see table 3 for more recent data on wage arrears and official unemployment, which underestimates the real situation as noted above).

Table 3: Selected Employment Statistics

	1995	1996	1997	1998	1999	2000
Population of Ukraine at year end, million	51.3	50.9	50.5	50.1	49.7	49.3
People Employed, million	23.7	23.2	22.6	22.3	21.8	21.6
Unemployment Rate						
Officially Registered Unemployment, % to Employed Population	0.5	1.3	2.3	3.7	4.3	4.2
Application per 1 Vacant Position, number of people	2	11	20	30	24	17
Wage Arrears, \$ million	N/A	2,286.8	2,770.8	2,587.7	1,526.2	905.91

Source: State Statistics Committee of Ukraine

A key point to highlight is that the major reduction in employment that took place in Ukraine during the 1990’s could not be blamed on privatization. It was the result of the fact that during Soviet times, most industrial enterprises were highly inefficient (in energy, raw materials and human resources use), were producing for declining markets (i.e., for the military), and were unable to compete in a market economy. In fact, many studies have shown that most state enterprises during Soviet times were not creating any value, but were value destroyers, with negative rates of returns if outputs and inputs were valued at international prices. After independence in 1991, most Ukrainian enterprises were either idle or running at 10-15% capacity utilization levels.

Under these circumstances, one of the key benefits of privatization (and thereby, the transition of Ukraine to a market economy) was not a major increase in employment, but an improvement in salary levels and productivity, and the reduction of wage arrears. The change to modern management methods at privatized companies resulted in the improvement of their efficiency. The appearance of interested owners (investors) stimulated improved companies’ operations, which manifested itself, in particular, in

the growing productivity of employees, better use of labor, and higher average monthly salaries compared to state companies (see tables 4 and 5 for comparisons for 2000 and 2001, respectively).

Table 4: Average Monthly Wages in Several Industries for 2000, US\$

Sector	Average	State	Non-State
Mining	74.12	69.28	82.77
Food Industry and Processing of Agricultural Products	49.08	41.74	49.74
Light Industry	28.84	20.46	29.08
Coke Production and Oil Refining	87.06	41.02	88.70
Metallurgy and Metal-Working	74.92	62.46	77.09
Machine-Building	40.40	38.70	40.88
Electricity, Gas, and Water Production	69.24	64.83	71.61

Source: State Property Fund of Ukraine

Table 5: Relationship Between Form of Ownership and Average Salary Rates for 2001

Sector	Average	State	Non-State
Mining	100%	93%	112%
Energy Materials Production	100%	92%	126%
Non-Energy Materials Production	100%	98%	101%
Processing Industry	100%	95%	101%
Food Industry and Processing of Agricultural Products	100%	85%	101%
Light Industry	100%	71%	101%
Wood Processing, Pulp and Paper	100%	119%	97%
Coke Production and Oil Refining	100%	47%	102%
Chemicals and Plastics	100%	105%	98%
Other Non-Metal Mineral Products	100%	127%	98%
Metallurgy and Metal-Working	100%	83%	103%
Machinery	100%	96%	101%
Other Production Sectors	100%	101%	100%
Production of Electricity, Gas, and Water	100%	96%	106%

Source: The State Property Fund of Ukraine

In nearly every industry, we consistently see that most privatized companies have higher salaries than non-privatized companies. In the metallurgy industry, a sector in which no new enterprises were created in the last 10 years, privatization caused a significant increase in average monthly salaries. These salary increases were in some case more than 100% as compared to the period before privatization (e.g. in 2001, average monthly salaries at Zaporizhstal were \$182 compared to \$75 in 1998, before privatization). In 2001, employees of privatized metallurgical companies earned more than 20% above what employees at similar government owned metallurgical companies earned. In the mining and energy materials production sectors, salaries at privatized companies (compared to non-privatized companies) were up to 20% greater in 2000, and up to 35% greater in 2001.

In general, non-state companies have significantly outperformed state companies in productivity and wage arrears. This lower level of arrears is a significant factor in employees being able to support their families and in their general well being. Wage arrears have long been a problem in the public sector. Many teachers and miners still have to wait several months before receiving their salaries. In Table 6 below, this differential is even more apparent. For example, in the mining industry, the average arrears

are more than two-times less in the private sector. In only two industries (metallurgy and light industry) do we see a difference in this trend. Most likely, this is a result of the small sample of state companies remaining to be privatized in those sectors.

Table 6: Ukrainian Labor Data by Form of Ownership (by sector), 2001

Sector	Form of Ownership	Number of Companies	Number of Employees on Payroll	Labor Productivity, UAH '000/person	Average Wage Arrears, months
Industrial Production	TOTAL	45,425	4,082,637	42.91	1.46
	State	3,328	1,073,998	35.38	2.18
	Non-State	42,097	3,008,639	45.60	1.17
Mining	TOTAL	990	592,863	36.64	2.47
	State	325	412,874	27.44	3.05
	Non-State	665	179,989	57.75	1.34
Energy Materials Production	TOTAL	432	439,363	34.06	3.01
	State	258	372,006	26.65	3.30
	Non-State	174	67,357	74.96	1.92
Non-Energy Materials Production	TOTAL	558	153,500	44.02	0.87
	State	67	40,868	34.56	0.96
	Non-State	491	112,632	47.46	0.84
Processing	TOTAL	42,704	2,951,964	42.92	1.26
	State	1,932	405,513	36.49	1.70
	Non-State	40,772	2,546,451	43.94	1.19
Food Industry / Processing of Agricultural Products	TOTAL	8,586	54,872	56.80	0.96
	State	278	42,199	37.73	1.05
	Non-State	8,308	500,673	58.41	0.95
Light Industry	TOTAL	4,287	254,620	11.99	1.33
	State	129	4,355	16.14	1.10
	Non-State	4,158	250,265	11.91	1.33
Chemical and Petrochemical Industry	TOTAL	2,785	217,482	57.12	1.28
	State	70	57,075	51.87	1.80
	Non-State	2,715	160,407	58.99	1.10
Metallurgy and Metal-Working	TOTAL	2,733	456,308	81.01	0.95
	State	80	69,591	86.77	0.90
	Non-State	2,653	386,717	79.97	0.96
Machinery	TOTAL	10,039	976,189	22.55	1.84
	State	372	196,438	16.64	2.60
	Non-State	9,667	779,751	24.04	1.65
Production of Electricity, Gas, and Water	TOTAL	1,731	537,810	49.80	1.01
	State	1,071	255,611	46.44	1.19
	Non-State	660	282,199	52.83	0.87

Source: State Statistics Committee

A margin analysis of sales and costs of Ukrainian companies provides a similar view of the economic efficiency of state ownership versus fully privatized companies. As shown in Table 7 below, in 2001, state enterprises that were fully privatized showed better profitability than state-owned enterprises. These fully privatized companies paid more taxes than state-owned companies. These taxes ultimately benefit the citizens of Ukraine.

Table 7: Margin Analysis (% of Net Sales) in Ukraine, 2001

	Net Sales	Cost of Goods Sold	Gross Income (+) / Loss (-)	Operating Income	Other Expenses / Income	Pretax Income	Extraordinary Revenues (+) / Costs (-)	Taxes	Net Income (+) / Loss (-)
Full State Ownership	100%	88.7%	11.3%	3.9%	0.9%	4.8%	1.2%	-0.9%	5.2%
100% Privatized Enterprises	100%	77.6%	22.4%	12.9%	-1.3%	11.7%	0.0%	-3.9%	7.8%

Source: State Statistics Committee

Conclusions

The conclusions below represent the view of the staff of The Bleyzer Foundation and SigmaBleyzer. Although we tried to be as objective as possible, it may not be totally impartial as SigmaBleyzer has been an active participant in the privatization process. It does represent the view, however, of many private sector observers.

The First Stage of privatization was particularly difficult in Ukraine. Even though most companies were sold to employees, the money that backed these employees came from a small circle of richer managers. Some of companies did well. On the other hand there are very few successes from the companies that were broadly owned by employees without “consolidated” ownership control, and many businesses that were privatized in this way did not improve until richer managers or backers took over, generally forcing many people out of work.

In the Second Stage, the Ukrainian Mass Privatization model can be characterized as an attempt to implement a “social equality model”. All citizens, from the very young to the elderly, had an opportunity to purchase state companies through a system of auctions. However, as the legislative and normative base of privatization lacked depth, not all levels of the population had equal opportunities to participate in privatization.

Because of hyperinflation, income instability, and the general economic contraction that Ukraine experienced through 1999, a lot of privatized companies were sold for relatively small amounts. It is through this process, that we can see the rise of powerful industrial groups and other regional players (the so-called “Oligarchs”) that began to control significant parts of the Ukrainian economy.

Throughout the entire process, owners were not as numerous as hoped. On the other hand, in companies where ownership was concentrated and not fractured, there was a greater likelihood of restructuring and turning the business around. This, of course, resulted in greater social improvements as well as individual benefits. Therefore, the concentration of ownership in many industries has also been a major reason for the improvement in social welfare.

Our overall assessment of the Ukrainian privatization model in the Second Stage (from 1995 to 1998) is mixed. On the positive side, from 1995 to 1998, over 70,000 state enterprises were privatized, helping in the creation of a private sector market-oriented economy. On the negative side, the process was not transparent, percentages of big companies were often sold at severely discounted prices, the purchasers rarely had the best interest of the company at heart (rather, they were more interested in stripping assets or damaging a foe / competitor), and new owners did not always understand the business they had just purchased. In addition, the process was too slow. Comparisons with countries that privatized faster, such as Hungary or the Czech Republic, clearly show the advantage of privatizing faster. It has taken Ukraine more than ten years to reach a level that some countries reached in less than half that time. This resulted in a time delay between the act of privatization and results of privatization. Only in the last few years have companies begun to show positive results, which has certainly contributed to the positive GDP growth of the last three years (5.9% in 2000, 9.1% in 2001 and 4.1% in 2002). An attempt to equitably distribute state property failed to achieve the anticipated result and the method was costly in terms of promoting efficiency and growth as well.

It is still too early to evaluate the results of the Third Stage of Privatization from 1999 to the present. The focus of the Government in this stage has been more on helping the fiscal budget by making money from privatization and less on the transformation of the economic environment through privatization. It is true that to improve the quality of life of their people, the Ukrainian government needs additional revenues. But in our opinion this goal could be reached more quickly by creating a greater number of healthy and profitable privatized businesses, thereby bringing the government a higher level of tax revenues, rather than trying to maximize the privatization proceeds in an environment not considered by many as investor-friendly. This accelerated privatization approach would have resulted in higher economic growth, additional jobs and a significantly improved economic situation for Ukrainian citizens.

Despite the above problems, we believe that privatization was an important factor in improving the welfare of the Ukrainian people. The quality of life improved for employees at privately owned companies. As the tables above show, salaries at these companies increased and were more likely to be paid on time, an important characteristic considering the high levels of inflation during those periods. In addition, companies that had been privatized paid more in taxes to the government. This provided the government with greater revenues with which to provide services to the Ukrainian people.

II. The Experience of SigmaBleyzer

General Experience

The experience of SigmaBleyzer, which has been operating in the Ukrainian investment business for more than 10 years, corroborates the conclusions discussed above. The company took part in all stages of privatization and after privatization; its portfolio included over 85 companies in all the regions of Ukraine and in most industries. Today, the company manages three funds, working with a portfolio of more than 60 companies. Diversification of the portfolio resulted from a deeper analysis of the Ukrainian economy on both a macro and micro level.

The first years of transition in Ukraine were characterized by a sharp decline in production volumes. Most Ukrainian enterprises were either idle or running at 10-15% capacity utilization levels. The official statistics did not reflect the real level of unemployment, as people were registered as employed, in reality being on indefinite leave without pay. However, this led to an indirect effect of privatization. Since efficient management of joint-stock companies had not yet formed, the most active workers on leave-without-pay created their own small businesses, often remaining officially employed by privatized companies. Most of these employees never returned to the parent firm.

This deterioration of official employment, which continues in some government owned companies today, was not directly caused by privatization. It was a result of the economic inefficiency of enterprises during Soviet times. It is well known that most production in those days was oriented on the military-industrial complex. Those companies had to suddenly change their focus to new customers (primarily consumers), and most had no experience in doing so. Most of these companies were woefully inefficient in production and energy consumption. Most had to recreate supply chains and suffered a severe disruption in trade. These factors put tremendous pressures on the companies trying to transition to a market economy.

There are several companies in the UGF portfolio that shed light on how privatization helped both the companies and the social welfare of the people. They are discussed in the sections below, as follows:

- (i) The Sevastopol Shipyard (SSY)
- (ii) Poltava Confectionery
- (iii) Berdyansk Agricultural Machinery and Melitopol Tractor Hydro Units Plants.

(i) The Sevastopol Shipyard

The Sevastopol Shipyard (SSY) is a prime example of a company that was significantly transformed by privatization. The shipyard, established in 1783, was originally charged with building and repairing naval vessels on the Black Sea. Located on the Crimean peninsula in Sevastopol, SSY has favorable climatic conditions and protected bays that allow it to work year round. For most of its history, the shipyard catered mainly to the military, producing and repairing military vessels. Today, the company has shifted its focus to commercial orders.

SigmaBleyzer acquired relative control (and the largest stake) in 1998 when it increased its previous holdings to 47.4%. It acquired an additional 2.8% the following year, bringing its total up to 50.2%. During this time, military ship repair contracts could not be relied upon as both Russia and Ukraine had insufficient resources to pay for such repairs. Yet the company had been unable to attract significant number of commercial customers to its docks prior to SigmaBleyzer's purchase. The company was in crisis and desperately needed restructuring.

Prior to 1998, the Government (owner and manager of SSY) had split the company into 39 individual companies. Essentially, no real analysis took place; each department was simply established as a separate company. This resulted in companies within SSY misallocating and misusing resources, paying extra VAT payments, and causing general chaos. In addition, the company had not developed a Western-style marketing function.

There were also organizational problems. For example, in other countries, a single foreman is assigned to each ship as the representative from the repair company to oversee all aspects of the repair. He acts as a single focal point for the customer. At SSY, several representatives (from the 39 companies) would vie for control in order to make sure their individual part was completed without an overall care for the end customer. Delays in delivering the job were frequent. As a result, customers developed a highly negative opinion of the company and sales plummeted. At the end of 1997, the last full year under government control, the company posted revenues and net income of \$12.7 million and -\$0.8 million, respectively.

Several events occurred after privatization. A project team was assembled to lead the company out of crisis. Western experts were brought in to make key recommendations on how to improve and restructure the company. These included Libis Engineering Ltd. Naval Architects & Marine Consultants, PriceWaterhouse Coopers, Thunderbird Corporate Consulting, Barrents Group (USAID program), and the Citizen Development Corps. Such expertise was often relatively inexpensive (sometimes free under grants from bilateral institutions) and easy to find, yet the government had made no attempts to do so. In addition, a team of SigmaBleyzer restructuring experts was assigned to live and work in Sevastopol.

As our team worked with external experts, we developed a plan to divide the company into five profit centers. New controls were put into place to get a handle on the business. We helped the company make a strategic decision to focus on ship repair and the port, and to abandon floating cranes (high capital outlays, low demand). A full market analysis of the region was carried out and a professional marketing department was created. Modern systems to control work progress were installed. The company began focusing on its customer needs, which it had never known before. These included pricing, delivery time, quality, and customer service.

Best practices of Western shipyards were adopted for use at SSY. Examples included attracting agents, visiting owners, conducting exit-interviews with ship owners, establishing an estimate department, and facilitating yard visits with new potential clients. Small investments were targeted, most of which would come from internal funds.

All of these changes occurred over 1-2 years; something the Government had been unable to do itself during the previous five years. By 2001, as a result of these changes, revenues increased 43%, net income increased to \$0.8 million, port volumes increased 349%, the number of repaired ships grew 523% (to 44), and debts (salary, payments to the government and social insurance) decreased from \$7.91

million to \$1.44 million (see tables 10 and 11). Without these changes, the company would most likely have gone bankrupt.

Table 10: Key Data for the Sevastopol Shipyard by Year

	1996	1997	1998	1999	2000	2001
Net Sales (millions)	\$ 9.40	\$12.70	\$12.81	\$11.28	\$14.62	\$18.06
Net Income (millions)	-\$ 1.50	-\$ 0.80	\$ 0.80	\$ 0.76	\$ 0.52	\$ 1.70
Port - Cargo Loaded (tons)	N/A	176	146	263	705	790
Ships Repaired	N/A	7	8	25	44	47

Source: Sevastopol Shipyard

Table 11: Selected Comparison Data for the Sevastopol Shipyard

Company	Average Monthly Salary		Net Revenue per Employee		Number of Employees		VAT Payments, ('000)		Profit Tax, ('000)	
	1997	2001	1997	2001	1997	2001	1997	2001	1997	2001
Sevastopol Shipyard	\$48	\$96	\$ 1,728	\$ 5,424	7,352	3,330	\$1,592	\$1,319	\$497	\$861

Source: Sevastopol Shipyard

Not only did these changes improve the overall condition of the company, but they also helped the employees and residents of the city. As mentioned, nearly \$6.5 million in back payments were made to the city and central government. Profit tax payments increased by about 75%. VAT would have increased if not for company restructuring and special laws freeing SSY from part of the burden. Average salaries increased from \$48 to \$96 (1997 to 2001). This salary of \$96 was more than 50% greater than the average for the city of Sevastopol and all of Ukraine.³

The table above shows that the number of workers decreased compared to 1997, but that is due to structural problems that existed under the Soviet Union. Furthermore, many of the official employees in 1997 were not attending work or receiving any salaries. As noted earlier, they were employees only on paper (see Section on Data Challenges for more detail). The number of “real” employees in 1980, when SigmaBleyzer took over the company, was 2,880. Since then, the number of employees has increased from 2,880 to more than 3,330 (in 2001) as the company improved its competitiveness.

Finally, in our discussions with local officials, we have seen a 180-degree change in their attitude towards the benefits of private ownership. When SigmaBleyzer initially took control of the shipyard, the officials of the city were aggressive and standoffish. They felt that we should be creating more jobs and supplying more investment. However, as the shipyard began to function more profitably (see figure 1), they saw that investments began to flow regularly (from profits) and that the demand for employment also climbed to meet the needs of the company.

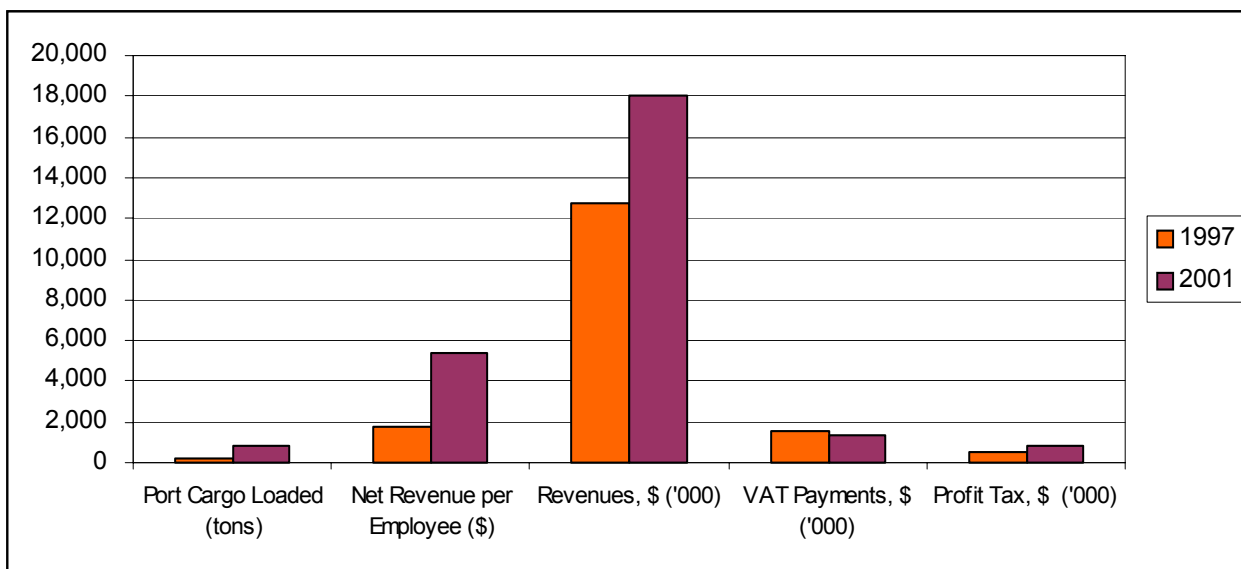
Today, we have a good working relationship with regional officials, because they have come to appreciate the large tax base, employment base, and the revenue that the company is able to generate for other local business. In Sevastopol, over 350 small to medium businesses are employing workers and paying taxes, because SSY is successful. That is, these companies’ existence and success are directly tied to the success and improvement of the shipyard. They provide products or services that the shipyard uses to meet the needs of its clients. These include ship design studios, architectural firms,

³ State Statistics Committee

machinery shops, cargo movers, parts suppliers, marine companies, agents, subcontractors, and other businesses that depend on the continued success of SSY. The employees of these businesses may not be working for SSY anymore, but they are gainfully employed by healthy and tax-paying enterprises, creating value by working with SSY.

While we do not know the exact financial results of these other small businesses, we do know that they rely heavily on demand from SSY. The increase in port activities (to approximately 800,000 tons of cargo in 2001 – see figure 1) has generated significant revenues for the customs authorities and railroad movers. The creation and success of the English language summer camp at the SSY resort area brings in more than 800 kids and 1,200 other guests per year, bringing more spending dollars to the region. The result to the city is a greater tax base, more employed citizens, less expenses on social services, increased revenue from public transportation, and an overall increase in consumer spending.

Figure 1: Key Data from the Sevastopol Shipyard



Source: Sevastopol Shipyard, SigmaBleyzer

Could this turnaround have occurred under Government control? We do not believe so. First, the Government did not understand the problems or how to fix them. In fact, their “remedy” came close to destroying the business. Second, the Government did not have the contacts to bring in Western expertise, a crucial element in the turnaround. Third, restructuring would have become highly political if it had been Government-led and it would not have been optimal for the company. And fourth, the company did not have a Western marketing function, the know-how that previous Government attempts had failed to acquire.

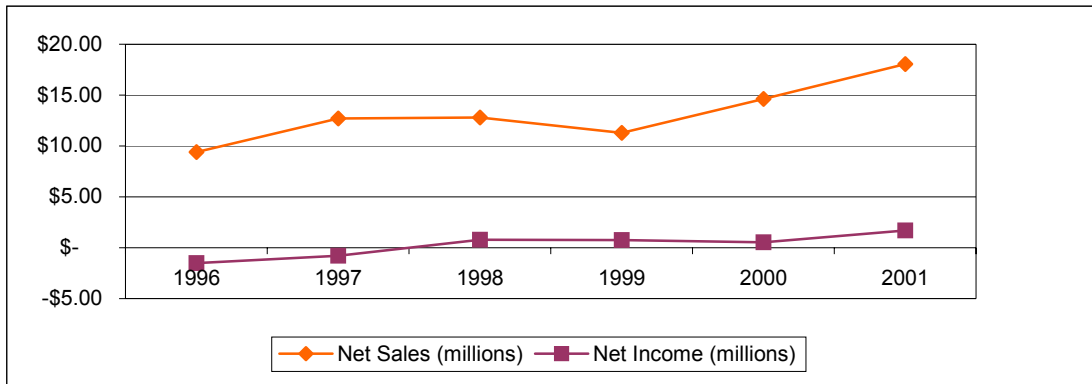
(ii) Poltava Confectionery

Poltava Confectionery produces chocolates, biscuits, caramel and other candies. It was privatized in 1996 (though SigmaBleyzer did not buy control until 1999). Privatization of the controlling stake proved to be a key event in the life of Poltava. Until 1996, the company showed continuing declines, producing only 4,921 tons of confectionery products that year (it produced about 20,000 tons in 1990). In 1996, the managers of the company, purchased control of the company. SigmaBleyzer bought a

controlling majority in 1999. Since that time, the growth has been phenomenal (see tables 14 and 15 for more details about Poltava).

In addition to the company doing well, it has increased the welfare of Poltava’s citizens; more people are employed at the company, tax payments have increased, and salary levels have grown. According to management, Poltava Confectionery was one of the top five taxpayers in Poltava for 2001. This would not be possible without increased revenues and profitability at the company (see figure 2).

Figure 2: Poltava Confectionery Results, \$ million



Source: Poltava Confectionery

At the end of 2002, the company completed a \$4 million investment project (funded by UGF and SigmaBleyzer) in a new confectionery facility that should produce an additional 60,000 tons of confectionery products. All of the construction work was done locally, supporting several construction companies, electrical companies, parts suppliers, construction materials suppliers, and other local companies. More importantly, the company hopes to increase sales more than three times over the next few years. This will result in more jobs, better wages, higher tax payments, and a general improvement in the community.

Table 14: Yearly Results for Poltava Confectionery

	1996	1997	1998	1999	2000	2001
Net Sales (millions)	\$ 7.16	\$ 9.84	\$11.14	\$13.35	\$15.35	\$20.36
Net Income (millions)	\$ 1.03	\$ 1.28	\$ 1.09	\$ 1.18	\$ 1.23	\$ 1.37
Production Output (tons)	4,921	7,110	9,160	15,970	19,540	21,820

Source: Poltava Confectionery

Table 15: Selected Data for Poltava Confectionery

Company	Average Monthly Salary		Net Revenue per Employee		Number of Employees		VAT Payments, ('000)		Profit Tax, ('000)	
	1997	2001	1997	2001	1997	2001	1997	2001	1997	2001
Poltava Confectionery	\$60	\$84	\$13,526	\$14,330	987	1,421	\$1,555	\$2,735	\$560	\$665

Source: Poltava Confectionery

(iii) Berdyansk Agricultural Machinery and Melitopol Tractor Hydro Units Plants.

SigmaBleyzer bought controlling stakes in the Berdyansk Agricultural Machinery Plant and the Melitopol Tractor Hydro Units Plant in 1998-1999. The control by SigmaBleyzer and the formation of corporate management teams from SigmaBleyzer in these joint-stock companies became the basis for the turnaround and restructuring of the plants. Restructuring of these plants took place in the 1999-2001 period. The main restructuring efforts are described below.

Berdyansk produces agricultural machinery, including grain and grain/legume reapers; tractor-mounted mowers, bailers and cultivators; and about 200 spare parts for agricultural machinery (particularly harvesters). When it was privatized, the company was operating at 30% of its capacity, due to lack of demand. Historically, about 80% of the company's sales were exports to Russia and Kazakhstan. But this trade was disrupted after the split of the Soviet Union. The company was headed for bankruptcy. The reconstruction plan included concrete measures to seek new markets, recover sales to Russia and Kazakhstan, reduce unit material consumption, reduce labor costs, and reduce power consumption. The company also undertook a major restructuring of its facilities to improve production efficiency. All useful equipment (particularly welding and assembly) was relocated from a number of sites and concentrated at only one site. Other sites were scrapped. The company also outsourced some of its activities that were not economical, such as foundry. The company is still facing difficulties, but it is already turning around, with an increase in sales in US dollar terms of 11% in the last two years.

The Melitopol Tractor Hydro Units Plant was once the largest producer of hydraulic parts for tractors and other farm-equipment in the former Soviet Union. Its production included hydraulic distributors, hydraulic cylinders, hydraulic steering units, shock absorbers, clutches, differential blocking sensors, electro-hydraulic distributors, and pressure-sensitive valves and hoses. The customers of the Melitopol plant included over 200 assembly plants and more than 200 machinery-repair shops. Unfortunately, many of these companies have been working at a small fraction of their Soviet output levels, greatly reducing the potential size of Melitopol's market. This lack of demand in the years before privatization resulted in the company cutting its workforce from 10,000 to 2,200 people. The rehabilitation plan included an aggressive program to find customers in Ukraine and outside Ukraine. As a result, exports are significant principally to Russia, Italy, France and the USA. Operating costs were also reduced through the implementation of various cost reduction programs. In the first stage, the plant focused on the manufacturing of spare parts to serve the large stock of old-type tractors that already exist in the former Soviet Union countries. It also reduced costs by scrapping equipment that would not be needed and concentrating its production facilities in a few areas. As a consequence of these activities, since 1999, the company has been able to increase sales in US dollars by 8% per year, as noted in Table 8 below.

At the time of privatization, Berdyansk and Melitopol were significantly indebted (see table 12 for debt situation), had decreasing sales and production volumes, were having difficulty in finding customers, and appeared headed for bankruptcy. The table below shows that by 2002, these two companies had rebounded (Table 8). The 2002 figures show how quickly the companies improved after the restructuring plans were implemented.

Table 8: Net Sales of Selected Companies in the UGF Portfolio, \$ ('000)

Company	1999	2000	2002
Berdyansk Reapers	3,635	3,417	3,798
Melitopol Tractor Hydro Units Plant	2,865	3,128	3,624

Source: Company Financials

Reduction in Government Debt and Back Wages

The experience of the SigmaBleyzer companies is that they have been able to pay off or significantly reduce their debts to the Government and wage arrears to the employees (see table 12 below).

Table 12: Debts of UGF Portfolio Companies

Company Name	Government Debts, \$ ('000)		Wage Arrears, \$ ('000)	
	1997	2001	1997	2001
Central Ore Mining	\$ 8,654	\$ 881	\$ 2,152	\$ 755
Chimik	\$ 54	\$ 9	\$ 21	\$ 5
Conditioner	\$ 678	\$ 523	\$ 207	\$ 187
Dneporazot	\$ 2,020	\$ 1,533	\$ 5	\$ 373
Kharkiv Machine-Building Plant (Svitlo Shakhtarya)	\$ 1,018	\$ 63	\$ 432	\$ 62
Khartsyzsk Pipe Works	\$ 6,214	\$ 241	\$ 4,176	\$ 1,109
Kherson Combines	\$ 192	\$ 847	\$ 870	\$ 1,017
Kyiv Refrigerator #2	\$ 16	\$ 18	\$ 59	\$ 33
Makiivka Pipe Rolling Plant	\$ 408	\$ 80	\$ 179	\$ 337
Marganets Repair	\$ 1,107	\$ 6	\$ 505	\$ 17
Mariupol Illicha Steel	\$ 9,551	\$ 1,809	\$ 3,625	\$ 4,224
Markokhim	\$ 5,135	\$ 615	\$ 145	\$ 102
Melitopol Compressor Plant** (data for 2000)	\$ 910	\$ 468	\$ 583	\$ 69
Melitopol Tractor Hydro Units Plant	\$ 865	\$ 10	\$ 527	\$ 152
Nikopol Pipe	\$ 208	\$ 61	\$ 226	\$ 11
Northern Ore Mining	\$295,650	\$ 876	\$52,417	\$ 1,232
Ordzhonikidze Ore Mining (data for 2000)	\$ 5,788	\$ 801	\$ 2,654	\$ 408
Pershotravnevy Agricultural Machinery Plant (Berdyansk Reapers)	\$ 1,387	\$ 177	\$ 864	\$ 132
Poltava Confectionery	\$ 86	\$ 50	\$ 42	\$ 123
Poninka Paper Combine	\$ 408	\$ 258	\$ 179	\$ 235
Rosava Tires	\$ 17,008	\$ 7,903	\$ 1,105	\$ 79
Sevastopol Shipyard	\$ 1,952	\$ 375	\$ 3,880	\$ 728
Slavyansk High Voltage Insulators	\$ 933	\$ 20	\$ 557	\$ 29
Zaporizhstal	\$ 4,055	\$ 3,372	\$ 3,074	\$ 1,995
Zhydachiv Pulp and Paper Combine	\$ 320	\$ 54	\$ 469	\$ 178
Zaporizhya Meat Processing	\$ 43	\$ 15	\$ 51	\$ 35
Totals	\$366,657	\$23,066	\$81,001	\$15,628

Source: Company Financials, SigmaBleyzer

From 1997 to 2001, SigmaBleyzer companies had a 94% drop in unpaid debts to the Government and an 80% drop in unpaid wages to employees. Clearly, the improved situation with wage arrears has been the key reason for some employees shifting from public to private sector. The wage arrears problem in the public sector has been a documented phenomenon for some time in Ukraine. As shown earlier in table 6, the backlog is generally higher in the public sector than in the private sector. Thus, the private sector is doing a better job at improving the welfare of its employees than the state.

The repayment of wage arrears by private companies was an important social and psychological issue of the ongoing post-privatization period. As the most acute social consequence of the crisis, wage arrears created a psychologically tense atmosphere. This often caused a negative attitude to the consequences

of the privatization process. It was the post-privatization equity concentration and formation of corporate management that ensured the appearance of efficient owners and management bodies controlled by joint-stock companies.

As presented earlier in Table 3, wage arrears were increasing until 1997 and declined sharply starting in 1998, with major declines in 1999 and 2000. From 1997 to 2000, wage arrears fell by more than 50% to less than \$1 billion.⁴ This is significant, since most owners only took control in 1997-1999. Therefore, the results in the reduction of wage arrears would seem to directly follow these privatization events.

This result was clearly part of the government's strategy as well. In most privatizations from the Third Stage, the government has generally stipulated two parts to the purchase: purchase price and debt payments. Naturally, companies pay less for the company knowing they will have to then pay off debts. A good example would be the Okean Shipyard, which was privatized in 2000. Prior to being privatized, the company had increased long-term debts to \$8.7 million (fluctuated in a range of only \$0.6 - \$0.8 million from 1995 to 1997). When Damen Shipyards purchased a 78% stake in 2000 (SigmaBleyzer already owned nearly 9% at that time), it paid approximately \$4.8 million. However, according to the agreement, it also paid an additional UAH 8 million (\$1.5 million) for unpaid salaries and debts to the government. This provided some immediate support to both public services and the local community that never would have occurred without privatization.

Conclusions

It is our opinion that privatization played a key role in improving the welfare of Ukraine's people. Wages have increased, debts have been reduced, communities receive more money from successful companies, and more small and medium companies have sprung up to support the larger privatized companies. Overall, the privatized companies have also enjoyed growing support from most regional or city leaders as taxable income has increased and more people are employed.

It is also our opinion that the first two stages of privatization were not carried out transparently enough and that too much wealth has been concentrated in a small number of owners. We feel these stages somewhat limited the full effect that privatization could have brought. However, the latest program of privatization has been better at providing a more transparent form of privatization. Such a trend must continue.

We also believe that the pace of the remaining privatizations must be significantly accelerated. Some objections to that by the Ukrainian government officials are based on their assertion that they simply cannot receive "fair" prices in the current environment. Our answer to them is that it is up to the market place to determine the fair prices and all that Ukrainian government can do to improve them is to create a better business and investment environment in the country.

⁴ State Statistics Committee

Appendix 1: A Short History of SigmaBleyzer

SigmaBleyzer is one of the largest and most experienced equity investors in Ukraine and manages three Ukrainian Growth Funds (or UGF family of funds). The first UGF fund was launched in 1996. Two more followed, resulting in approximately one hundred million dollars under management. SigmaBleyzer has distinguished itself from its many competitors, because UGF has not only maintained its value (unlike nearly all other Russian and Ukrainian funds), but increased in value. Through investment of the originally raised one hundred million dollars and reinvestment for several years of the proceeds of the realized exits, the UGF family of funds has invested over \$130 million in Ukrainian equities.

Using its financial expertise and international contacts network, SigmaBleyzer has helped in implementing Western management practices, attracting venture capital, advising on restructuring, helping in the transition to International Accounting Standards, implementing modern information systems, developing strong marketing and sales capabilities, and buying/selling shares in target companies. Professional analysts provide regular in-depth financial analysis on any company or sector. SigmaBleyzer currently follows more than 40 different sectors and 250 companies, as well as macroeconomic issues and the stock market. Our approach highlights an analysis of performance, expectations, and risks, thereby helping our investors make more informed decisions.

After working for several years in Ukraine, The Bleyzer Foundation was created as a non-profit, non-government organization in 2001. Its aim is to support the successful transition of the Former Soviet Union (FSU) countries into healthy, democratic market economies. The mission of The Bleyzer Foundation is to promote the development of the private sector and the use of best practices in government policies, which create capital-friendly environments and deliver improved quality of life. To achieve this objective, The Bleyzer Initiative was developed in 2000 - 2001 to provide a concrete action plan for all developing country governments to use in the transformation to a market economy. The Initiative is based on nine investment drivers that reflect the key policy areas that governments must address.

Over the last several years, we have worked to identify best practices among transition economies around the world in order to accelerate the flow of international private equity capital, and in particular, foreign direct investments (FDI). It is FDI that is truly the key to successfully completing transitions because it is the major source of financing the transitions, enabling economic growth and fighting poverty in developing countries. Those reform policies, or “investment drivers”, that have the greatest impact on FDI formed the basis for the Action Plan for Transition Economies, which is included in the Bleyzer Initiative.

The Bleyzer Initiative calls for a stronger partnership between the developed and developing countries. We believe that the transitions will be accelerated only if both work together. That is, developing countries need to implement the major economic reforms required to attract FDI, while the developed countries, on their part, must provide greater access to their markets, better targeted financial aid, and the know-how for building the market economy. Access to developed countries' markets is essential to generate and sustain economic growth in transition economies and developing countries, therefore enabling a more stable and secure environment in the world.

Appendix 2: Data Challenges

The former Soviet Union poses a significant challenge in evaluating the validity of data on a company level, especially when trying to compare companies across time periods. The planned economy under the Soviet government was the prime driver for building companies, allocating their expenses, creating a supply chain, and stimulating demand. When this system broke down, many companies could not sustain the business on their own and failed. Others looked to the government to continue supporting them, either through direct or indirect means. A few began to survive on their own.

Company data of privatized companies today is reasonably reliable to a certain point. In our experience, it is certainly more accurate than it was 10 years ago or even 2 years ago. However, older data is subject to significant doubt. We will use the example of the Sevastopol Shipyard (SSY) to illustrate our point. In 1990, SSY had 15,700 workers with sales of \$30.2 million. By 2001, the company had 3,609 workers with revenues of \$18.1 million.

Why are the employee numbers off? First of all, they include what we will call “phantom” workers. Official statistics did not reflect the real level of unemployment, as people were registered as employed, in reality being on indefinite leave without pay. As a result, they stayed on the company’s list as employed, while finding work elsewhere. Second, under the Soviet Union, everyone was required to work. Companies, therefore, were not set up to efficiently use their employees. Many workers performed useless tasks just to give them work. As spending was rationalized, it was clear that many employees simply weren’t needed or performed work that another employee could easily add to his/her workload. This is also one of the reasons that production per employee often radically increased. This is typical of most companies (pre-privatization) and is a well-known phenomenon of the period (certainly within the former Soviet Union).

Third, many of these employees supported municipal services such as public housing, public schools, hospitals, etc. that were funded by the Government. Since the company’s sales could not support such expensive public works, the company was forced to transfer these services back to the local government. Finally, some of the services were spun off or sold off, including company resorts and other businesses that were outside the core competencies of the company.

The net sales revenue from 1990 is also suspect, since this was under a command economy. There were only internal clients provided by the Government. Therefore, the comparison is not particularly helpful. With the loss of government orders, revenues and income at most companies declined significantly. When the supply chains were disrupted, companies had to become more competitive, something for which they were not ready and often failed to do.

Through our experience, we know that other numbers have either been inflated or reduced in order to make the company look better or worse. Companies today do everything possible to reduce net income to \$0 in order to avoid taxes and the law still provides relatively fair latitude in doing so. This should disappear in the future as the Government continues to institute GAAP/IAS rules.

Therefore, we realize that all of these numbers need to be taken with a healthy dose of skepticism. However, while the numbers themselves may be different, the trends still point to the same conclusions. Anecdotal evidence in our portfolio companies indicates that most companies have nevertheless, improved their situation dramatically after privatization, if the buyer had the desire to do so.

Appendix 3: Ukraine - Key Economic Statistical Data

	1996	1997	1998	1999	2000	2001	2002 (E)
GDP							
Real GDP, %	-10.0	-3.1	-1.9	-0.4	5.9	9.1	4.1
GDP (UAH, bn)	82	93	103	130	170	202	211
GDP/Capita (US\$)	870	856	828	612	555	775	824
Savings (%GDP)	20	19	18	22	20	20	21
Investments (%GDP)	23.1	21.5	20.7	17.4	18.6	20.4	22.5
Industrial Growth Rate, %	-5.1	-0.3	-1.0	4.0	12.4	14.2	7.0
Public Finances							
Fiscal Balance (%GDP)	-4.9	-6.6	-2.2	-1.5	0.6	-0.4	0.4
Revenues (%GDP)	37	30	28	25	29	27	28
Expenditures (%GDP)	42	37	30	27	28	28	28
Monetary Statistics							
Consumer Prices (%YOY)	39.7	10.1	20.0	19.2	25.8	6.1	-0.6
Monetary Base (%YOY)	38	45	22	30	40	37	34
Money Supply-M3 (%YOY)	35	34	25	40	45	42	42
Exchange Rate (UAH/\$)	1.9	1.9	3.4	5.2	5.4	5.3	5.3
Balance of Payments							
Goods Exports (\$, bn)	15.5	15.4	13.7	12.5	15.7	16.3	18.5
Goods & NFSE (\$, bn)	20.3	20.4	17.6	16.2	19.5	21.1	23.1
Goods Imports (\$, bn)	19.8	19.6	16.3	12.9	14.9	15.8	17.9
Goods & NFSI (\$, bn)	21.5	21.9	18.8	15.2	17.9	20.5	21.6
Trade Balance (\$, bn)	-4.3	-1.5	-1.2	1.8	1.5	0.6	1.5
Current Acc. Balance (\$, bn)	-1.2	-1.3	-1.3	1.7	1.5	1.4	0.8
Direct Investments (\$, bn)	0.5	0.6	0.7	0.4	0.6	0.8	0.5
Gross Reserves (\$, bn)	1.9	2.3	0.8	1.1	1.7	3.2	4.4
Public Debt							
External Debt (\$, bn)	8.8	9.6	11.5	12.5	10.3	9.8	8.1
External Debt Service (\$, bn)	1.2	1.2	1.8	2.0	1.7	0.3*	1.0
Domestic Debt (\$, bn)	1.3	4.6	3.7	2.9	3.8	4.0	4.0

* Direct public external debt service